Financing Alternative Development Through Double Bottom Line Private Equity Funds & A Real Estate Social Investment Framework

By

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ABSTRACT

The post-WWII period has seen a radical change in the growth patterns and composition of American cities, as a decentralized form of real estate development, conventional development, has become the dominant real estate development paradigm. As conventional development has become pervasive it has contributed to a host of negative economic, social, and environmental impacts. Growing dissatisfaction and concern over these negative impacts has given rise to development models that seek to accommodate the demand for new built space through alternative spatial forms, development locations, development practices, and development products. Collectively called “alternative development”, these development models seek to minimize or eliminate potential negative social and environmental externalities caused by real estate development. While alternative development has gained some traction in the real estate development industry, it still faces significant barriers. Chief among these barriers is the lack of access to reasonably priced debt and equity capital. As the availability of financial capital is one of the key factors determining what gets built, when, and where, the lack of access to capital for alternative development has profound effects on the economic, social, and environmental health of our communities.

This thesis argues that one solution to overcoming the financing barrier, and expanding access to capital for alternative development projects, is through the development of a “real estate social investment” framework and the use of this framework to guide the investment decisions of capital delivery vehicles that can deliver reasonably priced capital to alternative development projects that produce financial returns plus social and environmental returns (the double bottom line). This thesis offers suggestions on what a real estate social investment framework might entail and how the financial, social, and environmental return components could be measured and evaluated. This framework is then used as a lens through which to examine the existing practice of double bottom line (DBL) real estate private equity investment funds. Through analyze of existing theory and practice surrounding social investing and double bottom line real estate private equity funds, recommendations are proposed to advance both the practice of DBL real estate private equity funds and the development and maturation of a real estate social investment industry.

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CHAPTER 1: INTRODUCTION

The post-WWII period has seen a radical change in the growth patterns and composition of American cities as a decentralized form of real estate development, conventional development, has taken hold and become the dominant real estate development paradigm in the United States. Influenced by a number of forces - including technological change, supportive government policies, cultural changes, real estate capital market biases, and prejudice - development patterns in the U.S. have become increasingly decentralized with each passing decade. Conventional development can be described both in terms of a style of real estate development practice and a characteristic spatial form. As a style, conventional development refers to the practice of real estate development that strives to achieve short-term financial gain above all other considerations, constrained only by legal and moral standards. Conventional development also refers to, and can be defined as, a distinct spatial form of development generally described as dispersed, low-density, auto-dependent development characterized by land consumption at a greater rate than population growth, the strict separation of land uses into distinct areas or zones, visual repetition, strip roadside retail developments and big shopping malls, single-family residences clustered around cul-de-sacs, and commercial office parks surrounded by parking.

As conventional development has become pervasive, it has become more and more clear, to a wider and wider spectrum of society, that, while conventional development may benefit some, overall it has contributed to a host of negative economic, social and environmental impacts. Conventional development has put a strain on the fiscal resources of metropolitan areas as they grapple to build the infrastructure needed to sustain growing fringe communities while at the same time maintaining aging infrastructure and social support systems in older central city areas. Federal, state, and local government policies that directly and indirectly support conventional development have encouraged families and businesses to move out of older urban neighborhoods and into newer suburban communities on the urban fringe. This out-migration of social and financial capital combined with conventional developments income segregation tendencies has led to concentrated poverty in older, urban neighborhoods resulting in a host of poverty related social problems. Conventional development has also taken a significant toll on
the environment. Conventional development’s strict separation of land-uses, almost total reliance on the automobile for travel, and high propensity for consumption of once natural or semi-natural land, has led to increasing amounts of air and water pollution and dwindling habitat for wild plant and animal life.

Growing dissatisfaction and concern over the negative social and environmental impacts associated with conventional development has given rise to development models that seek to redress some of the negative impacts associated with conventional development by accommodating the demand for new built space through alternative spatial forms, development locations, development practices, and development products. Collectively called “alterative development” these models promote real estate development that seeks to minimize or eliminate potential negative social and environmental externalities caused by real estate development location, product, and program choices. In general, alternative development promotes denser, more compact, pedestrian-friendly, mixed-use, mixed-income development or redevelopment on underutilized land in existing urban or suburban areas. It encourages the use of alternative means of transportation including foot, bike, bus, and rail. By encouraging such transportation choices, alternative development reduces air and water pollution and promotes public health. Alternative development reduces wasteful spending on infrastructure and increases property tax revenues by increasing the property value per developed square foot. Alternative development has also focused more explicitly than conventional development on producing positive environmental and social value, such as the creation of affordable housing units as part of a mixed-income housing development or the use of green building practices to reduce development’s impact on the natural environment. While alternative development has gained some traction in the real estate development industry due to growing consumer demand, municipal regulatory changes, and other factors, it still faces significant barriers, including regulatory hurdles, NIMBYism, difficulties with land assembly, the prevalence of brownfields, and the lack of reasonably priced debt and equity capital. These barriers limit the ability of alternative development to reach scale and replace conventional development as the predominant development paradigm in the United States. This thesis focuses on, and explores solutions to, the financing barrier.

The availability of financial capital is one of the key factors determining what gets built, when, and where; which, in turn, has profound effects on the economic, social, and
environmental health of our communities. As will be explored in more detail in Chapter 3, due to a number of factors, the real estate capital markets are generally biased in favor of financing conventional development projects over alternative development projects. In general, this bias has created a bifurcated real estate development system in which conventional real estate projects – those that meet the real estate capital markets narrow perception of “safe” investments – have easy access to financial capital while alternative development projects – those that do not conform to these standards – have to turn to below-market rate, community capital sources of financing if they have any chance of being built. Community capital sources of financing are adept at transacting deals that target social and environmental benefits; but the stark reality for alternative development proponents is that the quantity of capital that flows through the community capital infrastructure is miniscule compared to the traditional, market-rate capital that flows through the mainstream capital markets. For alternative development to move beyond a niche practice in the real estate development field, it will be critically important to find ways to overcome the financing barrier and to direct mainstream, market-rate capital into alternative development projects.

This thesis argues that one solution to overcoming the financing barrier, and expanding access to capital for alternative development projects, is through the development of a “real estate social investment” framework and the use of this framework to guide the investment decisions of capital delivery vehicles that can deliver reasonably priced capital to alternative development projects that produce financial returns plus social and environmental returns (the double bottom line).

Social investing (SI) is an investment framework and body of practice that incorporates social and environmental issues into investment decision-making. Socially motivated investors seek to make money (the financial bottom line) without harming and, hopefully, helping society and the environment (the social and environmental bottom lines). The modern day social

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1 Market-rate is the financial rate of return that profit-seeking investors would charge based on the perceived risk, liquidity, and return potential. Below-market rate capital is not constrained by the same financial return pressures as capital sources that seek to maximize financial returns and thus it is usually cheaper form of capital.
2 The “community capital” infrastructure consists of government funding programs, foundation grants and program-related investments, and loans made by community development financial institutions, banks, and credit unions.
3 This multiple bottom line investment objective is generally referred to as either the “double-bottom line” or the “triple-bottom line”. “Double bottom line” means financial and social returns, with social returns standing for either social or environmental investment considerations or both. To eliminate confusion, those who want to emphasize that they are focused on incorporating both social and environmental considerations when investing, prefer to use the term “triple-bottom line”.

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investment movement began to gain traction in the 1960's when socially and environmentally conscientious investors realized they could use the power of their financial investments as a tool to push publicly traded companies to think more holistically about how their business practices were not only creating wealth for their shareholders but also producing negative social and environmental externalities. Since its beginnings, the SI framework has primarily been used to help socially motivated investors invest in the public equities markets (stocks, bonds, and mutual funds). According to the Social Investment Forum, by 2003 total assets in professionally managed portfolios came to $2.2 trillion, or 11% of the $19.2 trillion in professionally managed assets in the United States. That represents a 59% increase since 1999 when approximately $1.3 trillion was under professional management. As the notion of SI has matured and gained traction as a legitimate investment framework, it has spread over to the venture capital sector as well. Community and “double-bottom line” venture capital funds seek to employ the same basic framework – financial returns plus social and environmental returns – to investments in promising early-stage, privately-held business ventures. Socially-motivated high net worth individuals, pensions funds, insurance companies, and other investors who wish to place some of their investment capital into venture capital, now have a bevy of options to choose from. According to a study by Columbia University’s Research Initiative on Social Entrepreneurship (RISE), DBL private equity funds have received approximately $2.0 billion dollars worth of investments with which to invest in promising young businesses producing social and environmental benefits. Community venture capital has also seen tremendous growth in recent years. A study published by the Community Development Venture Capital Association (CDVCA), the trade association for community development venture capital funds, found that community venture capital funds have grown dramatically in the last ten years; from only a handful of funds in the early 1990’s to 79 funds investing, or in formation, with over $500 million in capital under management at the end of 2003. All told, a national Gallup Poll conducted in May 2000 found that 28% of all investors had heard of socially motivated investing

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and 11% of all investors had made one or more socially motivated investments. Curiously, despite the maturation in the socially investment movement, social investing is just beginning to take hold as a framework for generating wealth as well as positive environmental and social benefits through real estate investing.

The expansion of the existing social investment framework and practice - covering investment activity in the public equities and venture capital markets - to encompass real estate investing might be one mechanism for expanding access to reasonably priced capital for alternative development projects. However, a social investment framework for real estate alone cannot deliver capital to alternative development projects. The real estate social investment framework will need to be paired with capital delivery vehicles that can deliver reasonably priced capital to alternative development projects. This thesis takes a closer look at one such investment vehicle that has emerged recently – double bottom line real estate private equity investment funds (DBL funds). As defined by the author, DBL funds are real estate private equity funds that seek to invest institutional, financial return driven capital in alternative development projects that either implicitly or explicitly create measurable positive social and/or environmental returns. Such vehicles could potentially work to increase the flow of capital towards alternative development projects in four ways:

1. Through their commitment to achieving double bottom line (DBL) results, these funds could help overcome the real estate capital market failures by:
   - Developing the specialized knowledge and expertise necessary to understand the unique challenges and opportunities presented by alternative development locations (inner-city and inner-ring urban areas) as well as alternative development prototypes (mixed-use, mixed-income, urban infill, transit-oriented development, green building, greyfield development, etc.).
   - Exercising flexibility beyond what traditional real estate fund managers have at their disposal; and,
   - Working to develop an investment environment conducive to alternative development projects, through advocacy, public policy and other proactive measures.

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2. Raising capital from socially motivated investors who may have existing socially motivated investments in the public (stocks, bonds, and mutual funds), or private (venture capital), business equity markets but may not be currently investing in real estate or would prefer to be investing in socially motivated real estate investments if such vehicles existed. For these investors, real estate investment vehicles guided by a real estate social investment framework would represent an opportunity to diversify their social investment portfolios.

3. Demonstrating to the conventional real estate capital markets that investments in alternative development projects can achieve risk-adjusted, market-rate returns.

4. Putting pressure on conventional capital sources to allocate a share of their total capital towards socially motivated real estate investments (i.e. – alternative development projects).

To date, little analysis has been conducted to determine whether DBL funds are a) actually expanding access to reasonably priced investment capital for alternative development projects, and b) whether these investment funds are able to achieve their DBL investment objectives (financial returns plus social and/or environmental returns). To determine whether or not the emerging practice of DBL real estate private equity investing is achieving these objectives, this thesis first develops a real estate social investment framework and then uses this framework as a lens through which to look at the initial experiences of existing DBL funds.

This is an exploratory thesis intended to investigate the emerging practice of DBL real estate private equity investment funds as a mechanism for delivering market-rate capital to alternative development projects that create measurable social and environmental objectives. Information for this thesis is gathered from documents – books, journals, studies, and newspaper articles. In addition, interviews were conducted with investment fund managers, fund sponsors, investment underwriters, real estate finance and development academics, developers, and consultants.

**THESIS ORGANIZATION**

This thesis is organized into seven chapters. After this introduction…
Chapter Two explores the decentralizing forces, from the colonial period to the present day, that have led to the conventional sprawl development patterns that have dominated post-WWII planning and development in the United States. The chapter then summarizes the unintended economic, social, and environmental costs associated with these conventional development patterns.

Chapter Three looks at alternative development, the development models that have arisen to respond to the negative social and environmental impacts caused in part by conventional development patterns. The chapter looks at the demand for alternative development and the barriers alternative development faces as it struggles to take hold and gain traction against conventional development. Special emphasis is placed on the financing barrier and the difficulties alternative development projects have accessing reasonably priced financial capital.

Chapter Four lays out the rationale for real estate private equity funds guided by a real estate social investment framework as one possible solution to overcoming the financing barrier hampering the growth of alternative development strategies. The Chapter then proceeds to provide background information on real estate private equity funds, including fund structure, the investment cycle, managing entity income, investment strategy, return expectations, and investment products. The chapter concludes with the presentation of a real estate social investment framework for achieving the “triple bottom line” financial, environmental, and social returns objectives and explores how each component of return could be assessed and measured at the individual property and fund level.

Chapter Five looks at current practice of double bottom line (DBL) real estate private equity investment funds and reviews three investment fund models (Fund Manager, Contract, and Ownership) that are seeking to achieve, to varying degrees, the ideal of the triple-bottom line.
Chapter Six offers recommendations to advance the practice of double bottom line real estate private equity funds and to advance the creation of a social investment framework for real estate investing.

Chapter Seven concludes this thesis by synthesizing the key issues presented and explored in earlier chapters.
CHAPTER 2: CONVENTIONAL DEVELOPMENT

This chapter focuses on conventional sprawl development ("conventional development"). After briefly defining conventional development, the chapter explores the history of decentralization in the United States, from the earliest days of European settlement through the Industrial Revolution and the rise of the suburbs following WWII. Special emphasis is placed on the forces – including technological change, supportive government policies, cultural changes, and prejudice and discrimination – that caused this decentralization and gave birth to the conventional development patterns that typify America’s post-WWII development landscape. This chapter concludes with a look at some of the evidence supporting the argument that America’s conventional development patterns have produced unintended but real negative economic, social, and environmental impacts.

WHAT IS CONVENTIONAL DEVELOPMENT?

Conventional development can be described both in terms of a style of real estate development practice and a characteristic spatial form. As a style, conventional development refers to the practice of real estate development that strives to achieve short-term financial gain above all other considerations, constrained only by legal and moral standards. Conventional development also refers to, and can be defined as, a distinct spatial form of development generally described as dispersed, low-density, auto-dependent development characterized by land consumption at a greater rate than population growth, the strict separation of land uses into distinct areas or zones, visual repetition, strip roadside retail developments and big shopping malls, single-family residences clustered around cul-de-sacs, and commercial office parks surrounded by parking.
HISTORY OF DECENTRALIZATION AND THE FORCES THAT CAUSED IT

Pre-Industrial Revolution

In its earliest days, the American landscape was mostly agrarian and the majority of Americans resided on lands in agricultural use – i.e. family farms or large plantations. Only fraction of the nation’s population lived in the thriving port cities, like Boston, Philadelphia, New York, and Charlestown, where exchange of goods and services took place. These pre-industrial American cities were densely populated, compact\(^8\), mixed-income, pedestrian cities with a horizontal and vertical mix of commercial, residential, and manufacturing activities. The organizational form and density of these cities arose as a matter of practicality. Density facilitated economic interaction that benefited from the close physical proximity of people and goods. Additionally, in an era of slow, uncomfortable, inefficient, and expensive transportation, it was a major inconvenience to be outside of the central area – the hub of economic, social, religious, cultural, and governmental activity.

Industrialization

America’s cities grew dramatically in the 1800’s, as industrial growth became a key component of the U.S. economy. Waves of rural migrants and European immigrants flooded to U.S. cities seeking employment opportunities in the burgeoning textile mills and factories, and modern conveniences, such as electricity, trolley cars, and telephones. In 1790, only one out of thirty Americans lived in a town or city; but, by the end of the nineteenth century, one out of three did. In 1800, only six cities had populations of 8,000 or more; but, by the end of the century, there were almost 500.\(^{10}\) This wave of immigration into U.S. cities increased urban densities and expanded urban metropolitan boundaries.

With the growth of industrialization, the rush of humanity into the cities created unsanitary slum areas. By 1840 the typical American city was littered with garbage, and deadly diseases were commonplace. These conditions simultaneously sparked reform efforts to improve

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\(^{8}\) The radius of the largest cities did not extend over three miles.  
\(^{10}\) Ibid.
living conditions in the cities and gave birth to new cultural ideas and ideals touting the benefits of suburban living. These cultural ideas would eventually become ingrained in the philosophical and political values of the nation and form the central tenet of the “American dream”. These new ideas and ideals were a reaction to the “ills of industrial cities” – dirt and grime, air pollution, high crime rates, and dilapidated housing owned by absentee landlords—and fueled the perception that urban slums endangered the health and order of American society. This perception encouraged many middle and upper class residents to forsake their city dwellings to become property owners of single-family homes, among people with similar racial and ethnic backgrounds, in the quieter, greener, and more sparsely settled regions on the city’s edges. At the same time, technological innovation in transportation systems – such as the advent of reliable passenger rail service, ferries, and cable cars – provided the means for those who could afford it to migrate out to the suburbs. Thus, the Industrial Revolution that had originally brought households into the cities seeking employment opportunities now provided the impetus and the means for them to leave it.

**Rise of the Suburbs**

At the end of WWII, the combination of favorable government policies, financial discrimination, fear and prejudice, the rise of the automobile and truck, higher post-war personal incomes, and pent-up wartime demand, provided the necessary ingredients for a post-war suburban housing boom heretofore unseen. Between 1950 and 1970, 1.2 million housing units were built each year, the vast majority as suburban single-family dwellings, and the nation’s total housing stock increased by 50%, or 21 million units. The new suburbs were characterized by more remote peripheral locations and relatively low density. Between 1946 and 1956, about 97% of all new single-family dwellings were completely detached, surrounded on every side by

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11 The advent of the City Beautiful movement and development of nuisance ordinances, the early predecessors to zoning regulations, are two examples.


their own plots. In the U.S., postwar suburban expansion dwarfed urban growth: by 1950 the national suburban growth rate was ten times that of central cities.

The invention of the automobile and truck was perhaps the single biggest contributor to rapid out-migration of American cities and the suburban building boom. The automobile fundamentally transformed the equation for real estate land markets by reducing transportation costs, making development in peripheral locations at low densities economically feasible. The availability of low-cost, personal transportation provided unprecedented freedom of mobility for the average American. With this mobility, more Americans had the ability and the financial means to move to the suburbs and commute to jobs in the city. Moreover, urban expansion and suburban construction were freed from their dependence on fixed rail transport and the cable car, which had previously forced development to cluster along rail routes and at the junctions of transit lines. The explosion of automobile and truck use would not have been possible without a substantial and simultaneous government investment in road construction. The federal Interstate Highway Act of 1956 created a new generation of high-speed automobile roads, many of which connected the central cities with far-flung suburban locales, encouraging the development of new suburban homes and businesses within easy access of the roads. Under substantial pressure to adapt and compete with the suburbs and bolster declining rents and property values, many cities dismantled their urban streetcar rail systems and tore down thriving urban but ethnic neighborhoods to facilitate the creation of highways through the central city.

Access to financial capital and the operation of the financial markets also played a significant role in the decentralization of America. In the early days of decentralization and suburban development, it was unclear whether or not households would be willing to move en masse out to these new developments on the urban periphery. Thus, lending institutions were very conservative – reluctant to make loans for single-family housing without at least a 50% down payment. As most households lacked the requisite amount of savings for such a down payment, the vast majority continued to live in rented living quarters in the urban core of America’s cities. However, in 1934 President Roosevelt, in an effort to spur the U.S. economy by encouraging new construction, established the Federal Housing Administration (FHA) to

provide loan guarantees on private mortgage loans. The creation of the federal mortgage guarantee program reduced the risk of single-family lending and opened the door to a wave of new lending activity. The federal mortgage loan guarantee program became instrumental in fueling demand for single-family homes in the suburbs. More than 50% of suburban houses constructed after WWII were financed in part by federal mortgage instruments.\(^\text{16}\)

While the FHA supported the construction of new housing in the suburbs through the mortgage loan guarantee program, it also practiced financial discrimination in urban areas further fueling migration out to the suburbs and the decline of once vibrant urban communities. Under the program, guidelines were established to determine where federally guaranteed loans could safely be made and where they could not. These guidelines directed mortgage loan officers to look out for any signs of decay or neglect that might indicate a neighborhood was in decline, including the presence of African Americans, Jews, and “foreign born whites” such as Poles and Italians.\(^\text{17}\) Even a single home occupied by a minority family in a distant corner of a neighborhood could cause the entire area to be declared unfit for mortgage insurance. Residential areas were graded on a scale from "A" to "D" with each ranking denoted by a particular color. “A” areas were marked green and “D” areas were marked “red”, thus a new term was added to the lexicon – “redlining”. Ratings were given based on a neighborhoods proximity to downtown and the presence of minority populations. For example, “A” or “green” areas were usually new or recently built neighborhoods on the edge of town that were virtually free of people of color or “foreign-born whites.” Lenders were encouraged to provide the maximum amount of available capital to borrowers in the “A” areas. On the other had, “D” areas were usually struggling for survival and characterized by “undesirable population or an infiltration of it.”\(^\text{18}\) Mortgage lenders were encouraged to refuse all requests for loans for properties in these areas. It was the racist assumption of the era that when minorities moved into a "nice" neighborhood, property values for all would soon suffer. FHA also imposed restrictions on new developments in “A” areas, setting up minimum requirements for lot size, setback from the street, separation from adjacent structures, and even for the width of the house itself.

Instead of allowing the market to determine whether a neighborhood was suitable for mortgage,


\(^{18}\) Ibid.
the FHA used arbitrary assumptions about the socio-economic status of existing communities to exclude heterogeneous communities in favor of homogeneous suburban communities. As will be explored in the next chapter, the financial capital markets continue to this day to make judgments about what types of projects are “safe” to finance and which are not.

Local and municipal government also played an integral role in the decentralization of America. Once peripheral communities became established, they often welcomed new growth as a boon to their tax bases. Since WWII, many municipalities have tended to rely heavily on property taxes to balance their budgets, and they often viewed new development as a way to revitalize local economies through increased tax revenue for the improvement of municipal services. Through these policies and incentives, the government accelerated the rate of decentralization by promoting suburban development over investment in central cities.

The spread of the suburbs was also fueled by a fundamental shift in the structure of the U.S. economy, from a manufacturing to a service and information technology sector base. Following the end of WWII the U.S. manufacturing sector, that had expanded dramatically to support the war effort, turned its attention and mass production acumen to the effort of produced the durable goods to support the growing middle-class and its suburbanizing, convenience-oriented lifestyle. During and after WWII, a renewed wave of mechanization in agriculture plus growing racial discrimination pushed millions of unskilled, poor blacks off southern farms, while the lure of manufacturing and industrial employment opportunities pulled them to the great industrial and manufacturing cities of the North - Chicago, Pittsburgh, Cleveland, Detroit, to name a few. However, beginning, in the early 1980's, the manufacturing sector began a steady decline. The decline in manufacturing - the great anchor of many urban economies, especially in the Northeast and Midwest - decreased employment opportunities in America’s central cities. The new economy of “information” occupations or “producer services” – including finance, real estate, business, and professional services – was less dependent on specific locations (access to waterways, optimal road networks, cheap labor) and thus had greater freedom of locational choice. This freedom, combined with dramatic improvements in telecommunications networks and federal tax codes that encouraged businesses to abandon older structures in established areas

in favor of new construction in suburban locations, resulted in a "radical" and "fundamental" restructuring of metropolitan America as corporate businesses decided that it was best to move to new, lower cost facilities near the labor and consumer market located in the suburban rings outside of central cities. The result was a significant increase in office space outside of central city areas, the traditional center of metropolitan office employment. The 200 or so "edge cities" of offices and shopping, located along freeways on the suburban fringe of our metropolitan areas, now contain some two-thirds of all U.S. office space. This reflects astounding job growth on the fringe; suburbs of all types held only 25% of the country’s office space as recently as 1970. Around 95% of the 15 million new office jobs created in the 1980s were created in low-density suburbs.

By 1970 the dominance of suburbia was fully evident. The 1970 census was the first in U.S. history that showed more people living in suburbs than in cities. By the 1990s suburban areas in the United States had become "the dominant American cultural landscape" with population and employment growing most quickly at the lower density fringes of metropolitan areas and in certain non-metropolitan locations.

THE COSTS OF CONVENTIONAL DEVELOPMENT

As suburbanization of the American landscape intensified after WWII and central cities continued to struggle with the effects of disinvestment and abandonment, environmentalists, land conservationists, social justice/equity advocates, urban proponents, historic preservations, and others began, and continue, to voice serious reservations and objections to America’s conventional development patterns. These critics argue that America’s conventional development patterns contribute to a host of very serious economic, social, and environmental costs both for individuals and society as a whole. A few of the major arguments highlighting these concerns are summarized below.

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21 Federal tax codes allowed for greater depreciation for the new construction than for the improvement of existing buildings.
Economic

Though there is a great deal of disagreement and debate over the assumptions and calculations for economic cost estimates due to conventional development, there is general agreement that conventional development produces economic costs to individuals, cities, regions, and society as a whole. These costs are generally lumped together into two basic arguments. They are that:

1. Conventional development causes fiscal stress for both urban and suburban communities. For suburban communities the fiscal stress is related to the high costs associated with the provision of new infrastructure, such as roads, schools, and utilities. The development of new suburban communities drains older, urban communities of fiscal capital, resulting in lower tax revenues (due to lower property and sales tax dollars) and escalating costs (due to the need to provide greater levels of service to combat the effects of concentrated poverty). Overcrowding in schools, higher local taxes, and a decline in the level of public services all are evidence of fiscal stress.

2. Conventional development leaves individuals highly dependent on the automobile for mobility. Automobile use causes air pollution that has been linked to health problems. There are high health care costs associated with these health problems. A 1998 EPA study estimates that economic losses due to the health effects of traffic-related ozone pollution amount to between one and two billion dollars annually, depending on the value assigned to human life.26

Environmental

Air Pollution

Spread-out, auto-dependent, sprawl development has led to enormous increases in vehicle miles traveled and congestion (such as that captured in the image to the right),

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resulting in unhealthy air pollution that plagues almost every major city in the United States. In the early 1990s, over 90 U.S. metropolitan areas regularly exceeded the air quality standards for ozone. Nine areas, containing some 57 million residents, are considered “severely” polluted, meaning that they experience peak ozone levels that exceed the standard by 50% or more. Since carbon dioxide is a by-product of auto emissions, conventional development has also contributed to the growing concern over global warming.

**Destruction of Open Space & Vital Wildlife Habitat**

Critics argue that conventional development destroys the environment through its vociferous appetite for open space, destroying more than two million acres of parks, farms and open space each year. As development expands out into previously open space, the natural habitat of wild animal and plant life is destroyed, in some cases, threatening their continued existence.

**Social**

**Concentrated Poverty**

As the suburbs boomed, the central cities underwent dramatic physical and socioeconomic changes. The out-migration of financial, human, and social capital as well as job opportunities, from the cities to the suburbs, depleted central city areas of vital resources and resulted in the creation of large urban ghettos of concentrated poverty. These ghettos lacked the stable, working-class populations necessary to maintain economic vitality and social cohesion. This, in turn, left residents of these areas isolated from mainstream society, making it increasingly difficult for them to have access to jobs, educational opportunities, medical services, and other prerequisites for a higher standard of living, resulted in the rise of a number of adverse traits in these areas. These traits include high crime and drug abuse rates, unemployment, gang violence, poor quality schools, and high high-school dropout rates. Consequently, the concentration of poverty has also left many urban core areas with lower tax revenues and a disproportionate burden of providing costly services to poor households. This

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dynamic has created a downward spiral, as urban municipalities are forced to lower the quantity and quality of public services due to strained budgets and this in turn leads to further physical and social erosion in urban core areas. As former Maryland Governor Paris Glendening lamented in 1997, “As residents and employers flee to the suburbs, they leave behind boarded-up storefronts, the jobless poor, higher welfare caseloads, and increased crime.”

Quality of Life

Sprawl spreads development out over large amounts of land, putting long distances between homes, stores, and job centers and leaving many people isolated and totally dependent on driving in their daily lives. According to the Sierra Club, the average American driver currently spends the equivalent of 55 eight-hour workdays behind the wheel every year. Since the average hours worked per week have not declined as more and more time is spent in traffic, this translates into the fact that people have less and less time with family and friends and less leisure time. The social stresses resulting from this loss of family and leisure time has contributed to a host of stress related social and health problems.

