Mixed-Use Development as a Neighborhood Revitalization Strategy: Obstacles and Approaches to Financing

by

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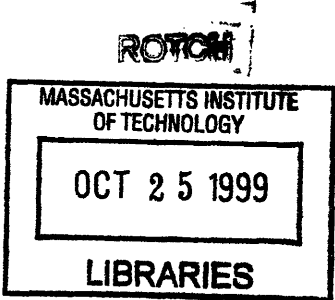

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ABSTRACT

The focus of this research paper is to identify and explore the obstacles to financing neighborhood mixed-use development. This model of development has proven to be an important neighborhood revitalization strategy for many inner-city neighborhoods. However, the difficulties in financing mixed-use projects limit the opportunity for replication in other communities. The case studies presented in this paper highlight the types of challenges that face developers in assembling financing for mixed-use projects. They also provide some insight into various strategies to overcome these obstacles to financing. The thesis concludes that the mechanisms for providing public resources to neighborhood mixed-use development are inefficient and add to the costs of a project; private lending institutions currently play only an inadequate and limited role in financing these projects; and the strength of the commercial component is critical to the success of a mixed-use project.

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CHAPTER 1:
Introduction

This thesis explores a particular kind of real estate development called "mixed-use" development, which combines multiple uses (residential, retail, office) in a single building or group of buildings. The idea of mixed-use development is certainly not novel, but it has been gaining popularity in recent years. Proponents of the New Urbanism have adopted it as a strategy for environmentally responsible, compact development. The U.S. Environmental Projection Agency is calling for more and better mixed-use development as part of its anti-sprawl "Smart Growth" campaign. Many cities have begun to design more flexible zoning, to allow a greater diversity of uses and promote thriving 24-hour neighborhoods and downtowns. Some community development practitioners believe that mixed-use development can contribute to the jobs/housing balance in inner-city areas.

While there are many potential benefits to this kind of development, mixed-use projects pose a number of challenges in terms of design, management, and particularly in terms of financing. Mixed-use projects, by nature, require an understanding of different kinds of real estate and are therefore more difficult to underwrite. Financing mixed-use development in inner-city neighborhoods – the focus of this thesis – can be even more complicated, due to higher development costs, greater perceived risk, and redlining practices. As a result, certain types of financing – equity sources and long-term capital in particular – can be difficult to find for these projects. The following chapters explore in detail the various obstacles to financing neighborhood mixed-use development.

Mixed-use development and neighborhood revitalization

I have chosen to look at mixed-use development in the neighborhood context because this type of real estate activity can also be an important strategy for neighborhood revitalization. Throughout this thesis, I will use the terms "neighborhood revitalization" and "community development" to describe the set of interventions that attempt to improve the physical, social,

and economic conditions of distressed urban neighborhoods. Community development work encompasses a variety of separate activities that try to bring about changes in a neighborhood, including small business lending, job training, and housing development. In the next chapter, I will assert that mixed-use development can be an effective strategy for bridging the many goals of community development. This argument underpins the entire thesis.

One of the particular challenges of neighborhood mixed-use development is that it combines housing and economic development – two community development activities that have traditionally been separate. This particular combination of neighborhood revitalization strategies has important implications for how project is designed and financed.

Need for neighborhood revitalization

The decline of urban neighborhoods has been well documented by historians, who trace the cause back to the late 20th century demographic trend known as suburbanization. The loss of urban population to the suburbs began after World War II and the outflow continued in subsequent decades. In 1950, 60% of the country's population lived in the central city. By 1970, the percentage of the country's population living outside the central city had outpaced its inner-city counterpart. In 1990, the roles had reversed; only 40% of Americans lived in the central city, while 60% lived in the suburbs and beyond.[1]

Major shifts in employment and retail patterns followed the population out of the city. Employment has also suburbanized over the last several decades, relocating mainly to large office parks convenient to major highway interchanges. The downtown department store has been replaced by the strip mall as the major American shopping destination.

The process of suburbanization has affected the way most Americans live, work, and shop. The residents of inner-city neighborhoods have perhaps been most severely affected by the growth of

[1] United States General Accounting Office, "Community Development: Extent of Federal Influence on "Urban Sprawl" is Unclear" (April 1999), p. 5.

the suburbs.[2] As jobs and more affluent families have left the city for the promise of suburbia, poorer residents have been left behind, essentially trapped in their declining inner-city neighborhoods. The gradual loss of population and employment base has had a devastating impact on all aspects of urban life. Without a healthy tax base, cities can no longer afford adequate services, and urban schools have declined rapidly. Without access to jobs, the inner-city population has become poorer. The deterioration of neighborhood housing has followed. Accompanying this decline in physical infrastructure has been a parallel decline in neighborhood and community infrastructure, due to a concentration of poverty and lack of opportunity for economic mobility. [3]

Leading the fight to restore and stabilize urban neighborhoods are the community development corporations (CDC). These small, locally-based non-profit groups have become adept at marshalling the financial resources needed to implement neighborhood revitalization projects - finding a way when the market has failed. CDCs will play a prominent role later in this paper, as they are the primary real estate developers in many low-income neighborhoods and the force behind each of the three case study projects.

Research Questions and Methodology

There are two questions I hope to answer through this research:

1. *Given that mixed-use development can be an effective neighborhood revitalization strategy, why are these projects so difficult to finance?*

To answer this question I first develop a set of criteria that describe a successful neighborhood mixed-use development project. I then develop an analytical framework, using the literature on market failures, to identify a set of explanations for why mixed-use development projects are difficult to finance. This framework helps to explain why the role of public financing is so

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[2] Beyond Sprawl: New Patterns of Growth to Fit the New California, 1995. A report put out by Bank of America and the California Resources Agency.

[3] Anthony Downs does a good job of explaining the effects of suburbanization on urban neighborhoods – especially urban housing markets – in *Neighborhoods and Urban Development.*

important to mixed-use projects and why role of private financing is relatively limited. Finally, I perform case study analyses of three "successful" projects to understand both the obstacles to financing these projects and some of the strategies used to overcome those obstacles. This analysis highlights the importance of federal housing program in financing these mixed-use development projects and helps frame my second research question.

2. *What are some strategies or tools available to facilitate the development of mixed-use projects?*

The case studies illustrate that neighborhood mixed-use development relies heavily on public financing to get the projects built. Therefore, to answer this second question, I focus on the types of programs and tools available to finance mixed-use development, the most important of which were federal housing programs. The research for this question was based on a review of the literature on federal housing programs, an analysis of specific program requirements, and interviews with administrators who work with these programs. Based on this analysis, I conclude that these programs should be made more flexible and should attempt to facilitate the involvement of private financial institutions.

To supplement the academic research for both of these questions, I interviewed non-profit and for-profit developers, public and private lenders, and investors who play a role in developing neighborhood real estate projects.

Thesis Outline

Chapter 2 presents an argument for mixed-use development as a possible neighborhood revitalization strategy for distressed inner-city communities. This argument is set in the context of current debates about community development.

Chapter 3 develops a framework to evaluate the obstacles to financing neighborhood mixed-use development. The framework draws from the literature on capital market failures and describes a set of market imperfections that influence how capital is allocated to these projects.

Chapter 4 presents the experiences of three non-profit developers who undertook major mixed-use development projects in their neighborhoods. Drawing on the discussion of market imperfections in Chapter 3, the case study analysis identifies several obstacles to financing these projects. The chapter also illustrates some of the strategies used to overcome these obstacles.

Chapter 5 focuses on the set of tools for financing development that are available through the various federal programs. The analysis focuses on whether these funding programs are well suited to the needs of neighborhood mixed-use development.

Chapter 6 provides some conclusions about financing mixed-use development projects and offers a set of recommendations for the policy-makers, program administrators, and developers involved in community development work.

CHAPTER 2:

Mixed-Use Development and its Role in Neighborhood Revitalization

The purpose of this chapter is to introduce the concept of mixed-use development and to present an argument supporting its importance as a strategy for neighborhood revitalization. In the introduction to this thesis, I described neighborhood revitalization as a set of interventions that attempt to address the physical, economic, and social problems of disadvantaged urban communities. In this chapter, I demonstrate that mixed-use development, a form of real estate that brings together housing and economic development activities, can advance each of these goals. While this community development strategy may not be appropriate for every neighborhood, there are numerous examples of successful mixed-use development projects that have helped to "turn around" distressed neighborhoods. Some of these projects will be described in Chapter 4, which presents three case studies of successful mixed-use development projects.

What is "mixed-use" development?

"Mixed-use" development is a rather broad term. It can be used to describe a building with multiple uses – retail, office, residential – housed under one roof. It can also describe a group of buildings within a certain area, such as a city block, that include various uses. Over the past two decades, the term "mixed-use" development has been commonly used to describe major real estate projects that include office, retail, hotel, and residential components designed to generate new vitality in downtown areas. The Urban Land Institute has created a separate project category for this last type, labeled MXD.[4] Some representative examples are Copley Place in Boston and Water Tower Place in Chicago.

The MXD projects of the 1980s and 1990s are novel in terms of their size, but they reflect a familiar development prototype. These projects attempt to recreate the traditional urban development patterns common to most older cities. Mixed-use development was a natural by-

[4] The Urban Land Institute's definition of mixed-use development is a project containing three or more self-sustaining, revenue-producing uses, which is integrated both physically and functionally, and which is developed in accordance with a coherent plan. Dean Schwanke, *Mixed-Use Development Handbook* (Washington, D.C.: Urban Land Institute, 1987).

product of early growth and development. Before advances in transportation technology like the train, the trolley and the automobile gave people more freedom to live and work where they pleased, cities were compact centers for housing, commerce, and employment. Because the supply of centrally located land was limited, economics dictated that separate uses share the same space. This pattern of development still holds in certain high density urban areas. In New York City, mid-rise buildings with retail stores on the street level, small offices on the second floor, and apartments above are commonplace. Commercial districts like Newbury Street in Boston, which combines upscale housing, street level retail, and many smaller professional offices housed in turn-of-the-century brownstone buildings, offer another example of mixed-use development.

For the most part, this pattern of mixed-use development has disappeared over time. There are three main reasons for this trend: the loss of urban population to the suburbs and the corresponding shifts in employment and retailing patterns, a focus on the automobile in shaping development patterns, and zoning practices that discourage the mixing of different uses.[5] These changes have had a tremendous impact on the way newer urban areas look and function. Today, instead of placing housing, retail and work together in mixed-use neighborhoods, development patterns have taken on a decidedly single-use form. Sprawling residential neighborhoods, endless strip malls, and well-landscaped office parks – usually separated by miles of highways – describe the typical landscape in newer cities like Phoenix or Atlanta.

In recent decades, however, the benefits of mixed-use development have been rediscovered. Planners and developers again appreciate the urban qualities that mixed-use development promotes, including the convenience of having home, shopping, and work in close proximity and the positive social and economic benefits of pedestrian activity. The success of large downtown projects like Copley Place suggest that there is still a role for mixed-use development in urban areas.

Mixed-use Development in the Neighborhood Context

Most of the renewed interest in mixed-use development has focused on downtowns. However, mixed-use development also has a long history as well as an important modern-day role in inner-city neighborhoods. Central commercial districts in most urban neighborhoods have traditionally combined housing, commercial, and institutional uses. As residents gradually moved to the suburbs, and the urban customer base has shrunk, some neighborhood centers have emptied out. Yet, for many densely populated urban neighborhoods, the mixed-use neighborhood business district still plays an important role in daily life.

Since the focus of the rest of this thesis will be on mixed-use development in the neighborhood context, the reader must understand what is meant by "neighborhood" mixed-use development. Perhaps the easiest way to define it is by comparison with its downtown counterpart. Whereas downtown mixed-use development tends to be very large, the neighborhood version is typically defined by smaller, low-rise buildings. Downtown mixed-use projects include major retail, hotel, and entertainment uses. The tenants in neighborhood mixed-use projects are usually local businesses, local professionals, and local residents. In terms of design, downtown projects tend to be enclosed spaces that focus inward. With neighborhood mixed-use development, the buildings are focused outward to the street and the community.

The Benefits and Challenges of Neighborhood Mixed-use Development

While mixed-use development can offer certain advantages over the standard single-use prototype, it can also pose a number of risks in terms of design, construction, and management. The following discussion covers some of the benefits and challenges of developing a neighborhood mixed-use project.

- *Planning and Design*

  From the perspective of design, mixed-use development makes for a more visually interesting streetscape. Mixed-use buildings in a neighborhood center typically include

[5] The creation of single-use zoning districts is also known as Euclidean zoning. For an interesting discussion of the evolution and current practice of zoning, see *The Zoning Game: Municipal Practices and Policies* by Richard F.

ground floor retail space, which puts many windows and doors at eye level and gives the passer-by a glimpse of the activity within these spaces. The residential uses are usually located above, to give residents some buffer from the activity on the street. In addition, the many older, historic buildings that are good candidates for neighborhood mixed-use development offer beautiful architectural detail. The main challenge of planning a mixed-use project is figuring out which uses can be effectively integrated. Retail use can be quite successful at the street level, but second floor commercial space is difficult to rent – especially since the demand for office space in most urban neighborhoods are weak.[6] The traditional combination of retail below and housing above still works in many communities, but some residents may find the presence of a retail operation obtrusive or distasteful.

Once a particular use mix is decided upon, the design of the project must then find a way to accommodate the needs of each use. A building that combines different uses under one roof requires careful separation of access for security and privacy, and frequently requires separate mechanical services. This can add to the construction costs to a project. If done poorly, the building may ultimately be more difficult to manage.[7]

Existing structures offer other kinds of design challenges. In many of the older buildings that exist in neighborhood commercial districts, the residential units can be quite spacious, but the retail space may not conform to the needs of modern commercial tenants. In addition, existing mixed-use development may introduce more retail space than the current resident population can support. One solution is to reduce and reconfigure the amount of commercial space.[8]

- *Development and Construction*

  The one clear advantage of doing mixed-use development in urban neighborhoods is that much of the infrastructure is already there, including the buildings in some cases.

Babcock.

[6] Interview with Bart Goldberg, appraiser.

[7] Dorothy Walton, "Challenges of Marketing Mixed-use Properties," *Journal of Property Management*, Nov./Dec. 1991.

[8] Anthony Downs, *Neighborhoods and Urban Development* (Washington, D.C.: The Brookings Institution, 1981), p. 161.