Conclusion

This chapter explored the forces that have led to the conventional sprawl development patterns characteristic of real estate development in the post-WWII period in the United States. Unfortunately, many of the forces that combined to support conventional sprawl development patterns continue to persist, reinforcing the dominance of conventional development.

This chapter, also, briefly explored the role that access to capital and the operation of financial capital markets can play in determining what gets built, when, and where. The creation of the FHA and the federal mortgage guarantee program had a major role in supporting the growth of the suburbs and the decline of once vibrant urban communities. As this dichotomy – growth of the suburbs and the decline of urban communities – intensified with every new decade, the mounting economic, social, and environmental consequences began to be noticed, triggering responses that would lead to the creation of alternative development models that would seek to

Eyewitness testimonies from the past five decades.


31 Smart Growth, New Urbanism, Community Development, Sustainable Development, Green Development, Transit-Oriented Development, and Progressive Development, are the most common.
redress some of the negative consequences of conventional sprawl development. These responses, their potential for alleviating some of the social and environmental impacts of conventional development, and the barriers – including capital market failures – that keep these alternative developments from achieving scale will be explored in the next chapter.
CHAPTER 3: ALTERNATIVE DEVELOPMENT

Growing dissatisfaction and concern over the negative economic, social, and environmental impacts caused by conventional development has given rise to alternative development models that seek to redress some of the negative impacts of conventional development by promoting alternative spatial forms, development locations, development practices, and development products. These models go by a plethora of different names and exhibit significant to subtle differences in their focus and approach. Taken together and placed under one unifying moniker, which for simplicity’s sake I will call “alternative development”, these models share several overarching principles and objectives, including:

- Directing new development towards communities with existing infrastructure;
- Protecting the natural and semi-natural environment, including the preservation of farmland, forests, and natural areas;
- Fostering distinctive, attractive communities with a strong sense of place and local character;
- Preserving historic buildings;
- Reducing the environmental impact of construction;
- Creating walkable neighborhoods with a diverse mix of land-uses, including office, mixed-income housing, retail, and community facilities;
- Creating a range of housing opportunities and choices including sufficient amounts of affordable housing;
- Providing access to public amenities such as parks and open space;
- Providing access to a variety of transportation choices, including alternative transportation modes such as pedestrian and bike trails, and public transportation such as bus and rail service;
- Encouraging historic preservation and the adaptive reuse and renovation of existing buildings;
- Promoting infill development\textsuperscript{32} including the redevelopment of underutilized, previously developed land, such as brownfield\textsuperscript{33} and greyfield\textsuperscript{34} development; and,
- Encouraging community and stakeholder collaboration in development decisions.

By adhering to the aforementioned principles and objectives, alternative development projects have the potential, on an individual and collective scale, to minimize and/or eliminate the negative social and environmental impacts created through the development process. The compact, mixed-use, pedestrian oriented nature of alternative development encourages the use of alternative modes of transportation including walking, biking, and the use of public buses, trolleys, or fixed rail trains thereby reducing dependency on the automobile and decreasing social isolation. Decreased automobile use also decreases health problems related to automobile pollution and improves general public health by encouraging walking and bike riding. Infill development can put vacant and underutilized land back into productive use, increasing jobs, property and sales taxes, and when brownfield sites are redeveloped, eliminating toxic pollutants that pose health risks to communities. Alternative development can also generate significant cost savings for municipalities by decreasing the amount they have to invest on infrastructure (such as highways, streets, schools, water and sewer pipes) and services (like police and fire protection). Research by the Real Estate Research Corp., Robert Burchell, and others suggests that this cost savings could be as great as 70 percent over equivalent volumes of conventional development. By promoting development on vacant and underutilized sites, alternative development can also be an engine for economic development, providing unemployed or underemployed inner-city workers with accessible jobs.

\textsuperscript{32} "Infill development" means increasing the density of already-developed areas through the addition of new buildings or the expansion of existing buildings.

\textsuperscript{33} A "Brownfield" is defined as "real property", the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant. U.S. EPA, "Brownfields Glossary of Terms," <http://www.epa.gov/swerosps/bf/glossary.html#brow>. According to the EPA there are as many as 450,000 official brownfield sites around the country, most of them in urban areas.

\textsuperscript{34} A "greyfield" is a real estate development opportunity on land currently, or previously, occupied by an aging strip mall or shopping center.
The growing recognition of the numerous economic, social, and environmental benefits associated with alternative development patterns is contributing to a growing demand for alternative development projects. The next section will take a closer look at some of the specific generators of this growing demand.

DEMAND FOR ALTERNATIVE DEVELOPMENT PRODUCTS AND LOCATIONS

The 2000 U.S. Census marked a turning point for many cities across the country. For the first time in decades, the data showed people moving into, not out of, cities. This is one indication of the growing interest and demand for alternative development. While there is still debate as to how substantial this demand is, and clearly more research needs to be conducted, there are three trends that suggest that demand for alternative development will continue to grow in the coming decades. These four trends are:

1. Demographic and consumer preference changes;
2. Metropolitan trends affecting location choice;
3. Public policy trends, including the growing impact of smart growth policies at the local, regional, state and national level; and,

This rest of this section explores these three trends in more detail.

Demographic and Consumer Preference Changes

In a significant reversal of the out-migration trend prevalent during the last half-century, urban centers are being re-inhabited at a level that has not been experienced since WWII. This re-inhabitation is being fueled both by changing demographic trends and by changing consumer preferences.

Demographic Changes

A number of demographic changes are contributing to the growing demand for alternative development including the aging of the baby boomers, the coming of age of the echo boomers, the growth of ethnic minority communities, and changing household composition.
Baby Boomers & Echo Boomers

The two largest segments of the U.S. population are baby-boomers, those born between the end of WWII and 1965, and echo-boomers, the children of baby boomers. As baby-boomers age and echo boomers come of age, both are increasing demand for alternative development projects.

Baby boomers represent a significant source of demand for alternative development projects. As active, empty nesters - without much need for large, multi-room homes in suburban locations near good schools – many baby boomers are seeking to trade space for convenience and amenity rich lifestyles. Thus, they’re driving demand for smaller lots and new housing products, such as loft condominiums, in urban core locations close to arts, culture, shopping, dining, and medical service amenities. According to one study, “Home buyers aged 45 and older who prefer denser, more compact housing alternatives will account for 31% of total homeowner growth during the 2000-2010 period, double that same segment’s market share in the 1990s.”

As people age their preferences for proximity to shopping, highway access, and public transportation increase while their preference for being in a good school district decrease. This trend is the most pronounced for Americans over age 44. According to the U.S. Census, the number of persons aged 44 or older in the U.S. will be at its highest level ever and is poised to increase dramatically over the next fifty years from approximately 34 million persons today to over 50 million by 2020 and 80 million by 2050.

The echo boomers are also fueling demand for alternative development. As a group, they are more diverse than previous generations, marry later and are more likely to be engaged in more off-peak work hours as the service industry, which employs them in large numbers, moves to a 24-hour economy. Thus, they are demanding more urban amenities and are seeking a different kind of living experience than the single-family suburban neighborhoods in which they grew up.

Growth of ethnic minorities

Another significant demographic factor contributing to the demand for alternative development projects is the growth of ethnic minority communities. Fueled by continued immigration, ethnic minorities will comprise 40% of the U.S. population by 2010 and that number is likely to continue to increase. Ethnic minority households, especially Latinos, tend to have a cultural preference for more compact urban forms and thus will contribute to the growing demand for alternative development patterns. 37

Changing household composition

Changing household composition is also playing a significant role in the demand for alternative development. While families with kids represent the largest segment of demand for suburban single-family home locations, their numbers are falling as a percentage of total households in the United States. Greatest growth in household composition is among childless couples, non-families, and single person households. According to the U.S. Census, while U.S. households will increase overall between 2000 and 2010, this increase will be led by couples without kids followed closely by non-family households and singles. Traditional “couple with kids” households will see real declines over the same period.

Change in Consumer Preferences

Consumer preferences are also playing a major role in the demand for alternative development projects. A survey commissioned by the Congress for New Urbanism (CNU) suggests that there is significant demand for alternative development patterns. The survey indicated that significant numbers of survey respondents value mixed-use, pedestrian-oriented neighborhoods (See Figure 3-1 on the following page).

Consider an easy walk to stores "extremely important" 53%
Prefer a less auto-oriented street pattern, with narrow streets to encourage walking 49%
Would like townhomes in their neighborhood 30%
Want to live in a townhome 15%
Want "narrow streets, sidewalks, and shared recreation facilities" rather than "larger lots and wider 33%
Wants smaller lots and/or clustered development 20%
Want lots of 1/6 acre or smaller 57%
Prefer something other than single-family homes 40%

Source: Congress for New Urbanism

Another survey conducted by the National Association of Home Builders (NAHB) and the National Association of Realtors (NAR) that looked specifically at home buyers housing preferences and asked respondents to rank three alternative methods for directing development found that while most respondents still seek new home locations “...in existing, partially developed suburban areas,” the second most preferred location was “new homes on vacant land in central city or inner suburbs” locations.

Furthermore, when the same survey asked respondents to rank three hypothetical choices on housing location, it found that 18% of homebuyers would prefer to buy a small single-family
home in the city close to work, public transportation, and shopping. Finally, on a question about homebuyers concern for the environment, at least 18% of homebuyers indicated that they were willing to pay for an environmentally friendly home while another 35% said they wanted an environmentally friendly home but were not willing to pay for it. Gary Gareynski, president of the National Association of Home Builders, summarized the findings with the following statement:

“A majority of consumers want single-family detached homes in a pedestrian-friendly community that has shopping within walking distance. They want a mix of open space, including parks, recreational facilities, playgrounds, farms, nature preserves and undeveloped areas, he added.”

Metropolitan Trends Affecting Location Choice

As discussed earlier in this chapter, as suburban communities have grown they have become less convenient then they once were as worsening traffic congestion has slowed the speed of movement between destinations. With virtually no other option besides the car, suburbanites are trapped by a lack of transportation choice. Consumers use to want to drive into downtown to work from the suburbs because the cost of doing so was worth the increase in housing value. Longer commute times are encouraging other options. More and more people are willing to consider non-single family housing options in urban locations due to the convenience of mixed-use living conditions, reductions in commuting times, and cost savings from decreased automobile use.

Another metropolitan trend that is changing consumers perception of the relative advantage of suburban versus urban living is the rising crime rates in suburban locations and the declining rates in urban locations. As urban centers shed their stigma as crime-infested centers of poverty and blight, they are instead increasing seen in more favorable light as attractive, lively, convenient places to live and work, and as centers of intellectual and creative capacity.

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38 National Association of Home Builders (NAHB) and the National Association of Realtors (NAR), Housing Choice and Smart Growth Survey, January 2002. For more information, visit www.NAHB.com.
39 Ibid.
41 The rise of gated suburban communities is one piece of anecdotal evidence of the rising concern of crime in suburban areas.
Public Policy Trends

In local communities and states across the nation, there is a growing recognition that conventional development patterns, and the public policies that support them, are no longer in their best interests. Though supportive of growth, these communities and states are questioning the costs of conventional development patterns and increasingly passing legislation in support of alternative development patterns. The states of New Jersey, Maryland, Massachusetts, and Pennsylvania have all passed legislation encouraging smart growth. Cities and states are also increasingly passing legislation encouraging environmentally friendly building practices and mixed-use and transit-oriented zoning. Change is happening on the federal level too. One example is the passage in 2000 of the New Markets Tax Credit (NMTC) program that encourages commercial real estate investment in underserved or distressed census tracts. As policy continues to shift in support of alternative development patterns, increasingly public funding decisions are incorporating alternative development criteria, and thus more resources are being allocated to projects that adhere to alternative development principles.

Conclusion

The trends and factors discussed in this section suggest that there is both existing and strong future demand for alternative development projects which should, absent market failures or development barriers, increase the supply of alternative development projects. However, as will be explored in the next section, barriers to alternative development do exist including significant real estate capital market failures. The next section will examine these barriers to alternative development with a particular focus on the financing barrier.

BARRIERS TO ALTERNATIVE DEVELOPMENT

While demand for alternative development patterns exists, and appears to have strong prospects for future growth, developers have been slow to deliver alternative development projects to meet this demand. One reason is because many of the forces, discussed in Chapter 2, that have encouraged conventional development patterns still exist, such as the dominance of the automobile and pro-conventional development government policies. In addition, there are other
unique barriers to entry in urban real estate markets that have complicated efforts of developers and investors to build alternative development projects. These barriers include:

- Regulatory environment,
- NIMBYism,
- Land Assembly,
- Brownfields, and
- Financing.

**Regulatory environment**

"Rigid separation of houses from jobs, stores, and services has created a landscape where nearly everyone must drive a one-ton car to purchase a one-pound loaf of bread."  

A whole system of zoning and building code regulations have evolved over time that, often times unintentionally, supports conventional development patterns. Unfortunately, these same regulations tend to inhibit alternative development patterns. Mixed-use development is one of the central tenants of the alternative development framework. In many places, existing single-use zoning codes (Euclidian zoning) prohibit the mixing of uses. Zoning regulations go even further by limiting building densities, requiring that new buildings be set back from the street and away from other buildings, and requiring minimum amounts of parking, the cost of which is often a significant financing barrier to the development of urban, infill projects. Many of these regulations are the product of citizen’s outrage over the lack of quality and character of new developments in older neighborhoods that were encouraged in the 60s and 70s by city boosters as necessary to stem the outflow of people and resources. Changing existing regulation so that it encourages alternative development projects will require active citizen participation, a central component of the real estate social investment framework that will be explored in the next chapter.

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NIMBYism

Some communities find infill development threatening because they have no experience with it. Not In My Backyard (NIMBY) activism is a common problem. Residents of the surrounding area often oppose redevelopment efforts, especially when they include affordable housing or a property type that is new to the neighborhood. NIMBYism can also take the form of protest against a project, especially one with government subsidies, when there is the perception that the project is enriching wealthy developers/investors and not meeting the needs of area residents.

Land Assembly

Land parcels in urban core areas are often small. To assemble enough parcels to develop at a financially feasible scale, developers often have to deal with many different landowners. There are high transactions costs associated with this practice that can be a financial drain on alternative development projects in these areas. Often times, these landowners don’t want to sell their properties, preventing the conversion of abandoned, under-used, or idle properties. The reason being is that sales price expectations are high, while the costs to maintain unproductive land and buildings are minimal. For many owners, there is no financial downside to holding on to a property and waiting for the “perfect deal”.

Brownfields

Existing and perceived environmental contamination can increase the time and cost of alternative development projects. They can also engender more community involvement and regulatory hurdles. Clean-up costs can be expensive. Environmental liability poses an additional risk.

THE FINANCING BARRIER TO ALTERNATIVE DEVELOPMENT

Even if a savvy, skilled entrepreneurial developer could overcome all the barriers discussed above, these barriers are reinforced by difficulties securing cost-effective financing. Financial capital plays a significant role in determining what gets built, when, and where. As
discussed in Chapter 2, the real estate financial system has played a significant role in supporting conventional development practice. Discriminatory lending practices initiated by the FHA effectively stifled reinvestment in urban neighborhoods and encouraged those with the means to migrate out to the burgeoning suburbs. As will be discussed below, the real estate capital markets still maintain biases against urban locations and "non-conforming" real estate prototypes.

There are several reasons why it continues to be difficult to finance alternative development projects with market-rate capital through conventional real estate capital markets. The reasons include:

1. Higher development costs and lower initial year operating returns,
2. Conventional real estate financial analysis,
3. Higher perception of risk,
4. Investor bias towards conventional real estate products, and
5. Limited knowledge and experience with alternative development.

1. Higher development costs

Alternative development projects tend to have higher first costs than conventional projects and can also display lower returns in the initial years of operation. The higher first costs can occur for several reasons. One reason is that alternative development projects often encounter and must overcome the barriers described above which require both time and money, increasing development costs. Another reason is that alternative development principles encourage extensive community participation in the design process, green building practices, and mixed-use design solutions. These practices can also add time and complexity, raising development costs.

While the higher costs of alternative development projects do not necessarily, in and of themselves, create a financing barrier, these costs, in conjunction with initially lower revenues, can create problems securing debt capital to finance the project. Debt lenders generally follow a number of criteria when determining how to size loans for commercial real estate projects. First, a first mortgage lender will typically only lend up to 70% or 80% of the total value of a project.

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43 The "first mortgage lender" is the lender with the first mortgage lien on the underlying property or, put another way, the first rights to the collateral assets.
This means that the developer needs to supply 20% to 30% of the total capital required to develop the project from other debt or equity sources. Also, lenders generally require that projects meet a certain debt service coverage ratio or DSC. The debt service coverage ratio is the ratio between the net operating income a project generates (revenues minus expenses) divided by the annual debt obligation (interest plus principal). If the projected DSC falls below a certain standard, generally 1.1 to 1.25\(^44\) in any year, the amount of debt a lender would be willing to lend will decrease until the standard is met. Thus, projects with high costs and low initial revenues in the first few years will need significantly greater amounts of equity to offset the lower amounts of debt that will be available from lenders.

2. Conventional real estate financial analysis

Christopher Leinberger, a partner in a real estate firm called Arcadia Land Company, argues that conventional development patterns can be directly traced to conventional real estate underwriting practices and the use of discounted cash flow analysis, which has gained wide acceptance in recent decades.\(^45\) Discounted cash flow analysis is an analytical tool used to help make investment decisions at the micro, or property, level of real estate investment. Essentially, the procedure converts the costs and benefits arising in the future to present-day values. This is accomplished by (1) estimating expected future cash flows, (2) estimating the reversion, or terminal value of the investment,\(^46\) and then (3) discounting the cash flows to present value at the required rate of return\(^47\), the discount rate.

Leinberger suggests that in order to promote alternative development patterns we must discount the use of discounted cash flow analysis when considering real estate investment decisions in alternative development projects. According to Leinberger, discounted cash flow analysis has a serious limitation in that it is biased in favor of quick-yielding investments; benefits accruing more than about 25 years in the future have virtually no present value at discount rates greater than 10 percent. He asserts that there may well be an investment curve for alternative development that shows less return in the first few years of a project’s life but mid-

\(^{44}\) Although this can vary depending on the perceived risk involved with the operator of the property or the tenants, competition in the debt markets, and other factors.


\(^{46}\) The expected value at the end of the investment holding period.

\(^{47}\) The rate of return the investor needs to achieve in order to make a decision to invest in the project.
and long-term returns that are far superior to and longer lasting than conventional development (see Figure 3-3 below). If true, these cash flow characteristics differ fundamentally from conventional development. Take shopping malls for example. Shopping malls have their highest returns when they are shiny and new; but, over time, returns decrease as costs and competition increase. After five to 10 years, a new capital infusion is necessary to “reposition” the mall for the next five to 10 year cycle. The graph below illustrates these potential differences in the investment cycles of alternative and conventional development.

Figure 3-3. Alternative and Conventional Development Investment Cycles

Conventional real estate financial analysis minimizes the value of these mid- to long-term returns. Thus, unfortunately, there is no way for mid-to long-term investors, such as pension funds, endowments, and insurance companies, to evaluate the potential of alternative real estate developments.

3. Higher perception of risk

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Alternative development projects, due in part to the barriers mentioned above, are generally more complex than conventional development projects. This complexity translates into higher perceived risk. To mitigate the higher risk, lenders and investors demand a higher rate of return on their investment, which has important potential, and real, implications for developers of alternative projects. One, the project may not be able to achieve these rates of return, particularly in the short term. Two, the higher rate of return further minimizes the value of later dollars in a 10-year discounted cash flow model. Three, 10-year discounted cash flow analysis considers cash flow in the early years to be the most important. Coupled with the higher demanded rate of return, the analysis magnifies the negative impact of any higher initial costs associated with complexity. As a result, the perceived risk that stems from the complexity of the project may prevent the project from securing financing and getting built. 49

4. Investor Bias Towards Conventional Real Estate Products

The fourth barrier to financing alternative development projects is that they do not fit into standard real estate product types. According to Chris Leinberger in “Financing Progressive Development”, “…conventional development has been codified into 19 standard product types which have defined America’s built environment over the past half century, particularly commercial strips, regional malls, neighborhood centers, power centers, office parks and walk-up apartments, as well as low density, for-sale housing tracts.” 50 Currently, these conventional real estate product types, listed in Figure 3-4 above, strongly influence lenders’ and secondary markets’ underwriting requirements, characterize real estate funds’ and REITs’ investment focus, and encourage developers and contractors to gain expertise in only one product type. Thus, projects that fit into a conventional type enjoy lower financing costs and faster investment processing. Investors demand higher financing costs, for both debt and equity, for projects that fall outside of these standard product types.

5. **Limited knowledge and experience with alternative development**

Few investors have the knowledge and experience that is critical to fully understand the potential risks and reward characteristics of alternative development projects. Unfortunately, because the amount of potential investment opportunities in alternative development projects is small compared to the investment opportunities in conventional deals, there is little incentive for investment management companies to invest the resources necessary to acquire the knowledge and expertise necessary to increase their comfort level with alternative development projects. Many investment management companies find alternative development deals too labor intensive to undertake proper due diligence and underwriting. With too little information to sufficiently analyze risks and an ample supply of less risky investments in suburban areas, there is little impetus for investors to operate outside of standard convention. Lack of knowledge may also lead investors to seek higher ex ante returns than is warranted by actual investment performance.
CONCLUSION

Alternative development projects differ significantly from conventional development projects. Conventional development is generally interested in delivering one of the 19 standard product types listed in Figure 3-4. Typically these products are built on cheap suburban greenfield sites in fast growing suburban communities and are only accessible by use of an automobile. On the other hand, alternative development is focused on compact, mixed-use, mixed-income, multi-generational, transportation-oriented development on underutilized sites in already urbanized locations. For these reasons, and the others discussed earlier in this chapter, alternative development patterns and projects generally produce more socially and environmentally optimal results than conventional development. Government policy makers, businesses, and households are starting to take notice of the benefits of alternative development and are fueling demand for alternative development projects. Yet, despite this apparent demand, alternative development projects face a number of barriers that can derail their implementation, including an unfavorable regulatory environment, NIMBYism, the costs and difficulties associated with assembling land in urban locations, environmentally contaminated land or brownfields, and difficulty acquiring reasonable priced financing. Savvy entrepreneurs backed by supportive community constituents who are prepared to listen to community concerns and deliver alternative development projects communities actually want to see developed can usually navigate, over time, most of these barriers; but, even after so doing, can often run into roadblocks acquiring the necessary financing to proceed with construction. The financing barriers are due, for the most part, to a lack of familiarity, knowledge, and expertise with alternative developments projects on the part of lenders and investors as well as the use of the discounted cash flow financial analysis tool. This uncertainty translates into a perception on the part of traditional conventional debt and equity investors that alternative development projects are riskier investments. To compensate for this risk, these investors seek higher expected returns and thus use higher discount rates when using the discounted cash flow analysis technique. These higher return expectations can be problematic for alternative development projects that tend to have higher development costs and lower operating returns in the initial years than conventional development. This translates into a situation where developers need to acquire more equity to make-up for the lower amounts of debt financing. But, equity is difficult to come by, especially for projects that are perceived to be risky by the real estate capital market that
tends to want to be in and out of a project in four to seven years. In the past, developers that aren’t well capitalized and don’t have a lot of available cash to invest in their development projects, have typically tapped local high-net worth individuals or “friends and family” to raise the necessary equity. Increasingly though, these investors, have opted to invest their real estate investment dollars into real estate private equity funds or publicly traded real estate investment trusts (REITs). Thus, to overcome the financing barrier new tools and new sources of capital will be necessary to direct capital towards alternative development projects.

This thesis argues that one solution to overcoming the financing barrier, and expanding access to capital for alternative development projects, is through the development of a “real estate social investment” framework and the use of this framework to guide the investment decisions of capital delivery vehicles that can deliver reasonably priced capital to alternative development projects that produce financial returns plus social and environmental returns (the double bottom line). The next few chapters will explore one such emerging capital delivery vehicle – DBL real estate private equity funds.
CHAPTER 4: REAL ESTATE PRIVATE EQUITY FUNDS AND A REAL ESTATE SOCIAL INVESTMENT FRAMEWORK

“If you’re going to be effective at all, you have to have money...If you have money, then you can have a tremendous influence, especially if you are using the money for a very specific purpose.”

– Ed Jensen, CEO of VISA International and a director of the Bay Area Council

As discussed in Chapter 3, alternative development projects – by virtue of their location, their design, and/or their development program – have the potential to deliver significant environmental and social benefits compared to conventional development. Chapter 3 also highlighted the fact that there is current and future demand for alternative development projects; increasing the likelihood that these projects could, over time, achieve market-rate returns for their investors. However, alternative development projects are significantly more complex and, for the most part, have different financial return characteristics – higher development costs and lower cash flow returns in the initial years of operation - than conventional development. Thus, as discussed in the previous chapter, conventional debt and equity investors, who lack sufficient investment experience and don’t want to deal with the uncertainty involved with alternative development projects, when there are no shortage of other, more “conventional”, deals to finance, tend to shy away from alternative development projects or insist on investment terms that cause the projects to become financially unfeasible to develop. For example, as discussed in Chapter 3, conservative underwriting practices have led to declining loan-to-value levels, causing entrepreneurial developers looking to develop alternative development projects to finance their projects with higher levels of equity financing. However, most developers, especially small and medium-sized developers, aren’t well capitalized and don’t have a lot of available cash to invest in their development projects. In order to raise the necessary equity, these developers have typically tapped local high-net worth individuals, “friends and family”, or the below-market, community capital market. Unfortunately, local high-net worth individuals

have increasingly opted to invest their real estate investment dollars into real estate private equity funds or public REITs.

Conservatism in the real estate capital markets and the rise of new investment vehicles for passive investors, have forced developers of alternative development projects to turn to the below-market, community capital sources of financing to fill the financing gap. Below-market, community capital finance sources include government funding programs, foundation grants and program related investments, and loans from community banks, community credit unions, and community housing loan funds. There are numerous government funding programs at the local, state, and federal level that can bridge the financing gap, by lowering the cost of capital for alternative development projects that create social and environmental benefits. Depending on the location and/or type of project, these programs can include: (1) tax-increment financing, (2) low-income housing tax credits, (3) federal HOME funds, (4) community development block grants, (5) brownfield redevelopment grants and loan programs, (6) historic tax credits, (7) New Markets Tax Credits, and many more. Foundation grants and program related investments, or PRI’s, have also been an important source of capital for alternative development projects that align with foundation social and environmental goals. Combined the community capital market is significantly under-capitalized compared to both the mainstream capital markets controlled by Wall Street and the tremendous need, and the growing demand, for alternative development projects. Bringing alternative development to scale will likely require a continuum of capital delivery vehicles, guided by a real estate social investment framework and armed with proven strategies and tools, to direct market-rate capital to alternative development projects.

This thesis focuses on real estate private equity funds, guided by a real estate social investment framework, that seek to achieve financial returns plus social and environmental returns (the “double” or “triple” bottom line), as one potential vehicle for delivering capital to alternative development projects. Such vehicles could potentially work to increase the flow of capital towards alternative development projects in four ways:

52 Program Related Investments, or PRI’s, are below market-rate loan or other investments made by a private foundation to a profit making or nonprofit organization to support the foundation’s stated purpose and interests. Source: The Foundation Center Frequently Asked Questions “What is a program-related investment?” (www.fdncenter.org/learn/faqs/html/pri.html)

53 Although it can vary from jurisdiction to jurisdiction, in general, tax increment financing, or TIF, is a municipal government program where the incremental tax benefits a real estate project will produce over a specified period are discounted to present value and contributed to the developer as a subordinate loan or grant as a mechanism to ensure the project will be built.
1. Through their commitment to achieving double bottom line (DBL) results, these funds could help overcome the real estate capital market failures by:
   - Developing the specialized knowledge and expertise necessary to understand the unique challenges and opportunities presented by alternative development locations (inner-city and inner-ring urban areas) as well as alternative development prototypes (mixed-use, mixed-income, urban infill, transit-oriented development, green building, greyfield development, etc.).
   - Exercising flexibility beyond what traditional real estate fund managers have at their disposal; and,
   - Working to develop an investment environment conducive to alternative development projects, through advocacy, public policy and other proactive measures.

2. Raising capital from socially motivated investors who may have existing socially motivated investments in the public (stocks, bonds, and mutual funds), or private (venture capital), business equity markets but may not be currently investing in real estate or would prefer to be investing in socially motivated real estate investments if such vehicles existed. For these investors, real estate investment vehicles guided by a real estate social investment framework would represent an opportunity to diversify their social investment portfolios.

3. Demonstrating to the conventional real estate capital markets that investments in alternative development projects can achieve risk-adjusted, market-rate returns.

4. Putting pressure on conventional capital sources to allocate a share of their total capital towards socially motivated real estate investments (i.e. – alternative development projects).

Several real estate private equity funds have been organized over the last six to eight years that are portending to invest with a “double bottom line” investment framework (financial plus social returns). An analysis of these existing funds is presented in Chapter 5.

To gain a better understanding of the potential of real estate private equity funds guided by a social investment framework to deliver capital to alternative development projects, the remainder of this chapter focuses on building the readers understanding of the characteristics of
real estate private equity funds and the possible components of a real estate social investment framework.

**REAL ESTATE PRIVATE EQUITY FUNDS 101**

To understand the opportunities and limitations of the use of real estate private equity funds to deliver capital to alternative development projects, it is important to develop an understanding about how these funds are designed, structured, and managed.

**Overview**

Real estate private equity funds enable passive institutional and individual investors who value the risk and return characteristics of commercial real estate but do not wish to be deeply or directly involved in the management and operation of underlying real estate assets an opportunity to invest in real estate debt and equity. Real estate private equity funds have several advantages over direct ownership, including professional management, greater liquidity for the units of the fund over that of the underlying properties, and, if of sufficient size, greater geographic and property-type diversification. Investors in real estate private equity funds are often interested in real estate’s ability to diversify an investment portfolio that otherwise consists largely of traditional corporate stocks and bonds. These investment vehicles are similar to corporate stocks in that they provide their investors with an ownership interest in the underlying asset; although, unlike corporate stocks and bonds, they are not traded in liquid public exchanges nor are their net asset values priced on a continuous, daily basis.

**Structure**

Real estate private equity funds are organized as either separate accounts or commingled funds. A separate account is a fund in which one institutional investor, typically a pension fund, is the sole investor in a fund managed by a professional real estate investment manager. A commingled, or pooled, fund comprises a pool of capital provided by a number of individual or institutional investors in which each party owns a pro rata number of units in the fund reflective of the amount of their original investment. In both separate account and commingled funds, a professional investment manager acts on behalf of the unit holders and acquires and disposes of
properties within the fund as outlined in the investment management agreement. Real estate private equity funds use two separate legal entities: a for-profit investing entity (the “fund”) typically organized as either a limited partnership (LP) or a limited liability company (LLC) and a managing entity (the “firm”).

**Investment Horizon**

Typically, real estate private equity investment funds are organized as closed-end funds in which the fund has a fixed investment time horizon with a stated maturity (termination) date. Generally this investment horizon lasts 10 years – a five-year investment period followed by a five-year harvest period (see the diagram below for an illustration), for a total basic term of ten years. Some funds include provisions in their partnership agreements that allow the fund to be extendable for two or three one-year periods at the option of the Fund manager, if necessary, to allow for orderly liquidation of the portfolio.⁵⁴

![Figure 4-1. Traditional Real Estate Investment Fund Time Horizon](image)

Closed-end funds typically purchase a portfolio of properties to hold for the duration of the fund and, as sales occur, typically do not re-invest the sales proceeds.

**Investment Cycle**

Funds are committed to a predefined investment strategy usually outlining property type, geographic diversification, and term to maturity, as well as basic underwriting policies. Funds are then drawn from liquid accounts, set up by investors in the fund, only after properties have been identified and approved for purchase by the fund’s Investment Committee. Once capital is raised and the fund is closed, generally few or no additional investors are allowed into the fund and there is limited access for investors to purchase or redeem units of the pooled fund. Redemption provisions tend to allow units to be sold only to other unit-holders of the Fund, often at a prescribed discount to the latest appraisal value of the partnership units. Some funds allow

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for private sales to take place (in the specialized secondary market for unit shares); but, again, usually at prescribed discount prices relative to the most recent appraisal.

There are disadvantages to closed-end pools beyond the liquidity constraints. As these funds have finite lives, properties have to be systematically sold prior to the term to maturity. Depending on the average purchase date of the properties relative to the commencement of the fund, holding periods may be significantly less than the actual life span of the pool. As the liquidity of properties is required by the end of the contractual period, the best execution of sales may not always take place in a fund manager’s haste to liquidate the properties before the deadline. Generally there are three ways that a Fund can “exit” its investment in a development project:

1. Refinancing,
2. Sale of interest to general partner of development, or a
3. Sale of property to a 3rd party.

Figure 4-2. Real Estate Private Equity Investment Cycle

Source: Jeffrey Levy (2005)

Managing Entity Income

The managing entity typically receives revenues from three sources:

1. An annual management fee (typically between 1% and 2% of total committed capital),
2. Transaction fees when capital is invested in real estate projects, and,
3. A carried interest\textsuperscript{55} (generally a 20% subordinated interest in all profits after a preferred return\textsuperscript{56} on investors’ capital, including capital invested by the managing entity).

The bulk of the managing entities compensation comes in the form of a carried interest in the financial returns of the fund. This creates a strong alignment of interests between fund manager and fund investors. Should the fund fail to exceed the preferred rate of return, the fund sponsor’s carried interest is worthless. Equally important in terms of incentive compatibility is that fund sponsors invest side-by-side with their investors. Generally 2% to 25% of all of the capital committed to a real estate private equity fund is committed by the managing entity of the fund. In a few cases, the sponsor’s own investment is even subordinated to other investors’.

**Investment Strategy**

While real estate private equity funds generally utilize a common legal structure, they employ widely divergent investment strategies. While no fund employs a single strategy exclusively, most funds specialize in one or two strategies. Each strategy requires special skills, networks, and underwriting by the sponsor.

There are generally three main investment strategies employed by real estate private equity funds: core, value, or opportunistic. Each strategy has different risk and return characteristics. A “Core” strategy involves the use of equity or debt instruments to invest in operating and substantially leased “institutional quality”\textsuperscript{57} real estate in the traditional property types (apartment, office, retail, industrial, and hotel). A “Value” strategy involves the use of equity or debt instruments to invest in real estate in need of rehabilitation, redevelopment, development, lease-up or repositioning. Finally, an “Opportunistic” strategy involves the use of equity or debt instruments to invest in real estate properties, operating companies and other investment vehicles involving significant investment risk. Generally, investments in alternative real estate typologies will involve the practice of value investing but could also display some characteristics typically associated with opportunistic investing.

\textsuperscript{55} The general partner’s share of the profits generated through a private equity fund. The carried interest, rather than the management fee, is designed to be the general partner’s chief incentive for strong performance.

\textsuperscript{56} The preferred return is the percent of cash flow that preferred investors receive before any other investors or the fund managing entity has rights to cash flow distributions.

\textsuperscript{57} “Institutional quality” real estate is generally characterized as large, fully operational, income-producing properties of high-quality construction in high-quality locations. Also known as Class A or premium properties.
Return Expectations

Real estate private equity funds guided by “value” and “opportunistic” strategies tend to display a J-shaped return curve (see Figure 4-3 below for an illustration) because management fees are charged from the outset and exits typically do not happen until three (3) to seven (7) years after the initial investment. That is, funds show very low (and often negative) returns in their early years, as many engage in development, redevelopment, and repositioning strategies. These early-phase negative cash flow activities, which are a key element of many value-enhancing strategies, make the returns look unattractive in their early periods. However, profits take off as assets mature or a specific event occurs that creates a value pop and the fund begins to exit its investments.

Figure 4-3. The J-Curve of Private Equity Real Estate Investment Returns

Funds typically seek alpha, defined as an appropriate risk-adjusted rate of return. This rate of return is based on:

- The structure of the investment;
- Relative risk of the investment due to the type, nature of, and relative control over the investment; and,
- The degree to which the investment risks can be reduced by guarantees or subsidies.

Equity real estate investments with medium risk usually require a 15% to 20% annualized IRR. Risky projects can require 30-35% returns. Rates of return for all levels of real estate investment risk can vary, though, depending on interest rates and the supply of real estate investment capital.
Investment Products

Real estate private equity funds generally utilize one of four investment products:

1. Straight equity,
2. Joint venture equity,
3. Participating mortgage, or
4. Mezzanine debt (mezz debt).

What follows is a general description of each investment product.

**Straight-equity**

Straight equity is a passive at-risk investment in a development project with little control on the part of the investment fund over decisions made by the development partner. Real estate private equity funds will invest straight-equity into development projects when there is a high degree of confidence in the management capabilities of the developer and the return prospects of the proposed development.

**Joint Venture**

In a joint venture, a real estate private equity fund and a development partner will form a partnership to purchase and/or develop real estate assets. The development partner usually provides the land, knowledge of the local real estate market, and political and community relationships. The investment fund provides investment capital. In exchange for its capital contribution, the real estate private equity fund will usually take a controlling interest – 50% to 99.99% - at the entity level of the development venture. Joint venture arrangements give the investor access to deals that it might not otherwise have a chance to participate in. In terms of the risk / return considerations, the principal advantage for the private equity fund is control over the value-creation process. The fund also taps into the local knowledge and local connections of the joint venture partner. Joint venture arrangements also have several benefits for the developer. For one, the infusion of capital from the investor partner gives the developer the ability to spread their resources to additional development projects. Second, the developer

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58 Typically a Limited Liability Company (LLC) or Limited Partnership (LP) established for the specific purpose of undertaking the specified development.
benefits from the investors development expertise and value-creation experience. Finally, by
team ing with a high-profile investor with clout in the industry, the developer benefits from a
marketing perspective. If all goes well, it is likely that the developer will have established a
solid relationship with the investor and thus will have an investment partner for future deals.
Developers often seek out joint venture arrangements for larger, higher risk deals.

Participating Loan

A participating loan is an investment product that generally takes the place of traditional
debt in the capitalization structure. It has a lower risk profile than a joint venture arrangement
but also a commensurate lower return. A participating loan gives the investor a base contract
rate of return (the contract interest rate on the loan which is generally lower than a typical loan)
in exchange for some equity-like participation in the property investment. Typically
participating mortgages give the lender some equity participation in both the annual operating
income and the sales proceeds from the property investment. For example, a lender might be
entitled to receive a specified percentage of the annual net operating income (NOI) of the
property above a specified threshold or after the base interest debt service is taken out. In
addition, after the loan balance is repaid the lender might be entitled to a certain fraction of the
property resale proceeds above a designated threshold. The equity participation payments are
often referred to as conditional interest, or kickers (because they kick in above the stated
threshold or base earnings). The exact amount of the participation payment (if any) is less
certain than the base interest, because it depends on the uncertain future NOI amount.

A participating loan increases the investors expected return above what would be implied
purely by the base contract interest rate on the loan, and it may reduce the risk of the loan from
the perspective of the investor’s real return, the return net of inflation. The investor may also
accept a higher initial loan-to-value ratio if the participation gives the investor sufficient
expected return. From the developer’s perspective, although some upside potential is lost to the
investor, the lower base interest rate enhances the positive leverage effect from the debt. In
addition, in a properly constructed participating mortgage the equity participation payments (on

59 The bulk of the following discussion is taken from Geltner, pp. 458-461.
both the annual income and reversion proceeds) are tax deductible to the borrower.\textsuperscript{60} because the Internal Revenue Service classifies participation payments as interest, not dividends, because the investor does not have governing control over the property. Another reason participating mortgages are appealing is that the lower base interest rate reduces pressures on the initial income coverage, as indicated by the initial debt coverage ratio. This is most important in situations in which the property NOI can realistically be expected to grow significantly over the life of the loan. For this reason, participating mortgages are often most appealing when inflation expectations have driven up interest rates.

\textbf{Mezzanine Loan}

Mezzanine loans can come in the form of stand-alone subordinate debt or can take on similar characteristics to participating loans. As the figure below illustrates, mezzanine debt (mezz debt) is a form of junior debt that bridges the gap between traditional debt and more costly private equity.

Figure 4-4. Risk & Return Characteristics

Mezzanine debt is advantageous to developers because it is generally cheaper than equity that can generally cost developers upwards of 20%. Mezzanine debt typically has a term of three to five years. While transactions differ, mezz debt that increases the LTV ratio from 65% to 75% generally carries an interest rate in the mid-to-high single digits. Mezz gets pricier as borrowers move to higher LTV ratios. A mezz loan that increases LTV to 90% from 80% may bear interest

\textsuperscript{60} The Internal Revenue Service classifies participation payments as interest, not dividends, because the investor does not have governing control over the property.
in the high teens. At higher LTV ratios, mezz debt agreements will also tend to include “kickers”, which enable lenders to share in a building's cash flows, sales proceeds, or both, for example. Mezzanine debt investors most commonly secure their loans by using the borrower’s equity interest in the building as collateral. Thus, if a borrower defaults, the mezz provider becomes the property's owner and operator. To mezzanine lenders, that risk and reward scenario is more appealing than providing equity. While equity suppliers demand higher returns for their investments, if a borrower goes into default, equity partners have little hope of recouping their investment.

A REAL ESTATE SOCIAL INVESTMENT FRAMEWORK

When investors place capital for which they do not have an immediate need into investment vehicles such as stocks, bonds, venture capital funds, or real estate private equity investment funds (in this case), typically their primary objective is to create future wealth by generating financial return on their investment. The social investment framework is an extension of the tradition of the financial bottom line investment focus. According to the Social Investment Forum (SIF), a trade group that encourages social investment in the public equities markets in the U.S., social investing is a “...process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis.” Socially motivated investors seek to make money (the financial bottom line) without harming and, hopefully, helping society and the environment (the social and environmental bottom lines). Social investing is not a more relaxed standard but a more stringent one.

The history of social investing began in the early 20th century when religious institutions divested their portfolios of alcohol, gambling, and tobacco stocks. The modern day social investment movement began to gain traction with a broader set of investors in the 1960’s, as investment practices came under scrutiny. Socially and environmentally conscientious investors realized they could use the power of their financial investments as a tool to push publicly traded companies to think more holistically about how their business practices were not only creating

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wealth for their shareholders but also producing negative social and environmental externalities. During the Vietnam War era, conscientious investors wanted to make sure that the companies they invested in weren't part of the military-industrial complex, and they began "screening" their investments to eliminate those that played a role in the war effort. During the 1970's the formation of the Environmental Protection Agency, the passage of the Endangered Species Act, and the oil embargo each contributed to heightened sensitivity of environmental issues on the part of investors. This realization led to the creation a social investment framework for incorporating social and environmental issues when investing in public equities markets (stocks, bonds, and mutual funds).

**A Social Investment Framework for Investing in Public Equities**

The social investment framework for public equities investing marries the first priority goal of achieving investment returns that meet, or hopefully exceed, the industry financial return benchmarks with an effort to direct investment capital towards companies that are not harming, and hopefully, helping society and the environment (the social and environmental bottom lines). To achieve the social and environmental return objectives, the framework employs three tools: screening, shareholder advocacy, and community investing.

*Screening* is the practice of including (positive screening) or excluding (negative screening) publicly traded securities from investment portfolios based on social or environmental criteria. The criteria for inclusive proactive screens range over a wide spectrum of concerns, including corporate governance, employment diversity and opportunity, the environment, human rights, renewable energy, beneficial products and services, and sustainability. Negative screening excludes companies that are directly or partially involved in certain industries, practices, or services. The traditional and most common negative screens are alcohol, tobacco, weapons, and nuclear power. Socially concerned investors generally seek to own profitable companies with respectable employee relations, strong records of community involvement, excellent environmental impact policies and practices, respect for human rights around the

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63 Hawken and Natural Capital Institute, p. 6.
64 Ibid.

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world, and safe and useful products. Conversely, they often avoid investments in those firms that fall short in these areas.65

Shareholder advocacy is the process of leveraging ownership positions in publicly traded companies to initiate dialogue with, and to put pressure on, corporate executives – through the filing of shareholder resolutions, media attention, and public education campaigns – to consider often-ignored social and environmental issues. According to the Shareholder Action Network (SAN), shareholder action has aided in66:

- Ending apartheid in South Africa through corporate divestment;
- Restricting harmful infant formula marketing by pharmaceutical companies in developing countries;
- Getting companies like General Motors, Ford Motor Company, and Sun Company to sign the CERES Principles, which require efforts to reduce pollution and increase environmental disclosure;
- Convincing at least 100 companies to diversify the makeup of their corporate boards and employees;
- Forcing multinational companies like Nike, which use contract workers in foreign countries, to clean up sweatshop-like conditions and take more responsibility for the welfare of these workers;
- Encouraging Home Depot—the world's largest distributor of home building materials—to phase out old-growth wood from its supplies; and,
- Convincing drug store chains to phase out mercury-filled oral thermometers.

Community investing describes investing that supports development initiatives in low-income communities both in the United States and in developing countries. Community investment provides affordable housing, creates jobs, and helps responsible businesses get started. Community Investing is achieved mainly through depository investments in Community

A Social Investment Framework for Investing in Venture Capital Funds

As the notion of social investing has matured and gained traction as a legitimate investment framework, it has spread over to the venture capital sector as well. While the industry’s origins date back over thirty years, it has grown rapidly within the last ten years, providing socially-motivated high net worth individuals, pensions funds, insurance companies, and other investors, wishing to place some of their investment capital into venture capital funds, with a bevy of investment options to choose from.

Community venture capital and double bottom line private equity funds are a subset of traditional venture capital, the high-risk investment practice of providing patient equity and/or debt capital to businesses with high-growth potential. Like traditional venture capital, these funds seek to secure financial returns on investments that compensate the high-risk investment strategy with high returns. These funds seek to employ the same basic social investment framework used to guide investment in the public equities markets – financial returns consistent with or better than industry benchmarks plus social and environmental returns - but, they apply it to investments in promising early-stage, privately-held business ventures.

Community venture capital and double bottom line private equity funds pursue a wide variety of social and environmental investment objectives. Double bottom line private equity

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67 Community Development Banks operate similarly to regular banks, but their business is the permanent, long-term economic development of low-and moderate-income communities. They target loan resources to residents of their primary service area - the people living, working, and doing business in their marketplace. Source: Social Investment Forum.

68 Community Development Credit Unions operate just like commercial credit unions, but focus on economic development in specific areas. Similar to banks, credit unions provide a range of savings and investment options. The difference is that credit unions are membership-owned and controlled and they are nonprofit financial institutions. There are over 100 Community Credit Unions in America, serving people and communities with limited access to traditional financial institutions. Source: Social Investment Forum.

69 Community development loan funds operate in specific geographic areas and act as intermediaries that pool investments and loans provided by individuals and institutions, often at below-market rates, to provide loans to businesses or real estate developments that can’t access private institutional debt capital.

70 Microenterprise lenders have lent more than $25 million to low-income individuals for home purchases and small business start-ups. These funds typically provide small loans, up to $25,000, to help people who may not be able to obtain financing through traditional lenders.

funds have tended to focus on renewable energy, food and organics, community development, and independent media, to name a few. Community development venture capital funds use the tools of venture capital towards a community economic purpose. While there is a diversity of social screens utilized by community development venture capital funds, most often the primary screen is the somewhat ambiguous objective of poverty alleviation. Functionally, this has meant a focus on high wage/low skill job creation and the provision of living wages for low skilled workers. Additional community venture capital social return objectives include: growth of entrepreneurial capacity, promotion of minority and women owned businesses, expansion of good employment practices, production of goods beneficial to high poverty communities, promotion of environmentally sustainable businesses and commercial/economic development and stability of high poverty neighborhoods or regions.\(^{72}\)

**Scale of Social Investing**

Social investing is a significant and rapidly growing aspect of the financial services industry. Millions of people and thousands of institutions want their investments to express social and environmental values. According to the Social Investment Forum, by 2003 total assets in professionally managed portfolios of public equities came to $2.2 trillion, or 11% of the $19.2 trillion in professionally managed assets in the United States. That represents a 59% increase since 1999 when approximately $1.3 trillion was under professional management. A national Gallup Poll in May 2000 found that 28% of all investors had heard of social investing and 11% of all investors had made one or more social investments\(^{73}\). Today, socially motivated investors can choose from over 83 different mutual funds that employ the social investment framework.\(^{74}\) These funds promise that investor’s money will either avoid companies producing socially and environmentally harmful products (examples include guns, tobacco, or products from the Amazon rainforest) or reward companies that work toward environmental responsibility, corporate social responsibility, and social justice. According to a study by Columbia University’s Research Initiative on Social Entrepreneurship (RISE), DBL private equity funds have received approximately $2.0 billion dollars worth of investments with which

\(^{72}\) Gaither, p. 24.


to invest in promising young businesses producing social and environmental benefits.\textsuperscript{75}

Community venture capital has also seen tremendous growth in recent years. A study published by the Community Development Venture Capital Association (CDVCA), the trade association for community development venture capital funds, found that community venture capital funds have grown dramatically in the last ten years; from only a handful of funds in the early 1990’s to 79 funds investing, or in formation, with over $500 million in capital under management at the end of 2003.\textsuperscript{76}

**A Real Estate Social Investment Framework**

Despite the maturation and growth in the social investment movement, the movement for generating wealth as well as positive environmental and social benefits through real estate investing is only in its infancy, in terms of duration, scale, and definition of what it means to achieve social and environmental returns. In order for the practice of real estate social investing to gain currency in the investment community it is necessary and important to understand how to measure and weight, from a real estate perspective, the financial, social, and environmental components that make up a real estate social investment framework. In addition, these measures need to be useful and applicable for evaluating investment decisions both at the project, or individual property, level and the portfolio, or asset class, level. This section lays out a framework for measuring and assessing whether an investment of capital meets the real estate social investment objectives of financial, environmental, and social return and discusses the issues associated with different return measures.

The real estate social investment framework builds off of the social investment frameworks for public equities and venture capital discussed above. In other words, it seeks financial returns consistent with industry benchmarks as a first priority plus measurable social and environmental returns.

To develop the real estate social investment framework, I reviewed the existing literature on real estate investing to learn more about how financial return is measured at both the micro, or

property, level and the macro, or portfolio, level. I also reviewed the existing literature on the
theory and practice of alternative development and the notion of achieving environmental and
social return through real estate development.

Financial Return

As mentioned above, financial return is the conventional measure of return in an
investment endeavor. In simple terms, the financial return on an investment is expressed as a
percentage calculated by determining what you get at the end of the investment period,
subtracting what you started out with or invested, and then dividing that sum by what you started
out with. For example, if you invest $10 and end up a year later with $11, then you have made a
10% return ($11-$10 = $1 and $1/$10 = 10%). Real estate private equity investment funds need
to be able to quantify financial return at both the micro, or individual property, level and the
macro, or portfolio, level. They also need to be able to quantify an expected, or going-in,
financial return over the anticipated investment period as well as measure periodic return
performance. Real estate investors typically utilize the internal rate of return, or “IRR”, to
quantify financial return. The IRR is the discount rate\(^77\) that, applied to all cash flows associated
with an investment, results in a zero net present value (NPV). The IRR takes into consideration
the time value of money and the risk associated with future cash flows.

Investors in real estate private equity funds typically invest their money over a 10-year
investment period and expect an annual risk-adjusted, market-rate of return\(^78\) in the mid-teens to
mid-thirties depending on the risk characteristics of the investment, the supply of capital
available for real estate investments, and the expected rates of return on other assets with similar
risk / return characteristics. As discussed earlier in this chapter, in the “Real Estate Private
Equity 101” section, real estate private equity funds will generally communicate upfront to
potential investors, through the investment term sheet, what annual return they can expect. An
investment fund will calculate an expected annualized return commiserate with the level of risk
based on the proposed investment strategy and expected cash flow distributions. Potential
investors can compare expected IRR’s between real estate private equity funds and between
other investment options, such as stocks or bonds. Actual annual IRR’s will be calculated as the

\(^{77}\) Rate at which expected future dollars are discounted to determine their present value equivalents.
\(^{78}\) The market-rate of return is basically an abstract that suggests that one investment should attain a comparable
return to other investments with similar risk characteristics.
The ability of a private equity real estate fund to achieve its expected IRR for its investors is dependent on finding investment opportunities in individual properties that, when aggregated, produce the expected financial returns targeted by the fund. Total gross investment returns consist of both an annual period net cash flow (cash-on-cash or income return) plus the net revenue from the reversion (or sale) of a property (growth return component). Achieving expected returns is dependent on finding investment opportunities where anticipated rental income sufficiently exceeds operating costs so as to cover debt service obligations and pay the expected return to the fund but that also have the potential for appreciation over the investment period.

For purely financial return driven funds, the IRR is the predominant metric investors would be interested in. Fund performance would be evaluated based on the ability to meet or exceed the stated IRR goals set out in the fund term sheet and embedded in the fund’s legal documentation. Conventional real estate funds typically seek to maximize financial returns as the sole criteria for investment. Real estate private equity funds utilizing a social investment framework would typically strive to achieve, but not necessarily exceed, an expected risk-adjusted, market-rate of return on invested capital as well as measurable social and environmental returns. To the extent that expected or realized financial returns on any one project exceed the fund’s expected financial return, real estate private equity funds utilizing a social investment framework would likely seek to “direct” those investment proceeds towards efforts to increase the social and/or environmental return component.

**Environmental & Social Return**

Since the social investment framework is specifically focused on generating social and environmental returns as well as financial returns, some attempt must be made to summarize the funds successes in achieving the social and environmental objective as well.

**Measurement Challenge**

While the IRR measure allows investment fund managers to compare the expected return performance across prospective investment deals and investors to compare performance across
funds or asset classes, no universally accepted, standard measures exist to compare the potential or actual environmental and social returns. What follows is a review of assessment and measurement techniques for the environmental and social return components of the real estate social investment framework.

**Environmental Return**

As noted in Chapter 2, current development patterns – both in terms of the form of development and the way buildings are designed, constructed, and operated – have had and continue to have, significant negative impacts on environmental quality and public health. The goal of achieving environmental return on investment is to create a built environment that maximizes the health, welfare, and productivity of society while minimizing the direct and indirect impact of development on the natural environment. Environmental return can be achieved through development and building practices that reduce:

- **Land consumption**;
- **Resource consumption**, in four areas: (1) the production of building materials, (2) the construction process, (3) during ongoing building operations, and (4) the means of transportation necessary to transport goods and people to the building;
- **Indoor and outdoor pollution generated**; and,
- **Contaminated land, or brownfields.**

**Environmental Return and the Development Process**

The conventional real estate development process involves four main stages that impact environmental returns:

1. *The initial project conceptualization*, including site selection;
2. *Design*, including land-use planning, site design, and building design;
3. *Construction*; and,
4. *Building operations and management*.

Decisions made at each stage in the development process can positively or negatively affect the potential to achieve environmental return. In conventional development, the drive for financial

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79 The EPA defines a brownfield site as “property, or portion thereof, that has actual or perceived contamination and an active potential for redevelopment or reuse.”
return provides a disciplined guide for decision-making at every point in the development process. An environmental return metric can do the same thing but with the end goal of achieving a certain level of environmental return. Projects that set out to achieve environmental returns approach decisions made at each of the four stages in the development process differently than projects in which environmental return is not a priority. What follows is a discussion of each of the four main stages in the development process and an environmental return perspective on each stage.

Initial Project Conceptualization

From an environmental return perspective, the main difference between a conventional approach and an environmental return approach to initial project conceptualization is Site Selection. Site Selection has to do with the site characteristics of the real estate project that will receive the investment and can be broken down into three sub-categories:

- **The location of the project**, whether the site is located on an urban, suburban, or greenfield\(^8\) site.
- **Accessibility to/from existing transportation infrastructure**, especially public transportation; and
- **The condition of the soil and/or existing buildings on the site** (has prior use caused hazardous waste contamination?).

From an environmental perspective the re-use or recycling of existing buildings and/or sites in urbanized areas is preferable to lower density suburban development; and, suburban infill or redevelopment of existing suburban development is preferable to new development on greenfield sites. Suburban development can be ranked ordered by whether it is transit-oriented, transit-adjacent, or suburban infill, respectively. In almost all cases, greenfield development would not be considered to add environmental value even if it is designed to the highest environmental return standards because of the resulting negative environmental impacts caused by such development. Positive environmental returns are generated when investments are made in real estate projects that are located close enough to existing public transportation routes that they increase public transportation use and reduce automobile dependency. The closer a site is located to public transportation the greater the environmental return. From an environmental return perspective, the reuse of environmentally contaminated, urban infill sites is the highest order of development for which a real estate investment fund can invest.