Development and construction in the inner-city is in most other respects challenging and expensive. In an Urban Land Institute article, one developer includes untested markets, environmental issues, high land costs and development costs, and outdated infrastructure as major obstacles to developing inner-city sites.[9]

- *Operations and Management*

From a financial perspective, mixed-use projects offer a number of potential benefits to the developer. If the project is large enough, it can create certain economies of scale as a result of shared infrastructure. In theory, this development type can also serve as a hedging strategy against market cycles, because it allows for the diversification among uses within a single project.[10] In a smaller neighborhood project, however, this particular benefit is harder to capture because there may be only two uses. Finally, mixed-use development has the potential to create synergies among its various uses, as a result of self-reinforcing supply and demand. For example, a retail tenant in a mixed-use project might that benefits from the business created by the comings and goings of office workers or residents who share the same address might be willing to pay a higher rent. In other words, in a successful mixed-use project, the whole is greater than the sum of the parts.

Despite these advantages, the critical challenge in achieving financial success in a mixed-use project is understanding the different retail, office and residential real estate markets and finding the synergy among them. This can be particularly difficult in urban neighborhoods, where there have been fundamental shifts in demographics and employment patterns.

Neighborhood revitalization strategies: housing vs. economic development

Neighborhood revitalization and community development can be defined in several different ways. Avis Vidal describes community development rather broadly as "when investments (of either capital or labor) produce changes in the institutional infrastructure locally available to

[9] Diane R. Suchman, "Urban Change and Infill Housing Development," *Creating More Livable Metropolitan Areas* (Washington, D.C.: The Urban Land Institute, 1993), p. 17.

develop and sustain productive members of the community."[11] More specifically, the goals of community development can be broken down into two categories: improving the physical place of a community and improving the situation of people who live in the community. The first strategy usually incorporates housing and other real estate development activities, while the second focuses more on job training and business development.

In practice, the distinction between place-based and people-based strategies is less clear. Most community development corporations combine both strategies in their work to revitalize neighborhoods. As Vidal points out, "The relevant policy issue is not people versus place or rebuilding the fabric of poor neighborhoods versus dispersing their residents to other places and somehow starting over. Rather, the issue is whether and under which circumstances a specific set of interventions targeted to and tailored to the needs of disadvantaged neighborhoods has a constructive role in the policy portfolio."[12] I share this belief that a combination of place-based and people-based strategies is required to achieve neighborhood revitalization.

One of the biggest challenges of mixed-use development – from a community development perspective – is that it combines both housing and economic development activities. Most CDCs – about 88%, according to a 1991 survey by the National Congress for Community Economic Development – participate in housing development activities and have become successful affordable housing developers. Success in economic development activities, however, has been more elusive.[13] Teitz suggests this is because local groups often lack the financial resources, technical expertise, and appropriate outlook to cope effectively with the problems of economic development.[14] Unlike the market for affordable housing, which reflects to a local demand that can easily be estimated, the market for economic development projects is influenced by the larger, regional economy. Estimating the demand for a new retail store, for example, is therefore

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[10] Since the markets for residential, retail, and office space do not typically move together, this means that a downcycle in one market will not necessarily bankrupt a project. Paul D. Childs, Timothy J. Riddiough, and Alexander J. Triantis, "Mixed Uses and the Redevelopment Option," *Real Estate Economics*, September 1996.
[11] Avis C. Vidal, "Reintegrating Disadvantaged Communities into the Fabric of Urban Life: The Role of Community Development," *Housing Policy Debate*, Vol. 6, Issue 1 (1995), p. 172.
[12] *Ibid.*, p. 171.
[13] Avis C. Vidal, "Rebuilding Communities: A National Study of Urban Community Development Corporations," (Community Development Research Center, New School for Social Research), p. 5.

much more difficult. Furthermore, in a neighborhood mixed-use development project that combines residential and commercial uses, what works as an economic development strategy may not be compatible with affordable housing.

Mixed-use Development as a Neighborhood Revitalization Strategy

Mixed-use development is therefore relevant as a neighborhood revitalization strategy because it synthesizes two important community development activities: housing development and economic development. In this way, it can have a more comprehensive impact on a neighborhood. And, beyond providing housing and economic development benefits, a mixed-use project that achieves the right synergy among uses will generate the kind of social activity that makes a place a good place to live. Mixed-use development also generally contributes to a neighborhood's "quality of life," to use a term popular with urban planners these days.

This is not to suggest mixed-use development as a panacea for every community. Some community development practitioners claim that retail development is ineffective as an economic development tool. This is a valid criticism, and I agree that a single project does not typically have a major impact on a neighborhood's economy.[15] Also, as with all physical revitalization strategies, there is always the possibility that, by improving neighborhood conditions, such development will help create the conditions for gentrification and the displacement of existing residents. Nevertheless, I believe that mixed-use development can be an effective strategy for improving the physical, social, and economic environments of a community.

Impact on the Neighborhood's Physical Environment

Mixed-use development can promote neighborhood revitalization by improving the physical fabric of a community. Many neighborhood commercial centers, which have the greatest potential for mixed-use development, have suffered from disinvestment. The evidence of this

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[14] Michael B. Teitz, "Neighborhood Economics: Local Communities and Regional Markets," *Economic Development Quarterly*, Vol. 3, No. 2 (May 1989), p.112.

[15] The Lithgow Project in Codman Square, Dorchester, which will be discussed in Chapter 4, is an exception to this rule.

disinvestment can be seen in abandoned storefronts, boarded up buildings, and vacant lots where buildings once stood.

Physical improvements created by new mixed-use development can have a tremendous effect on residents' and visitors' perceptions about a neighborhood. Main streets and commercial districts, in particular, are the community's "most visible face to the world." Bendick and Egan, through their research on inner city business development, found that the "appearance of commercial strips along major thoroughfares sometimes is a primary influence on decision makers from outside the community – such as politicians and bankers – in forming opinions concerning the condition of the neighborhood."[16] Thus, it follows that the development of highly visible buildings or lots may improve a neighborhood's ability to attract visitors, political support, or investment.

Mixed-use development can also improve the physical environment of a neighborhood by preserving its traditional character and scale. In many neighborhood commercial districts, there are buildings – now historic – that were originally designed to house multiple uses. Today, these buildings may be in need of repair or their space may be outdated for modern tenants, but they are important neighborhood resources nonetheless. The opportunity to redevelop such properties as mixed-use projects is an important revitalization tool for communities. Richard Moe, former president of the National Trust for Historic Preservation, writes "..community after community is proving that reinvestment in the historic built environment offers some of the best hope for improving a community's self-image, increasing civic activism, luring new residents to replace the ones who have left, and bolstering long-term neighborhood stability."[17] Each of the projects used as case studies in Chapter 4 involves the redevelopment of historic structures – buildings that the neighborhood found too dear to demolish.

Even infill projects – new construction on vacant sites in an otherwise developed area – can be an effective strategy for repairing the physical fabric of a neighborhood. Communities that have been plagued by arson or that have lost abandoned buildings to the wrecking ball are left with

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[16] Marc Bendick and Mary Lou Egan, "Business Development in the Inner-City: Enterprises with Community Links," New School for Social Research, 1991. p. 13.

ugly gaps in the streetscape and open lots that quickly accumulate trash and empty beer bottles. As mentioned above, these vacant lots send a negative message to local business owners and residents. New, mixed-use development projects on these sites help to reclaim parcels that are a liability to the neighborhood.

Impact on the Neighborhood Economy

As a tool for economic development, mixed-use development can improve various aspects of a neighborhood's local economy. There is great potential to improve a community's retail economy. Many researchers have documented the disappearance of inner-city retail. Vidal writes that "Poor inner-city neighborhoods, especially communities of color, have notably poor access to convenience goods shopping. The lively neighborhood shopping districts and small shopping malls anchored by major chain supermarkets that are commonplace in middle class neighborhoods are conspicuously absent in much of the inner city."[18] Mixed-use development projects that include retail space can provide an important missing link in the economy of many low-income neighborhoods by helping to bring back retail services.

Although many stores have left, significant demand for retail services remains. Inner-city neighborhoods are still more densely populated than the surrounding suburbs and therefore represent a sizable customer base for retail stores.[19] And, although the remaining residents may be generally poorer than those who left, the size of the inner city population translates into a market with substantial purchasing power.[20] Mixed-use development in urban neighborhood therefore offers the opportunity to take advantage of the significant market power represented by the community.[21] The success of certain inner-city retail ventures offer evidence of the market power of urban communities. For example, the Boston Consulting Group reported this finding: "An analysis of inner-city supermarkets in the six major markets we examined revealed that

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[17] Richard Moe and Carter Wilkie, *Changing Places: Rebuilding Community in the Age of Sprawl* (New York: Henry Holt and Company, 1997), p. 139.
[18] Vidal, "Reintegrating Disadvantaged Communities," p. 206.
[19] Denise DiPasquale and William C. Wheaton, Urban Economics and Real Estate Markets (Englewood Cliffs, NJ: Prentice Hall, 1996), p. 65.
[20] Michael E. Porter, "The Competitive Advantage of the Inner City," *Harvard Business Review* (May-June 1995), p. 58. Porter estimates that the total family income of Boston's inner city is $3.4 million.
[21] *Ibid.* p. 57. According to Porter, one of the key competitive advantages of inner city locations is the opportunity to take advantage of the local market.

inner-city markets can generate average grocery sales per square foot of up to 40% higher than the regional average."[22] The study also found that retail categories like drug stores and footwear can generate sales far above the regional average.

In addition to providing retail services, neighborhood mixed-use development can provide renovated space for local business owners or entrepreneurs. These types of projects can also bring jobs to the neighborhoods. While smaller retail businesses may offer only a few jobs, large neighborhood institutions – a community health center, for example - are big employers in many inner-city neighborhoods.

Impact on the Neighborhood's Social Environment

Finally, in addition to achieving the more concrete goals of physical and economic revitalization, nixed-use development can also contribute to a community's quality of life. Mixed-use development supports neighborhood revitalization by enhancing the social framework of a community. A mixed-use project that combines residential, retail, and office uses generates considerable pedestrian activity and presence in a neighborhood. This activity creates opportunities for social interaction and helps to promote a sense of community. Today, private developers are trying package and sell this sense of community by building mixed-use districts in new, suburban communities.[23] Ironically, these developments borrow directly from the traditional neighborhood center prototype.

A second social benefit associated with mixed-use development is that it contributes to the safety of an area by providing many "eyes upon the street."[24] Furthermore, by creating a new home for residents, businesses, and workers, mixed-use development introduces new sets of stakeholders into the community. Together, these effects can help to improve the quality of life for a neighborhood. In its handbook on neighborhood revitalization, the National Council for Urban

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[22] Boston Consulting Group, "The Business Case for Pursuing Retail Opportunities in the Inner City" (1998), p.11-12.

[23] The newly built community of Seaside, Florida, is one example.

[24] Jane Jacobs, *The Death and Life of Great American Cities* (New York: Random House, 1961), p. 35.

Economic Development writes, "Having a safe and convenient neighborhood commercial district in which to stroll, socialize, and shop is important to quality of life..."[25]

A Model for Neighborhood Mixed-Use Development

Given these arguments for mixed-use development as a tool for neighborhood revitalization, it is important to define what kind of project or development satisfies these goals. I believe a successful neighborhood mixed-use project should exhibit most of the following characteristics:

- ***Two or more uses.*** By definition, a mixed-use development project includes multiple uses. In the case of neighborhood mixed-use development, these uses may include residential, retail, office, and community or cultural facilities. The particular types of uses – family vs. senior housing; office vs. retail – should fit the neighborhood's context and needs. After housing, retail is the most common use in such projects. But an office use, if viable, can generate tremendous social and economic benefits for the neighborhood.

- ***Neighborhood scale.*** Neighborhood mixed-use projects should be built at a neighborhood scale. This generally means smaller projects, which match the height and massing of the existing urban fabric. At the same time, the project should be large enough to have a presence in the community. In terms of size, the project might include between 10,000 and 50,000 gross square feet. The costs for this type project generally falls between $1 million and $5 million.

- ***Prominent neighborhood location.*** The rule of location is just as important in an urban neighborhood setting as it is for other types of real estate. Neighborhood mixed-use projects should take advantage of central neighborhood locations, such as major intersections or along business district corridors. They should also be convenient to public transportation routes.

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[25] National Council for Urban Economic Development, *Neighborhood Economic Revitalization: Problems and Solutions* (Washington, D.C.: National Council for Urban Economic Development, 1994), p. 61.

- ***Residential neighborhood.*** The project should be located in a densely populated residential neighborhood. A critical mass of people is necessary to support the commercial component of a mixed-use project.

- ***Rehabilitation or infill construction.*** The project should improve the physical environment of a neighborhood by renovating an abandoned structure or by developing a new building on a vacant parcel. Projects should target important historic buildings, as long as their location and structure are still viable. New construction projects should avoid designs which recreate suburban development patterns.

- ***Major housing component:*** Neighborhood mixed-use projects should involve a major housing component to provide social and economic stability to the project. For projects with a commercial component, residents represent a built-in market for goods and services; they also provide a 24-hour presence, which contributes to neighborhood safety. More importantly, there is strong demand for rental housing - and affordable housing in particular - in low-income neighborhoods.[26]

- ***Provide neighborhood services.*** The commercial component of a neighborhood mixed-use project, particularly the retail, should provide services to community residents. But this does not mean that the commercial space should be occupied only by locally-owned businesses, which often lack staying power. Ideally, the project should contribute to a neighborhood balance between larger, national chains and local enterprises.

- ***Neighborhood impact.*** Though this quality is difficult to define and measure, a neighborhood mixed-use project should have a positive impact on the surrounding area. It should bring new activity to the neighborhood and encourage other new development.

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[26] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1999*, p. 22. The report states that very low income households account for most of the growth in renters in the 1990s.

- ***Financially stable.*** The project should be financially successful, as measured by ability to repay mortgages, proper maintenance, low vacancy rates, and healthy operating and capital reserves.

Summary

Mixed-use development can be an important neighborhood revitalization tool because it can combine housing and economic development activities, thereby creating a more comprehensive community development strategy. The discussion in this chapter has illustrated the many ways in which neighborhood mixed-use development can potentially benefit a community's physical, economic, and social environment. The hypothetical project described above provides a model for mixed-use development that will maximize these benefits the community. The reader will see that the case study projects in Chapter 4 exhibit many of the characteristics described this model. What benefits the community, however, may not necessarily please the banker. The next chapter will explain how certain characteristics of neighborhood mixed-use development projects make them difficult to finance.

CHAPTER 3:
Obstacles to Financing Mixed-use Development

In the previous chapter, I set out a basic definition of neighborhood mixed-use development and presented an argument for why this model of development is important to neighborhood revitalization. This chapter presents evidence suggesting that, despite its community benefits, neighborhood mixed-use development is more difficult to finance than other types of real estate projects. The obstacles to financing can be explained by the failure of the financial markets to properly allocate capital to such projects. Four types of market imperfections are presented as possible causes of market failures; these are broadly categorized as lack of competition, discrimination, lack of mechanisms to address risk, and information and transaction costs. I will provide evidence for each of these imperfections and illustrate how they can affect the financing of mixed-use development projects.