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\(^8\) A greenfield is land not previously developed or polluted such as farmland and woodland.
Design

Design includes land-use planning, site design, and building design. Land-use planning is concerned with how the site is put to productive use - what will be located on the site? In general, positive environmental value is created when sites are designed to contain a mix of uses, that can decrease the need for off-site travel, and maximize density. Site design has to do with the way buildings are laid out on the site. In order to create positive environmental value, care should be taken to minimize disruption to existing natural vegetation, habitat, and drainage systems and to maximize opportunities for natural heating and cooling. Building Design to achieve positive environmental return seeks to optimize building system integration so as to maximize natural heating and cooling, energy efficiency, and indoor air quality. It also seeks to:

- Minimize global and local pollution, by utilizing renewable energy generation;
- Maximize the use of building materials made from renewable resources, such as bamboo for flooring; and,
- Maximize the use of durable, long-lasting building materials to minimize the need to replace building materials.

Construction

An environmental return approach to construction would seek to minimize construction waste through deconstruction practices when the building program requires demolition or rehabilitation. It is also concerned with minimizing waste generated through the construction process by reusing or recycling construction materials.

Building Operations and Management

Includes optimizing building systems so they operate at maximum energy efficiency, using environmentally friendly cleaning supplies, encouraging the use of alternative transportation to get to and from the building, and recycling tenant waste.

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81 While overly simplified, in general, the greater the ratio of building area to land area, the more environmental value is being created due to resource demand declines and efficiency gains.
82 Deconstruction is the process of dismantling a building in order to salvage the materials for reuse.
Measuring Environmental Return

The notion of trying to achieve improved environmental performance through the design, construction, and operations of a building is generally referred to in the industry as Green Building. A number of local, national, and international rating systems have been developed over the last ten years that attempt to measure the environmental performance or “greenness” of buildings. Some examples include the United States Environmental Protection Agency’s Energy Star program, the U.S. Green Building Council’s Leadership in Energy and Environmental Design (LEED), the City of New York High Performance Building Guidelines, Austin Energy’s Green Building Program, and the Commonwealth of Pennsylvania’s Guidelines for Creating High-Performance Buildings.

Although imperfect and still evolving, there is a general perception that the United States Green Building Council’s (USGBC) Leadership in Energy and Environmental Design (LEED) points-based rating system has become the most widely used and recognized standard.83 The USGBC, a national non-profit entity organized to promote the development of green buildings, developed the LEED Green Building Rating System to rate new and existing commercial, institutional, and high-rise residential buildings according to their environmental and performance attributes. The LEED system utilizes a list of 34 potential performance based “credits” worth up to 69 points, as well as 7 prerequisite criteria, divided into 6 categories84:

- Sustainable Sites
- Water Efficiency
- Energy and Atmosphere
- Materials and Resources
- Indoor Environmental Quality
- Innovation & Design Process

LEED allows the project team to choose the most effective and appropriate sustainable building measures, from the 34 credits, for a given location and/or project. These “points” are then tallied to determine the appropriate level of LEED certification. Four levels of LEED certification are possible; depending on the number of criteria met and points accumulated. Each successive level of LEED rating indicates increasingly sustainable building practices. The four levels are:

- LEED Certified: 26-32 points
- LEED Silver: 33-38 points

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83 For more on LEED and the U.S. Green Building Council, go to www.usgbc.org.
84 See Appendix A for a sample LEED Green Building score sheet.
LEED Gold: 39-51 points
LEED Platinum: 52+ points

One method for achieving the environmental return within a real estate social investment framework is to require that all potential investment projects be designed to meet LEED certification standards. This would provide a standardized way to measure the relative environmental return of one investment versus another and also provide a means for comparing results at the portfolio level.

Pros & Cons of Using the LEED rating system

Cons

The LEED system does have some drawbacks that need to be taken into consideration in order to optimize the measure. These are:

1. LEED doesn’t actually measure absolute impacts; it only measures relative impacts.

   Since LEED is a point-based rating system, projects have options to choose from when attempting to accumulate the requisite point totals to achieve one of the LEED ratings. Achieving a higher LEED rating means that a project is achieving a higher environmental return on a relative basis. However, two projects can achieve the same LEED rating but one project could provide more environmental value if measured in absolute terms. For example, LEED certified buildings can be located anywhere – on an urban, suburban, or greenfield site. While points are given for urban, brownfield sites and no points are awarded for suburban or greenfield sites, two projects can achieve the same overall point total and one project could be located on an urban, brownfield site while the other is located on a greenfield site. As discussed earlier, from an environmental return perspective, the location of a project affects the overall environmental value of the project – an urban site is preferable to a suburban site which is preferable to a greenfield site.

2. LEED in its current form is limited to new construction of commercial and institutional buildings.

   As such the rating system does not cover a host of potential alternative development investment opportunities, such as smaller infill housing projects and the rehabilitation of existing
buildings. The USGBC is currently undertaking an effort to expand the LEED rating system to cover neighborhood development and the rehabilitation of existing buildings; but, that effort has not been completed to date.

3. Cost

The LEED process consists of registering a building project and then fulfilling the credit requirements and submitting the required documentation. Additional costs for the LEED certification process can run into the tens of thousands of dollars.

Pros

Although LEED is not without its imperfections, its simple structure, based on achieving points, has given it enormous institutional appeal and support and made it the most widely accepted and used program of its kind in the United States. With this appeal and support comes credibility, and thus enumerating the number of portfolio projects that have achieved a LEED rating is an easy way to measure and evaluate the environmental achievements of a fund.

Social Return

This section seeks to develop an appropriate framework to evaluate the degree to which a real estate development project or a real estate investment has met explicit social goals. There are two main questions this section will attempt to answer. They are:

1. What does Social Return mean in terms of real estate development and investing?
2. How can it be measured?

What does Social Return mean?

Within a real estate social investment framework, the goal of creating social return has to do with the alleviation of the negative social impacts created by conventional development. As discussed in Chapter 2, conventional development has contributed to a host of negative social problems, including concentrated poverty, income and racial segregation, social isolation, and their concomitant effects. There are two main schools of thought on how alternative real estate development and investment can create social benefits – the place-based physical revitalization, or implicit, approach, and the people-based, or explicit, approach.
Place-Based Physical Revitalization, or Implicit, Approach

Historically social return in terms of real estate development and investment has generally been linked to the notion of physical revitalization in targeted geographic areas - in older central core urban areas and inner ring suburbs - that have suffered from disinvestment or a lack of new investment. The physical revitalization approach seeks to alleviate or eliminate conditions, such as blight, crime, high land prices, environmental contamination, and the like, that can cause disinvestment or hinder new investment. Physical revitalization advocates argue that elimination of these barriers will create both economic and social return by leading to new investment in real estate and business development resulting in new or rehabilitated buildings, new or refurbished leasable space, and new businesses. It is generally believed that these revitalization efforts will act as a catalyst for follow-on investment and will generally improve the quality of life for residents of the revitalizing area by expanding employment and shopping opportunities and raising property values and local tax revenues; which, in turn, will improve the provision of government services. In other words, the rising tide will lift all boats.

People-Based Approach

Advocates of the people-based approach to community revitalization counter that physical revitalization efforts don’t necessarily translate into direct benefits for community residents, such as new or better jobs, increased economic wealth, increased skills, and the like. They contend that physical revitalization efforts fail to contemplate, plan for, or implement programs that specifically seek to improve the socio-economic conditions in the community by providing direct community benefits. Furthermore, they argue that because the physical revitalization approach can lead to increased rents and property taxes, it can cause displacement and gentrification, which shifts underlying socioeconomic problems to new locations without addressing the root causes of the problems.

The people-based approach focuses on community-based strategies to directly link real estate development with efforts to improve the quality of life of those residing in the communities in which new real estate development is occurring. Some specific goals of people-based advocates are to:

85 Gentrification is the process where deteriorated urban areas undergo revitalization or redevelopment.
- Ensure that the community has a voice in design and planning efforts,
- Create jobs for local workers,
- Create job training opportunities,
- Create opportunities for wealth generation for local residents,
- Create other goods and services needed by the community,
- Create affordable housing, and
- To ensure that local communities share in the increased wealth generated through revitalization efforts.

**How can Social Return be measured?**

In reality, alleviating the negative social impacts attributable to conventional development requires both physical revitalization and people-based approaches. Social return, then, is created when real estate development projects seek not only to physically revitalize a community through the creation or rehabilitation of physical space but also to contribute in a direct and intentional way towards efforts that will help solve underlying socio-economic problems. However, there is very little public discourse addressing the issue of how social return could or should be measured. Real estate developers often make claims that their projects are providing social benefits and public finance sources often attempt to evaluate these social, or community benefits, when making decisions on whether or not to invest public dollars in private real estate projects. However, these measurement and evaluation efforts are typically more qualitative than quantitative, which makes it difficult to compare social return across investment opportunities at the project and portfolio level. Physical revitalization based strategies have usually emphasized the number of housing units created or the number of square feet of commercial space developed. People-based strategies have typically emphasized levels of employment, income, and wealth; but have problems isolating changes over time, created through new real estate investment. To date, no rigorous, quantifiable, standard framework exists that can be used to compare the social return of one project versus another or the social performance of one asset class to another.

One possibility for quantifying the social return component, and overcoming existing assessment and measurement gaps, is to develop a ratings system similar to the LEED rating system for measuring the environmental return component encapsulated by green building
practices. This type of scoring system could guide developers and real estate investors (as well as public officials and foundation funders) in how to optimize real estate development so as to achieve social returns. Points could be awarded based on expected performance and then post-audited and adjusted based on actual results achieved. This type of system would also give communities and developers flexibility to customize their approach to achieving the social return based on what makes the most sense in terms of the local context and in terms of integrating the social return objective with the financial and environmental return objectives.

Developing a LEED type rating system for measuring and quantifying the social return component requires industry stakeholder consensus on a list of explicit, attainable social return metrics. This list should include metrics for capturing both the physical and people-based approaches to generating social return. Measuring physical revitalization is a fairly straightforward and established industry practice. Assessing and measuring people-based approaches is a little more elusive and complex. However, there are three existing frameworks for thinking about what specific people-based metrics commercial real estate development could achieve. These frameworks include the:

- The Local Initiative Support Corporation’s (LISC) Social Objective Criteria for Commercial Real Estate (LISC SOC)\(^86\),
- The Bay Area Smart Growth Fund’s Social Equity Criteria (Bay Area SEC)\(^87\), and
- The New Markets Tax Credit program’s “community impact criteria” (NMTC CIC).\(^88\)

Utilizing standard physical revitalization measurement metrics and borrowing social return components from the existing frameworks listed above, what follows is an attempt to lay out some of the general categories and metrics a social return rating system might include.

Social Return Metrics

1. **Geographic targeting**

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\(^86\) See Appendix B for more details on this social return framework.

\(^87\) More detail on these criteria can be found in Chapter 5 under the discussion about the Bay Area Smart Growth Fund’s “Investment Objectives”.

\(^88\) For a list of these criteria see page 72 or visit the “New Markets Tax Credit program” at the CDFI Fund website, www.cdfifund.gov.
As discussed in Chapter 3, alternative development seeks to direct development to specific geographic areas where it will minimize negative, or create positive, social and environmental impacts. Thus, a geographic targeting category would explicitly distinguish and rank (through an allocation of points) optimal investment locations from a social return perspective. The basic premise is that directing development to specific locations will directly or indirectly create localized benefits.

Both the Bay Area SEC and the NMTC CIC seek to direct real estate investment dollars towards specific geographic areas. The NMTC CIC seeks to direct NMTC tax-credit equity to census tracts with median incomes below 80% of area median income\(^{89}\) or to census tracts with poverty rates greater than 20%. In addition to these threshold criteria, NMTC CIC also seeks to direct investment to:

- Census tracts with poverty greater than 30 percent,
- Census tracts with median incomes of less than 60 percent of area median income,
- Census tracts with unemployment rates at least 1.5 times the national average,
- Federally designated Empowerment Zones, Enterprise Communities, or Renewal Communities,
- Federal Small Business Administration designated HUB Zones,
- Brownfield redevelopment areas,
- Areas encompassed by a HOPE VI redevelopment plan,
- Federally designated Native American or Alaskan Native areas, Hawaiian Homelands, or redevelopment areas by the appropriate Tribal or other authority,
- Areas designated as distressed by the Appalachian Regional Commission or Delta Regional Authority
- Colonias areas as designated by the U.S. Department of Housing and Urban Development,
- Federally designated medically underserved areas,
- CDFI Hot Zones, and
- State or local tax-increment financing districts, enterprise zone programs, or other similar state/local programs targeted towards particularly distressed communities.

The Bay Area SEC seeks to direct investment to census tracts with AMI of 80% or less of the county’s AMI based on either the 1990 or 2000 census, brownfield sites, or closed military bases. In addition to the geographic areas identified above, a geographic targeting category could also include other geographically defined areas, such as historic districts or transit-oriented development zones, or distance metrics. Distance metrics could include threshold distances from the development site to public transportation or employment centers, as an example.

\(^{89}\) As measured by the metropolitan area in which the census tract is located, or as measured by the statewide area median income, whichever is greater.
To measure geographic area geographic targeting metrics, each geographic area criteria would be assigned a point value and a project would accumulate points for each criterion met. For example, if a project were located in both a census tract with a poverty rate greater than 30% and a CDFI Hot Zone, the project would receive 2 of the possible points available within the geographic targeting category.

2. Real Estate Products

Certain types of real estate assets, such as affordable housing; historic preservation; and civic, cultural, arts, education, or community buildings, are generally considered to provide social value to their communities.

Possible measures for real estate products include:

- Provides affordable housing (yes/no), with additional points awarded based on the total value of the affordable units compared to the rest of the project and/or the rent level as a percentage of area median income served.
- Historic preservation (yes/no).
- Civic, cultural, arts, education, or community-oriented building (yes/no).

3. Tenancy

Tenancy is concerned with whether or not leasable space is provided to specific types of tenants on a priority basis or at below-market lease rates. The specific types of tenants targeted include:

- Local businesses and/or low-income or women- or minority-owned businesses, or
- Tenants that provide goods and services needed by the community, such as healthy food, banks, healthcare, childcare, educational services, counseling, access to technology, other social services, etc.

Healthy local businesses and supportive services are a basic component of strong, sustainable communities. They generate job opportunities for residents, and that keeps money circulating within the neighborhood rather than draining outward. In urban communities of color, businesses owned by people of color (known to most government programs as “minority-owned”
businesses) are particularly important. Research shows that minority businesses hire much greater percentages of minority employees than majority-owned firms do.\textsuperscript{90}

The NMTC CIC seeks to support these objectives by suggested that NMTC financing should:

- Finance or assist businesses owned by residents of, or otherwise committed to remain in, low-income communities;\textsuperscript{91}
- Finance or assist minority- or women-owned businesses, or businesses owned by low-income persons;
- Finance or assist businesses (including non-profit organizations) or real estate projects that provide childcare, health care, educational or other benefits to low-income persons or residents of low-income communities; and
- Provide goods and services to low-income persons or residents of low-income communities.

The LISC SOC has three criteria that address the tenancy objective – “Community Services”, “Small Business Development”, and “Nonprofit Office Space”. The “Community Services” criterion measures the percentage of the project tenants that were previously unavailable in the community according to a community needs assessment survey conducted within the last three years. The goal is that a majority of the tenants will provide at least one service identified as lacking in the community by the survey. The “Small Business Development” criterion measures the “percentage of tenants that are disadvantaged businesses which would not otherwise be able to lease comparable space”. The goal of this criterion is that at least fifty percent of tenant businesses will be owned and operated by minority first-time entrepreneurs. The “Nonprofit Office Space” criterion measures the “percent by which rents for nonprofit (arts, service, etc.) tenants are below market rents for the area” based on an annual rent study. The goal of this criterion is that space will be leased to nonprofits at rates at least 20% below the prevailing rent for comparable space in the area.

\textsuperscript{91} Low income communities are defined for purposes of the NMTC program as census tracts where the area median income is below 80% of area median income for the metropolitan area or the state, whichever is lower. Or census tracts in which the poverty rate is greater than 20%.
The Tenderloin Neighborhood Development Corporation, a non-profit development corporation working to improve the Tenderloin neighborhood in downtown San Francisco, provides one example of this objective in action. In Figure 4-4 is text taken from a program statement guiding how the organization will approach leasing of new space in one of its developments.

Figure 4-4. Description of the Tenderloin Neighborhood Development Corporation's Priority Leasing Program.

"TNDC will prioritize commercial storefront rental to nonprofit business enterprises which operate with the goal of providing employment training and experience to neighborhood residents. All potential commercial tenants will be asked to describe the number of job positions that will be employed in their enterprise and to develop an appropriate "first source" hiring agreement as a condition of their lease. Specific rental concessions/incentives may be considered to obtain commercial tenants who can help TNDC achieve this goal. However, tenant job placement or lack thereof will not be a sole determinant in leasing arrangements."  

Source: Tenderloin Neighborhood Development Corporation

Possible measures for tenancy include:

1. Percent of building square feet leased to different types of targeted tenants, with the number of points increasing as the percent increases.

2. Higher points for different types of targeted tenants.

4. Jobs

The goal of the jobs objective is to ensure that target population groups (likely including community residents, low-income persons, minorities, women, formerly unemployed or underemployed persons, etc) have access to the new construction and permanent jobs created or retained by the project. This is typically manifested through a negotiated agreement as to hiring goals. This ensures that economically isolated communities benefit from economic development and reinvestment happening in their community, and promotes balance within a region’s employment opportunities. 92

Possible measures include:

- Percentage of total jobs created or retained that go to target populations.
- Points for achieving progressively higher ratios of jobs for target populations versus jobs for non-target populations.

Example target populations include:
- Low-income individuals,
- Disabled persons,
- Minorities,
- The working elderly,
- Youth,
- Formerly homeless individuals,
- Single-mothers,
- Former inmates,
- Other.

5. Resident Ownership Mechanisms (ROM)

The goal of the ROM objective is to increase opportunities for community residents and/or community-based institutions to become owners in the real estate development process – to be “stockholders” instead of just “stakeholders” - by explicitly providing ownership/profit-sharing opportunities for community residents and/or community-based institutions. According to a 2001 PolicyLink report entitled “Sharing the Wealth: Resident Ownership Mechanisms,” one strategy is to raise equity for a development project by selling shares to area residents or community-based institutions.⁹³ This not only gives these groups an ownership stake and some control over the development but also provides them with a potential source of income and wealth. Another strategy is to prioritize investment in developments sponsored by non-profit, community-based developers who will use development fees and excess operating cash flow to finance mission-driven programs that will fulfill other social return objectives. A third, less optimal, strategy is to award points to projects that dedicate a percentage of cash flow to specific community-based organizations or to fund specific community programs.

Possible measures for *resident ownership mechanisms* include:

- Equity shares in the development have been sold to community-based residents or community-based institutions (yes/no).
- Project developed by a non-profit, community-based developer, in whole or in part (yes/no).
- Project has dedicated income stream to community-based organization or programs that benefit community residents (yes/no).

**CONCLUSION**

This chapter started off by developing the rationale for real estate private equity funds guided by a real estate social investment framework as one potential vehicle for overcoming the financing barriers discussed in Chapter 3 and delivering capital to alternative development projects that explicitly or implicitly create social and environmental returns in addition to delivering risk-adjusted, market rate financial returns to investors. The chapter also provided additional context by exploring the characteristics of real estate private equity funds. A large portion of this chapter was focused on a discussion of the real estate social investment framework.

The real estate social investment framework seeks to expand the conventional investment framework that focuses only on the financial return to include a triple bottom line framework that considers financial return as well as social and environmental return. Like the conventional real estate investing framework, the real estate social investment framework also prioritizes achieving risk-adjusted, market rate financial returns for its investors. Without prioritizing this objective, the real estate social investment framework cannot successfully achieve the goal of expanding access to capital for alternative development projects by linking the mainstream capital markets with alternative development projects that produce implicit or explicit social and environmental objectives. However, there are two key differences between the conventional real estate investment framework and the real estate social investment framework. This first key difference, is that the real estate social investment framework seeks to achieve financial returns while simultaneously achieving social and environmental return; thereby, internalizing the negative externalities that can be caused by real estate development and optimizing the
development process so that social and environmental returns are key components in the financial return optimization equation. The second key difference is that the social investment framework does not seek to maximize financial return; it seeks to maximize the sum of financial, social, and environmental return. In other words, under the real estate social investment framework, excess potential or realized financial return can be redirected towards the creation of social and environmental return. This contrasts with the conventional real estate investment framework that seeks to maximize the creation of financial wealth.

In order for the practice of real estate social investing to gain currency in the investment community it is necessary and important to understand how to measure, from a real estate perspective, the financial, social, and environmental components that make up a real estate social investment framework. In addition, these measures need to be useful and applicable for evaluating investment decisions both at the project, or individual property, level and the portfolio, or asset class, level. This section laid out a framework for measuring and assessing whether an investment of capital meets the real estate social investment objectives of financial, environmental, and social return. As discussed earlier in this section, the IRR measure is the universal standard for measuring expected and realized financial return performance at both the project and portfolio level of real estate investment. Unfortunately, to date, no universally accepted, standard measures exist to compare the potential or actual environment and social returns generated from one real estate project or one real estate investment vehicle to another. However, as discussed, the U.S. Green Building Council’s LEED point-based rating system could be utilized to measure the environmental return. While it does not capture all of the components involved with achieving environmental return, its institutional support and broad appeal make it a useful proxy until a better metric can be developed. The social return component of the real estate social investment framework is perhaps the most difficult to achieve and quantifiably measure. One possible way to measure the social return component would be to develop a point-based rating system similar to LEED. In order to develop such a rating system, industry consensus needs to be built around a set of specific and measurable social return components that can be reasonable achieved, directly or indirectly, through real estate development. The social return section of this chapter attempted to start the dialogue around this issue by laying out some possible social return categories and metrics for determining expected and realized results. While it would be optimal, in terms of a real estate social investment
framework, to be able to quantify financial, social, and environmental returns together - so as to arrive at one return number - that is not possible yet. Thus, we are left with a somewhat clumsier assessment and measurement tool but one that is still useful in optimizing decision-making so as to simultaneously achieve financial return as well as social and environmental return. The issue of whether or not it is possible to achieve the ideal of the real estate social investment framework will be explored in the next chapter as part of a broader look at the experience of existing double bottom line real estate private equity funds. As defined by the author, DBL funds are real estate private equity funds that seek to invest institutional, financial return driven capital in alternative development projects that either implicitly or explicitly create measurable positive social and/or environmental returns.
CHAPTER 5: DOUBLE BOTTOM LINE REAL ESTATE PRIVATE EQUITY FUNDS – A SURVEY OF EXISTING PRACTICE

In the previous chapter, I argued that real estate private equity funds guided by a social investment framework (i.e. – double or triple bottom line funds), could be one capital delivery vehicle to help alternative development projects overcome the financing barrier discussed in Chapter 3. The previous chapter provided some background information on the characteristics of real estate private equity funds as investment vehicles. The chapter also outlined a social investment framework for real estate investing, providing some suggestions on how to quantify and measure the financial, social, and environmental return components. This chapter investigates the current state of practice in the nascent field of double bottom line real estate private equity funds (DBL funds). As defined by the author, DBL funds are real estate private equity funds that seek to invest institutional, financial return driven capital in alternative development projects that either implicitly or explicitly create measurable positive social and/or environmental returns.

An exhaustive Internet search and literature review - on such topics as “financing smart growth”, “socially responsible real estate investment”, and “double/triple bottom line real estate investment”, as well as many variations of these queries – turned up three distinct models of privately managed real estate investment funds seeking to achieve double (or triple) bottom line investment objectives:

1. **Fund Manager Model** – These are separate account and commingled funds sponsored and managed by established professional real estate investment managers. These funds tend to be well capitalized with greater than $100M in equity capital. Many of these funds operate primarily in California and are supported in whole or in part by substantial investments from CalPERS[^94], through its California Urban Real Estate Initiative (CUREI). However, there are at least two other commingled funds,

[^94]: CalPERS is the California Public Employees' Retirement System. CalPERS provides retirement and health benefits to more than 1.4 million public employees, retirees, and their families and more than 2,500 employers. CalPERS has an investment portfolio market value of over $171 billion. For more information, visit their website at [www.calpers.ca.gov](http://www.calpers.ca.gov).
UrbanAmerica LP and American Ventures Urban Initiatives Fund that operate without investment capital from CalPERS.

2. **Contract Model** – These are commingled funds designed and sponsored by a community-based, mission-oriented, non-profit organization and then contracted out to a for-profit investment manager for fund management services. These funds are typically focused on serving a specific local geography – either a city, county, or metropolitan region. As compared to funds in the fund manager model, funds operating under the contract model tend to be more explicit about their goals to promote alternative development projects that generate double bottom line returns. Currently there are approximately six funds operating under this model although several others are in the planning stages. These funds range in size from $29 million to $150 million.

3. **Ownership Model** – These are commingled tax-credit funds designed and managed by national, state, or local non-profit, mission-driven organizations. While for-profit fund managers also exist in this space, the Ownership model refers specifically to non-profit tax-credit fund sponsors. These funds range in size from less than ten million to hundreds of millions of dollars in investment capital. These funds are similar to funds operating under the Fund Manager model except that they are managed by mission-driven, not-for-profit organizations and they invest in properties by syndicating federal and state tax-credits.

The three distinct fund models, briefly described above, generally vary in terms of their organizational structure, geographic scale, investors, and capitalization. As such each fund model approaches the notion of real estate social investing from a slightly different perspective. A closer look at the existing practice will illuminate these differences.

This chapter takes a closer look at each of the three fund models, and some of the existing funds within each model, to gain a better understanding of the double bottom line investment objectives that these funds are seeking to achieve, whether or not the funds are finding success in meeting their investment objectives, and what the possibilities and limitations are with each fund model in terms of achieving the ideal of a real estate social investment framework, as articulated in Chapter 4. The insights gained from this investigation will help inform the recommendations presented in the next chapter for (1) design and management improvements that could further the
success of such funds in terms of achieving the social and environmental return components of the real estate social investment framework while still meeting financial return expectations, and (2) supporting the development of a real estate social investment industry to support the development and maturation of real estate social investment vehicles.

Chapter Organization

Each model is presented in the following format: overview of the model, background on existing funds utilizing the model, followed by a discussion of capitalization, investment objectives, and investment practices. Finally each section concludes with a discussion of findings summarizing the key design, operating, and management components of the fund model and the funds operating within it. The chapter concludes with an overall discussion of what the experience of the funds profiled suggests about the investment framework, design, and operation of double bottom line private equity funds.

Methodology

Details for the case studies presented in this chapter were collected from interviews with select fund representatives95, where possible. Not all funds profiled were reached for interviews. Conference notes; reports; newspaper, magazine, and journal articles; company websites; and marketing materials, were used to supplement the interviews.

CASE STUDIES

Fund Manager Model

Under the Fund Manager model, experienced, for-profit, professional real estate investment fund managers have developed funds, either through self-initiation (commingled funds) or in response to pension fund solicitation (in the case of separate account funds). These funds focus on providing capital to real estate deals in urban communities and are in business, first and foremost, to achieve financial returns for investors and profits for the investment fund.

95 See bibliography for a full list of interview participants.
manager. There are at least two motivators that are driving the creation of these funds. Several fund managers, such as Canyon Johnson Realty, UrbanAmerica LP, and American Ventures, have developed urban-focused funds to diversify their investment portfolios and take advantage of unrealized opportunities (specifically in the retail sector) in urban markets. Other funds have been created to respond to capital that has been made available by public pensions funds under pressure to address public policy goals in support of alternative development. The prime example is CalPERS and its California Urban Real Estate Initiatives (CUREI) program.

**Overview of the Funds**

Unfortunately, very little secondary research exists that looks at the investment practices of real estate private equity funds within the Fund Manager model. Thus, it is difficult to get a sense for the depth of the market of Fund Manager funds that explicitly or implicitly promote the real estate social investment framework. What follows is a brief overview of the funds that were highlighted in the relevant literature.

**CalPERS CUREI**

Initiated by CalPERS in 1996, the California Urban Real Estate Initiative (CUREI) is an investment initiative that provides investment capital to a number of urban-focused funds managed by experienced professional pension fund investment managers. Based on web research, CalPERS appears to be the only pension fund in the country that has developed an explicit policy initiative to target some of its “alternative investment” capital towards real estate investments in urban locations (in this case, primarily urban locations in California). Since its inception, CUREI has supported over a billion dollars of real estate investment in urban areas. Some of the CalPERS CUREI investments include:

- A $125 million venture with California Urban Real Estate Fund LP, Hollywood, which invests in commercial and residential projects;
- A $100 million venture with Bridge Housing Corp. called Bridge Urban Infill Land Development (BUILD) that develops residential and mixed-use infill projects throughout California with a focus on the re-use and revitalization of underutilized properties. BUILD focuses on new large-scale projects in urban infill locations that ideally occur in tandem with local public and private infrastructure and development.

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96 “Alternative Investments”, for pension fund portfolios, generally refers to any investment other than stocks or bonds, including real estate, commodities, private equity, venture capital investments, and distressed securities.

97 As of 2001, more recent numbers were not available.
activities in order to ensure larger neighborhood turnaround rather than isolated development projects.

- A $100 million venture with RREEF Funds of San Francisco, which will back infill projects such as new construction and renovation of existing structures in older urban areas;
- A $100 million partnership with Commonwealth Pacific LLC, Los Angeles, which invests in southern California;
- A $125 million new program with Kennedy Associates Real Estate Council Inc., Seattle, which invests in housing.
- The $750 million California Urban Investment Partners (CUIP) is a joint venture private equity fund between CalPERS and MacFarlane Partners, a leading real estate investment firm that has previously invested over $3 billion primarily in inner city mixed-use real estate development as a core investment manager.
- A $60 million investment with Legacy Partners, focusing on new multifamily housing in California with a minimum 20% affordable housing component.
- A $125 million+ investment in CIM Urban Real Estate Fund, LP, managed by the CIM Group. The Fund invests in all product types including mixed-use, apartments, condos, office, retail, entertainment and parking in urban and "main street" districts throughout the United States.

Urban America LP

Launched in 1998, UrbanAmerica is a $120 million fund focused on acquiring and developing commercial real estate in low-income communities in major inner city markets. UrbanAmerica’s $400+ million portfolio includes more than 28 office and retail properties in New York, New Jersey, Maryland, Pennsylvania, Virginia, Nevada, and Florida.

American Ventures Urban Initiatives Fund (UIF)

UIF is a new initiative of American Ventures, a vertically integrated (investment management, asset management, research, leasing and finance) group of companies founded in 1979. The firm’s investment management division, American Ventures Realty Investors, is the largest real estate investment manager in the state of Florida and has been managing commingled funds and separate accounts for institutional real estate investors since 1992. UIF is a national family of region-specific real estate mezzanine debt funds that provide market rate capital to qualified developers of urban core development projects. This fund is designed to appeal to regulated financial institutions as well as tax-exempt institutional investors such as local foundations. The first Urban Initiatives Fund was launched in New Mexico in the fall of 2003,
and a second Fund was opened in South Florida in the spring of 2004. American Ventures is preparing to open additional Urban Initiatives Funds in other markets across the country.

**Canyon-Johnson Urban Fund**

The $300 million Canyon-Johnson Urban Fund is a real estate equity fund managed by Canyon-Johnson Realty Advisors LLC. The Fund focuses primarily on retail projects in emerging inner city real estate markets; and, according to the fund’s website, on fostering economic opportunities for the underserved residents of the urban neighborhoods in which it invests.

**Capitalization (Raising $ / Investor Expectations)**

Funds in this space are typically capitalized by hundreds of millions of dollars in pension fund investments; but also receive investments from other institutional investors such as banks and insurance companies. This contrasts with Ownership and Contract funds, which tend to be primarily capitalized by investments from regulated financial institutions, such as banks. However, UrbanAmerica LP and UIF are both primarily capitalized by banks. According to press articles on UrbanAmerica, the fund exists almost solely because of the federal Community Reinvestment Act (CRA). The law has been an additional incentive, beyond basic returns on investment, for banks to buy equity stakes in UrbanAmerica, which qualify as regulatory credit toward CRA compliance. Of the 18 pension funds, banks, insurance companies, and foundation investors in UrbanAmerica, 8 are banks.

**Investment Objectives**

These funds are driven by the maximization of profits as the primary consideration. All of these funds, to some degree, have other investment purposes as well. Almost all are focused on directing at least a portion of their investment capital into urban locations, thereby potentially

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99 The Community Reinvestment Act was passed by the U.S. Congress in 1977 to end the discriminatory practice of redlining, in which banks would refuse to make loans in certain neighborhoods based only on the socioeconomic mix of that neighborhood. The CRA requires that banks and thrifts, that accept deposits from low-income, minority neighborhoods, also lend to those same communities.
creating some implicit social and environmental value. The UrbanAmerica LP Fund is the only fund with explicit social objectives (consistent with at least one of the social return objectives outlined in the previous chapter) – targeted investments in underserved communities (geographic targeting) and job creation. UrbanAmerica LP seeks to invest in inner-city markets as defined by the federal government’s geocoding system as low- to moderate-income areas. According to UrbanAmerica, these markets may include federal empowerment zones, enterprise communities and state economic development zones. The Canyon-Johnson Urban Fund’s website suggests that the fund “focuses…on fostering economic opportunities for the underserved residents of the urban neighborhoods in which it invests”; yet, does not provide additional information explaining what, or how exactly, they achieve, or try to achieve, this in practice.

The principal goal of the CUREI program is to achieve the “highest total rate of return for the System” by diversifying CalPERS real estate portfolio while also meeting the state’s need for housing and development in urban localities. CUREI investment policies suggest that fund managers should, among other things, try to find projects and development sites characterized by the following key elements:

1. Sufficient size to create a mix of uses and critical mass;
2. Single ownership and control;
3. Compatible surrounding land uses and densities;
4. Environmentally clean or manageable remediation; and
5. Access to public and private transportation routes, housing, retail services, and amenities.

As long as the risk-adjusted rate of return is consistent, the CUREI program guides investments to the following real estate asset types: urban infill development, community redevelopment, single-family housing, multi-family units, low-income housing, rehabilitation of core industrial and office properties, new development of office and industrial properties, and mixed-use development in urban settings. Through CUREI, CalPERS is willing to explicitly invest in projects designed to provide environmental returns (see #4 & #5 above) as well as social returns by investing in projects that provide direct benefits to businesses, employees, or residents of low-to moderate-income areas, or underserved markets. All project investments made through CUREI must meet strict underwriting criteria designed to ensure that sufficient risk-adjusted rates of return are achieved. Some CUREI investment funds seek to offset the risks associated

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with investments in alternative development projects by leveraging public resources, typically in the form of direct subsidies from municipal government authorities.

**Investment Practice**

Due to the fact that none of the funds operating under this investment model strive to achieve explicit environmental objectives and only one fund, UrbanAmerica LP, seeks to achieve explicit social objectives, it is not especially surprising that there is little in the way of investment practice that sheds light on the issues explored in this thesis. However, it is worth noting that these funds are directing large amounts of institutional capital towards real estate located in urban areas. UrbanAmerica LP is the only fund with explicit social objectives - targeted investments in underserved communities and job creation. According to its website, UrbanAmerica LP has created over 1,500 jobs for residents of its target low to moderate-income communities through ground-up development, lease up of vacancy, tenant expansions, and greater services to properties; although, it is unclear exactly how UrbanAmerica is measuring job creation, what types of jobs are being created, or who is receiving the jobs created.

Where these funds are achieving social and/or environmental benefits, these benefits seem to be derivative of the project location and site rather than explicit development goals pursued via design, management, leasing, or related development activities. In some cases, these funds are achieving social and/or environmental benefits because they acquired the land through a below market-rate, public land disposition or because they are receiving public financial support in the form of direct or indirect project subsidies. Several of the funds, such as Bridge Urban Infill Land Development and the CIM Urban Real Estate Fund, specifically seek out public/private partnership investment structures. Public investment partners can provide the resources that mitigate development and investment risks as well as ensure the provision of auxiliary social and environmental benefits.

**Other Findings**

Funds operating under the Fund Manager model are indirectly helping to promote alternative development by directing large amounts of institutional capital, which otherwise might flow to investments that promote conventional development patterns, to urban infill, mixed-use, and transit-oriented development. While many of these funds make cursory claims
that social benefits accrue from their investment activities, only UrbanAmerica has developed explicit social return objectives. However, several of the CUREI supported funds (BUILD and CIM) focus almost exclusively with public and non-profit partners who can provide resources to mitigate investment risks and produce auxiliary social and environmental benefits.

The strength of this model is that the fund manager already has a proven track record and relationships with potential investors. The generally larger size of these funds, and the experience and expertise of the investment managers, allows these funds to take on larger/riskier projects than the other fund model types. This larger scale provides greater opportunities to affect positive change.

In general, these funds are fairly conservative in their approach and tend not to focus on explicit social and environmental return.

**Contract model**

Under the Contract model community-based, mission-oriented, non-profit organizations sponsor and develop the concept for the fund and then contract with a for-profit real estate investment fund manager for fund management services. These funds are typically focused on serving a specific local geography – either a city, county, or metropolitan region. As compared to funds in the fund manager model, funds operating under the contract model tend to be more explicit about their goals to promote alternative development projects that generate double bottom line returns.

These funds represent an innovation to the traditional, Fund Manager, real estate private equity model, in that they are initiated and sponsored by non-profit community-based organizations. The non-profit fund sponsor develops the concept for the for-profit fund and tests the feasibility of the concept with potential investors and developers. Then, through a competitive Request for Proposals (RFP) process in which lead investors and community stakeholders are involved, the sponsor selects a professional fund manager to raise investment capital and manage the investment activity of the Fund. Once selected, the investment fund manager, non-profit sponsor, and lead investor(s) structure the funds so as to:

- Embed the double-bottom line goals of the funds in the operating agreements,
- Protect the final investment decisions of the fund manager behind a firewall\textsuperscript{101}, and,

\textsuperscript{101} The term “firewall” in this context refers to the fact that fund managers are protected from outside influence and have the full authority to make investment decisions.
Support the non-profit sponsor with a small portion of the management fee and carried interest in the investment performance of the fund that the sponsor can use to create, or enhance existing, programs that produce measurable job and wealth creation. The non-profit sponsor maintains an active role in overseeing the Fund as well as in providing technical assistance and development services to support the Fund.

The basic premise underlying Contract funds is that DBL returns are possible if professional fund managers with a proven track record of successful management of real estate equity and development are paired with community stakeholders who are capable of delivering measurable social and environmental returns. Thus, these funds are designed to create a deal flow large enough to attract high-quality investment fund managers with outstanding track records that in turn can attract large regional and national institutional investors. Community fund sponsors and their community constituents are responsible for determining the second bottom line goals and objectives and then developing the infrastructure and systems to ensure that these goals and objectives can be incorporated into the development process without jeopardizing the financial feasibility of the development projects or the fund’s targeted financial return. The delivery of the second bottom line through this infrastructure is designed to contribute to the first bottom line by reducing fear, creating community and government support, and lowering opposition; translating into faster permitting, lower soft costs, and faster space absorption times. These community stakeholders, as special limited partners, are then rewarded for their success with a small portion (usually 1-3%) of the management fee and carried interest in the fund.

There are currently six funds operating in this space (with more funds in the planning stages). The six include:

- The $66 million, **Bay Area Smart Growth Fund**, sponsored by the Bay Area Council and managed by Pacific Coast Capital Partners;
- The $85 million, **Genesis L.A. Real Estate Fund I**, sponsored by the Genesis L.A. Economic Growth Corporation and managed by Shamrock Capital Advisors;
- The $150 million, **Genesis L.A. Real Estate II**, sponsored by the Genesis L.A. Economic Growth Corporation and managed by Shamrock Capital Advisors;

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102 However those returns are defined by the fund sponsor.
- The $100 million, **Genesis L.A. Workforce Housing Fund**, sponsored by the
  Genesis L.A. Economic Growth Corporation and managed by Phoenix Realty Group;
- The $29 million, **Sacramento Valley Smart Growth Fund**, sponsored by Nehemiah
  Corporation and managed by Pacific Coast Capital Partners; and,
- The $60 million, **San Diego Smart Growth Fund**, sponsored by the San Diego
  Community Collaborative and managed by Phoenix Realty Group.

Of these six funds, both the San Diego Smart Growth Fund and the Genesis L.A. Real Estate
Fund II are still in the fundraising stage and have not closed any transactions. Of the remaining
four funds, interviews were conducted with representatives of three of the funds - the Genesis
L.A. Real Estate Fund I (L.A. Fund), the Bay Area Smart Growth Fund (BASGF), and the
Sacramento Valley Smart Growth Fund (SVSGF).

**Overview of the Funds**

**Genesis L.A. Real Estate Fund I (L.A. Fund)**

The L.A. Fund is an $85 million real estate fund, sponsored by the Genesis L.A. Economic
Growth Corporation (Growth Corporation) and managed by Shamrock Capital Advisors\(^\text{103}\),
that provides gap financing in the form of equity, preferred equity, and/or mezzanine debt to retail,
industrial commercial and select mixed-use development projects in Los Angeles County that:

- Qualify for Community Reinvestment Act (CRA) credits;
- Are located in and benefit low-to-moderate income neighborhoods; and
- Provide appropriate risk-adjusted financial returns.

The L.A. Fund is one of three independent, targeted, private sector funding vehicles that make up
the $142 million Genesis L.A. Family of Funds.\(^\text{104}\)

The Growth Corporation and the L.A. Fund were launched in 1998 by the former Mayor
of the City of Los Angeles, Richard Riordan, and spearheaded by Deputy City Manager Rocky
Delgado and Assistant Deputy City Mayor Debbie La Frankie. The Growth Corporation and

\(^\text{103}\) Shamrock Capital Advisors is an affiliate of Shamrock Holdings, Inc., based in Burbank, California. Shamrock
Holdings, Inc. began as an advisor to the Roy E. Disney family in 1978 and is a diversified organization with
interests in real estate and private equity. According to its marketing material, Shamrock is one of the leading
merchant banks in the United States and has participated in a broad range of partnerships as investment manager and
general manager. Shamrock Capital Advisors manages more than a billion dollars for the Disney Family.

\(^\text{104}\) The other two vehicles are the Genesis L.A. Workforce Housing Fund and the Fulcrum Capital Partners Growth
L.A. Fund were developed in response to previous failed efforts – most notably the Rebuild LA and Los Angeles Community Development Bank initiatives – to deliver capital to underserved inner-city neighborhoods that had experienced civil unrest during the Rodney King riots and were reeling from the effects of military base downsizing and the attendant loss of good-paying jobs. Sponsors and supporters of the Genesis initiative, in looking for new strategies to combat these problems, started with two basic questions:

1. **What is the main type of capital gap that is hindering economic development in inner-city neighborhoods?**

2. **What is the best way to deliver that capital?**

Initial feasibility studies indicated that developers who wanted to develop or rehabilitate commercial and industrial real estate in inner city neighborhoods experienced a capital gap – they couldn’t put up the 20-30% of upfront equity that was needed to get the debt financing for their projects. Thus, the sponsors and supporters of the Genesis initiative decided to start a real estate fund, the L.A. Fund, to address the challenges of job creation and land development in the low- and moderate-income communities of Los Angeles.

The Growth Corporation, the non-profit fund sponsor, was created to support the L.A. Fund as well as the other two funds in the Genesis L.A. Family of Funds, the Genesis Workforce Housing Fund and the Fulcrum Growth Capital Fund. The Growth Corporation supports the fund by helping to generate deal flow and by working with developers in the targeted communities to help them see their small or medium size development projects through to fruition.

**Sacramento Valley Smart Growth Fund (SVSGF)**

The SVSGF was initiated in 2000 by the Nehemiah Community Reinvestment Fund™, a subsidiary of the Nehemiah Corporation of America. The Nehemiah Corporation of America is a national non-profit community development corporation, with corporate headquarters located in Sacramento, CA, that specializes in homeownership, affordable housing and community development. Nehemiah developed the SVSGF to “combat the unintended effects of growth and to improve the economic competitiveness and overall quality of life in targeted communities within the Sacramento Valley.” Nehemiah was an initial investor in Genesis L.A. Real Estate Fund I, and the success of this fund spurred their interest in starting the Sacramento fund. The
Fund was formally started in 2002 when Nehemiah selected Pacific Coast Capital Ventures (PCCV), the fund manager for the Bay Area Smart Growth Fund (BASGF), to manage the fund. The Fund was capitalized at $29.2 million with investments from nine capital sources, including Nehemiah Community Reinvestment Fund ($3 million), Wells Fargo Community Development Inc. ($5 million), Washington Mutual Community Development Inc. ($5 million), Citicorp USA Inc. ($5 million), as well as several other investors who invested smaller amounts.

Bay Area Smart Growth Fund (BASGF)

One of three private equity funds that make up the Bay Area Family of Funds, the BASGF, is a $66 million real estate private equity fund sponsored by the Bay Area Council\textsuperscript{105}, a regional public policy organization, and managed by Pacific Coast Capital Partners (PCCP). The Bay Area Family of Funds and the BASGF evolved out of a 4 year process in which Bay Area business leaders, community activists, environmentalists, and government officials worked together to identify and develop solutions to mounting economic, environmental, and community problems and needs. What emerged from this effort was the recognition among the region’s leaders that persistent poverty and inequities in the region threatened future regional prosperity. A key study sponsored by the Bay Area Council declared, “The Bay Area must protect its position by encouraging the adoption of policies and actions that over time will sustain the Bay Area as an attractive place in which to live and do business.”\textsuperscript{106} The BASGF invests in mixed-income housing and mixed-use commercial and industrial development. The Fund, which had its final closing in December 2002, is well over 50% invested in community revitalization projects that are expected to produce 15-18% net financial returns to fund investors (See Appendix C for a chart highlighting BASGF investments.)

Capitalization (Raising $ / Investor Expectations)

The primary investors in these funds, to date, have been banks. They are motivated by: 1) the expected financial returns on their investments, 2) the Community Reinvestment Act (CRA) credits they will receive, and 3) the positive public relations and goodwill generated by investing in these projects. Of the 13 investors in the L.A. Fund, nine are banks. Shamrock

\textsuperscript{105} For more information about the Bay Area Council go to www.bayareacouncil.org.

\textsuperscript{106} Bay Area Economic Forum. The Bay Area: Leading the Transition to a Knowledge-Based Economy: A Profile of Comparative Economic Performance. 1996.
Holdings of California (an affiliate of the investment manager), Stewart Title, the California Community Foundation, and the Nehemiah Corporation are the other four investors. Both the BASGF and the SVSGF are similarly capitalized. Approximately 70% of the $66.5 million invested in BASGF comes from banks and insurance companies – both of which are motivated by government regulatory considerations. California insurance companies are motivated to invest in these funds to avoid imposition of CRA-like regulation by the state legislature.\footnote{Plastrik, Pete. The Bay Area Family of Funds: The Art of “Double Bottom Line” Investing in Regional Sustainable Development. January 12, 2003, p. 29.} Bank investors make up over 50% of the invested capital in the SVSGF.

**Investment Objectives**

All three of the funds profiled above strive to achieve not only risk-adjusted, market-rate IRR returns in the low to mid-teens but also explicit social and/or environmental return objectives. However, each fund strives to achieve different social and/or environmental return objectives. Below is a description of the social and/or environmental return objectives of each of the three funds:

**Sacramento Valley Smart Growth Fund (SVSGF)**

The goal of the SVSGF is to combat the unintended negative effects of the Sacramento region’s tremendous growth and to improve the economic competitiveness and overall quality of life in targeted communities by making millions of dollars of real estate investment in traditionally underserved communities. According to Peggy Jones, director of Nehemiah’s Community Reinvestment Fund, the SVSGF only adheres to one measurable investment objective: investments are located in or adjacent to low- and moderate-income\footnote{The Federal government defines low- and moderate-income neighborhoods as census tracts in which the average median income is 80% or less of the metropolitan statistical area (MSA).} neighborhoods within the counties of region, El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba, as well as in the cities of Lodi, Stockton, and Modesto.\footnote{Interview with Peggy Jones, Nehemiah Community Reinvestment Fund, 1/8/04.}

**Genesis L.A. Real Estate Fund I (L.A. Fund)**

As mentioned earlier, the L.A. Fund provides gap financing in the form of equity, preferred equity, and/or mezzanine financing to retail, industrial, commercial and selected

\footnote{Plastrik, Pete. The Bay Area Family of Funds: The Art of “Double Bottom Line” Investing in Regional Sustainable Development. January 12, 2003, p. 29.}

\footnote{The Federal government defines low- and moderate-income neighborhoods as census tracts in which the average median income is 80% or less of the metropolitan statistical area (MSA).}

\footnote{Interview with Peggy Jones, Nehemiah Community Reinvestment Fund, 1/8/04.}
mixed-use development projects in Los Angeles County. These projects must qualify for Community Reinvestment Act (CRA) credits, be located in, or adjacent to low- and moderate-income neighborhoods, provide appropriate risk-adjusted financial returns, and generate jobs for local residents.

Bay Area Smart Growth Fund (BASGF)

The BASGF has the most ambitious investment criteria of the three Contract funds profiled in this thesis, which is primarily due to the depth of research and community involvement that preceded the creation of the fund. The BASGF strives to achieve a comprehensive set of "social equity" objectives to revitalize the 46 most distressed communities in the six-county Bay Area through a combination of place-based strategies focused on upgrading the physical environment and people-based strategies such as job and wealth creation for community residents. Five specific "social equity criteria" were incorporated into the legal framework of the fund. These five criteria are described in the chart below:

\[\text{Chart Describing Five Social Equity Criteria} \]

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\[\text{Footnote 110: Efforts are currently underway to capitalize the Genesis L.A. Real Estate Fund II, which will expand the geography of the Fund to 9 counties in the Los Angeles region.} \]

\[\text{Footnote 111: Passed into law in 1977, the Community Reinvestment Act, or CRA, requires banks and savings and loans to offer credit throughout their entire market areas and prohibits them from targeting only wealthier neighborhoods with their lending and services. The CRA mandates that each banking institution be evaluated to determine if it has met the credit needs of its entire community. That record is taken into account when the federal government considers an institution's application for deposit facilities, including mergers and acquisitions.} \]
Figure 5-1. Bay Area Smart Growth Fund – Social Equity Criteria.

<table>
<thead>
<tr>
<th>BAY AREA SMART GROWTH FUND - SOCIAL EQUITY CRITERIA</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geographic Targeting</td>
<td>The investment project is located in a census tract with AMI of 80% or less of the county's AMI based on either the 1990 or the 2000 census.</td>
</tr>
<tr>
<td>Composition of the Development Team</td>
<td>The development team is led by a non-profit developer or a for-profit developer or a joint venture of both types of developers, and exhibits community support and incorporates community participation that adds demonstrated financial and social value to the project.</td>
</tr>
<tr>
<td>Community Benefits Plan</td>
<td>The investment project includes an explicit plan to produce measurable benefits for community residents.</td>
</tr>
<tr>
<td>Strategies for Community Involvement</td>
<td>The investment project includes a community input/oversight structure, which is expected to be established through the local entitlement process, or, if the local entitlement process does not include such a structure, through some other means. This process could include a plan for project-specific community outreach and education and may result in letters of endorsement for the project from community residents, neighborhood leaders, and public, private, and non-profit proponents of the project.</td>
</tr>
<tr>
<td>Connection to Existing Local Initiatives</td>
<td>The investment project fits into a larger existing or proposed neighborhood strategic plan, initiative, collaborative planning process or revitalization program, wherever such a plan or program exists. The investment project fits into an overall regional strategy for smart growth, by incorporating mixed income, mixed use development strategies that are conducive to transit and other self-sufficiency services.</td>
</tr>
<tr>
<td>Monitoring and Evaluation Plan</td>
<td>The investment project includes a plan for monitoring, evaluation and mid-course adjustment to ensure that the project is meeting the financial and social objectives of the Smart Growth Fund.</td>
</tr>
</tbody>
</table>

Notes:
* As written in the term sheet of the Bay Area Smart Growth Fund

Source: Bay Area Smart Growth Fund Investments: Preliminary Analysis

The chart below further clarifies the intent of the “Community Benefit Plan” objective described above:

Figure 5-2. Bay Area Smart Growth Fund - Examples” of Community Benefits.

<table>
<thead>
<tr>
<th>BAY AREA SMART GROWTH FUND - EXAMPLES OF COMMUNITY BENEFITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hiring local residents.</td>
</tr>
<tr>
<td>Contracting with locally owned and minority and/or women-owned business enterprises for project design, construction, and ongoing operations.</td>
</tr>
<tr>
<td>Building community equity through opportunities for ownership/profit-sharing for community residents and/or community-based institutions.</td>
</tr>
<tr>
<td>Obtaining funding from the development and/or other sources of public or private funding to build the infrastructure of community-based institutions in the target neighborhood in ways that adds financial and social value to the project.</td>
</tr>
<tr>
<td>Using green design and construction processes, and pollution prevention technologies.</td>
</tr>
<tr>
<td>Increasing transit, health care, and childcare services.</td>
</tr>
<tr>
<td>Expanding access to technology.</td>
</tr>
<tr>
<td>Improving affordable housing and/or job opportunities.</td>
</tr>
</tbody>
</table>

Source: Bay Area Smart Growth Fund Investments: Preliminary Analysis
Investment Practice

In general, these funds have had little difficulty finding projects that meet their investment criteria and committing their investment capital. In its first full year of operation, the SVSGF has committed 77% of its investment capital in five deals with an average investment size of approximately $4.5 million. The L.A. Fund has committed $74.8 million to 11 deals (92% of total capital) and is in the midst of raising funds to capitalize a second fund, Genesis L.A. Real Estate Fund II. As of August 2004, the BASGF had committed about 50% of its $66 million in investment capital to 7 projects. What follows is a description of the investment practices of each of the three funds.

Sacramento Valley Smart Growth Fund (SVSGF)

As of December 2004, the SVSGF was achieving its stated investment objectives by having committed $22.7M of its $29.2M of investment capital to assist in the construction of 488 new homes and apartments and the conversion of 527 apartment units to condominium units in low- to moderate-income neighborhoods in its target counties.112

Genesis L.A. Real Estate Fund I (L.A. Fund)

The L.A. Fund has made investments and commitments in 11 deals throughout Los Angeles with a 12th and final deal pending113 and thus far has exceeded its initial IRR goal of 15-20% returns; for the five projects for which return information was available – realized returns varied from 17% to 100%. In order to assess to what extent the L.A. Fund meets its job creation objective, the L.A. Fund contracts with Segway Corporation, an affiliate of CB Richard Ellis, to undertake job creation estimates. The L.A. Fund also contracts with legal counsel to obtain legal opinions verifying that projects meet CRA investment criteria. When interviewed, Richard Gentilucci could not say how many jobs the Fund had created. The information, however, was later made available on the L.A. Fund’s website. According to the website, the L.A. Fund has created 4,075 jobs (numbers only include data for seven projects). Mr. Gentilucci was unable to provide any information about the quality of the jobs created and socioeconomic data about who

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112 A table listing the deals the SVSGF has closed is presented in Appendix D.
113 A table listing the deals the L.A. Fund has closed is presented in Appendix E.
has received these jobs because, according to Mr. Gentilucci, the L.A. Fund had not collected that information.

**Bay Area Smart Growth Fund (BASGF)**

As of December 2004, the BASGF had committed approximately $34.8 million of its $65 million of investment capital into six projects and was on target to meet its mid-teen financial return objective. The BASGF has done the most of any of the funds profiled in terms of analyzing its investment performance with regards to meeting its social and environmental investment objectives. The BASGF has developed a qualitative “preliminary evaluation” of fund investments that outlines how each investment has met the BASGF’s social equity criteria described above. What follows is a summary of the Fund’s performance in relation to the six BASGF social equity investment criteria described earlier in this chapter:

1. **Geographic Targeting.** All projects are located in one of the Fund’s 46 target neighborhoods.