To facilitate this discussion, I will begin with a brief overview of real estate finance, in which I introduce the concepts of risk and return, debt and equity, public and private markets, and primary and secondary mortgage markets. This section will give the reader a basic understanding of how real estate development projects are financed.

Why are mixed-use projects difficult to finance?

Anecdotal evidence suggests that developing a neighborhood mixed-use project is a challenge. As I conducted my research and looked for case studies in the Boston area, several community development practitioners and real estate developers explained that there simply aren't a lot of these projects around because mixed-use development projects are difficult to develop. They identified a variety of reasons why this may be true – city zoning regulations discourage it, development costs are high, design issues are complicated. One developer pointed out that there is a strong correlation between mixed-use development and commercial development; when demand for commercial space is weak, the demand for mixed-use development is also weak.[27]

[27] Interview with Ed Marchant.

More than any of these problems, however, developers emphasized that financing is a critical obstacle to developing mixed-use development.

A review of real estate finance

In order to understand challenges that developers face in trying to finance mixed-use projects, it is important to understand how real estate finance works. I will first cover some fundamental real estate concepts: risk and return, debt and equity, public and private markets. The following discussion will introduce the various investors and financial institutions involved in real estate and will describe how a typical project is financed.

The role of risk and return

In real estate, as in all types of investment, there is a critical relationship between the risks associated with a particular investment and the return generated by that investment. Returns are a measure of profits; the simplest way to calculate return is income less expenses. Risk refers to the possibility of not earning the expected return on an investment.[28] There are many kinds of risk that investors face: interest rate risk, liquidity risk, credit risk. Real estate investors generally don't like risk – they are "risk-averse" – and therefore need to be compensated according to the level of risk they bear. In other words, lower risk typically requires lower returns and higher risk typically requires higher returns.

An important aspect of risk is the difference between systematic and unsystematic risk. Systematic risk is related to the performance of the overall economy, while unsystematic risk is related to the performance of a specific investment. In real estate, unsystematic risk is represented by factors such as geographic location, asset type, etc. A critical difference between the two is that unsystematic risk can be reduced, or "diversified", through risk pooling or risk spreading. Some of the mechanisms that have evolved in the real estate financial markets to reduce unsystematic risk will be discussed below.

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[28] David Geltner, Real Estate Finance and Investment (MIT, Course 11.431J, Fall 1998), Lecture notes: p. 2-7.

The role of debt and equity

In a real estate development project there are usually two types of investors: debt investors and equity investors. Equity refers to funds invested by an "owner" in a project, who buys the right to a portion of the income generated by the project.[29] Equity investors do not receive a specified return; rather, their return is a function of a project's return above fixed costs and therefore varies according to the project's performance. Real estate equity typically comes from individual investors, groups of investors, partnerships, pension funds, and insurance companies.[30] "Equity-like" financing can also be obtained in the form of government or other grants, which typically do not require a return.

Debt investors typically provide capital to a project through a mortgage, with the underlying real estate serving as collateral for the loan.[31] The lender's return takes the form of interest payments on the debt, and the lender receives a specified loan payment – usually on a monthly basis – that is determined by contract. There are two types of debt required to develop a real estate project. One loan is for the construction phase of the project, which can last between one and two years. Construction loans can come from a commercial bank, a mortgage banking company, or, in some cases, a savings and loan association. These types of banks usually have short-term deposits, which means they prefer to make short-term loans so that their assets and liabilities are balanced. When construction is complete, the construction loan is paid off by a second loan called a "permanent" mortgage. The term of a permanent loan typically ranges between 5 and 10 years for commercial real estate, and up to 30 years for residential real estate.[32] Permanent loans usually come from life insurance companies. pension funds, or in some cases, large commercial banks with long-term liabilities that can afford to keep capital invested in a project over the long term.[33]

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[29] William B. Brueggeman and Jeffrey D. Fisher, *Real Estate Finance and Investments, 10th edition* (Boston: Irwin McGraw-Hill, 1997), p. 307.
[30] Leland Consulting Group. "Smart Development Program: Financing Capital Sources" (1997), p. 2. The report also notes that REITs are starting to play a bigger role in development financing.
[31] Brueggeman and Fisher, p. 307.
[32] The real estate markets treat residential and commercial real estate differently. Residential real estate refers to owner-occupied housing. Commercial real estate refers to income-producing properties. Mixed-use development falls into the category of commercial real estate.
[33] Brueggeman and Fisher, p. 484

A typical real estate development project carries a significant amount of debt – usually between 70 and 80%. Developers prefer to use debt over equity for several reasons. For larger projects, developers simply cannot raise enough equity to cover all costs. Even if a developer had the money to fully finance a particular project, debt financing allows the developer to diversify his risk by investing in several different projects. Debt also allows developers to leverage their equity investment, thereby magnifying their return.[34] This financing strategy works because debt costs less then equity. (When a project generates income, the debt investor gets paid first and the equity investor gets whatever is left over. Debt is therefore less risky than equity and – according to the rules of risk and return – requires a lower rate return.)

Public markets and private markets

Another important distinction in real estate finance is the difference between public markets and private markets, which together make up the "capital markets." The private market is the set of financial intermediaries – banks, insurance companies, pension funds – that raise and manage funds on behalf of their investors. The role of these financial institutions is to allocate capital to various projects, according to their investors' risk and return profiles. The investor (the bank depositor, the pension fund holder) is therefore indirectly investing in a project.

In contrast, the public market offers a more direct form of investment, in which the investor buys a small share of a project. The public markets are characterized by fairly uniform financial instruments like stocks and bonds, which are traded on an open market. The advantage of this market is that, by allowing many investors to buy only a small piece of a project, it helps to spread risk and thereby increases returns. The public markets also provide the benefit of liquidity, which means that an investment can be easily bought or sold. These benefits come with very high transaction costs, such that only larger projects or investments can access the public markets.

The primary and secondary mörtgage markets

Debt investors in real estate projects can invest either through the primary or secondary mortgage markets. The distinction between the two relates directly to the difference between the private

[34] Brueggeman and Fisher, p. 356. Although not covered in this discussion, debt also offers certain tax benefits.

and public markets. Investors in the primary mortgage market are the banks, insurance companies, pension funds, and other financial institutions that make direct loans to real estate projects. The terms of investment are negotiated between the institution and project's owner, on a deal by deal basis. Construction and permanent loans are therefore "originated" in the primary market.

The "secondary" market is one in which existing mortgages are bought and sold in a public market. The role of the secondary market in real estate finance is to facilitate the flow of funds between the private and public capital markets. The transfer of capital between these markets is facilitated by packaging together the cash flows from many mortgages and creating more liquid, mortgage-related securities.[35] This process is called "securitization". Projects that can access debt financing through the secondary market can typically receive a lower interest rate than possible in the primary market, due to the diversification benefits associated with the public markets. The existence of the secondary markets means that lenders have the option to hold the loans they have originated in a portfolio or to sell them. Banks that hold loans are called portfolio lenders, because they keep loans within their investment portfolio.[36]

Residential mortgages and commercial mortgages are traded separately. The secondary market for residential mortgages is very large, and it accounts more than $1.5 trillion in mortgage financing - nearly half of the home mortgages originated by lenders are sold to the secondary market. By comparison, the secondary market for commercial mortgages is much smaller. Only $67 billion in loans, which represents 6.3% of all multifamily and commercial mortgages, are securitized.[37] As a result, the private markets remain the primary source of funds for commercial loans.

[35] Terrence M. Clauretie and James R. Webb. *The Theory and Practice of Real Estate Finance*, 1993. p. 260.
[36] Brueggeman and Fisher, p. 558.
[37] *Ibid.*, p. 560-561.

Putting it all together: How a real estate project gets financed

Consider a hypothetical office tower project. A developer will find a site, commission a design, and market the building to potential tenants.[38] After finding a tenant, the developer will use his own equity or will find equity partners to invest in the project. He will then negotiate with lenders to supply the remaining financing (construction and permanent) to the project. Assuming that his deal can offer a reasonable rate of return to each investor – a rate of return that compensates the investor for any risks involved – the developer will secure both equity and debt financing. (The critical underlying assumption here is that the income generated by the office tower will be sufficient to pay both the debt and equity investors; the building's rents therefore determine how much the developer can afford to spend on the project.) In this way, the project gets built.

The case studies of neighborhood mixed-use projects found in the next chapter describe a much more complicated financing transaction than the hypothetical office development project described above.[39] The projects include multiple layers of equity and debt financing, which come from unconventional sources such as government grants, tax credit syndication, and specialized lending institutions. The following section on capital market failures offers several explanations for why - as proposed at the beginning of the chapter - the financing a mixed-use project is more difficult.

Failures in the Financial Markets

Usually, the financial markets manage to efficiently allocate capital to projects. Sometimes, however, the market breaks down and debt and equity are denied to projects that offer a competitive rate of return. Litvak and Daniels define two basic categories of market failure:

> "One class of failure prevents the financing of investment projects that do in fact offer a competitive *private* return. This type of capital failure reflects several different imperfections in the financial system... The other class of capital

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[38] Whereas commercial real estate development in the 1980s was often speculative in nature, today's lenders typically require a tenant in place. Gerald Fogelson, "'80s Mentality Must Adjust to '90s Industry," *National Real Estate Investor* (August 1993).

[39] This is not to say that developing an office tower is a simple task. I only mean that, unlike the office project, the case study projects do not follow the conventional rules of real estate finance.

markets prevents the financing of investment projects that do not offer a competitive private return but provide compensating social benefits."[40]

Both kinds of market failures have serious implications for the way neighborhood mixed-use projects are financed.

Externalities

For a neighborhood mixed-use development project that resembles the model described in Chapter 2, there are two fundamental financing issues. The first is that the income generated by the project is not sufficient to support the cost of the project. This results from the low rents associated with a weak, inner-city real estate market and the project's mission to provide affordable housing.[41] The project therefore does not offer the "competitive private return" that Litvak and Daniels mention above and will be denied the capital necessary to cover its costs.

The second issue is that the project offers certain positive externalities, such as neighborhood safety, increased access to jobs and services, pleasant physical environment - Litvak and Daniels' "compensating social benefits." Since none of these qualities can offer a direct financial return, projects that generate these less tangible benefits will typically not be financed by the capital markets or will be unable to secure sufficient capital. However, the presence of externalities justifies investment from a social point of view. This category of market failure helps to explain why the role of public financing – through grants or other forms of "equity" – is critical to financing neighborhood mixed-use development projects.

Market Imperfections

The presence of externalities offers a partial explanation for the difficulties in financing neighborhood revitalization projects and the need for government support in place of equity financing. Externalities do not explain, however, why a mixed-use project cannot attract debt capital. Unlike some other community development activities that have no direct value in the marketplace, mixed-use development is a kind of commercial real estate development and

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[40] Lawrence Litvak and Belden Daniels, *Innovations in Development Finance* (Washington, D.C.: The Council of State Planning Agencies, 1979), p. 18-19.

therefore generates income. This income stream takes the form of cold, hard cash – a benefit that can easily be valued by the capital markets. That neighborhood mixed-use development might be difficult to finance despite the fact it can offer some financial return suggests that the financial market may not be operating exactly as it should.

The team of Parzen and Kieschnick, drawing on the work of and Litvak and Daniels, has built a framework that helps to explain the possible causes of market failures.[42] Their research focused on explanations for why there is a lack of capital available to economic development projects, but their findings also work well to explain failures in the real estate capital markets. The framework based on market imperfection that they developed will be helpful in understanding the obstacles to financing neighborhood mixed-use projects. I have summarized their findings in the following four categories: 1) lack of competition among investors; 2) discrimination; 3) lack of mechanisms to address risk; and 4) higher transaction and information costs. The following pages will explain these concepts and how they apply to real estate financial markets.

Lack of Competition

Lack of competition among lenders and investors can occur either through specialization, regulation, or regional concentration.[43] In real estate finance, there can be specialization according to product type (construction loans vs. permanent loans) or asset type (commercial vs. residential). In addition – particularly in the realm of mortgage finance – there are rules governing what types of assets banks can hold and what level of risk is prudent. Regulations such as the risk-based capital requirements created under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) require certain levels of capital backing based on the presumed risk associated with different classes of real estate. Many banks that previously made relatively large amounts of riskier commercial real estate may now choose to reduce the amounts of these loans in favor of other classes that are classified as less risky.[44] As a result, there may be

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[41] Diane R. Suchman, "Revitalizing Low-Income Neighborhoods: Recommendations from ULI Advisory Services Panels" (Washington, D.C.: The Urban Land Institute, 1994), p. 52.
[42] Parzen and Kieschnick in *Credit Where It's Due*, 1991; and Litvak and Daniels in *Innovations in Development Finance*, 1979.
[43] Litvak and Daniels, p. 21.
[44] Brueggeman and Fisher, p. 565.

fewer lenders or types of lenders that are eligible to finance a project, thereby reducing competition among debt investors.

Market concentration can be a problem when there is a single, dominant bank with monopoly power. Although this is not usually a problem in most cities, the current trend toward bank consolidation has reduced number of banks within many urban areas. For example, in 1990 there were 8 major banks with assets greater than $3 billion[45] in Boston. At the end of 1999, with the recently announced mergers between Fleet and Bank Boston and US Trust and Citizens, the number of major banks has dwindled to two. The trend towards mergers could mean a weakening in local relationships, since bank headquarters may be located far away from local centers. Parzen and Kieschnick comment that, "Local areas will be increasingly financed, or not financed, by distant lenders who have no stake in lending to one community over another. While this [interstate banking] will improve the overall flow of capital .... it may also lead to a more rapid flight of capital from declining cities and to less room for judgment about borrowers in lending decisions."[46]

A lack of competition among investors can sometimes lead to a shortage of capital for riskier projects. Studies show that when market concentration exists, investors are more risk averse and may employ a practice called "credit rationing", where only the least risky investments receive capital.[47] In such situations, more risky projects may not receive capital at all.