2. **Composition of the Development Team.** Only one of the six projects identified in the Preliminary Evaluation - the Gateway Retail Center in Marin City - includes the involvement of a Community Development Corporation. This project has been identified by several people involved with the BAGSF fund as the best example of the goal of this objective. The Gateway Retail Center is a community-based shopping center with 182,054 square feet of retail space. BASGF formed a joint venture with Marin City Community Land Corporation (MCCLC), a non-profit land trust, and provided $7.91 million to purchase Gateway Retail Center. BASGF’s investment will assist MCCLC to preserve its ownership interest in the property and provide current cash flow necessary for MCCLC to fund affordable housing, community services, and administration of programs through the Marin City Community Services District. BASGF projects that the Gateway Retail Center will be refinanced in 2008 at which time the MCCLC will become the 100% owner. Despite the success of the Marin City project, it appears the BASGF has not been able to achieve this objective - of directing capital to projects involving non-profit developers - to the extent originally anticipated when the Fund was created. Many

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114 The table in Appendix C summarizes the investment activity of BASGF to date.
of the local CDC’s have expressed frustration that the Fund’s capital is too expensive and thus not beneficial to them.\textsuperscript{115}

3. **Community Benefits Plan.** Each project has achieved this goal to varying degrees. Fund investments will help to create approximately 540 residential units affordable to families earning between 80-120\% of area median income (AMI). However, the AMI in the neighborhoods in which these housing units will be developed is generally well below 80\%. For example, the Fund is helping to finance the development of 200 apartment or condominium units in Vallejo where local residents have average incomes at 39\% of AMI. Thus, without public subsidies, these residents will not be able to afford these new housing units. On another scattered-site housing development that BASGF is financing, there is an attempt to partner with local community-based homeownership assistance centers to ensure that the homes will be sold to first-time homebuyers. Two of the six projects, Ascend Housing and Oakland Airport Business Park, have provided opportunities for minority-owned contractors and local workers to be involved in construction. For other goals such as job creation, green design and construction, and opportunities for small businesses, it appears from my research that relatively little has been accomplished to date.

4. **Strategies for Community Involvement.** All of the projects financed by the BASGF to date have received community support and approval by community groups and government agencies where appropriate. My research reveals that little has been done to solicit and monitor letters of endorsement for individual projects from community residents, neighborhood leaders, and public, private, and non-profit proponents of the project as originally anticipated. Also, some community representatives involved with the BASGF have expressed frustration that deals brought to the attention of PCCP by the community have not, thus far, received capital commitments.\textsuperscript{116}

5. **Connection to Existing Local Initiatives.** Two of the projects are located in, or adjacent to, official, municipal-designated “redevelopment” or “revitalization” areas; the Gateway Retail Center project is directly connected to community-based affordable housing and

\textsuperscript{115} Interview with Trina Villanueva, Coordinator, Community Council, Bay Area Smart Growth Fund, January 12, 2004.
\textsuperscript{116} Interview with Trina Villanueva, Coordinator, Community Council, Bay Area Smart Growth Fund, January 12, 2004.
job training initiatives. While other projects fit within general local and regional strategies, there has been little explicit connection with existing local initiatives. The Ascend project is attempting to link new affordable housing units with first-time homebuyer programs, but as of the time the preliminary evaluation was conducted, this effort had not yet achieved success.

6. **Monitoring and Evaluation Plan.** The Preliminary Evaluation did not identify results for this objective. Thus, I am assuming that none of the projects have explicit social criteria monitoring or evaluation plans in place. While these investment results have not met the high expectations of some community stakeholders who were involved in setting up the fund, one has to keep in mind that these results were achieved without any below-market public investment dollars. Thus, the BAGSF fund is proving that market-rate capital can, to a limited degree, simultaneously achieve financial, social, and environmental returns.

**OTHER FINDINGS & ANALYSIS**

**Explanation of Variation in Investment Objectives**

In terms of investment objectives, significant variation exists from fund to fund. The SVSGF has the least explicit set of social objectives, as it is only concerned with targeting investments to specific geographies; in this case, low- to moderate-income communities. The BASGF, on the other hand, is trying to achieve a significantly more robust set of social and environmental objectives. The social and environmental return objectives that a particular fund strives to achieve appear to be driven by the goals and objectives of the founding sponsor and other stakeholders involved with established the fund. The SVSGF was founded by a national non-profit organization - the Nehemiah Corporation – whose principle mission is to help low and moderate-income families achieve homeownership. The organization has few ties to other community economic development efforts in Sacramento and there appears to be little direct involvement with the fund from community representatives outside of the organization. Thus, it is not surprising that the SVSGF fund has primarily invested in housing projects with a significant portion of for-sale housing units. In contrast, the BASGF was developed over a period of many years with the involvement of a diverse consortium of Bay Area government, business, social and environmental interests. The triple-bottom line investment objectives of the
fund represent this diversity of interests. The L.A. Fund emerged out of a need to spur economic development and job creation in distressed communities in Los Angeles. Thus, the fund is focused on targeting investments to projects located in targeted geographic areas that create new jobs for community residents. Neither the SVSGF nor the L.A. Fund had stakeholders at the table during the fund conceptualization phase that were interested in environmental considerations; and thus neither of these funds focus on trying to achieve environmental return objectives.

Geographic Commitment
Similar to the Ownership model and in contrast to the Fund Manager model, Contract funds are distinguished by a commitment to a particular geographic area. This commitment gives investment managers an incentive to become more deeply involved in the community and to tailor their investment practices to meet community needs. It also ensures that capital will continue to be available even when there is a downturn in the local market; in contrast with Fund Manager funds who could conceivably switch their investment focus to another real estate market.

Fund Structure
The role of non-profit community sponsors in collaborating with for-profit investment managers to deliver the second bottom line, and then to be rewarded for the value they add as special limited partners, is an important new concept that is now being tested. The structure, whereby the non-profit fund sponsor can raise tax-deductible contributions to offset the costs associated with the provision of important value-added services - such as technical assistance, deal packaging, project advocacy, community education, and the like - allows for more value-added services then would likely be provided under a purely for-profit investment framework.

However, the research indicates that the degree to which these technical services are being provided by the fund sponsor and are resulting in measurable social and environmental benefits is mixed. The skills and capacity of the fund sponsor seem to be critically important, but thus far scant attention seems to have been paid to who is most capable of delivering the necessary technical assistance and development services. The Growth Corporation seems to be doing the most in terms of providing technical assistance and development services. This makes
sense when considering that the Growth Corporation was established for the sole intent purpose of supporting the L.A. Family of Funds. The sponsors of the BASGF (the Bay Area Council) and the SVSGF (the Nehemiah Corporation) are both pre-existing non-profit organizations who have other core activities besides supporting their respective funds.

**Expanding access to capital**

Interviews with fund stakeholders revealed that approximately 50% of deals financed by the funds would have been funded by other debt and equity sources if the Contract fund did not exist.

**Ownership Model**

With the Ownership model, a non-profit organization develops the concept for the DBL private equity real estate investment fund, initiates the creation of the fund, raises capital and acts as the investment fund manager – overseeing and managing the fund. The success of this structure hinges on the ability of the non-profit to raise capital from investors and develop the expertise in-house to effectively manage the funds. One of the key distinctions between this model and the other models is that these funds are primarily mission-driven, but have to balance mission with financial performance in order to satisfy the expectations of investors.

The research indicates that the real estate funds that exist within this model are funds in which investors are primarily driven by tax credits and passive losses they receive in return for their equity investments. There are three main federal tax credit programs around which these funds are organized – the Low-Income Housing Tax Credit (LIHTC), the Historic Tax Credit (HTC), and the New Markets Tax Credit (NMTC). Under this model investor returns are not generated based solely on cash distributions; but, instead, are generated by tax credits and operating loses generated at the partnership entity levels that are then passed-through to investors. Investor’s IRR return expectations are priced accordingly. Because investors don’t expect either a partial or no cash-on-cash return on their investments, the equity capital contributed to the projects typically acts like either grant money, with a minimal economic return requirement, or a below market investment.

In general, LIHTC’s and HTC’s are purchased by the same tax-credit syndicators. My research indicates that there are approximately twenty (20) non-profit tax credit syndicators –
two (2) national funds\textsuperscript{117} and eighteen (18) state and local funds.\textsuperscript{118} Typically a syndicator will sponsor multiple limited liability or limited partnership funds; generally a new fund is created each year. For example, there is a fund in Massachusetts called the Massachusetts Housing Investment Corporation (MHIC) that sponsors a multi-year tax-credit fund called the Massachusetts Housing Equity Fund (MHEF). The fund is actually a series of funds, MHEF 2000, MHEF 2001, MHEF 2002, etc. In addition, there are a number of non-profit community development entities (CDE’s) that have applied for, and received, allocations of New Markets Tax Credits (NMTC) from the U.S. Treasury Department’s Community Development Financial Institution (CDFI) Fund. To date, the CDFI Fund has awarded two rounds of NMTC allocations worth $6 billion to a combined total of 129 for-profit and non-profit CDE’s.\textsuperscript{119} Another $2 billion worth of NMTC credits will be allocated in May 2005.

Of the funds in this space, there were three in particular that I looked at more closely - the Massachusetts Housing Investment Corporation, the Enterprise Social Investment Corporation’s Green Communities Initiative, and the Portland Family of Funds’ Portland New Markets Fund.

\textit{Overview of the Funds}

\textbf{Massachusetts Investment Corporation (MHIC)}

MHIC is a 14-year old, self-sustaining, 501(c)(3), non-profit CDFI and CDE focusing on providing debt and tax-credit equity to affordable housing projects, historic preservation projects, and commercial real estate development projects in NMTC-eligible census tracts, throughout the State of Massachusetts. MHIC also provides debt financing for acquisition or pre-development. In its 14-year history, MHIC has started and closed 10 equity funds\textsuperscript{120}, has managed a revolving loan fund, and is one of only ten CDE’s nationwide to receive allocations of NMTC in both the first and second round of funding. MHIC has invested and committed over $717 million to

\textsuperscript{117} The two national funds, managed by the two national community development intermediaries, are the Enterprise Foundation’s Enterprise Social Investment Corporation and the Local Initiatives Support Corporation’s National Equity Fund.

\textsuperscript{118} For more on the state and local funds visit the National Association of State and Local Equity Funds (NASLEF) at \texttt{www.naslef.org}.

\textsuperscript{119} Not all of the funds are using the NMTC to finance commercial real estate development. Some are using the credits to finance business development instead.

\textsuperscript{120} As of December 31, 2003.
finance the development and preservation of more than 10,500 housing units in 227 projects.\textsuperscript{121} MHIC has also recently closed five NMTC projects.

**Portland Family of Funds’ Portland New Markets Fund (PNMF)**

PNMF is one of a number of debt and equity funds that make up the Portland Family of Funds, an initiative of the Portland Development Commission (PDC). The PDC is Portland, Oregon’s urban renewal, housing, economic development and redevelopment agency. PNMF is a $100M fund developed to make catalytic debt and equity investments in real estate developments in Portland’s federally qualified NMTC eligible census tracts. PNMF is the only real estate private equity fund in the country that truly espouses a triple bottom line investment ethic. As PNMF begins investing its funds in projects, it has chosen to focus on more than just financial and social returns. By also incorporating environmental returns into its investment decisions, PNMF seeks to stimulate a significant volume of green building projects. PFF intends to create a profitable investment niche by exploiting current market failures in the finance and valuation of green buildings.

**The Green Communities Initiative (GCI)**

The Enterprise Foundation\textsuperscript{122} and The Enterprise Social Investment Corporation (ESIC)\textsuperscript{123}, along with the Natural Resources Defense Council (NRDC)\textsuperscript{124}, have recently launched the Green Communities Initiative. The GCI is a five-year, $550 million initiative aimed at improving the quality of life in underserved communities by advancing green affordable housing development. In general, the initiative seeks to support – through technical assistance, grants, and debt and tax-credit equity investments – affordable housing development that promotes health, conserves energy and natural resources, and provides easy access to jobs, schools and services. The GCI believes these goals will be achieved through strict underwriting


\textsuperscript{122} \texttt{www.enterprisefoundation.org}.

\textsuperscript{123} The Enterprise Social Investment Corporation is a subsidiary of the Enterprise Foundation, a national community development intermediary. ESIC makes equity investments in rental housing nationwide by forming partnerships with corporate investors and non-profit and for-profit developments. Since its creation in 1986, ESIC has raised over $4 billion in capital through closed and committed equity funds, for investment in the production of more than 70,000 units of low-income housing nationwide. Over 70 percent of ESIC’s developer partners are nonprofit organizations who also have access to significant training, technical and financial community development resources from The Enterprise Foundation. For more visit \texttt{www.esic.org}.

\textsuperscript{124} \texttt{www.nrdc.org}. 
standards in terms of location, accessibility, energy efficiency, and healthy and environmentally friendly materials and construction techniques.

**Capitalization (Raising $ / Investor Expectations)**

All of the private equity funds in this space are capitalized by cash equity generated from corporate investors (and in some rare cases from individuals). By investing in LIHTC, HTC, or NMTC developments, investors can then claim the tax credit on their income tax returns over the federally mandated investment period\(^{125}\) and thereby reduce their tax liability on a dollar-to-dollar basis. Like the Contract funds, most of the Ownership funds are capitalized by federally regulated financial institutions (e.g., banks and savings institutions). These institutions not only reduce their tax liability when they invest in LIHTC projects, they also receive, as an additional incentive, Community Reinvestment Act (CRA) credit.

Several of the non-profit fund sponsors/managers were initially founded and capitalized by the banks that are the primary investors in their equity funds. For example, MHIC was originally started through the State Bankers Association - a consortium of national, regional, and local banks operating in Massachusetts - in response to a Federal Reserve Bank Boston study showing racial discrimination in home mortgage lending among Boston banks.

**Investment Objectives**

The principal objective of these funds is to comply with the rules and regulations mandated by the federal tax-credit program under which they operate – the LIHTC, HTC, and/or NMTC – and to generate a financial, IRR, return by delivering tax credits, cash flow, and/or partnership losses to their investors. By complying with the rules and regulations that govern these tax-credit programs, Ownership funds produce the specific social benefits that the federal programs are designed to create. For example, the federal government created the LIHTC in 1986 in order to spur the development of affordable housing for low- and moderate-income households. The NMTC program was enacted by Congress in 2000 to encourage investment in commercial real estate development in low-income communities. However, the NMTC program

\(^{125}\) The investment period varies for each tax-credit program. For the LIHTC and HTC program, the investment period is 10 years. For the NMTC program, the investment period is 7 years.
also seeks to achieve a number of secondary objectives called “community impacts”. These impacts include:

- Create or retain jobs for Low-Income Persons (LIPs) or residents of NMTC Target Areas;
- Increase wages or incomes for Low-Income Persons or residents of NMTC Target Areas;
- Finance or assist businesses owned by residents of, or otherwise committed to remain in, the NMTC Target Areas;
- Finance or assist minority- or women-owned businesses, or businesses owned by LIPs;
- Finance or assist businesses (including non-profit organizations) or real estate projects that provide childcare, health care, educational or other benefits to LIPs or residents of NMTC Target Areas;
- Facilitate wealth-creation or asset accumulation (such as home ownership) by LIPs or residents of NMTC Target Areas;
- Provide goods and services to LIPs or residents of NMTC Target Areas.

Every for-profit and non-profit Community Development Entity (CDE) receiving an allocation of new markets tax credits is required by the U.S. Treasury Department’s Community Development Financial Institution Fund (CDFI Fund) to qualitatively and quantitatively report on their ability to achieve these impacts. Thus, the NMTC program has, in theory\(^\text{126}\), spurred a more intentional, “community-benefit”-oriented style of real estate investment management.

In contrast to private tax-credit syndicators, Ownership fund managers are non-profit, mission-driven organizations. As such, they tend to strive to fill market gaps by providing capital to underserved areas. For example, since its inception, MHIC has been focused on delivering capital to the underserved low- and moderate-income, minority communities throughout Massachusetts. During its first five years in operation, MHIC had little to no competition for LIHTC deals in these communities; and, where there was competition, competitors were paying $0.5 to $0.10 less per tax credit dollar than MHIC. As MHIC’s success grew and competitors saw that they could operate profitably in these markets, MHIC began to face competition from private tax-credit syndicators on almost every available deal.

In general, Ownership funds also strive to provide collateral benefits to their communities and constituents beyond those mandated by the specific federal tax-credit program. Most provide some form of technical assistance or development services and cater to non-profit community-based developers operating in underserved areas. By supporting community-based

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\(^{126}\) I say “in theory” because I was unable to find any published research that suggests whether or not the purported benefits are being achieved.
developers not only through financing but also through technical assistance, these funds help ensure successful developments and thus help to build the financial capacity of local community-based development organizations by ensuring that they earn their development fees. These fees are a vital source of revenue for non-profit community-based developers and these revenues are generally used by these organizations to support other program activities such as economic development, job training, community organizing, etc.

Since its inception, MHIC has striven to ensure maximum community benefit for the projects that it finances. Special emphasis has been placed on ensuring that minority contractors and minority workers are involved in project construction. More recently, as MHIC has developed its NMTC program, the organization has also strived to create deeper social returns by meeting, and in many cases exceeding, the community impact goals established by the CDFI Fund for the NMTC program. In addition to meeting the social objective of the LIHTC and NMTC program, respectively, ESIC’s Green Communities Initiative and the PNMF go beyond the requirements of the tax-credit program to encourage environmental returns as well. PNMF strives to meet an investment objective that every project it invests in achieves a LEED silver rating or higher from the U.S. Green Building Council (USGBC). The Green Communities Initiative requires that every project it finances adhere to its strict “Green Communities Underwriting Criteria” that requires affordable housing developers to meet certain design, development, and operating objectives.

**Investment Practices**

Ownership funds have been instrumental in utilizing federal tax-credit programs to create hundreds of thousands of affordable housing units for low- and moderate-income households and helping to revitalize low- and moderate-income communities by financing historic preservation and commercial real estate projects. In addition, these funds have also, through their technical assistance and development services programs, helped to build the capacity of hundreds of community-based development organizations that in turn have utilized the income generated through their development activities to support their other mission-oriented program goals.

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127 The U.S. Green Building Council (USGBC) is the nation’s foremost coalition of leaders from across the building industry working to promote buildings that are environmentally responsible, profitable and healthy places to live and work. For more information on the USGBC visit [www.usgbc.org](http://www.usgbc.org).

128 See Appendix F for a copy of these criteria.
In order to achieve their investment objectives, these funds typically operate with the same degree of professionalism and conservative underwriting practices generally found in the conventional real estate investment world. One method these funds utilize to ensure success is to hire staff with significant institutional real estate experience. At MHIC, many of the staff members spent years working for local banks prior to joining MHIC.129

In general, since Ownership funds are non-profit and mission-driven they are willing to take on more risk than traditional sources of financial capital both with the products they offer and the customers they serve. According to MHIC President and CEO, Joseph Flatley, many of the customers MHIC deals with are not bankable in some sense, either because they require a lot of technical assistance or because they do not have many net assets.130 To accomplish its minority participation investment objective, MHIC has developed a focused minority participation program. Through this program, MHIC and project sponsors negotiate and set goals as to the level of participation of minority construction workers, and the percentage of construction dollars that will go to minority-owned contractors. For example, in projects financed by MHIC in Boston over the last few years, over 66% of the construction jobs have gone to minority workers, and 53% of the total development costs have gone to minority-owned businesses. To accomplish its NMTC-related social return investment objective, MHIC has expanded its standard underwriting analysis to evaluate the degree to which potential projects meet MHIC’s NMTC community impact goals. With a pipeline of over $225 million dollars in potential tax credits and an allocation of only $115 million, community impact criteria have become a mechanism for ranking potential investment opportunities. The NMTC program has also meant new requirements for asset management, as MHIC attempts to track the impacts created through its NMTC investments over the seven-year NMTC compliance period. To facilitate data collection, MHIC has developed and distributed survey instruments to track the results of its financing activities. Although MHIC has incorporated community impact criteria into its deal selection and underwriting process, it has not, to date, worked to develop any programs to provide technical assistance to project sponsors to try and increase or enhance their ability to meet MHIC’s NMTC community impact goals. Instead MHIC simply relies on the project sponsor to come to the table with the desire, technical know-how, and relationships

129 Staff biographies are available on the MHIC website at www.mhic.com.
necessary, to achieve additional social benefits beyond those automatically produced by fulfilling the requirements of the federal tax credit financing program.

PNMF has been in operation for less than a year and has yet to close on any deals with its New Market Tax Credit allocation; although several are in the predevelopment stages, including the $10-million Vanport Square project as well as the Meier and Frank building. PNMF is involved with one project, the Portland Amory project, which is aiming to achieve a LEED Platinum rating. On this project, PNMF is acting as investment manager for a Texas-based NMTC entity.

The Green Communities Initiative is also a brand new initiative that was only rolled out in the fall of 2004. Recognizing that successfully incorporating green building objectives into a real estate project takes an early commitment on the part of the developer and higher up-front costs in order to achieve long-term operating and management savings, the GCI has been structured to help skeptical for-profit and undercapitalized non-profit affordable housing developers make the decision to incorporate green building practices into their affordable housing developments. GCI’s investment structure combines education, information resources, and technical assistance with three types of funding products for developers that commit to following GCI’s “Green Underwriting Criteria”. These products include:

- **Grants**, to help cover the additional upfront costs of planning and implementing green components for affordable housing projects, as well as tracking their costs and benefits;
- Favorable term **predevelopment loans, acquisition, and construction loans**, to support the development of affordable rental and homeownership housing that adheres to Green Communities Underwriting Criteria; and
- **Tax-credit equity**, to nonprofit and for-profit developers for new construction and/or rehabilitation of affordable rental housing that generally adheres to the Green Communities™ Underwriting Criteria.

ESIC is able to provide the grants and favorable loan terms due to the support of its non-profit and foundation partners.

The GCI has several projects, which have already closed or are currently in the pipeline, that have incorporated its green standards into the planning and development, including High
Point Phase I in Seattle, Washington; Plaza Apartments in San Francisco, CA; and Pleasantville Senior Rental Housing in Pleasantville, New York.

**OTHER FINDINGS & ANALYSIS**

**Achieving Financial, Social and Environmental Return**

The GCI is the first Ownership fund in the country to combine the social return inherent in LIHTC investing with a strict environmental return objective. The PNMF is also striving to produce environmental returns from the projects it finances with its allocation of NMTCs. The creation of the GCI and the PNMF is a signal to other Ownership funds that the social return objective can be married with an environmental return objective if the fund manager has the desire and will to do so. In fact, because the LIHTC, HTC, and NMTC programs generate tax credits based on the “qualified” development costs, the higher up-front costs typically found when trying to incorporate green building practices, can be partially offset because higher development costs can generate additional tax credit equity.

Every Ownership fund could apply green underwriting standards and thus achieve environmental return. Striving for environmental returns makes sense from a mission standpoint since many low-income housing occupants suffer disproportionately from health problems, such as asthma, which can be exacerbated by bad indoor air quality. Also, lowering tenant utility bills through energy efficiency measures enables low-income tenants to either buy more housing with their extra income; more essential goods and services such as food, health care, and education; or create wealth through savings.

Furthermore, GCI’s use of education, technical assistance, seed grants, and early-stage loan financing combined with LIHTC tax-credit equity financing, suggests a possible operations innovation that could be utilized by other funds to help developers overcome the particular difficulties inherent with trying to put together complicated alternative development projects that seek to create explicit social and environmental return objectives.

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131 “Qualified” refers to the accounting rules governing the tax-credit program established by the Internal Revenue Service (IRS).
132 In the case of the NMTC program, the tax credits are actually generated based on an equity investment into a qualified business. When CDE’s like MHIC and the PNMF utilize the tax credits to invest in real estate they are actually making an investment in a limited liability company (LLC) or limited partnership (LP), the qualified business that will develop and manage the real estate.
Fund Structure: Non-profit versus for-profit fund managers

Analysis of the investment performance of Ownership funds suggests that in terms of achieving social and environmental returns, the non-profit investment manager structure has several advantages over the for-profit investment manager structure. First, as Joseph Flatley, MHIC’s President and CEO, explains, non-profit fund managers don’t have to maximize investor yields. They can push investment yields to the margin, or low-end, of the expected return range investors are willing to accept. MHIC offers its investors the minimum return they are willing to accept in exchange for investment capital. If investors are willing to accept a particular rate of return, all MHIC has to do is achieve that rate of return. If MHIC is able to exceed the stated return objective on one project in a fund, it can reinvest those extra returns into a deal that might achieve lower financial returns but offer more social return. Second, as direct investment managers, in contrast to funds operating under the Contract fund model where the non-profit sponsor contracts with a for-profit investment fund manager and then receives a small percentage of management fees and carried interest, as direct investment managers, Ownership funds can generate significantly greater amounts of income for the organization. These investment proceeds can then be used to further the mission of the non-profit organization. For example, MHIC uses some of its investment profits to fund a scholarship program for children living in MHIC financed projects.

CONCLUSION – A SUMMARY OF KEY FINDINGS

Achieving the Financial, Social, and/or Environmental Returns

The research presented above provides some evidence that establishing social and/or environmental return objectives, in addition to financial return, for real estate investment capital can influence investment decisions and result in positive social and environmental outcomes that might not otherwise result if financial capital was left unencumbered. Yet there appears to be limits as to how far financial return conscious capital can be pushed to achieve explicit non-financial return objectives. While all of the fund models and funds discussed above are pursuing some implicit environmental and social returns, primarily by directing investment capital to

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1 Interview with Joseph Flatley, September 9, 2004.
underserved urban real estate markets, only a few of the funds are explicitly focused on trying to achieve one or more social goals through their investment activities and only one non-tax credit driven fund, the BASGF, is explicitly trying to achieve both social and environmental returns.

At this point there is no conclusive evidence that it is possible to marry a more robust set of social and environmental return objectives, as laid out in Chapter 4, with market-rate financial returns. There are three main reasons underlying this inconclusiveness. First, existing practice is still very immature – many of the funds are still closing their initial investments or haven’t yet exited previously closed investments – and thus it is difficult to fully analyze investment results. Second, there is little transparency in the field. Since these funds are private funds, as opposed to publicly traded mutual funds, which have public disclosure requirements, they are under no obligation to share fund performance with the public and thus there is very little public information available. Finally, thus far there has been little real concerted effort to both achieve DBL investment objectives and measure results in a rigorous manner. Most of the existing DBL effort is focused on simply directing capital to underserved, low- and moderate-income geographic areas. While this is worthy goal, and certainly a socially optimal result compared to investment that encourages conventional development, this investment objective alone can cause other social problems such as displacement and gentrification. The BASGF is the only non-tax credit fund that has really developed an ambitious set of social investment objectives that focuses more on achieving positive people-based and place-based results. The GCI and PNMF are also pushing the limits of current practice by incorporating environmental return considerations into federal government designed tax-credit programs designed to achieve specific social return objectives. More time, effort, and analysis will be needed to determine what social and environmental returns can or cannot be achieved without incorporating below-market rate capital into the capital structure of a fund or project.

Investment Management

Unlike in the public equities and venture capital markets, there does not appear to be any for-profit real estate investment funds with an organizational culture committed to achieving the DBL (financial plus social and/or environmental returns). All of the non-tax credit funds surveyed are managed by conventional real estate investment fund managers with experience and expertise with conventional real estate investment practices and the social and environmental

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objectives appear, for the most part, to be layered on top of a conventional approach to real estate investment management. There has been little innovation in terms of deal evaluation or financial analysis to incorporate social or environmental considerations.

The Contract model is a new investment structure with a unique characteristic - the involvement of a non-profit community sponsor who helps to steer DBL deals around, and through, the potential barriers to alternative development. In exchange, the non-profit community sponsor receives a small percentage of the management fee and a stake in the financial performance of the fund. This structural feature has real potential as it could reduce some of the typical risks characteristic of alternative development projects, such as NIMBYism, and increase returns due to faster permitting. The non-profit community sponsor also monitors the investment activity of the fund manager to ensure that the double-bottom line investment objectives incorporated into the legal structure of the fund are being met. In this way, Contract funds are held accountable for their investment activity and the more the fund sponsor is rooted in the community or in social and environmental movements – BASGF compared to SVSGF – the more likely it is the fund will be required to meet a more ambitious set of social and environmental criteria. This contrasts with Fund Manager funds, which are only accountable to their national investors, and have no binding commitment to particular places or investment objectives. The small percentage share (usually 1.5 to 2%) of the carried interest in the performance of the fund that the non-profit fund sponsor receives can be used to pay for the operations of the organization, provide technical assistance to potential projects, or provide additional social and environmental benefits to the community.