Impact on Neighborhood Mixed-use Development

The trend towards bank consolidation is an important issue for inner-city communities. More relaxed banking regulations are partially responsible for the mergers craze, but some banks are leaving the center city of their own accord. Many smaller, community banks are have decided to move their operations to suburbs, where banking is easier.[48] The net effect of these trends is less

[45] Based on findings of Jim Campen in his report, "Changing Patterns of Mortgage Lending in Boston, 1990-1993. The report was done for the Massachusetts Community and Banking Council in July 1995.
[46] Julia Ann Parzen and Michael Hall Kieschnick, *Credit Where It's Due: Development Banking for Communities* (Philadelphia: Temple University Press, 19??), p. 44.
[47] Litvak and Daniels, p. 50.
[48] Interview with Jeff Gibbons, Bank Boston.

competition among banks for a neighborhood's business, with larger regional banks taking on the role of neighborhood lending.

The impact of this trend depends on the bigger banks' attitudes about neighborhood development projects. Community activists worry that remote decision making will lead to less flexibility and a loss of commitment to the local community. But some banks see inner-city lending as a new market frontier. Larger banks like Bank Boston have proven to be effective community lenders; in fact, Bank Boston has played a critical role in financing one of the case study projects in the next chapter, the Lithgow project. Whether or not other new, consolidated banks decide to enter the neighborhood market comes down to a "question of will."[49]

Discrimination

Sometimes the financial markets fail to allocate capital to a project as a result of discrimination. Making assumptions based on stereotypes, banks may decide that loans to certain borrowers or projects are too risky. The discrimination by banks to minority borrowers and projects in low-income neighborhoods, a practice referred to as redlining, is well documented.[50] Over the past few decades, several federal programs have attempted to address the problem of discrimination. One of the first was the Federal Housing Administration's mortgage insurance program, which was designed to help minority borrowers in low-income neighborhoods access home mortgage financing.[51] The Community Reinvestment Act, first introduced in 1977, was created to ensure that banks were lending in inner-city neighborhoods. Although original legislation was not very effective, new requirements passed in 1989 were more stringent and seem to have greater effect.[52] More recently, Congress passed legislation that established low-income and central city

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[49] Gibbons interview.
[50] Vidal, "Reintegrating Disadvantaged Communities," p. 189.
[51] Ironically, the FHA program may have done more harm than good. Although it was meant to counteract problems of redlining, the program may have contributed to neighborhood instability. Anthony Downs writes that a concentration of FHA loans, which have lower downpayments requirements and less stringent underwriting standards, in a particular area can lead to lower housing standards. See Downs, *Neighborhoods and Urban Development*, p. 144.
[52] Heather MacDonald, "Expanding Access to the Secondary Mortgage Markets: The Role of Central City Lending Goals," *Growth and Change* (Summer 1996).

lending goals for the government-sponsored secondary mortgage markets, Fannie Mae and Freddie Mac.[53]

Discrimination can also occur towards projects that are unfamiliar or innovative. It may be easier for banks to say no to an unusual deal than to invest the time in trying to understand it.[54] This problem ties into the issue of information and transaction costs, which is discussed below.

Impact on Neighborhood Mixed-use Development

Some lenders have tried to explain their poor inner-city lending records by suggesting that there is a little demand for credit in these communities or that inner-city loans are too risky. Several recent studies have provided evidence to the contrary. Vidal summarizes this research by saying, "Inadequate demand and excessive risk are not the principal issues at the margin and that it is possible to make headway against any existing difficulties in assessing and managing borrower risk."[55] CRA legislation has helped many communities gain access to credit, especially in terms of home mortgage financing. Despite these advances in home mortgage lending, mixed-use development in urban neighborhoods may still be subject to discrimination because it is an unconventional type of development project.

Lack of mechanisms to address risk

The discussion on risk and return at the beginning of the chapter mentions several kinds of risks that affect investors: interest rate risk, liquidity risk, and credit risk. Interest rate risk refers to the chance that economic condition might change after an investment is made such that the interest rate on an investment is insufficient. Liquidity risk refers to investor's ability to get his original investment back. Unlike stocks or bonds, which can be sold on the stock market in a single day, real estate assets take time to sell and are therefore illiquid. Credit risk refers to the borrower's ability to repay a loan. If investors cannot find a way to address these risks, either they will require a higher rate of return to be compensated for bearing risk or they will not allocate capital to that particular project.

[53] The specific legislation falls under Title XIII of the 1992 Housing and Community Development Act.
[54] Litvak and Daniels, p. 22.

Fortunately, most kinds of risk can be reduced through diversification. As investors have come to understand the benefits of diversification, certain mechanisms have evolved in the financial markets to reduce the risks associated with real estate investment. One example is the secondary mortgage market, which allows investors to diversify by pooling risk. Another mechanism to address credit risk in particular is mortgage insurance.

Impact on mixed-use development

It is true that are many risks associated with neighborhood mixed-use development. A mixed-use project can be difficult to design and manage, and finding the synergy among uses is a challenge. Developing in an urban neighborhood adds to the risk, because real estate markets can be weak – especially for commercial space. Furthermore, the non-profit developers that do these projects are not a "bankable" source of repayment.[56]

In theory, the secondary mortgage market system and mortgage insurance offer mechanisms through which lenders can address risk; these mechanisms should therefore increase access to debt capital for this kind of project. However, these financial tools may not be available for all types of investments. As a result, these projects may not be able to attract capital.

For example, the standard underwriting criteria that ultimately determine admission into the secondary market clearly do not favor mixed-use projects in urban neighborhoods. MacDonald's research has found that, " the age of properties, average value (thus loan size), neighborhood racial composition, proportion of renters relative to owners and of two-to-four units dwellings relative to single units, appear in practice to affect the likelihood that a loan will be salable on the secondary market under traditional guidelines. These attributes provide the basis for a definition of neighborhoods excluded from or neglected by secondary market sources of credit."[57] And, to the extent that these secondary market underwriting guidelines set the standards for lending in

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[55] Vidal, "Reintegrating Disadvantaged Communities," p. 191.

[56] Francis W. Wankowicz, "Construction Lending on Low-Income Housing Tax Credit Multifamily Projects." *Journal of Lending and Credit Risk Management* (Jan. 1999).

[57] MacDonald, "Expanding Access to the Secondary Mortgage Markets".

the primary markets, portfolio lenders may now be more reluctant to take on a riskier project like neighborhood mixed-use development.[58]

Mortgage insurance is more commonly available for home mortgages than for commercial mortgages. The Federal Housing Administration (FHA) offers a small mortgage insurance program for multi-family housing; this program will be discussed in greater detail in Chapter 5. Commercial mortgage insurance exists, but it is difficult to find for inner-city properties. Dreier writes that, "Redlining by insurance companies, in terms of both residential and commercial policies, also exacerbates the problem of urban disinvestment."[59] Mixed-use development projects therefore have more difficulty addressing credit risk.

Higher transaction and information costs

A fourth explanation for why certain projects do not receive capital has to do with transaction and information costs. Every loan or equity investment requires careful market research, financial analysis, and investigation of alternative investment options (assuming that the investor is rational and prudent.) Banks call this process "underwriting."[60] The costs of acquiring and processing this information can be significant. While larger projects offer some economies of scale, transaction costs for small projects can be relatively expensive.[61]

Banks have managed to streamline many types of transaction costs through standardization; we see this in standard applications for auto loans, home mortgages, and credit cards. Litvak and Daniels point out that, "Much of history of financial intermediaries in the U.S. has been reduction of transaction and information costs."[62] However, as with the secondary market, if a project does not meet standard guidelines, it is more difficult to reduce costs.

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[58] Parzen and Kieschnick, p. 45.
[59] Peter Dreier, "America's Urban Crisis: Symptoms, Causes, Solutions," *North Carolina Law Review*, Vol. 71 (1993), p. 1383.
[60] Brueggeman and Fisher, p. 164.
[61] MacDonald, "Expanding Access to the Secondary Mortgage Markets."
[62] Litvak and Daniels, p. 20.

Impact on Neighborhood Mixed-use Development

From the lender's perspective, the information costs associated with underwriting mixed-use development are high. Bankers refer to these projects as "story" projects, because they do not fit any particular model. Mixed-use development projects are more difficult to underwrite because they requires an understanding of multiple real estate markets. Since these projects typically require smaller loans, which mean smaller returns, banks may be less willing to spend the time doing the underwriting. Mixed-use projects also lack adequate comparables, which banks typically rely on for information about development and operating costs.[63] Banks respond to these higher information costs by imposing higher transaction costs. Transaction costs can be particularly difficult for smaller, neighborhood projects to bear. High transaction costs limit the ability of smaller projects to access financing – in both the primary and secondary markets.

Conclusion

Not all of the obstacles to developing a mixed-use project are financial. Nevertheless, this analysis of the real estate capital markets offers some explanations for why, as I hypothesize in beginning of chapter, mixed-use development is difficult to finance. The existence of externalities creates an important role for public finance on the equity side, while various market imperfections create disincentives for private investment on the debt side. Lack of competition among lenders is certainly an issue for inner-city neighborhoods, but the emergence of larger, regional banks can benefit these communities if these banks make it their business. Discrimination continues to be a problem in many urban neighborhoods, but government attempts to address this problem seem to be effective. The most serious obstacles to financing neighborhood mixed-use projects are the lack of mechanisms to address risks and the high information and transaction costs associated with these projects.

What are the combined effects of these capital market failures on community development? Parzen and Kieschnick refer to studies that have shown evidence of gaps in capital availability to small businesses, new businesses, nontraditional organizations, and all types of businesses in

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[63] Leland Consulting Group, p.18.

low-income neighborhoods.[64] Exactly how these obstacles are played out in the realm of mixed-use development will be illustrated next chapter, through case studies.

A note on the role of community development finance institutions

Certain specialized financial institutions already exist to address many of the capital market imperfections described in this chapter. These community development financial institutions (CDFIs) were created as a direct response to capital market failures that affect development in low-income urban areas. Various CDFIs play an important role in financing each of the case studies in Chapter 4.

The experience of some CDFIs in inner city lending has shown that investing in neighborhood projects can in fact provide a competitive rate of return. Conventional lenders and equity investors are beginning to follow the CDFIs' lead, with comparable results. In some markets, these CDFIs are even facing competition from private lenders, which raises questions about the ongoing role of CDFIs. I will come back to this question in the section on conclusions and recommendations in Chapter 6.

[64] Parzen and Kieschnick, p. 37.

CHAPTER 4:

Case Studies in Neighborhood Mixed-use Development

Introduction

In this chapter, I present three case studies that illustrate some of the challenges associated with financing neighborhood mixed-use development. The projects selected vary in size and complexity, but each of them achieves the neighborhood revitalization goals laid out in Chapter 2. In terms of physical impact on the neighborhood, all three projects have preserved and restored important historic buildings. In terms of economic impact, they have helped to create conditions for new investment. In terms of social impact, they have provided the surrounding neighborhoods with needed housing and services.

Despite the value of these projects to the neighborhoods in which they are located, each faced considerable difficulty in acquiring financing. In some cases there was little or no bank interest in supporting these deals. Financing strategies for the residential components of projects were also hindered by the presence of a commercial component. In addition, all of the projects were faced with extremely high development costs, which made the role of subsidy critical to the financial structure of each deal. The framework on capital market imperfections developed in Chapter 3 will be used to evaluate the obstacles to financing these projects. In addition to highlighting the challenges of mixed-use development, the chapter will also illustrate the strategies used by developers and investors to get these projects built.

Project Summaries

The three case studies presented in this chapter are the Lithgow Block project in Dorchester, MA the Beaver Block project in Worcester, MA and the Taylor's Market project in South Boston, MA.[65] The table below summarizes some of the relevant programmatic information on these projects. They range in size from about 10,000 s.f. to nearly 70,000 s.f., which is a typical scale

[65] By using only projects located in Massachusetts as case study subjects, I hoped to achieve some consistency in terms of market conditions, funding programs available, etc.

for a neighborhood development. Housing is the major use in each case, but the relative size and type of commercial space (retail vs. office) varies somewhat.

NEIGBORHOOD MIXED-USE DEVELOPMENT: 3 CASES

	Lithgow Project *Dorchester, MA*			Beaver Project *Worcester, MA*			Taylor's Market *South Boston, MA*		
Uses (gross s.f.) *									
Residential		43,000	*63%*		23,000	*79%*		8,000	*80%*
Retail		10,000	*15%*		6,000	*21%*		1,000	*10%*
Office		15,000	*22%*		-	*0%*		1,000	*10%*
TOTAL		68,000	*100%*		29,000	*100%*		10,000	*100%*
Financing									
Equity									
Public	$	3,459,319	*44%*	$	1,075,000	*55%*	$	705,000	*63%*
Private	$	309,624	*4%*	$	-	*0%*	$	-	*0%*
Subtotal	$	3,768,943	*48%*	$	1,075,000	*55%*	$	705,000	*63%*
Debt									
Public	$	1,336,250	*17%*	$	875,000	*45%*	$	25,000	*2%*
Private	$	2,718,750	*35%*	$	-	*0%*	$	385,000	*35%*
Subtotal	$	4,055,000	*52%*	$	875,000	*45%*	$	410,000	*37%*
TOTAL	$	7,823,943	*100%*	$	1,950,000	*100%*	$	1,115,000	*100%*
Cost/s.f.	$	115.06		$	67.24		$	111.50	

* Gross square footage was rounded to nearest thousand.

Sources: *Codman Square Neighborhood Development Corporation, Main South Community Development Corporation, South Boston Neighborhood Development Corporation*

The table gives a simplified summary of project financing, separating sources into the traditional categories of "debt" and "equity". It also differentiates between public and private sources of financing. "Public" financing refers to any of the various local, state, or federal subsidies used to finance these projects: direct grants, tax credits, low-interest loans, forgivable loans, etc. "Private" financing therefore refers to market rate loans and any other private investment in the projects. The purpose of identifying the sources of financing this way is to facilitate the analysis of the respective roles of public and private financing and debt and equity in these projects. In doing so, this table begins to show where gaps are and provides clues as to where capital imperfections are. These gaps will be explored further in discussion of individual cases that follow.

Case 1: The Lithgow Block

Project Description

The old Lithgow Building is an important neighborhood landmark in the Codman Square section of Dorchester. With its prominent location at the intersection of Washington Street and Talbot Avenue, the historic, 3-story masonry building was once the centerpiece of the neighborhood's commercial district. But the structure was damaged by several fires in the 1970s and stood vacant for nearly a decade. Many people who lived in the neighborhood saw the vacant Lithgow Building – with boarded windows and a tree growing through the roof – as a reminder of the area's economic decline.[66]

The story of Codman Square's decline mirrors that of many urban neighborhoods. The exodus of families and businesses to the suburbs in the 60s and 70s left empty storefronts and abandoned buildings. However, though the demand for retail and housing space has diminished over the years, the area remains vital. Codman Square is a racially and economically diverse neighborhood, with a population of 5,000 households within a half-mile radius of the square.[67] Included among the many longtime residents are some with strong ties to Boston's City Hall. These influential neighbors helped to generate a tremendous amount of political support for the redevelopment of the Lithgow Block during the 1980s.

The Lithgow Block includes the Lithgow Building and the other structures located on the triangular shaped block bounded by Washington Street, Talbot Avenue, and Lithgow Street. The project, which was completed in 1991 by the Codman Square Neighborhood Development Corporation, involved the rehabilitation of the Lithgow building and the construction of three new buildings. The project includes 31 units of affordable and market rate rental units and 25,000 gross square feet of commercial space.

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[66] Deb Chien, David Fernandes, Diana Markel, Bob Pipik, and Mario Turner. "From Despair to Development: An Evaluation of the Lithgow Residential and Commercial Projects." Report prepared for Professor Ed Marchant, Harvard University, 1996. p.5.
[67] *Ibid.*, p. 3.

Neighborhood Impact

Many residents and local business owners believe that the Lithgow project has played a critical role in the revitalization of the Codman Square. [68] The project's impacts have influenced many aspects of community life:

- *Physical Impact:* The project has restored an important neighborhood landmark to its original grandeur and has helped rebuild the physical fabric of Codman Square. The redeveloped Lithgow Block represents a positive visual gateway for residents and visitors.
- *Economic Impact:* The Dorchester Counseling Services (DCS), which moved its offices to the Lithgow building, has helped to generate significant new economic activity in the neighborhood. Whereas the Square used to be a "ghost town", the DCS office now draws one hundred workers and clients to the area each day.[69] Codman Square is once again a place to do business - more than 40 new businesses have opened up in Codman Square since the project was completed.[70]
- *Social Impact:* The project introduced several new services into the neighborhood, including a bank, a pharmacy, and an insurance agency. When the Codman Square Pharmacy opened in the Lithgow building in 1991, it marked the first time in more than two decades that the neighborhood had a pharmacy.[71] These new services have helped to improve the quality of life for Codman Square residents.

Project Financing

The Lithgow project is infamous, at least among community development practitioners, for its high costs and for its complex financing. The project ultimately cost about $115/s.f. to develop and required 12 different sources of financing. Another notable aspect of the project financing is that the developer financed each use – residential and commercial – separately. The advantages and disadvantages of this strategy will be discussed further below.

Equity accounts for nearly half of the project financing for the Lithgow Project. Funds were pieced together from a variety of local, state and federal programs. Most of the equity for the

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[68] *Ibid.*, p. 36.
[69] Interview with Jim Keefe, Trinity Financial.
[70] Kimberly Blanton, "New Life in Codman Square," *The Boston Globe*, March 26, 1995, p. 1.
[71] *Ibid.*

project was raised through tax credit syndication, a federal subsidy program that encourages private investment in certain kinds of real estate development.[72] The residential component of the project received equity through the Low Income Housing Tax Credit (LIHTC) program, which promotes the creation of affordable housing. The commercial component of the project received equity through the Historic Preservation Tax Credit Program, which promotes the restoration of historically significant structures – in this case, the Lithgow Building. At the time, combining the two tax credit programs in this way was considered an innovative approach. It was one of the few investments of its kind for the National Equity Fund, which syndicated the tax credits.[73] Additional housing and economic development grants from the City of Boston and the federal government rounded out the equity contribution to the project.

On the debt side, the largest source of debt financing was the Massachusetts Housing Finance Agency, which provided $2.3 million in permanent loan to the project. I have considered this loan as "private financing" because the MHFA accessed capital through the bond markets to make this loan. (This kind of bond financing is only feasible for larger projects, like the Lithgow.) Other financing was provided primarily by specialized community development finance institutions. (The reader will remember from the discussion in Chapter 3 that CDFIs are publicly sponsored lending institutions that specialize in affordable housing and community development projects.) One private bank, Bank of Boston (now Bank Boston, and soon to be acquired by Fleet Bank), provided some construction and mortgage financing to the project. The breakdown of financing is summarized below.

[72] The tax credit program and other grant programs will be explained in greater detail in Chapter 5.
[73] Chien and others, p. 17. Today, NEF does several projects a year that combine historic and low-income housing tax-credits. Interview with Janet Lasky, National Equity Fund.

Lithgow Project					
SOURCES OF FINANCING					
Equity			***Permanent Debt***		
Public			*Public*		
Low Income Housing Tax Credit	(Federal)	$ 1,191,433	Massachusetts Government Land Bank	$	981,250
Linkage	(City)	$ 1,100,000	Community Development Finance Corp.	$	280,000
LEND Program	(City)	$ 600,000	Local Initiatives Support Collaborative	$	75,000
Office of Community Services (OCS) Grant	(Federal)	$ 350,000			
Historic Preservation Tax Credits	(Federal)	$ 309,624	*Private*		
Community Development Action Grant	(City)	$ 193,000	Massachusetts Housing Finance Agency	$	2,300,000
			Bank of Boston	$	418,750
Private					
Deferred Developer's Fee		$ 24,886	***Construction Debt***		
			Private		
			MHFA	$	2,300,000
			Bank of Boston	$	1,400,000

At the time when the development deal was put together, the Lithgow project was considered a very risky venture. At the project's groundbreaking, the Boston Globe reported: "A growing drug trade, the flight to the suburbs of many longtime residents, a failed supermarket venture on Codman Square and other neighborhood business failures made investors wary."[74] This, combined with the economic downturn and crisis in the banking industry, made the search for private financing difficult. Furthermore, the Lithgow Block redevelopment was one of the first projects of its kind in Boston, so lenders had no frame of reference. The multiplicity of financing sources on both the debt and equity sides in this project suggests that no single investor was willing or able to take on the risk of the project.

Financing Strategies

- *Financing commercial and residential components separately*

  As highlighted above, tax credit financing, and the LIHTC program in particular, was a key piece of equity for the Lithgow project. The amount of funding through the tax credit program is based directly on the amount of affordable housing provided; program regulations explicitly state that commercial and other non-residential uses do not qualify for financing.[75] Although the Lithgow project was conceived and executed as a unified project, the developer decided to separate out the commercial component of the project for financing purposes.[76]

[74] Jim Kerstetter, "Rebuilding of Codman Square Begins," *The Boston Globe*, July 28, 1990, p. 21.
[75] Joseph Guggenheim, *Tax Credits for Low-Income Housing: Opportunities for Developers, Non-Profits, Agencies and Communities under Permanent Tax Provisions, 10th edition* (Glen Echo, MD: Simon Publications, 1998), p. 43.
[76] Jim Keefe explained that breaking out the residential and commercial portions of the project was easy to do because they occupy separate buildings.

Jim Keefe, development consultant for the project, explained that this strategy "presented a cleaner, clearer picture" of what project finances actually looked like and helped to maximize the amount of tax credit funding for the project.[77] The strategy also helped the project access other sources of debt and equity for affordable housing development. While separating residential and commercial components of the project may have facilitated the financing of the residential piece, there were few advantages for the commercial side. This part of the project was more difficult to finance and required relatively greater amounts of subsidy.

- *Securing a long-term lease for the project's commercial component*

  What ultimately made the financing of the commercial component of the project possible was finding a strong tenant for the second floor commercial space. This part of the project needed an office user, because the upper floor space was not well suited to retail use.[78] The ability of the developers to secure a 10 year state-funded lease for the Dorchester Counseling Services gave banks more confidence in the project's cash flows. Furthermore, the rent paid by DCS was higher than market rate. A smaller (in terms of rent) but equally important tenant for the project was Bank Boston, which leased ground floor space for a retail branch office. The bank's presence in the project gave it credibility and encouraged other lenders to get involved.[79] Some of the remaining retail space, which was not fully preleased, remained vacant for longer than anticipated. Part of the reason was that the renovated Lithgow space was more expensive than surrounding retail space; part of the reason was because the developer overestimated the amount of space that could be absorbed by the market.[80]

Case 2: The Beaver Block Project

Project Description

The Beaver Block is a cluster of buildings located at the corner of Main and Beaver Streets in Worcester, Massachusetts. This section of Main Street, which lies south of Worcester's downtown area, is the main commercial spine of the Main South residential neighborhood,

[77] Keefe interview.
[78] Goldberg interview.
[79] Keefe interview.
[80] Chien and all, p. 18.

which is an economically and racially diverse community. The Main South corridor is a thriving commercial district dominated by ethnic stores and restaurants. Clark University occupies a central location in the neighborhood and the original campus faces Main Street.

Like the Lithgow project, the Beaver Block project involved the restoration of an historic neighborhood landmark, the Beaver Building, originally built in 1899. The Beaver Building is a traditional mixed-use structure with ground floor retail and residential units above. Over the years, new structures were added, including a 1-story commercial storefront building along Main Street and two, wood-frame residential structures behind along Beaver Street. The complex of buildings had been damaged by fire in the 1980s and was in foreclosure. The Main South Community Development Corporation bought the properties in 1993 and renovated three of the four structures; the 1 story commercial building received only façade improvements. After another fire in 1997, the Beaver Building was vacated again, and a second round of renovations, including the installation of a brand new sprinkler system, was completed in December of 1998.[81] The Beaver Block project is smaller in scale than the Lithgow project; it provides 26 units of rental housing for low-income households and roughly 6,000 s.f. of retail space.

Neighborhood Impact

- *Physical Impact:* The Beaver Block has a strategic location; it anchors the edge of the neighborhood that abuts Clark University campus. One of the reasons that Main South CDC took on project was to improve the condition and appearance of this highly visible area.[82] Also, the Beaver Building itself is an important neighborhood resource, both architecturally and historically.
- *Economic Impact:* The project has spurred new investment, including several new housing development projects by the CDC on the same block. The renovated commercial space in the Beaver Building has allowed a local business owner to expand his pizza parlor.
- *Social Impact:* The redevelopment of the Beaver Block has made the neighborhood more attractive to homebuyers. The CDC reports that are several new owners along Beaver Street, which has helped to increase the stability of neighborhood.

[81] Linda Bock, "Refurbished Properties Get New Life: Beaver Block Celebrates its Grand Reopening," *Worcester Telegram and Gazette*, December 17, 1998, p. B3.

Project Financing

The financing package for Beaver Block was much simpler than the Lithgow project's financing. Lower cost is one explanation for the difference. (When measured in terms of cost per square foot, the Beaver project was 40% cheaper than the Lithgow project.[83]) As a rule, fewer funding sources are needed for a $1.9 million project than a $7.8 million project.

The majority of funding for the Beaver project was equity financing. A combination of tax credit financing and HOME funds provided more than $1 million for the project. The development was not eligible for historic tax credits, which may explain why the CDC decided not to include the 1-story commercial building in their renovation plans. On the debt side, a state-chartered CDFI called the Massachusetts Government Land Bank provided permanent financing in the amount of $875,000. A local commercial bank, Flagship Bank, provided the construction loan for the project. After the fire in 1997, proceeds from the insurance claim covered the costs of the second round of renovations.

Beaver Block Project				
SOURCES OF FINANCING				
Equity			***Permanent Debt***	
Public			*Public*	
HOME Program	(Federal)	$ 400,000	Mass. Gov't Land Bank	$ 875,000
Private			***Construction/Interim Debt***	
Low Income Housing Tax Credit	(Federal)	$ 675,000	*Public*	
			CDFC	$ 325,000
			Private	
			Flagship Bank	$ 450,000

The Beaver Block project presented certain risks that concerned investors. The Worcester real estate market was weak in 1993, but the CDC was confident that it could rent the affordable

[82] Interview with Paul Dell'Aquila, Project Manager at Main South CDC.
[83] In general Boston is a more expensive place to do business than Worcester is. But the Lithgow project also included certain construction features, like parking garages, that added to the cost of the project.

rental units. The commercial space in the building was somewhat outdated and had to be reconfigured. In addition, the Beaver Block was Main South CDCs largest real estate development project to date.

Clark University's presence in the deal, as a kind of "silent" partner, balanced out these risks. To support the CDC during the predevelopment process, Clark provided a $20,000 seed grant. Clark had a special interest in this project, as the University's Admissions Office is located directly across the street from the Beaver Building.

Financing Strategies

- *Having an Institutional Partner*

  Clark University was and continues to be very involved in the neighborhood revitalization work taking place in the Main South neighborhood, because the current administration believes that the condition of the neighborhood has a direct impact on the University's business. As part of its commitment to the neighborhood, Clark supports the work of Main South CDC, both directly and indirectly. The University provides the CDC with predevelopment loans, technical assistance, and a line of credit. Clark also helps the CDC by lending its reputation and political clout.

  Andrea Daskalakis, who underwrote the tax credit financing for the project, says that the CDC's partnership with Clark made it easier to invest in the project. Even though the University was not a formal investor in the Beaver project, its relationship to the project gave investors "added confidence" in the deal, despite concerns about the project's retail component and the developer's limited experience with projects of that size.[84] The presence of Clark University in the neighborhood, and indirectly in the project, gave the Beaver project credibility in the same sense that Bank of Boston gave the Lithgow project credibility.

[84] Interview with Andrea Daskalakis, Senior Equity Investment Officer for Massachusetts Housing Investment Corporation (MHIC).

- *Having Commercial Tenants in Place*

  Unlike the Lithgow project, which had an office tenant but few retail tenants in place, the Beaver project had all of its commercial tenants in place.[85] This gave lenders and investors confidence that the retail space was viable in that market. Vacant retail space may have hindered the project's financing, according to Main South CDC's Executive Director, Steve Teasdale.[86]

Case 3: The Taylor's Market Project[87]

Project Description

The Taylor's Market project involved the rehabilitation of one of South Boston's oldest remaining commercial buildings, originally built in the 1830's. Located at the corner of West Broadway and E Street, the building is part of South Boston's main commercial district. As the neighborhood lost population over the years, the retail area along Broadway contracted somewhat. When Taylor's Market building was damaged in a fire in the early 1980s, the owners left it vacant for years, contributing to the decline of the entire block. More recently, as newer immigrants have moved into the neighborhood, the business on Broadway has been expanding again. But, for many years, nothing happened on the Taylor's Market block.

Several private developers had attempted to redevelop the building over the years, but without success. Part of the problem was the terrible condition of the building – it would clearly be quite expensive to renovate. The developer who ultimately took on the project was a small CDC called South Boston Community Housing. This organization had targeted the Taylor's Market building as a strategic parcel in the revitalization of West Broadway. The CDC prepared a development proposal that restored the retail space at the lower levels and created new, affordable rental units above. The project, which included a new, locally owned bakery and office space for the CDC, opened in 1997.

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[85] Of course, this meant that the space could not be fully renovated.
[86] Interview with Steve Teasdale, Executive Director of Main South CDC.
[87] The author was the primary project manager for the Taylor's Market project and is therefore intimately familiar with the details of the project.