Yet at this stage in the young life of Contract funds, the extent to which the non-profit community sponsors are in fact providing value to the fund is unclear. More research should be undertaken to determine whether integrating a community sponsor into the financial incentive structure of a Fund a) actually enhances the value proposition of the Fund as intended, and b) provides the sponsor with enough of a revenue stream to support its intermediary functions. A more promising alternative might be to integrate community sponsors into the incentive structure of the individual deals themselves through for-profit/non-profit joint development arrangements where the for-profit developer is either a local developer or the Fund manager itself.

What is clear from the research is that achieving DBL returns will not happen without a significant, applied effort. Deals that incorporate DBL returns will likely require more
coordination than deals that focus only on the financial bottom line and thus they will be more complicated and more labor-intensive for the developer and the investment fund manager. Thus, conventional real estate investing, in which the financial bottom line is the only consideration, will always be easier.

**Capitalization**

Fund Manager funds are typically capitalized by hundreds of millions of dollars in pension fund investments. In contrast, Ownership and Contract funds are typically capitalized by investments from regulated financial institutions, such as banks, that receive collateral benefits, such as CRA credits and good public relations, from their investments in addition to financial return. Some foundations have participated as investors. Conspicuously absent from the current pool of DBL investors are high net worth socially motivated investors and endowments from non-profit organizations that advocate for social and environmental causes. The fact that existing practice is currently straddling the line between competitive, risk-adjusted market-rate returns and measurable social and environmental benefits could be one explanation for the lack of diversity among investor types. Perhaps other financial return conscious investors have yet to invest due to a lack of clear evidence that their financial return objectives can be met. Investors more interested in social and environmental returns probably haven’t yet invested due to a lack of clear evidence that their social and environmental returns objectives can be achieved to the extent desired.
CHAPTER 6: RECOMMENDATIONS

The research presented in Chapter 5 suggests that the practice of DBL real estate private equity investing is a small and very immature niche of the larger practice of conventional real estate investing. Even within the niche of DBL real estate private equity investing, investment practice varies from fund model to fund model; and within these fund models, from fund to fund. Currently, while a social investment framework and infrastructure exists to support the notion of social investing in the public equities and venture capital markets, there is no such equivalent in the real estate sector. As discussed earlier in this thesis, in order for alternative development projects to overcome the apparent financing barrier, it will be important to identify or develop capital delivery vehicles that can deliver reasonably priced investment capital to alternative development projects. DBL real estate private equity funds are capital delivery vehicle for delivering this capital and Chapter 5 explored the current practice of such funds. This chapter seeks to build off of the real estate social investment framework laid out in Chapter 4 and the research on the existing experience of DBL real estate private equity funds presented in Chapter 5 to provide some recommendations to advance both the practice of DBL real estate private equity funds and the development and maturation of a real estate social investment industry. The Chapter will first explore some ideas and approaches to the design and management of DBL real estate private equity funds that could enhance the ability of these funds to direct reasonably priced capital to alternative development projects that can achieve double- or triple-bottom line return objectives. Following this, the focus will turn to the bigger picture and ideas will be explored for further development of the real estate social investment movement so that it can support the efforts of DBL real estate investment funds.

ADVANCING THE PRACTICE OF DBL REAL ESTATE PRIVATE EQUITY FUNDS
While there are numerous issues to consider in the design and management of DBL real estate private equity funds, this section will look only at those issues where, based on the research presented in Chapter 5, it appears that there are opportunities to improve upon the existing design, operations, or management of DBL real estate private equity funds. This section will focus on six key issues for advancing the practice of DBL real estate private equity funds and their ability to enhance their social and environmental returns while achieving financial return expectations. These issues include:

1. Fund Structure,
2. Investment Time Horizon,
3. Investment Strategy,
4. Geographic Scale,
5. Finding and Shaping Deals, and

**Fund Structure**

Both the Fund Manager and Contract fund models rely on private, for-profit investment managers to manage the DBL funds. Due to the barriers described in Chapter 3, alternative development is more complicated, takes longer to develop, and generally has higher development costs than conventional development. Thus, these projects, as compared to conventional development projects, can require more time and energy on the part of the investment manager to complete due diligence, underwriting, and closing. This extra time and energy translates directly into extra costs for the investment fund managers that are difficult to recoup through enhanced project level financial returns. Unless investment managers are rewarded for these extra costs through higher management fees (charged to investors) or by passing these costs on to developers through investment fees, for-profit investment managers are likely to pursue practices that maximize their own, corporate financial bottom line and thus would seek to minimize their organization and administrative costs.

One potential organizational innovation would be to expand the Ownership model beyond the realm of tax-credit driven returns and into the realm of at-risk equity capital (i.e. – a blend between the Contract model and the Ownership model). Thus, instead of contracting with a professional, for-profit real estate investment fund manager, as is the case under the Contract
model, the non-profit fund sponsor would manage the private, for-profit fund internally. With this model, investment profits accumulated through fees, participation, and carried interest could be reinvested in fulfilling the mission of the organization instead of enriching the investment fund manager’s staff and corporate investors. These savings could be reinvested into technical assistance, grant funding, and other programs that could help DBL funds achieve their social and environmental return objectives. In other words, the non-profit investment fund model could be a useful model for directing capital towards deals with lower financial returns but higher potential environmental and social returns. Below is a diagram depicted what a non-profit investment fund structure might look like.

The Ownership structure has several other advantages as well:

- The 501(c) 3 status provides a clear statement of social purpose and opens the door to all types of below-market funding streams that can be used to support and enhance the funds social and environmental return objectives.

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134 While this model does not yet exist on the real estate side, there are several social venture capital funds that are organized this way. One example is Coastal Ventures which is a for-profit social venture capital fund subsidiary of Coastal Enterprises, Inc. (CEI), a 501(c)(3) organization dedicated to sustainable community economic development principally in the state of Maine. To learn more about Coastal Ventures, visit CEI’s website at www.ceimaine.org.
A mission-based, non-profit fund sponsor can be a more credible partner with government and community-based groups; because these partners can relate to and want to support the mission driven goals of the fund. As a non-profit, potential government and community-based supporters, can trust that the funds fees are priced as low as possible and that its return expectations will also be as low as possible without jeopardizing its ability to secure profit-motivated investment capital. The research presented in Chapter 4 touched on this issue only cursory; but it warrants further research.

While there are reasonable arguments in favor of expanding the investment management role of Ownership funds to take on the management role for at-risk equity, the biggest hurdle to overcome before this idea can be implemented is investor expectations. Applying the Ownership model to non-tax credit private equity real estate investment funds would break the principle of aligning the financial motivation of the Fund manager with that of investors. As discussed in Chapter 4, investors typically like to see investment fund managers “put their money where their mouth is”. Thus, they might worry that without the profit motive there will be a mis-alignment of interests. However, one could argue that interest alignment still exists because a failure on the part of the non-profit investment fund manager to meet the funds financial return objectives would threaten the organizations survival and ability to carry out its mission. Ownership funds could also assuage investors concerns by:

- Hiring dedicated, experienced investment professionals;
- Investing some of the organizations available cash in the fund;
- Partially compensating investment staff based on financial returns;
- Allowing or requiring individual investment managers to invest side-by-side with investors; and
- Incorporating investor representatives on investment committees that would play an oversight role in making investment decisions.
Investment Time Horizon

One of the keys to advancing the practice of DBL real estate private equity funds, specifically, and social investing in real estate, in general, will be finding creative ways to expand the conventional investment time horizon in order to take advantage of the superior mid-to long-term investment returns that might be possible with alternative development projects.

As described in the “Real Estate Private Equity 101” section of Chapter 4, conventional real estate private equity investment funds generally operate on a 10-year investment horizon – a five-year investment period followed by a five-year harvest period, for a total basic term of ten years (see the diagram below for an illustration).\(^{135}\) Some funds include provisions in their partnership agreements that allow the fund to be extendable for two or three one-year periods at the option of the Fund manager if necessary to allow for orderly liquidation of the portfolio.

<table>
<thead>
<tr>
<th>TRADITIONAL REAL ESTATE INVESTMENT FUND TIME HORIZON</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Period</strong></td>
</tr>
<tr>
<td>Year 1</td>
</tr>
</tbody>
</table>

As discussed in Chapter 3, alternative development projects likely have different return characteristics than conventional real estate deals;\(^{136}\) it has been hypothesized by Chris Leinberger and others, that while alternative development might cost more to develop and have significantly less short-term value, it can hold investment value longer than conventional development. If this is true, DBL investment funds will never reach their full potential unless the investment time horizon can be extended to capture these superior mid- to long-term returns.

While not infeasible, extending the investment time horizon will likely pose a major hurdle, as intrepid advocates will need to overcome two principal investor concerns – liquidity and obsolescence. Real estate investing is a fairly illiquid venture especially compared to the significantly more liquid public equities markets. Investors generally try to maximize returns while minimizing risk and maximizing liquidity. Liquidity allows investors to rebalance their investment portfolio - to respond to changes in cash needs or investment objectives, new market information, and/or changes in the relative performance of different asset classes - with the goal that investment capital is always investing in assets that provide optimal financial return

\(^{136}\) Although more research needs to be conducted to verify the veracity of this claim.
performance based on investor investment objectives and given a certain level of risk. In general, investors will be resistant to decreasing the liquidity of their real estate investments. More experimentation needs to be done and research conducted to develop strategies for extending the investment time horizons on real estate investments in alternative development projects while also allowing a sufficient amount of liquidity for investors. One option for fund managers is to give investors more control around fund liquidation parameters. This would require mechanisms that could provide investors with the information necessary to for them to evaluate the future cash flow and appreciation potential of portfolio properties. Armed with this information, investors could decide to continue to hold portfolio investments for an additional, reasonable period of time within which a sufficient amount of the mid- to long-term return potential could be realized. This type of strategy could have significant benefits for long-term investors in real estate assets as it gives them the opportunity to stay invested in real estate without incurring the additional risks and transaction costs associated with liquidating their investments in one Fund and reinvesting the proceeds in another Fund. One key for this idea would be to develop appraisal systems that more accurately project the value of alternative development projects than current appraisal systems. Such appraisal systems could also help DBL funds benchmark actual performance versus expected performance. This would provide investors - who value liquidity and want to exit the partnership prior to the end of the funds life – with an opportunity to exit the fund by selling their rights to expected future cash flow to another potential investor, allowing them to re-coop much of the value potential of their original investment.

Another reason, in addition to the liquidity issue, that the typical investment period is seven years is that it is generally believed that functional and economic obsolescence sets in after seven years and thus the risk of bank foreclosure increases dramatically after this point. However, if Leinberger’s theories are correct, well-designed, developed, and managed alternative development projects, might not experience obsolescence in the same fashion typical of conventional development.

Investment Strategy

Advancing the practice of DBL funds might require a focus on investment strategies that either aren’t currently being explored by the DBL funds reviewed in Chapter 5 or aren’t being
practiced to their full potential. One such strategy has to due with the timing of soliciting fund investors. Conventional real estate private equity funds tend to design a fund, raise capital, and then go out to the marketplace to seek investment opportunities. All of the funds discussed in Chapter 5, followed this standard protocol. Since fund investors dictate, to a large degree, the investment objectives and practices of the fund manager, and alternative development projects are more complicated and might exhibit stronger mid- to long-term returns, one investment strategy that merits further investigation is the idea of matching an investment pipeline with capital raising efforts. This strategy could:

- Achieve a more efficient pricing of investment capital;
- Reduce the financial return risks associated with predevelopment delays; and,
- Increase the investment period (within the standard 10-year investment horizon) to maximize the potential superior mid-range returns characteristic of alternative development projects.

Another potential investment strategy, explored to some degree by the BASGF, is the idea of focusing DBL investments on projects either wholly or jointly developed by non-profit community-based developers. The research presented in Chapter 5 seems to indicate that where social returns are being achieved, it is mainly outside of the capital structure of the development projects. Thus, in order to advance the practice of achieving social returns, someone has to be willing to provide and pay for special services needed to realize those returns. Investing in deals driven wholly or in part by non-profit community based developers could achieve the social return, while also achieving the financial return expectations of investors, because non-profit community based developers typically are willing to trade-off financial return for social return. Thus, they are likely not to have the same financial return expectations a private, for-profit developer would and thus would be willing to put this money back into the deal in order to create social return. Or, they could utilize their non-profit status to raise money outside of the capital structure of the deal to support the achievement of the social return. In the case of joint non-profit community-based developer/for-profit developer partnerships, the non-profit community-based developer can provide immeasurable help in the government approval process, building community consensus, and in covering the costs and delays involved in a sometimes lengthy predevelopment period. The non-profit community based developer could also help secure
valuable government owned land at significant discounts to market value. In these joint non-profit/for-profit developer deals, the non-profit community-based developer can ensure that social and environmental benefits are attained while the private developer will ensure that the financial goals of the project are met. By partnering and collaborating each sector brings its unique expertise to the development deal.

Geographic Scale

As discussed in Chapter 5, the geographic scale of a DBL fund seems to play a role in the extent of the DBL fund’s commitment to achieving social and environmental return. This would seem to suggest that in order to advance the practice of DBL investing, proponents should focus on community-based funds with a geographic scale no larger than a metropolitan area. There are also several other advantages to a smaller geographic scale in order to advance the practice of DBL funds. As discussed in Chapter 3, there are numerous barriers that must be overcome before alternative development projects can reach fruition. Also, the research presented in Chapter 5 seemed to suggest that where social and environmental returns are being explicitly achieved, it is happening outside the capital structure of projects. Both of these points seem to suggest that advancing the practice of achieving social and environmental return will require strong connections with local resource providers and decision-makers who could help projects achieve their social and environmental return objectives. Developing these connections will require a local presence and commitment. More localized funds might also help DBL funds raise socially and environmentally motivated investment capital. Since real estate investing is a more tangible place-based investment opportunity that other asset classes, some investors might be motivated to invest in a DBL fund out of a desire to help revitalize a particular geographic area.

Finding and Shaping Deals

The research presented in the previous chapter sheds little light on how best to find and shape deals to maximize social and environmental return while also meeting financial return objectives. Yet logic suggests that the ability of DBL funds to achieve DBL returns is dependent on finding deals with significant opportunities for DBL value-creation. One of the keys to achieving DBL returns is early commitment from project sponsors towards achieving such returns and an integrated, multi-disciplinary team that can work together to achieve those returns.
In other words, designing projects with the goal of achieving DBL returns is significantly easier than layering DBL return onto otherwise formulated projects. Thus, early value-added involvement on the part of the DBL investment fund managers is one potential key to finding and underwriting deals to maximize DBL returns.

One way DBL funds could advance the practice of achieving social and environmental return, is to take an aggressive approach in optioning development sites and then finding local joint venture partners willing to lead the development process forward. This way DBL funds are involved early and retain some control over the value creation process. It is very likely, that DBL funds will need to spend more time prospecting for “good” deals. Traditional funds operating under profit-pressures will be hesitant to expend the extra resources that may be required in this regard.

One finding from the research presented in Chapter 5, is that Contract funds tend to invest in projects sponsored by developers with whom they have prior investment relationships. Building off of this finding, one way that DBL funds could enhance DBL returns is to seek out and partner with developers who share the funds values and vision. Developers most likely to be good strategic partners will have explicit social and environmental development principles that guide their development activities and will have significant prior experience developing projects that meet the DBL return objectives. Some examples of these types of developers include BuildGreen Developments Inc., Jonathan Rose Companies LLC, and The Trust for Sustainable Development. Below are passages culled from their respective websites that speak to their development philosophies and the types of projects they develop.

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**BuildGreen Developments Inc.**

BuildGreen is committed to working on projects that make positive and significant contributions to the communities and ecosystems in which they are located. We are committed to developments and building projects that strive to lessen society’s reliance on our limited natural resources while at the same time enhancing the local quality of life. BuildGreen is committed to delivering practical, cost effective design innovation. Our triple bottom line approach ensures environmental, social and financial considerations are integrated in all BuildGreen projects. Our client’s requirements are met through the implementation of several BuildGreen approaches, including integrated design, respect for local considerations, financial sustainability, enhancing local realities, changing of the status quo, and innovation.


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Our mission is to repair the fabric of cities, towns and villages, while preserving the land around them. To do this, we plan and develop diverse, mixed-use, transit-accessible, mixed-income communities or components focused on nodes of transportation. At the same time, we develop plans to preserve surrounding farms and open spaces. The result is equitable, and supports the cultural, environmental and biological health of the bioregions we work in.

Source: Jonathan Rose Companies LLC. website - (www.rosecompanies.com/whoweare/index.html)
Visited on December 14, 2004.

Committed to the principles of sustainability, The Trust's objective is to develop land in a sustainable way according to the United Nations' Brundtland Commission definition: "meeting the needs of the present generation without sacrificing the ability of future generations to meet their own needs". The Trust sponsors development based on the more traditional patterns of well defined towns and mixed neighborhoods. Within these patterns, a greater number of people can be accommodated in a higher quality of life, with a smaller consumption of land, a reduced demand on infrastructure and less impact on the environment.

It may seem as if "community" and "sustainability" are issues beyond the control of the development industry, but developers use land that either fosters or inhibits a sense of community and can establish precedents for destructive or friendly environmental practices. In its developments, The Trust seeks to create places that are beautiful and livable, and that enhance quality of life and respect the natural environment.

Source: The Trust for Sustainable Development website – (www.tsd.ca/overview.html)
Visited on December 14, 2004.

Evaluating and Underwriting Deals

"Underwriting" is the word that real estate investors use to describe the decision-making process they undertake to evaluate, and compare, the merits of potential real estate investment opportunities. The purpose of underwriting is to make a thorough assessment as to whether or not the project fits with the investment objectives of the Fund and to clarify the risks involved with the investment. Once the investment risks are identified, investors determine what risk mitigation measures should be employed to reduce risk to acceptable levels. For debt investors, the purpose of underwriting is "to make default a rare event." For private equity investors, the purpose of underwriting is to increase the probability that expected investment returns will materialize. In general, real estate underwriting practices tend to follow fairly well established industry standards. There are several key components of a deal that are routinely evaluated. These components include:

- The capacity and experience of the development team, including the developer, project architects, engineers, contractors, consultants, brokers, and legal counsel;
- The sources of investment capital, including any terms and conditions attached to financing commitments;

• The uses of investment capital, including the development and operating budgets;
• The market (supply & demand) for the proposed development program;
• Zoning, entitlements, site control, environmental studies and reports;
• A credit analysis of the developer and any prospective tenants.

As discussed in Chapter 3, alternative development projects differ significantly from conventional development projects by their location, their mixture of different real estate product types (i.e. – housing and retail or office and retail), their mixture of different income levels (in terms of housing), their emphasis on green building techniques and technologies, to name a few differences. Also, unlike conventional development, which tends to be more formulaic by comparison, the value proposition of alternative development projects tends to be more context driven; emanating from intangibles, such as architectural quality, sense of place, convenience, and proximity, that are hard to quantify and evaluate. In theory, these differences between conventional development and alternative development would suggest that DBL funds would need to develop specialized project evaluation and underwriting techniques as conventional project evaluation and underwriting techniques would fail to capture potential value creation and overstate development and financing risks. Yet, all of the funds interviewed suggested that they followed fairly standard conventional underwriting practices. The L.A. Fund had developed a step in their standard underwriting practice for contracting with a third party vendor to perform a job creation analysis. Both BASGF and MHIC had specific social equity and community impact criteria, respectively, that projects were evaluated against to determine whether or not they were eligible for an investment.

One reason the existing DBL practice might be limited could be due to a lack of a clear project evaluation and underwriting framework for evaluating the risks of simultaneously trying to achieve the financial, social, and environmental return. In addition to conventional project evaluation techniques and underwriting practices, some additional underwriting questions DBL investment managers might want to consider when underwriting alternative development projects include:

General

- How will this project achieve the financial, social, and/or environment return objectives the fund seeks? What and who can help ensure that these returns will materialize?
- What are the costs and expected benefits associated with environmental and social returns? How will they affect the projects ability to achieve its financial return target?
- Is the proposed development large enough to be profitable for the developer while also achieving social and environmental benefits?
- Does the project sponsor have the legitimacy and the capacity to garner the community support necessary to get this project through the entitlement process faster than is typical?
- What is the context of the area in which the investment is located? What are the prospects for near-term public and private follow-on investments in the project vicinity?
- Is it possible to get the community to accept zoning changes (i.e. – higher density or lower parking requirements) in return for social and environmental benefits?

Financial Return

- Will the project need financial assistance to achieve its financial return hurdle as well as social and environmental return?
- If so, who will provide this funding?

Environmental Return

- What is the expected payback period for additional up-front costs (if any) to implement green building technologies?
- How proven are the technologies being used to achieve the environmental returns?
- Are there liabilities associated with the products or technologies being used to achieve the environmental returns?
- Are lease terms structured so that the tenant will pay for the energy savings measures that have been put in place through the development?
- What building management systems or procedures need to be in place to maximize return on environmental investments?

**Social Return**
- Will the project meet the social return objectives established by the Fund? If so, how?
- Who will manage and ensure these returns will be met?

Real estate development and investment relies on assumptions driven forecasting. Without good information on which to base market assumptions – bad investment decisions – either in terms of foregoing good opportunities or in terms of investing in bad opportunities will occur. If anything, the existing sources for obtaining market information fail to capture “real” demand for alternative development projects – either because the methodology for measuring demand is flawed or because there is a lack of adequate comparable projects for which operating projections can be compared. There is evidence that conventional market analysis methodologies underestimate the demand for alternative development projects and that markets in urban communities need to be evaluated differently. Population densities, income levels, spending patterns, and physical barriers typically are different in urban real estate markets than in suburban real estate markets. One example is the research conducted by Michael Porter and the Initiative for a Competitive Inner-City (ICIC), with assistance from the Boston Consulting Group, looking at the retail potential in America’s inner-city communities. This research, published in “The Business Case for Pursuing Retail Opportunities in the Inner City,” found that urban communities, despite lower median incomes, had up to six times the “purchasing power” of surrounding areas when looked at on a per acre and per mile basis.\(^{139}\) Their research was instrumental in a wave of new retail investment in urban markets fueled by the likes of real estate investment management firms like UrbanAmerica LP and Canyon-Johnson Urban Initiatives Fund highlighted in Chapter 5.

Tapping into the growing body of knowledge on how to evaluate the market alternative development product types, such as transit-oriented development and green building, will provide DBL funds with a higher degree of analysis about the potential of alternative development projects, which should reduce the risk of such investments and increase the feasibility of achieving the DBL.

**ADVANCING REAL ESTATE SOCIAL INVESTING**

This section explores and presents ideas for developing and advancing real estate social investing. This section looks at ideas for expanding the current investor base and developing a support infrastructure for achieving DBL returns. This section also discusses the importance of standardized social and environmental return components and measures and suggests that an industry trade group might add significant value towards efforts to advance the practice of real estate social investing and expand access to capital for alternative development projects.

**Expanding the Current Investor Base**

Since investors, especially early or lead investors, expect to have significant influence on a fund, a DBL fund might have to be more selective about from whom it seeks its equity investments. Ideal partners would either be long-term, patient investors that could derive value from an expanded investment time horizon or investors that would be willing to trade off some financial return in exchange for more social and environmental return. Potential long-term, patient investors might include endowments, pension funds, and life insurance companies who value long-term versus short-term cash returns. If such investors could overcome the liquidity issues associated with expanded investment time horizons they could benefit from the possible superior mid- to long-term returns plausible from investments in alternative development projects.

The research presented in Chapter 5, indicated that most of the investors in DBL funds are pension funds, banks, and insurance companies. Banks and insurance companies are investing in all three fund types (Fund Manager, Contract, and Ownership). Pension funds are tax-exempt and thus have no appetite for investing in tax-credit driven Ownership funds. Because pension funds have a fiduciary responsibility to their members, they tend to invest
mostly with the larger and more geographically diverse Fund Manager funds to spread risk. Insurance company investments are also regulated and thus they also tend to invest the majority of their investment capital with Fund Manager funds. These types of institutional investors value financial returns over social and environmental return. Some progressive pension funds, such as CalPERS, are willing to support alternative development projects by investing in DBL funds if these funds can prove they can achieve returns comparable to other investments of similar risk. To expand the pool of institutional, financial return sensitive capital to alternative development through a social investment framework, DBL funds will need to demonstrate to these investors that the goals of achieving financial returns plus social and environmental returns are compatible.

To increase the amount of social and environmental return DBL funds are able to achieve, they will probably have to make a bigger push to find and attract socially motivated investors who value the creation of social and environmental return and might be willing to trade-off some financial return in exchange for social and environmental return. These investors could include high net worth individuals, city and state pension funds, foundations, socially-responsible banks, endowments from major environmental as well as social justice organizations. For these investors, DBL funds will need to demonstrate that they can produce compelling and measurable social and environmental returns.

Perhaps the biggest potential market is with individual investors. There doesn’t appear to be any real estate investment funds focused on the social investment needs of socially motivated individual investors. Contacts made with SRI industry professionals indicated that there would be strong potential demand for the right product, although it is difficult to predict the scale of this demand.\textsuperscript{140} Many of these investors are likely to be location driven and interested in measurable social and environmental impacts. More research should be done to determine how best to structure a fund so as to tap this potential source of investment capital.

**Developing a Social Investment Infrastructure**

The premise behind the Contract fund model, explored in Chapter 5, is that incorporating social and environmental return components into a development project can engender the community support critical to overcoming the barriers to alternative development in a way that adds significant financial value to a project. What is unclear from the research is how much

\textsuperscript{140} Interview with Hall Brill, October 28, 2004.
social and environmental return projects can support without jeopardizing the ability of the
project to meet its financial return expectations. The BASGF was the only DBL working to
achieve a robust set of social and environmental return objectives. A look at early practice
suggests that the fund is not meeting full expectations but that it is clearly providing social and
environmental returns that would likely not be generated if not for the fund.

In order to enhance the ability of DBL investment vehicles to achieve social and
environmental returns, a social investment infrastructure - including programs, partners, and
below-market rate capital - will need to be developed to support developers in their efforts to
program social and environmental return components into their alternative development projects.
As examples, this infrastructure could include resources for determining what green building
technologies can achieve returns on investment within a conventional investment time horizon or
programs that train low- and moderate-income individuals for construction jobs. This type of
infrastructure already exists in some fashion in many communities, but resources are often
dispersed in many different silos – job training, green building, non-profit resource centers, etc. –
and usually aren’t connected in with the real estate development industry. To support the
creation of DBL returns, programs and processes will need to be put in place on the local level
that can help developers and DBL investment fund managers find and tap into the resources that
will help them achieve their social and environmental return objectives.

**Standardized Social and Environmental Measures**

There are currently no standard measures of social and environmental return. As
evidenced in the previous chapter, DBL funds are striving to achieve a broad range of social and
environmental objectives. Thus, there is no way to compare the social and environmental merits
of one project or one DBL fund against another. For the practice of real estate social investing to
gain traction in the broader real estate investing field, standards will need to be developed so that
there is a common language and common expectations. There needs to be an easy way for
investors to rank funds not only on their financial performance but also on their social and
environmental performance.
Trade Association

Currently there is no group identity for real estate investment funds that are striving to advance the practice of real estate social investing by directing market-rate financial capital to alternative development projects that can create measurable social and environmental benefits. A trade association could help the practice of real estate social investing grow and achieve scale. Such organizations have been important components of the growth of other social investment efforts. Examples of such organizations include the Social Investment Forum for the public equities market and the Community Venture Capital Association (CVCA) for community venture capital. A trade association could provide a number of benefits, including:

1. Raising the stature and profile of the practice;
2. A venue for sharing best practices and lessons learned;
3. Advocating for supportive local, state, and federal public policies; and,
4. Conducting and disseminating industry-wide research.

There are a number of industry-wide research questions and initiatives that could help advance the field. A trade association would be the logical body to tackle these research questions. These research questions and initiatives include:

Questions
- Do alternative real estate products outperform conventional real estate over a medium and long-term investment horizon?
- What is the best method for structuring investments in order to maximize financial, social, and environmental returns?