Neighborhood Impacts

- *Physical Impacts:* The project successfully restored one of the neighborhood's oldest remaining commercial buildings, and simultaneously removed a physical blight and safety hazard from South Boston's main commercial district.
- *Economic Impacts:* The redevelopment of Taylor's Market encouraged abutting property owners to make similar investments in their properties. The project also gave a local entrepreneur the opportunity to open her own business.
- *Social Impacts:* The project came on line soon after the repeal of rent control in Boston, and market rents in South Boston were rising rapidly. The new, affordable housing opportunities in the Taylor's Market project allowed low-income residents to remain in their community.

Project Financing

This project is unusual in that it caught the attention of a local community bank, Mt. Washington Cooperative Bank, which agreed to provide construction and permanent financing to the project. Mt. Washington had worked with South Boston Community Housing on a much smaller renovation project in the early 1990s. Other than this loan, the project relied heavily on public grant money.

Taylor's Market Project				
SOURCES OF FINANCING				
Equity			***Permanent Debt***	
Public			*Public*	
HOME Program	(Federal)	$ 588,000	Historic Massachusetts	$ 25,000
Community Development Block Grant	(Federal)	$ 50,000		
Federal Home Loan Bank	(Federal)	$ 60,000	*Private*	
			Mt. Washington Bank	$385,000
			Construction Debt	
			Private	
			Mt. Washington Bank	$385,000

Financing Strategies

- *Achieving a Critical Mass*

  One serious obstacle to financing the Taylor's Market project was its size. The renovated Taylor's Market building would provide only 7 units of affordable rental housing - too few units to make the project eligible for some grant programs. The project was also too small to support the cost of using tax credit financing, which can add tens of thousands of dollars to the cost of a project in legal and consulting fees. To address this problem, the CDC packaged the Taylor's project with the rehabilitation of another building – a triple-decker structure a few blocks away. The "scattered site" project now met the 10 unit minimum requirement for the HOME program, which ultimately provided the majority of the funding for the project. Other developers working in neighborhoods with a smaller building stock – buildings with 6-8 units, for example – have also adopted this strategy of "scattered site" development as a means of accessing financing.

- *Working with a local community bank*

  Taylor's Market is the only project of the three case studies that involved a local community bank. Mt. Washington has little experience in working with public subsidy programs like HOME and the Affordable Housing Program and was initially reluctant to take on the project. Today, however, the bank views the project as a good investment; the spillover effects from the rehab of Taylor's Market have led to other business for the bank.[88] The bank's role in the project was critical, because of the flexibility it offered. Mt. Washington bank has a long-time commitment to the South Boston community and has done other business with South Boston NDC. The bank was therefore more willing to negotiate the terms of the loans. The more specialized CDFIs, which have played such an important role in financing the other projects discussed in this chapter, were too expensive for the Taylor's project.[89] The project was too small to bear the standard transaction costs – inspection fees, closing fees, etc. – that these financial institutions impose.

[88] Interview with Annette Serino, Mt. Washington Bank.
[89] Interview with Beverly Byer Gallo, former Director of Development at South Boston Neighborhood Development Corporation.

General Observations on the Obstacles to Financing Mixed-Use Development

There are certain themes that emerge from the stories of these projects and how they were financed – the need for subsidy, lack of bank interest, high transaction costs. These financing issues relate back to the discussion of capital markets in Chapter 3, which identified several causes of market failure. The most relevant impacts of market imperfections are described below.

These deals require significant subsidy, especially in the form of equity.

One of the fundamental characteristics of neighborhood mixed-use development, as defined in this thesis, is that these projects have limited income potential. This is partly due to the market in which they are located; in distressed neighborhoods, rents for residential and commercial space tend to be low. It is partly due to the policy goals of the project – to provide affordable housing at below market rents. This means that these projects can only support a certain level of debt, usually lower than typical real estate development projects, which leaves a funding gap. This gap must be filled with equity. And because the market does not value the social benefits of this type of development, that equity must take the form of subsidy.

In addition, neighborhood mixed-use development projects are expensive, for several reasons. They are costly because they are located in "difficult to develop" areas like Boston, where land and construction costs are high. These projects are also costly because of the symbolic nature of the project. They have preserved historic buildings even if the structure was falling apart with a tree growing through the roof, because the building was an important symbol for the neighborhood. Or they are the toughest projects in the neighborhood.[90] These kinds of projects are typically too expensive for the private sector take on, and are generally not feasible without some kind of subsidy.

This situation is played out in each of the case studies. All of the projects have low loan to value (LTV) ratios, which ranged between 37 and 52%. The corresponding equity contribution was therefore between 48 and 63%. The Lithgow project needed less equity than the other projects

[90] Gibbons interview.

because it included some market rate residential units and an above market rent for the office space. Taylor's Market, on the other hand, required 63% equity to make the project work. The equity in these projects comes from various housing and community development grant programs, mostly federal. Tax credits, when available, are the largest single source of equity for these projects. Nearly 20% of the Lithgow project's financing came from tax credit equity; for the Beaver project the amount was closer to 35%.

Another trend that becomes evident in this case study analysis is that equity is easier to find for residential uses than for the commercial uses. This last point has significant implications for mixed-use development. Some of the most important sources of equity – the LIHTC, HOME, the Affordable Housing Program, are available only for affordable housing development. This makes structuring a deal more difficult, because investors (or funders, in the case of grants) want assurance that the money is spent for its intended purpose. The case study projects show some different responses to this challenge. The Lithgow project financed its residential and commercial components separately, the Beaver project omitted the commercial building from its rehab plans, and Taylor's Market cross-subsidized its commercial space through its residential. None of these strategies offer a satisfying solution to the problem, because each adds additional costs or complexity to the project.

Private lenders play only a limited role in providing debt financing for the projects.

While there was some involvement in these projects by private banks, most of the lending was done by specialized lending institutions. In terms of attracting private financing, the projects in these case studies were much more successful in attracting short-term debt than they were in attracting long-term, permanent debt. Securing private financing for construction was relatively easy: Bank Boston provided funds for the Lithgow project; Flagship Bank for the Beaver project; and Mt. Washington Bank for the Taylor's Market project. But, the terms of these loans were short, ranging between 1 year and 18 months. Developers saw these as low-risk loans, since equity and take-out financing for the project were already secured.[91] From the banks' perspective, the construction loans were generally "safer" because the banks had experience in

[91] Teasdale, Gallo interviews.

this area and because the projects were principally renovations of existing neighborhood stock, which could serve as collateral for the loans.

Why were private banks less interested in providing long-term financing for these projects? One explanation for the lack of interest is that the private lenders were unwilling to take on the risks associated with longer-term lending. The reader will remember from the discussion in Chapter 3 that these risks include interest rate risk, liquidity risk, and credit risk. Without a mechanisms to address such risks, private banks will not make long-term loans on these kinds of projects. Another explanation is that the complexity of the transaction, created by many layers of grant and tax credit financing, requires a specialization that smaller, private banks don't have.

Ideally, small banks should be able to play a role in neighborhood revitalization projects; they know the market, they are committed to the community, and have a less rigid, more generalist approach to lending. But, there are fewer of these banks today, as a result of mergers. And those that remain are often scared away by the complexity of such deals.[92] This situation reinforces the need for specialized lending institutions, or specialized units within larger banks, that have both the experience to deal with housing programs and the access to resources that help address the risks associated with permanent financing.

Redressing barriers to private bank financing is important for neighborhood mixed-use development because the lack of involvement by private banks ultimately hurts these projects. Public resources are limited and are best used as direct subsidy; it is therefore more economically to use private financing on the debt side. Furthermore, the participation of private financial institutions gives credibility to a project.

Information and transaction costs are high for both public and private financing.

Mixed-use development projects are "story" projects. They require time and effort to understand the project, the neighborhood, and the different markets associated with each use. The projects described in this chapter were subject to three main sources of higher information and transaction costs: the added cost of underwriting the residential *and* commercial components of mixed-use

project; the cost of using public subsidies and grant programs: and the cost of using multiple funding sources.

One strategy to address this problem is to make more efficient use of information. Bank Boston's role in the Lithgow project illustrates this principle. Bank Boston provided the construction loan, permanent financing, and opened a retail branch in the project. The information costs were shared across all of these transactions, thereby reducing the marginal cost. When several of the commercial loans came due in 1998, Bank Boston refinanced all of them. This was easier to do because Bank Boston already knew the project.

Securing commercial leases is critical to securing financing.

In general, lenders to commercial real estate projects are more conservative than they used to be. The speculative development frenzy of the 1980s, and the subsequent real estate crash, have made banks much more cautious about lending to retail and office projects. Securing tenants in order to obtain financing for a project is standard practice for market deals, and it is rapidly becoming standard for community deals as well. In these case studies, most of the commercial space was spoken for, and having tenants in place was critical to getting financing for the projects.

Lenders' concerns about the commercial component of these projects are related to the risks involved in commercial real estate, and the higher interest rates on commercial loans reflect these higher risks. The demand for retail and office space is particularly sensitive to changes in the economy. The demand for retail and office space in urban neighborhoods is much weaker than the demand in central business districts. With urban retail space, tenants are usually "mom and pop" stores or new business ventures. There is a greater chance of failure with these types of enterprises, and to underwrite that risk, banks need to act more like small business lenders than real estate lenders.[93]

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[92] Gibbons interview

[93] Gibbons interview.

Summary

The analysis in this chapter leads to some conclusions - both about the nature of mixed-use development and about the obstacles to financing this kind of development. The projects discussed here share certain characteristics that have made them successful. They therefore offer important lessons to other neighborhood developers interested in doing this kind of project.

Lessons on developing a mixed-use project

While each of the projects described in this chapter include both residential and commercial components, the commercial component seems to play a more important role in the success or failure of the project. The most important lessons to take from these projects are:

- The success of the commercial component is critical to the success of the project; inclusion of retail or office space must be thought through carefully and cannot be an afterthought. An understanding of urban retail and small business lending is important to determining what works. Many CDCs are well equipped take on this role, as many are already involved in economic development and small business technical assistance. In both the Taylor's Market project and the Beaver Block project, the local CDC provided technical assistance and small business loans to their tenants.
- Location is also critical, especially with respect to the project's commercial component. Projects must be developed in area with existing commercial activity. Or, the project must be able to generate the activity itself, as the Lithgow project did with Dorchester Counseling Services.
- Finding an influential partner to help champion the project is important. The participation of Clark University and Bank Boston illustrates how these institutions can give credibility to a project. These institutions benefit from the partnership as well, by taking advantage of the spillover benefits that these projects creates.

Lessons on financing mixed-use development

Even successful projects that have these characteristics will encounter obstacles to financing. To summarize, the most critical obstacles seem to be:

- Assembling the necessary subsidy from public sources;
- Attracting private investment in terms of debt financing.; and
- High information and transaction costs for both equity and debt financing.

In the following chapter, I will focus on the kinds of financing tools available to address these obstacles.

CHAPTER 5:

Tools for Financing Mixed-use Development

The case studies reviewed in the previous chapter have shown how some of the market imperfections described in Chapter 3 play themselves out in the context of real project. The major obstacles to financing mixed-use development that were identified through the case study analysis were:

- Assembling the necessary subsidy from public sources;
- Attracting private investment in terms of debt financing; and
- High information and transaction costs for both equity and debt financing.

Using the case study findings as a framework, this chapter will focus on the role that various housing and community development programs play – or could play – in financing mixed-use development. In doing so, I will try to answer the following questions: What federal programs are available for financing neighborhood mixed-use development? How well to they serve this purpose?

The discussion in this chapter will focus on federal programs. Compared to the various state and local tools available for financing mixed-use development, these federal tools are more consistently available across cities and neighborhoods. This exercise should offer some insight into the inconsistencies that exist from both a policy and a program perspective.

Addressing the Need for Equity

The most obvious finding of the case study analysis in Chapter 4 was that neighborhood mixed-use development requires significant equity investment in order to bring the projects to fruition. These projects rely heavily on equity for two reasons: first, these projects tend to be very expensive, and second, the typical end users – low-income renters or small retail businesses –

inherently limit the project's potential to generate income, and thereby limit the amount of debt service the project can support. In addition, since the project itself can not generate a direct, financial return on that investment, the equity must be provided in the form of a grant.

The federal government offers many grant programs for housing and community development activities. These programs were created to address the externalities problem defined in Chapter 3; their purpose is to support projects that offer important social benefits that may not be valued by the market. Equity can be provided to a project through two different mechanisms: grants or tax credits. The difference between these two approaches will be discussed below.

Grant Programs

The largest and most important housing and community development grant programs are designed and administered by the Department of Housing and Urban Development (HUD). A few smaller funding programs come from the Department of Commerce and the Department of Health and Human Services; the focus of these grants is primarily economic development. The Federal Home Loan Bank, which is not a federal agency but is sponsored by the government, offers grant programs for housing development. The source and current funding level for the most important of these grant program is listed in the table below:

Summary of Federal Grant Programs for Housing and Community Development

Program Activity	Program Name	Source	FY '99 Funding (millions)
Housing and Community Development	Community Development Block Grant *(CDBG)*	Dept. of Housing and Urban Development	$4,750
	HOME Investment Partnership Program *(HOME)*	Dept. of Housing and Urban Development	$1,600
	Economic Development Initiative *(EDI)*	Dept. of Housing and Urban Development	$225
	Affordable Housing Program *(AHP)*	Federal Home Loan Bank	$100[94]
Economic Development	Economic Development Administration *(EDA)*	Dept. of Commerce	$206[95]
	Office of Community Services *(OCS)*	Dept. of Health and Human Services	$30

[94] The amount of funding for the program is determined by the Bank's profits. The program receives either 10% or $100 million, whichever is greater.
[95] Total funding for EDA grants was $368 million, but only a portion of the funding (Public Works grants) is available for real estate development projects.

- Community Development Block Grant: CDBG is the largest federal grant program currently available for housing and community development activities. CDBG is an entitlement program, which means eligible cities automatically receive a certain amount of funding each year.[96] Each municipality creates a plan for how the grant money will be used. The program's national objectives are intentionally rather broad, which enables communities to carry out a wide range of activities directed toward neighborhood revitalization, economic development, and improved community facilities and services.[97]

- HOME Program: The HOME Investment Partnership Program is another formula-based allocation program that provides grants to state and local governments to implement local housing strategies. Funds can be used for tenant-based assistance, housing rehabilitation, assistance to first-time homebuyers, and new construction.

- Economic Development Initiative. This grant fund is meant to be used in conjunction with a HUD loan program called Section 108, which is targeted to economic development projects or other activities that meet CDBG regulations.

- Affordable Housing Program: Another grant source for affordable housing development is the Affordable Housing Program, administered by the Federal Home Loan Bank. The program was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989, in an effort to expand the Bank's role in lending to affordable housing and community development projects. The program provides grants to non-profits to finance the purchase, construction, or rehabilitation of rental and ownership housing.

- EDA Grants. The Economic Development Administration, which sits within the Department of Commerce, offers a range of smaller grants targeted to economic development projects, including commercial real estate development. The kinds of projects funded through the

[96] The amount is determined by a formula that takes into account factors such as poverty, overcrowding, and housing conditions.

[97] The national objectives of the CDBG program are: to benefit low or moderate income family; to aid the prevention or elimination of blight; or, to meet a critical community need.

EDA program typically include industrial parks, business incubators, and infrastructure projects.

- Office of Community Services. Another program targeted to economic development is the OCS grant. Administered by the Dept. of Health and Human Services, the program specifically targets neighborhood-based organizations for economic development in low-income communities. These grants are extremely competitive, since the program's funding level is so small. (The Lithgow project received an OCS grant for the commercial component of the project.)

As the table above indicates, there is a considerable amount of grant funding available to housing, community, and economic development projects that serve low-income persons and neighborhoods. Some of the programs are better suited to mixed-use development than others. CDBG funds are particularly attractive to developers because of the wide range of eligible activities that the program allows. The National Low Income Housing Coalition, in its guide for affordable housing advocates, described the CDBG program as, "probably the most flexible funding source available to cities from the federal government." [98] (Interestingly, only one of the projects highlighted in the case studies utilized this source of grant funding. A possible explanation has to do with city funding priorities.) The Federal Home Loan Bank's AHP program is also quite flexible, but the grant amounts tend to be small; it is meant to be used in conjunction with other grant programs.[99]

The other grant programs described above seem to offer less flexibility in the context of a mixed-use development project. HOME grant funds may only be used for the housing component of a mixed-use project. OCS and EDA grants are restricted to commercial development[100]. Developers that use HOME funding for mixed-use development must be able to demonstrate that no cross-subsidizing has occurred.

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[98] National Low Income Housing Coalition, *1999 Advocate's Guide* (1999), p. 38.

[99] The maximum grant awarded in Federal Home Loan Bank's 1998 Affordable Housing Program round was $250,000. FHLB News Release, July 6, 1998.

[100] Based on author's interpretation of grant program descriptions in the *1997 Catalog of Federal Domestic Assistance*, from the Office of Management and Budget and the General Services Administration.

Another factor that affects the availability of these grant funds for mixed-use development is the funding priorities of the city, state, or regional (in the case of the FHLB) entity that administers the funds. Funding priorities can change from year to year. In some years, for example, home ownership may be a priority. This kind of policy decision would make CDBG, HOME, or AHP funding more difficult to access for mixed-use development projects.

Tax Credit Financing

Tax credits are the other major source of equity available for housing and community development projects. Tax credits differ from the grant programs described above in that they involve private investors, who receive a return on their investment. (In this way, tax credit financing is more like real equity than grant funding.) The return, however, does not come directly from the project. Instead, the Internal Revenue Service (IRS) gives investors credits against their federal income tax liability, sometimes over a period of several years. Tax credits are structured this way to encourage private investment in projects that meet certain policy goals. There are currently two federal tax credit programs available for real estate development.[101] These are the Low Income Housing Tax Credit (LIHTC), which was designed to support the creation and preservation of affordable housing, and the Historic Preservation Tax Credit, which was designed to encourage the restoration of historically significant structures. Of these, the LIHTC program is, by far, a more important source of equity for mixed-use development.

Each state receives an annual allocation of low income housing tax credits equal to $1.25 per capita. (In 1998, Massachusetts allocation was $7,647,500.[102]) States, usually through their housing finance agencies, are responsible for distributing the LIHTC credits to projects that meet the goals of the State's Qualified Allocation Plan. The QAP sets forth the "methods, criteria, preferences and priorities they will use to select projects."[103] The Plan must first give preference to projects that serve the lowest income tenants, but the other criteria – including geographic location, rehab or new construction, projects that serve special populations – are determined by

[101] While the discussion in the chapter focuses on federal tax credit programs, it is important to note that some states have begun develop their own tax credit initiatives.
[102] Guggenheim, p. 66.
[103] *Ibid.*, p. 69.

the State. Ten percent of the amount in each state is reserved for use by non-profit housing groups.

The Historic Preservation tax credit is targeted to the rehabilitation of historic structures. The program is overseen by the National Park Service and the U.S. Department of the Interior. To be eligible to receive credits, a building must be listed in the National Register of Historic Places, or be located in a registered historic district. The program requires that certain standards of rehabilitation, such as preserving original windows and architectural detailing, are met. An eligible project will receive credits equal to 20% of certified rehabilitation expenditures, and credits are received during the first year that the building is placed into service. Historic credits can be used for residential or non-residential properties.[104]

The combination of the LIHTC and Historic Preservation programs can work well for mixed-use development that involves the rehabilitation of an historic building, as we saw with the Lithgow project. Not every project can take advantage of both programs, and the LIHTC is more commonly used for such projects. The primary benefit of tax credit financing is that it can provide significant equity for a project. The Lithgow project received approximately $1.5 million in historic and low income housing tax credits – which accounted for almost 20% of the total cost of development. In the Beaver Block project, tax credit financing played an equally critical role, although the Beaver Building was not eligible for historic credits. Often, tax credit financing is the critical piece of equity for a project, since the credits can generate more money than a project can raise through HOME or CDBG funds.

The benefits of using tax credit financing must be weighed against the costs. Because tax credit syndication involves a complex legal transaction, lawyers, accountants and other consultants must be brought in to review the deal. The use of these specialists adds significant costs to the project. An early U.S. General Account Office evaluation of the LIHTC program calculated that

[104] *Ibid.*, p. 93.

these costs average 27% of the equity investment in a project.[105] although experience with the program and standardization have helped to reduce costs over time.

The high cost of tax credit programs is a major limitation to the use of this financing mechanism for neighborhood revitalization projects. This was the case for the Taylor's Market project.[106] Mixed-use projects that take advantage of extant neighborhood building stock may be particularly vulnerable to the high costs of tax credit programs, since these types of projects are typically small. One potential solution to this problem is to expand the size of local projects by merging them into single, scattered site developments. This solution suffers from increasing construction costs.

The complexity of tax credit programs also creates indirect costs for projects using tax credit financing. A bank that lends to a project with tax credits must familiarize itself with the program. An analysis of the program the lender's perspective states, "LIHTC activity requires banks to adapt to non-traditional underwriting and evaluation requirements, as the players, transaction structures, and economics all differ materially from conventional multi-family lending."[107] The complexity of utilizing tax credits may scare small lenders away from mixed-use projects.

Finally, the way the tax credit program is structured gives incentives to maximize the housing component of the project. Program regulations state that, "In a mixed-use building with commercial uses... Costs attributed entirely to commercial or other non-residential uses cannot be included in the basis for earning tax credits."[108] The Lithgow project overcame this potential obstacle by separating the residential and commercial components of its financing. The Beaver developer sidestepped this issue by electing not to include one commercial building in the renovation.

Conclusions

There are three main issues that emerge from this analysis of federal grant programs:

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[105] Michael A. Stegman, "The Excessive Costs of Creative Finance: Growing Inefficiencies in the Production of Low-Income Housing," *Housing Policy Debate*, Vol. 2, Issue 2, (1990), p. 371.
[106] Gallo interview.
[107] Wankowicz.

- Mixed-use projects are able to use programs that support either affordable housing or economic development. However, only the CDBG program includes both of these activities as eligible activities.
- While grant funds are available to these projects, they are not generally distributed in such a way that a project's equity needs are met by a single program. As a result, most projects have multiple layers of public financing.
- The most significant source of equity, the tax credit program, imposes large transaction costs.
- Finally, all of these programs are subject to the whims of local politics, so that the same sources of financing may not be available from one year to the next.

In conclusion, larger, simpler, more flexible programs are needed.

Attracting private debt capital

A second major financing gap identified through the case study analysis in Chapter 4 was the lack of participation by private lenders, especially in providing long-term debt. This role was more often played by public or quasi-public lending institutions that specialize in housing finance. This is typical for many affordable housing and neighborhood development projects. One of the reasons why private banks are reluctant to provide debt financing to neighborhood mixed-use development projects is because there are insufficient mechanisms to address interest rate risk, liquidity risk, and credit risk.

The Secondary Mortgage Market: Fannie Mae and Freddie Mac

The reader will remember from the discussion in Chapter 3 that part of what limits a bank's ability to lend money over a long period is the potential mismatch between assets and liabilities. Another concern for lenders is interest rate risk, which increases as the term of the loan increases. Sometimes banks use an adjustable rate mortgage, with an interest rate that moves up and down with the prevailing interest rate, as a way to hedge against inflation.

A neighborhood mixed-use project like the ones described in Chapter 4 has an income stream that is essentially fixed. For the project to work, it needs a predictable debt service payment over

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[108] Guggenheim, p. 43.

the life of the loan. Either an adjustable rate or short-term loan, which could mean widely fluctuating monthly debt service payments, would threaten the financial viability of the project.

Access to the secondary market is one strategy to encourage private lenders to increase the supply of long-term debt to projects. The secondary mortgage market is one in which individual mortgages are packaged together, securitized, and sold on the public market. It allows banks to offer long-term fixed-rate financing by providing a market for these loans. In this way, the secondary market relieves banks of interest rate risk and renews the banks' supply of capital so it can more easily balance assets and liabilities. The main players in the secondary mortgage market for housing are two government sponsored entities (GSEs) – Fannie Mae and Freddie Mac.[109]

As a strategy for financing the type of mixed-use development discussed in this thesis, which is primarily rental housing, the secondary market has the potential to improve the flow of long-term debt to these projects. Both Fannie Mae and Freddie Mac already have programs to securitize multifamily housing mortgages. Fannie Mae is the nation's largest private investor in multifamily housing, with over $47 billion in assets.[110] Furthermore, under 1992 Federal Housing Enterprises Safety and Soundness Act, Fannie Mae and Freddie Mac were given a government mandate to meet certain purchasing goals in the low-income and minority neighborhoods.[111]

In practice, however, there have been problems with the implementation of this strategy. Many multifamily loans don't fit the standard underwriting criteria that Fannie Mae and Freddie Mac have developed for the secondary market. These standards make it especially difficult to underwrite a mixed-use development project, because of the commercial component. (Fannie Mae's underwriting standards for multifamily housing restrict commercial income to 20% of the project's total effective gross income.[112]) A report by the Urban Institute on secondary mortgage market practices in urban neighborhoods states: "Buildings with both residential and commercial

[109] Fannie Mae is the nickname for the Federal National Mortgage Association (FNMA); Freddie Mac is the Federal Home Loan Mortgage Corporation (FHLMC).
[110] Tyson Freeman, "Capital Markets: Look Who's Coming to Dinner," *National Real Estate Investor* (April 1999), p. 11.
[111] MacDonald, "Expanding Access to the Secondary Mortgage Markets."
[112] Fannie Mae Multifamily Delegated Underwriting and Servicing (DUS) Guide, 8/1997

uses are common in many cities, particularly in low-income neighborhoods. However, community groups claim that secondary market agency underwriting guidelines restrict the ratio of commercial-to-residential square footage on the mortgage loans they will purchase."[113] Furthermore, DiPasquale and Cummings report that one side effect of this standardization process is that more and more banks have been following Fannie Mae's lead: "To the extent that there are industry standards in underwriting multifamily, they are represented by Fannie Mae and Freddie Mac."[114]

A lack of information and research on the performance of multifamily housing has contributed to such rigid underwriting standards.[115] As proxy, Fannie Mae and others seem to be using standards for single-family housing to assess multifamily housing projects, even though these two asset types have little in common. For example, the reliance on such factors such as loan to value ratio, which are important in the performance of home mortgages, are not necessarily good indicators of the performance of multifamily and mixed-use projects. Lending institutions that have more experience with this type of lending know that income stream and debt service coverage are more important.[116]

Accessing the Public Markets: The Federal Home Loan Bank System

The Federal Home Loan Bank is another financial intermediary that could encourage private banks to play a larger role in financing neighborhood mixed-use projects. The FHLB was established in 1932 as a publicly chartered system of regional banks to support the housing finance system. Because it can borrow directly from the Federal Reserve System, the FHLB can provide advances to member banks at a lower rate of interest. The Bank serves as a central credit facility for principal mortgage lenders, savings and loan associations - a bank for other banks. Like the secondary markets, the Federal Home Loan Bank provides an indirect source of credit to projects.

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[113] Constance R. Dunham, "A Survey of Community Group Views on Secondary Mortgage Market Agency Policies and Practices" (Washington, D.C.: The Urban Institute, 1991), p. 23.
[114] DiPasquale and Cummings, "Financing Multifamily Rental Housing", p. 98.
[115] Jean Cummings and Denise DiPasquale, "A Primer on the Secondary Mortgage Market," Prepared for the National Community Development Initiative Meetings (June 4, 1997), p. 8.
[116] DiPasquale and Cummings, "Financing Multifamily Rental Housing", p. 110.

The FHLB was originally created to support the home mortgage finance system. But starting in 1989 with the passage of FIRREA, the FHLB developed a program that would allow these benefits of lower cost capital to be passed on to community development projects as well. The Bank called the program the Community Investment Program (CIP), and targeted funds from this program to projects that serve low-income communities and residents. Projects can receive fixed-rate, low interest rate loans for a term of up to 20 years through this project.

The CIP program has not been very successful. The FHLB does little lending in this arena, especially when compared to the much more popular Affordable Housing Program. According to developers, the program is too expensive: "The CIP provides reduced lending rates for nonprofits doing community economic development. Although some CDCs have accessed CIP funds, it has been difficult. CDCs find the adjusted interest rate, even with the reduction, too high to be affordable for the project unless it is subsidized..."[117] The program also leaves unresolved the question of credit risk. Unlike Fannie Mae, the FHLB does actually buy the loan, so the local banks that originate the mortgage must take on the credit risk associated with loan.[118]

Addressing credit risk: FHA multifamily mortgage insurance

As we saw in the case studies in Chapter 4, the presence of commercial space in mixed-use projects is often a concern for lenders. The nature of commercial real estate - office and retail – is more risky than residential, especially in low-income neighborhoods. Compared to the market of potential users for affordable rental housing, the market for users for neighborhood retail is small. Furthermore, the type of tenant that occupies retail space in an urban neighborhood setting is usually a small business owned by a single entrepreneur with few financial resources. The life span of these "mom and pop" operation can be quite short, which makes for a potentially unreliable tenant.