Initiatives
- Developing a set of best practices, looking at ways to successfully integrate financial returns with social and environmental returns and around how best to connect real estate development, investment, and management with workforce development and job training.
• Developing a set of market “comparables” that can help potential developers and investors understand the unique investment characteristics and likely performance of alternative development projects.
CHAPTER 7: CONCLUSION

“Financial innovation is the act of creating and then popularizing new financial instruments as well as new financial technologies, institutions and markets.”

-- Peter Tufano, Harvard Business School

“Alternative development”, as defined in Chapter 3, represents a significant opportunity to accommodate future growth in demand for built space while alleviating some of the negative economic, social, and environmental impacts associated with conventional development, which has become the prevalent development form in the United States since the end of WWII. Yet despite apparent current and future demand on the part of consumers, developers continue to confront significant barriers when attempting to develop alternative development projects. One of the most significant barriers is a lack of access to reasonable priced financial capital due to market failures within the real estate financial sector. These market failures translate into unfavorable investment terms for institutional debt and equity capital – lower loan-to-value ratios and higher expected rates of return on investment capital – forcing developers of alternative development projects to capitalize their projects with higher amounts of equity capital from high-net worth individuals, “friends and family”, and below-market, community capital sources. However, high-net worth individuals are increasingly choosing to invest their real estate investment capital in professionally managed, passive investment vehicles, such as REITs and real estate private equity funds. And, unfortunately, there is a finite limit to the amount of available “friends and family” and below-market, community capital, as these capital sources are miniscule compared to the mainstream, Wall Street driven real estate capital market.

This thesis has argued that to truly expand access to capital for alternative development projects that can deliver financial returns as well as explicit social and environmental returns, new investment vehicles and institutional mechanisms are needed to channel investment capital and direct it to alternative development projects. This thesis suggested that real estate private equity funds, guided by a real estate social investment framework modeled, in part, after the existing social investment frameworks guiding investment in the private equities and venture

capital markets, could be one potential capital delivery vehicle. Such vehicles could potentially work to increase the flow of capital towards alternative development projects in three ways:

1. Through their commitment to the achieving DBL results, these funds could help overcome real estate capital market failures by:
   - Developing the specialized knowledge and expertise necessary to understand the unique challenges and opportunities presented by alternative development locations (inner-city and inner-ring urban areas) as well as alternative development prototypes (mixed-use, mixed-income, urban infill, transit-oriented development, green building, greyfield development, etc.).
   - Exercising flexibility beyond what traditional real estate fund managers have at their disposal; and,
   - Working to develop an investment environment conducive to alternative development projects, through advocacy, public policy and other proactive measures.

2. Raise capital from socially motivated investors who may have existing socially motivated investments in the public (stocks, bonds, and mutual funds), or private (venture capital), business equity markets but may not be currently investing in real estate or would prefer to be investing in socially motivated real estate investments if such vehicles existed. For these investors, real estate investment vehicles guided by a real estate social investment framework would represent an opportunity to diversify their social investment portfolios.

3. Put pressure on conventional capital sources to allocate a share of their total capital towards socially motivated real estate investments (i.e. – alternative development projects).

Chapter 5 took a look at the existing practice of double bottom line real estate private equity funds - real estate private equity funds guided by the basic premise behind the real estate social investment framework developed in Chapter 4. The existing funds in this space can be grouped into three fund models - the Fund Manager, Contract, and Ownership model. The investigation into these models, and the funds within each model, found that current practice is immature and lacking a unifying social investment framework to guide the design, management, and investment decisions of these funds. Thus, the funds investigated exhibited a wide variety of
investment objectives and investment practices. Conventional investment management methodologies and practices still appear to be prevalent in the Fund Manager and Contract fund models, causing social and environmental return objectives to be layered on top of a financial return driven investment decision-making process. The research also highlighted the fact that there are very few funds managed by investment fund managers with an organizational culture driven by the goal of successfully achieving the double bottom line. This raises the question of whether or not private, for-profit investment fund managers are really best suited to manage double bottom line funds without a mechanism to hold the investment manager accountable for also achieving social and environmental returns. The Contract fund model, which pairs a non-profit, community-based fund sponsor with a professional, for-profit investment fund manager, represents a fund structuring innovation designed to enhance the ability of funds to achieve the double bottom line and to provide a level of accountability that the fund will seek to achieve social and environmental return objectives as rigorously as the financial return objective. Yet existing practice is inconclusive as to whether or not this mechanism is achieving anticipated results. It is clear that existing double bottom line funds are achieving DBL returns that likely would not be achieved if not for the funds. However, improvements to existing practice can be made to increase the ability of the funds to achieve the social and environmental return without jeopardizing their ability to meet their financial return expectations. Institutional and infrastructure advances also need to be made for the practice of real estate social investing to gain traction as a legitimate real estate investment practice.

In order for the practice of real estate social investing to gain currency in the investment community it will be necessary to develop industry consensus around an analytic system for measuring expected and realized financial, social, and environmental returns. While it would certainly be advantageous to be able to financially quantify the value of social and environmental return components so they could be seamlessly integrated into the IRR calculation used to measure financial return, this is unlikely in the near term. Instead, for the time being, it seems that each component will need to be evaluating and measured on its own, using industry supported metrics, and then evaluated together to determine the degree of success in achieving financial, social, and environmental return expectations at both the project and fund level. To date, this real estate social investment framework does not exist and thus the nascent field of real estate social investment is being driven by the work of individual funds. It is likely that some
sort of cohesion will be needed if the field has any chance of reaching scale. The formation of an industry trade group could provide the sort of cohesion necessary to truly build a real estate social investment movement. Such a group could support the efforts of individual funds by developing best practices, advocating for favorable public policies, developing programs to support funds in their efforts to integrate the social and environmental bottom lines, and lead the effort to answer some of the big research questions that exist. For examples of how such groups can help advance practice, the nascent real estate social investment industry only needs to look at the community development venture capital industry and the work of the Community Development Venture Capital Association or the public equities social investment industry and the work of the Social Investment Forum. A real estate social investing trade association would be an appropriate intermediary to lead the effort to develop an industry-accepted, standard real estate social investment framework. The association could also lead the research effort to determine the viability of simultaneously achieving financial, social, and environmental returns and to develop case studies highlighting successful projects.

The development of a real estate social investment industry is important if our society is going to move towards a more sustainable approach to real estate development, one that maximizes the positive aspects of development while minimizing the negative impacts that can result when maximizing financial return is the sole investment objective. It is clear that much works still needs to be done in order to realize the great potential and promise of real estate social investing. It is only through critical self-examination and constant refinement that the emerging practice of real estate social investing will grow in credibility and scale and help alternative development projects overcome the critical financing barrier that limits its ability to supplant conventional development as the dominant real estate development pattern in the United States.
## APPENDIX A: LEED Green Building Checklist

### LEED-NC Version 2.1 Registered Project Checklist

<< enter project name >>

<< enter city, state, other details >>

<table>
<thead>
<tr>
<th>Sustainable Sites</th>
<th>14 Points</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PreReq 1</strong> Erosion &amp; Sedimentation Control</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Credit 1</strong> Site Selection</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 2</strong> Development Density</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 3</strong> Brownfield Redevelopment</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 4.1</strong> Alternative Transportation, Public Transportation Access</td>
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</tr>
<tr>
<td><strong>Credit 4.2</strong> Alternative Transportation, Bicycle Storage &amp; Changing Rooms</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 4.3</strong> Alternative Transportation, Alternative Fuel Vehicles</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 4.4</strong> Alternative Transportation, Parking Capacity and Carpooling</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 5.1</strong> Reduced Site Disturbance, Protect or Restore Open Space</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 5.2</strong> Reduced Site Disturbance, Development Footprint</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 6.1</strong> Stormwater Management, Rate and Quantity</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit 6.2</strong> Stormwater Management, Treatment</td>
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<tr>
<td><strong>Credit 7.1</strong> Landscape &amp; Exterior Design to Reduce Heat Islands, Non-Roof</td>
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</tr>
<tr>
<td><strong>Credit 7.2</strong> Landscape &amp; Exterior Design to Reduce Heat Islands, Roof</td>
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<tr>
<td><strong>Credit 8</strong> Light Pollution Reduction</td>
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<table>
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<tr>
<th>Water Efficiency</th>
<th>5 Points</th>
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<tr>
<td><strong>Credit 1.1</strong> Water Efficient Landscaping, Reduce by 50%</td>
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</tr>
<tr>
<td><strong>Credit 1.2</strong> Water Efficient Landscaping, No Potable Use or No Irrigation</td>
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</tr>
<tr>
<td><strong>Credit 2</strong> Innovative Wastewater Technologies</td>
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<tr>
<td><strong>Credit 3.1</strong> Water Use Reduction, 20% Reduction</td>
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<td><strong>Credit 3.2</strong> Water Use Reduction, 30% Reduction</td>
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<table>
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<tr>
<th>Energy &amp; Atmosphere</th>
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<tr>
<td><strong>PreReq 1</strong> Fundamental Building Systems Commissioning</td>
<td>Required</td>
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<tr>
<td><strong>PreReq 2</strong> Minimum Energy Performance</td>
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</tr>
<tr>
<td><strong>PreReq 3</strong> CFC Reduction in HVAC&amp;R Equipment</td>
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</tr>
<tr>
<td><strong>Credit 1</strong> Optimize Energy Performance</td>
<td>1 to 10</td>
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<tr>
<td><strong>Credit 2.1</strong> Renewable Energy, 5%</td>
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</tr>
<tr>
<td><strong>Credit 2.2</strong> Renewable Energy, 10%</td>
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<tr>
<td><strong>Credit 2.3</strong> Renewable Energy, 20%</td>
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<tr>
<td><strong>Credit 3</strong> Additional Commissioning</td>
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<td><strong>Credit 4</strong> Ozone Depletion</td>
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<td><strong>Credit 5</strong> Measurement &amp; Verification</td>
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<td><strong>Credit 6</strong> Green Power</td>
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continued...
### Materials & Resources

<table>
<thead>
<tr>
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<th>Description</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prereq 1</td>
<td>Storage &amp; Collection of Recyclables</td>
<td></td>
</tr>
<tr>
<td>Credit 1.1</td>
<td>Building Reuse, Maintain 75% of Existing Shell</td>
<td>1</td>
</tr>
<tr>
<td>Credit 1.2</td>
<td>Building Reuse, Maintain 100% of Shell</td>
<td>1</td>
</tr>
<tr>
<td>Credit 1.3</td>
<td>Building Reuse, Maintain 100% Shell &amp; 50% Non-Shell</td>
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</tr>
<tr>
<td>Credit 2.1</td>
<td>Construction Waste Management, Divert 50%</td>
<td>1</td>
</tr>
<tr>
<td>Credit 2.2</td>
<td>Construction Waste Management, Divert 75%</td>
<td>1</td>
</tr>
<tr>
<td>Credit 3.1</td>
<td>Resource Reuse, Specify 5%</td>
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<tr>
<td>Credit 3.2</td>
<td>Resource Reuse, Specify 10%</td>
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<tr>
<td>Credit 4.1</td>
<td>Recycled Content, Specify 5% (post-consumer + ½ post-industrial)</td>
<td>1</td>
</tr>
<tr>
<td>Credit 4.2</td>
<td>Recycled Content, Specify 10% (post-consumer + ½ post-industrial)</td>
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<tr>
<td>Credit 5.1</td>
<td>Local/Regional Materials, 20% Manufactured Locally</td>
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<tr>
<td>Credit 5.2</td>
<td>Local/Regional Materials, of 20% Above, 50% Harvested Locally</td>
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<tr>
<td>Credit 6</td>
<td>Rapidly Renewable Materials</td>
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<tr>
<td>Credit 7</td>
<td>Certified Wood</td>
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### Indoor Environmental Quality

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<tr>
<td>Prereq 1</td>
<td>Minimum IAQ Performance</td>
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<tr>
<td>Prereq 2</td>
<td>Environmental Tobacco Smoke (ETS) Control</td>
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<tr>
<td>Credit 1</td>
<td>Carbon Dioxide (CO₂) Monitoring</td>
<td>1</td>
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<tr>
<td>Credit 2</td>
<td>Ventilation Effectiveness</td>
<td>1</td>
</tr>
<tr>
<td>Credit 3.1</td>
<td>Construction IAQ Management Plan, During Construction</td>
<td>1</td>
</tr>
<tr>
<td>Credit 3.2</td>
<td>Construction IAQ Management Plan, Before Occupancy</td>
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</tr>
<tr>
<td>Credit 4.1</td>
<td>Low-Emitting Materials, Adhesives &amp; Sealants</td>
<td>1</td>
</tr>
<tr>
<td>Credit 4.2</td>
<td>Low-Emitting Materials, Paints</td>
<td>1</td>
</tr>
<tr>
<td>Credit 4.3</td>
<td>Low-Emitting Materials, Carpet</td>
<td>1</td>
</tr>
<tr>
<td>Credit 4.4</td>
<td>Low-Emitting Materials, Composite Wood &amp; Agrifiber</td>
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</tr>
<tr>
<td>Credit 5</td>
<td>Indoor Chemical &amp; Pollutant Source Control</td>
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</tr>
<tr>
<td>Credit 6.1</td>
<td>Controllability of Systems, Perimeter</td>
<td>1</td>
</tr>
<tr>
<td>Credit 6.2</td>
<td>Controllability of Systems, Non-Perimeter</td>
<td>1</td>
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<tr>
<td>Credit 7.1</td>
<td>Thermal Comfort, Comply with ASHRAE 55-1992</td>
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</tr>
<tr>
<td>Credit 7.2</td>
<td>Thermal Comfort, Permanent Monitoring System</td>
<td>1</td>
</tr>
<tr>
<td>Credit 8.1</td>
<td>Daylight &amp; Views, Daylight 75% of Spaces</td>
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</tr>
<tr>
<td>Credit 8.2</td>
<td>Daylight &amp; Views, Views for 90% of Spaces</td>
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</table>

### Innovation & Design Process

<table>
<thead>
<tr>
<th>Credit</th>
<th>Description</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit 1.1</td>
<td>Innovation in Design: Provide Specific Title</td>
<td>1</td>
</tr>
<tr>
<td>Credit 1.2</td>
<td>Innovation in Design: Provide Specific Title</td>
<td>1</td>
</tr>
<tr>
<td>Credit 1.3</td>
<td>Innovation in Design: Provide Specific Title</td>
<td>1</td>
</tr>
<tr>
<td>Credit 1.4</td>
<td>Innovation in Design: Provide Specific Title</td>
<td>1</td>
</tr>
<tr>
<td>Credit 2</td>
<td>LEED™ Accredited Professional</td>
<td>1</td>
</tr>
</tbody>
</table>

### Project Totals (pre-certification estimates)

Certified 26-32 points  Silver 33-38 points  Gold 39-51 points  Platinum 52-69 points
## APPENDIX B: LISC Social Objective Criteria

<table>
<thead>
<tr>
<th>Objective</th>
<th>Metric</th>
<th>Target (Examples)</th>
<th>Tracking Method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rental Housing Affordability</strong>&lt;br&gt;<strong>Example</strong></td>
<td><strong>Rent as a percentage of area median income</strong></td>
<td><strong>Units should remain occupied by and affordable (&lt;30% of income) to families earning 60% of Area Median Income.</strong></td>
<td><strong>Annual tenant income certification</strong>&lt;br&gt;&lt;br&gt;<strong>Annual comparison of rents to income statistics published by HUD.</strong></td>
</tr>
<tr>
<td><strong>Job Creation</strong></td>
<td><strong>Net new jobs provided by businesses leasing space.</strong>&lt;br&gt;<strong>(Total jobs less any that existed prior to relocation)</strong></td>
<td><strong>Unit will be leased to businesses that generate at least 25 net new jobs</strong></td>
<td><strong>Comparison of pre-occupancy and post-occupancy surveys of business tenants.</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Jobs provided to disadvantaged workers by businesses leasing space.</strong></td>
<td><strong>15 jobs provided to individuals classified as difficult to employ.</strong>&lt;br&gt;(i.e. Long term unemployed, welfare recipients, etc.)</td>
<td><strong>New employee information forms administered by all business tenants for each hire.</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Number of jobs provided which meet the local living wage standard.</strong></td>
<td><strong>30 jobs will be provided on site which pay $9.25 per hour of $8 with Benefits adjusted annually by the City’s Living Wage Ordinance.</strong>&lt;br&gt;(or some other living wage standard if no adequate city ordinance)</td>
<td><strong>Annual Employment and Benefits Survey administered to each employer.</strong></td>
</tr>
<tr>
<td><strong>Job Training Opportunities</strong></td>
<td><strong>Number of formal job training spots provided.</strong></td>
<td><strong>Space will be leased to professional job training organizations (or employers working closely with such organizations) for uses that provide training to a minimum of 100 people per year.</strong></td>
<td><strong>Annual report on enrollments and placements completed by training providers.</strong></td>
</tr>
<tr>
<td><strong>Community Services</strong></td>
<td><strong>Percentage of the project tenants that provide services that were previously unavailable in the community</strong></td>
<td><strong>The majority of tenants will provide at least one service identified as lacking in the community by the community needs assessment prior to their move-in.</strong></td>
<td><strong>Community needs assessment survey conducted at least every three years.</strong></td>
</tr>
<tr>
<td><strong>Income Generation</strong></td>
<td><strong>Amount of annual unrestricted cash flow generated</strong></td>
<td><strong>The building will generate a minimum of $75,000 annual net revenue (after reserve contributions) to be used to support tenant services.</strong></td>
<td><strong>Financial Audits.</strong></td>
</tr>
</tbody>
</table>

141
<table>
<thead>
<tr>
<th><strong>Small Business Development</strong></th>
<th>Percentage of tenants that are disadvantaged businesses which would not otherwise be able to lease comparable space.</th>
<th><em>Fifty percent</em> of tenant businesses will be owned and operated by minority first-time entrepreneurs.</th>
<th>Ownership and previous business experience information requested on rental application.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nonprofit Office Space</strong></td>
<td>Percent by which rents for nonprofit (arts, service, etc.) tenants are below market rents for the area.</td>
<td>Space will be leased to nonprofits providing services to building residents and other community members at least 20% below the prevailing rent for comparable space in the area.</td>
<td>Annual area rent study.</td>
</tr>
</tbody>
</table>
## BAY AREA SMART GROWTH FUND

<table>
<thead>
<tr>
<th>#</th>
<th>Project Name</th>
<th>Location</th>
<th>Amount Invested</th>
<th>Investment Type</th>
<th>Development Type</th>
<th>Developer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Ascend Housing</td>
<td>scattered site</td>
<td>$ 3,000,000</td>
<td>equity</td>
<td>residential</td>
<td>Ascend Residential Properties</td>
</tr>
<tr>
<td>2</td>
<td>Gateway Retail Center</td>
<td>Marin City</td>
<td>$ 7,910,000</td>
<td>joint venture</td>
<td>retail</td>
<td>Mcle/Blake Hunt Ventures</td>
</tr>
<tr>
<td>3</td>
<td>North Richmond Land</td>
<td>North Richmond</td>
<td>$ 2,700,000</td>
<td>equity</td>
<td>land development</td>
<td>BASGF/ZKS</td>
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<tr>
<td>4</td>
<td>Oakland Airport Business Park</td>
<td>Oakland</td>
<td>$ 6,000,000</td>
<td>equity</td>
<td>office</td>
<td>Lincoln Property</td>
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<tr>
<td>5</td>
<td>Story &amp; King</td>
<td>East San Jose</td>
<td>$ 10,000,000</td>
<td>equity</td>
<td>retail</td>
<td>Blake Hunt Ventures</td>
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<td>6</td>
<td>Vallejo Plaza</td>
<td>Vallejo</td>
<td>$ 5,200,000</td>
<td>loan</td>
<td>retail/residential</td>
<td>La Caze Development</td>
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**TOTAL** $ 34,810,000
<table>
<thead>
<tr>
<th>#</th>
<th>Project Name</th>
<th>Location</th>
<th>Amount Invested</th>
<th>Investment Type</th>
<th>Development Type</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Ironworks</td>
<td>West Sacramento</td>
<td>$2,700,000</td>
<td>equity</td>
<td>residential</td>
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<tr>
<td>2</td>
<td>Alder Grove Apartments</td>
<td>North Highlands</td>
<td>$3,900,000</td>
<td>equity</td>
<td>condo conversion</td>
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<tr>
<td>3</td>
<td>Woodlake Place Apartments</td>
<td>Lodi</td>
<td>$4,500,000</td>
<td>equity</td>
<td>condo conversion</td>
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<tr>
<td>4</td>
<td>Rollingwood Commons</td>
<td>Fair Oaks</td>
<td>$5,500,000</td>
<td>equity</td>
<td>condo conversion</td>
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<tr>
<td>5</td>
<td>Union Pacific</td>
<td>Truckee</td>
<td>$6,000,000</td>
<td>equity</td>
<td>residential / retail</td>
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</table>

TOTAL $22,600,000
<table>
<thead>
<tr>
<th>#</th>
<th>Project Name</th>
<th>Location</th>
<th>Development Type</th>
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</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Nthorne $ 20,000,000 Joint Venture I Industrial Lowe Enterprises Downtown Los Angeles Nuys Inland Empire</td>
<td>$ 2,000,000 Joint Venture Industrial</td>
<td>$ 5,500,000 Mezzanine Loan Industrial</td>
<td>$ 2,500,000 Joint Venture Industrial</td>
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<td>2</td>
<td>Silver Creek Properties - Silver Creek Properties</td>
<td>Residential/Commercial</td>
<td>$ 2,000,000 Mezzanine Loan Residential/Commercial</td>
<td>$ 2,000,000 Mezzanine Loan Residential/Commercial</td>
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<td>3</td>
<td>GTO Hampton</td>
<td>Mixed Use</td>
<td>$ 4,380,000 Joint Venture Mixed Use</td>
<td>$ 2,750,000 Joint Venture Mixed Use</td>
</tr>
<tr>
<td>4</td>
<td>Sunshine Platforms</td>
<td>Retail</td>
<td>$ 20,000,000 Joint Venture Retail</td>
<td>$ 20,000,000 Joint Venture Retail</td>
</tr>
<tr>
<td>5</td>
<td>Seventh Street Development</td>
<td>Industrial</td>
<td>$ 1,890,000 Mezzanine Loan Industrial</td>
<td>$ 3,140,000 Mezzanine Loan Industrial</td>
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<td>6</td>
<td>Hampton Development</td>
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<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
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<td>7</td>
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<td>Residential/Commercial</td>
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<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
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<td>Residential/Commercial</td>
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<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
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<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
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<td>10</td>
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<td>11</td>
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<td>Residential/Commercial</td>
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<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
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<td>12</td>
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<td>Residential/Commercial</td>
<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
<td>$ 5,000,000 Joint Venture Residential/Commercial</td>
</tr>
</tbody>
</table>

**Amount Invested Total**: $ 74,870,000

**Date**: To Date

**AppENDIX E: Genesis L.A. Real Estate Fund I Investments**
APPENDIX F: Green Communities Initiative Underwriting Criteria

Green Communities:
Summary of Underwriting Criteria

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(Full criteria with technical specifications will be provided in a supplement that will be made available by November 1, 2004)

A. Mandatory Items

Integrated Design Process
Explore green development options in the design phase through a structured planning process using a multi-disciplinary team that includes at least one team member experienced in green design.
Incorporate all Mandatory criteria items into a Green Development Plan with a minimum number of optional measures (see Section B, below). When working drawings are completed the project architect will certify that these Criteria have been met.

Smart Site Location
Locate projects on sites with access to existing roads, water, sewers, and other infrastructure within or contiguous to existing development.
Do not locate new development on wetlands, steep slopes, prime farmland or parkland.
Locate projects within walking distance of community and retail facilities.

Walkable, Accessible Neighborhoods
Include sidewalks or other suitable pathways within a multi-family property or single-family subdivision to encourage walking within and off the site.

Compact Development
Average minimum density for new construction should be 6 units per acre for detached or semi-detached; 10 for town homes; and 15 for apartments.

Environmental Remediation
Conduct a Phase I Environmental Site Assessment and additional assessments if required, then provide a plan for abatement of any hazards.

Erosion and Sedimentation Control

Water Usage
Select trees and plants appropriate to the climate, including drought-tolerant species in regions with low levels of rainfall.
Irrigate only with water efficient systems, captured rainwater or reclaimed water in areas with declared water shortages.
Use appliances and plumbing fixtures that reduce water use and sewage outflow; OR If a rehab project, use low-flow toilets and showerheads and meet requirements for
replacement of any other fixtures and appliances.

**Energy Efficiency**
Demonstrate energy efficiency by meeting Energy Star standards or a HERS design score of 86; OR if a rehab project, demonstrate energy efficiency by implementing cost-effective energy improvements with a 10 year payback or better as identified by a qualified engineer or energy auditor.
- Install individual or sub-metered electric meters in multifamily housing units (except zero bedroom dwelling units).
- Install Energy Star labeled appliances and lighting fixtures.
- Install daylight sensors on all outdoor lighting.

**Healthy Living Environment**
- Use composite wood (e.g. particleboard) only if free of added urea formaldehyde.
- Use Carpet and Rug Institute’s Green Label certified carpet in carpeted areas.
- Specify low-toxic, solvent-free, or low volatile organic compound paints, primers, sealers and adhesives.
- To ensure effective removal of moisture, install fans in bathrooms exhausting to the outdoors equipped with a humidistat sensor, low speed control or timer.
- Vent kitchen range hoods to the exterior.
- Do not install mold-propagating materials such as vinyl wallpaper and unsealed grout, in wet areas.
- Insulate cold water pipes in climates and building conditions susceptible to moisture condensation.
- To avoid moisture problems, use tankless hot water heaters or install conventional hot water heaters so that overflow or leaks are captured by drains.
- Use highly durable, moisture resistant materials in tub/shower enclosures.
- Appropriately size HVAC systems to prevent short-cycling of heating or air conditioning and ensure adequate dehumidification.
- Provide proper drainage down to the lowest level of concrete and provide vapor barriers under all slabs.
- Provide surface drainage of water away from foundations.
- Ventilate air spaces under any floor slabs in Zone 1 radon areas.
- Provide a fan with a CO sensor for any enclosed garage space.
- Adequately ventilate all living areas by providing 15 cubic feet per minute of fresh air per occupant either via the HVAC system or through natural ventilation.

**Owner and Resident Education**
- Provide a plan for educating the owner regarding the intent of integrated Green building features as well as their proper use and maintenance.
- For multi-family projects, provide a Green Home Guide for residents describing the intent, benefits, use and maintenance of Green building features.
B. Options that Must Total at Least:
25 Points for New Construction
20 Points for Rehabilitation

Additional Resource Conservation
Locate the project on a greyfield, brownfield or adaptive reuse site. (10 points)
Increase average density above the levels specified in the Mandatory Compact Development item. (5 points for an increase of at least 2 units/acre)
Achieve reductions in the square footage of building envelope (outer walls and ceilings) as compared to the developer’s most compact previous development of the same type. (5 points for each 5% reduction in envelope area for a maximum 15 points)
Exceed Energy Star standards through passive or active solar energy features, superinsulation, or other methods. (5 points for each 5% additional savings for a maximum 15 points; **OR if a rehab project**, 15 points for adopting additional improvements that extend the payback period to 14 years or more)
Install photovoltaic panels to provide at least 10% of the project’s estimated electricity demand. (5 points, plus 5 points for each additional 10% increment up to a maximum of 15 points)
Assure that at least 5% (by dollar value) of all newly-installed materials have some recycled content. (2 points, plus two points for each additional 5% increment, not to exceed 14 points)
Install natural linoleum in kitchens and bathrooms or install bamboo floorings in living rooms and bedrooms. (5 points)
Use at least 50% wood products and materials from salvaged wood, wood certified in accordance with the Forest Stewardship Council, or engineered framing materials. (10 points)
Use water-permeable materials in 50% or more of walkways. (5 points)
Use water-permeable materials in 50% or more of parking areas. (10 points)
Install reflective or open-grid paving. (5 points)

Surface Water Management
Capture the first ½ inch of rainfall that falls within a twenty-four hour period. (5 points)
Label all storm drain or storm inlets. (2 points)

Walkable, Accessible Neighborhoods
Locate center of development within a ¼ mile of public transit service or ¼ mile from a fixed rail station. (5 points for rehab of an existing residential building; 10 points for other redevelopment, as defined above, or new construction)
Provide at least 3 separate and remote connections to sidewalks or pathways in the surrounding neighborhoods. (5 points)
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