Because of these issues, it is harder to find private banks that are willing to lend to mixed-use development projects with commercial space. As a result, these projects are highly reliant on equity and specialized lenders. The projects discussed in the previous chapter offer some

[117] National Low Income Housing Coalition, p. 69.
[118] Interview with Ken Willis, Federal Home Loan Bank.

strategies on how to make a project more palatable to lenders. Financing commercial and residential components separately (as we saw in the Lithgow project) improves the housing proforma, but doesn't address the problem of finding financing for the commercial side. This strategy can also increase transaction costs.

One strategy not seen in the case studies is the reduction of project risk through mortgage insurance, which is sometimes also called "credit enhancement". Although mortgage insurance did not play a role in financing any of the case study projects, the Beaver Block project did enjoy a kind of implicit credit enhancement as a result of the developer's partnership with Clark University. Investors in the project knew that the University would come to the rescue if the project got into financial trouble. This relevance of credit enhancement for mixed-use projects is that it will also help to maximize private debt available for such projects.

The Federal Housing Administration was created in 1934 to help stabilize the housing industry after the Great Depression. Its objective is to make housing affordable to lower- and middle-income families. This has been accomplished by allowing such families to purchase homes with lower down payments than would be required under conventional lending standards. Today, the FHA achieves this goal by providing mortgage insurance. Unlike conventional insurance, which protects the lender against some portion of the potential loan loss, FHA mortgage insurance insures the lender completely against any default losses.[119]

Most of FHA's insurance programs target single-family residential mortgages. However, the FHA also has some smaller programs for multifamily loans. These loans work in the same way, by protecting the lender from losses associated with default. Unfortunately, the track record of FHA's multifamily products has been poor. The Administration suffered major losses in the late 1980s; these climbed as high $6.4 billion in 1989.[120] When the FHA underwent a major restructuring in mid-1990s, the poor performance of the multifamily program sparked much debate about what the FHA's role should be in that market.[121]

[119] Brueggeman and Fisher, p. 167.
[120] DiPasquale and Cummings, "Financing Multifamily Rental Housing," p. 106.

The multifamily insurance program survived the "reinvention" of HUD and the FHA, and today this program is the only major source of insurance for multifamily housing.[122] In addition, the program specifically targets low and moderate-income families and neighborhoods. As such, it could be an important resource for mixed-use development that includes an affordable housing component. Projects that involve the rehabilitation or new construction of 5 or more units qualify for the program, so the housing component need not be large.[123] Yet, FHA's role in the multifamily market has diminished considerably since the 1980s, when the value of FHA insured multifamily properties peaked at more $10 billion.[124] By comparison, FHA's section 220 program (mortgage insurance for rental housing in urban areas) insured only $101 million in mortgages in 1997.[125] Clearly, there is a need for other actors to take on the role of providing credit enhancement for projects.

Conclusions

In addition to providing direct financial support for neighborhood mixed-use projects, the federal government has created institutions that provide incentives for private sector involvement in such projects. And like many of the subsidy programs described in the previous section, these institutions are not always suited to the mixed-use prototype. The relevant points that arise from this discussion are:

- Current underwriting standards for the secondary market are too inflexible, making it difficult for projects that don't fit the mold to gain access to lower-cost financing. A better understanding of the real risks of multi-family housing is necessary to make the program work better.
- The CIP program could be a helpful tool for giving smaller banks access to long-term debt capital, but the FHLB's unwillingness to bear any credit risk in mortgage transactions greatly reduces the attractiveness of the program to its member banks.
- While mortgage insurance for multifamily housing exists through the FHA, other sources of credit enhancement are needed for mixed-use projects that include sizable commercial components.

[121] See Vandell, Retsinas, and Weicher in *Housing Policy Debate*, Vol. 6, Issue 2 (1995).
[122] DiPasquale and Cummings, "Financing Multifamily Rental Housing," p. 101.
[123] FHA program regulations
[124] DiPasquale and Cummings, "Financing Multifamily Rental Housing," p. 102.

Reducing Transaction and Information Costs

Information costs and transaction costs are an issue for each of the programs discussed in this chapter. Improvements in the both areas – public and private financing - would help to bring down overall transaction costs for projects. Some strategies to address this problem include:

- Reducing the number of subsidy sources needed to finance the equity component of a mixed-use project.
- Developing specialization with regard to neighborhood mixed-use development to overcome information costs.
- Providing more information on the performance of mixed-use projects, thereby making such projects easier for investors to evaluate.

Summary of Findings

The theme that runs throughout this chapter is that mixed-use development is that it doesn't fit neatly into any of the financing sources that the government has created to support community development. The dichotomy between "housing development" and "economic development" seems to hurt those projects that seemingly fall in between, even if the projects achieve both of these goals. So, despite the fact that the federal programs described in this chapter offer the means to address the challenges of financing mixed-use development, most are difficult to access for such projects. In Chapter 6, I will make some recommendations on how to improve the usefulness of these programs for financing mixed-use development.

[125] HUD webpage, Section 220 program description, www.hud.gov/progdesc/220dft.html.

CHAPTER 6:

Conclusions and Recommendations

The focus of this research paper has been to identify and explore the obstacles to financing neighborhood mixed-use development. This model of development has proven to be an important neighborhood revitalization strategy for many inner-city neighborhoods. However, the difficulties in financing mixed-use projects limit the opportunity for replication in other communities. The case studies presented in this paper highlight the types of challenges that face developers in assembling financing for mixed-use projects. They also provide some insight into various strategies to overcome these obstacles to financing.

Given that mixed-use development can be an effective way to combine the housing development and economic development goals of neighborhood revitalization, the obstacles to financing mixed-use development should be addressed. The case study analysis has led to the following conclusions about the financing of mixed-use projects:

- The mechanisms for providing public resources to neighborhood mixed-use development are inefficient and add to the costs of a project;
- Private lending institutions currently play only an inadequate and limited role in financing these projects; and
- The strength of the commercial component is critical to the success of a mixed-use project.

These observations also lead to a set of recommendations for the public subsidy programs, private financial institutions, and developers that play a role in creating neighborhood mixed-use projects. These recommendations, which are outlined in this chapter, apply across the board – at the policy, program and project levels. In terms of public financing, I argue for increased flexibility and simplicity in the federal subsidy programs that target community development. In terms of private financing, I argue for strategies that will encourage greater participation by the private sector in mixed-use development projects. I also recommend reducing information and transaction costs across both sectors, to the greatest extent possible. Finally, in terms of project

design and development. I argue for greater emphasis on the commercial aspects of mixed-use development.

Role of federal subsidy programs in providing equity financing

The role of public funding programs – and federal programs in particular - is critical to financing neighborhood mixed-use development. These programs provide the deep subsidy, what I have called "equity", needed to close gap between the debt that the project can support and the total costs of developing the project. The equity gap problem is an issue for most community development projects, because they cannot offer a competitive private return even though they provide offsetting social benefits or externalities. The case studies in Chapter 4 - in which public subsidy averages about half of total project costs - illustrate the high level of public equity needed for these projects. These cases also illustrate that finding subsidy for mixed-use development, which does not fit neatly in either the housing development or economic development category but rather involves both, can be particularly difficult.

Based on the findings of this research, the obstacles to financing the equity portion of mixed-use development projects can be summarized as follows:

- There is no single source of subsidy for community development in general and mixed-use development in particular; funding must be pieced together from several housing and economic development programs.
- The high transaction cost associated with assembling multiple public funding sources burdens the project.
- The complexity of the public financing package complicates the debt financing of project.

Challenge of multiple funding sources

The case study projects discussed in Chapter 4 utilized several subsidies from various housing and economic development programs. At the extreme was the Lithgow project, which involved six different public equity sources. One could interpret this broad array of funding programs as broad-based support for important community development projects like the Lithgow. A more

accurate interpretation is that there is a lack of funding sources for projects that combine housing and economic development activities in the way that mixed-use development does.

One issue that the case studies highlight is that the objectives of housing and economic development funding programs are not always compatible with the broader goals of community development. Several of the housing programs discussed cannot be used for the development of commercial space, even if housed in the same building. The economic development programs will not fund any housing related activities, even if the project is located in a residential neighborhood. This separation of activities is difficult to achieve in a mixed-use development project. Furthermore, there are fewer sources available for economic development, so housing resources often implicitly cross subsidize commercial component of project.

Recommendations

The problem of multiple but incompatible funding resources leads to an argument for more flexible program regulations. The objectives of federal funding programs for housing and economic development should be made more compatible with the interdisciplinary goals and activities of community development. One strategy to achieve this goal, as proposed by Newman and Schnare, is to incorporate explicit neighborhood criteria – such as evidence of comprehensive planning - into housing and economic development programs.[126] Funding levels for economic development programs should also be increased, to reduce the need for cross-subsidization by housing programs.

High transaction costs

The transaction costs associated with assembling multiple housing and economic development programs can be very high. These costs can be calculated both in terms of time and money. Application deadlines for funding programs are not usually coordinated among the local, state, and federal agencies that administer the programs, so it can take months or years to assemble the necessary subsidy. Furthermore, the combination of application fees, consultant fees, and closing costs can be a significant financial burden to a project. The Lithgow project, for example, spent

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[126] Sandra J. Newman and Ann B. Schnare. "...And a Suitable Living Environment": The Failure of Housing Programs to Deliver on Neighborhood Quality," *Housing Policy Debate*. Vol. 8. Issue 4 (1997), p. 729.

nearly $640,000 on such costs.[127] The Low Income Housing Tax Credit is the worst offender in this department; one study revealed that the programs requires an average of 27% of the equity it generates for fees and expenses.[128] This calculation was made early in the program's existence, and syndication fees have come down over time as a result of increased competition by private investors.[129] Nevertheless, the net effect of using multiple public financing sources is that it adds to cost of project, which then increases to the amount of subsidy required. This system is inherently inefficient and wasteful.

Recommendations

The administration of programs for housing and economic development needs to be altered such that the burden of assembling grant funding is shifted away from the project and to the state or local government entities that manage the programs. In addition, there should be a single body in charge of administering the financing. Not only would such changes benefit the projects that use these programs, but they would also help reduce abuses. As Michael Stegman points out in his criticism of the tax credit program, "When no one is in charge of orchestrating so many separate loans and subsidies, an unethical or highly inefficient developer may receive more subsidy than is needed to get the project built."[130]

A possible approach to streamlining program costs would center on the state agencies that administer the tax credit program. This is the logical place to start, since tax credit financing is typically the largest piece of equity financing available to a project. For every project that receives a tax credit designation, the State should be responsible for ensuring that the remaining gap is filled with other public subsidies. This could mean contributing HOME funds, which must then be matched by city CDBG funds. In this way, the project receives a single contribution of public equity. The flaw in this approach is that it neglects those smaller projects that typically cannot attract tax credit equity, as a result of the intense competition among projects. To address this problem, states and cities should set aside fund specifically for smaller projects, perhaps through the creation of a "small projects" program.

[127] Calculation based on the budget information included the Harvard report on the Lithgow project. The total includes legal, accounting, financing, and development consultant line items.
[128] Stegman, p. 371.
[129] Daskalakis interview.

Need for specialization

As we saw in each of the case studies on neighborhood mixed-use development, the use of multiple subsidy programs complicates the project's overall financing and creates a need for specialization. Unfamiliarity with the public funding programs and their requirements may have the effect of discouraging private banks – especially smaller institutions – from getting involved. A few larger banks, like Bank Boston, have the in-house expertise to work with the public subsidy programs, but the deals otherwise seem to be taken on by specialized lending institution like the community development finance institutions. (This is only one of the factors that hinders involvement by private banks in neighborhood mixed-use projects; other explanations and recommendations will be discussed in the next section.)

Recommendations

While streamlining the way that public subsidy is administered to projects will help to improve this situation, other incentives need to be put in place to encourage greater private involvement in these deals. Larger banks could develop specialized departments that deal exclusively with community lending – including residential real estate, commercial real estate, and small business lending. Smaller banks may not have the capacity to build such expertise in house; they may instead require technical assistance from lenders with more experience with neighborhood mixed-use development.

A note on the role of state and local subsidy programs

While this thesis has focused primarily on the role of federal subsidy programs in financing mixed-use development, the importance of state and local resources should not be overlooked. City and state governments can support neighborhood mixed-use projects through grants and other subsidies or by providing public tenants for the commercial space; Massachusetts has effectively used this tool to support a number of Boston neighborhood mixed-use projects, including the Ruggles Plaza and Ferdinand Building projects. Local municipalities can also provide credit enhancement pool for neighborhood projects, as the City of Boston has done in the

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[130] Stegman, p. 364.

Dudley Square neighborhood.[131] As a reduction in resources at federal level leads to increased reliance on state and municipal programs, local commitment to neighborhood mixed-use development will be critical.

Role of private sector in providing debt financing

We saw from case studies in Chapter 4 that the private sector has played only a limited role in providing debt financing to neighborhood mixed-use projects. I believe policy should be directed toward increasing the private sector's role in this area for several reasons. First, private financial institutions need to play a greater role in these projects for the simple reason that public resources are limited and are best used as direct subsidy. Private sector involvement can benefit neighborhood mixed-use projects by providing credibility and discipline, especially in terms of the commercial component of these projects – an area in which most banks have valuable experience. Finally, I believe that the private sector has a moral obligation to participate in these neighborhood revitalization projects, since the private sector ultimately reaps the benefits of the projects' spillover effects.

The disinvestment in urban neighborhoods by private banking industry in 1960s and 70s had a devastating effect on those communities. Specialized lenders that have reentered these neighborhoods have shown that it is possible to make a reasonable return from investing in neighborhood revitalization projects. If private banks can have the same positive experience, then they will be more willing to lend again – thereby protecting against another cycle of disinvestment. We have seen some participation by private lenders, especially in construction lending. Yet, there remain obstacles to attracting other types of private debt – namely, permanent financing. As introduced in the discussion of market imperfections and highlighted in the case studies, these obstacles are:

- Insufficient mechanisms to address risk
- High information/transaction costs.

[131] Daskalakis interview.

The following discussion will offer conclusions and recommendations for role of both the secondary mortgage markets and portfolio lenders, which are the two main sources of debt capital for real estate.

Role of the Secondary Mortgage Market

One way to improve the flow of private capital to neighborhood mixed-use projects is through the secondary mortgage market. The secondary market allows lenders to address interest rate risk, credit risk, and liquidity risk by pooling risk across many mortgages and creating a more liquid investment tool. DiPasquale and Cumming's research suggests that improving access to the secondary market could broaden the pool of investors in multifamily housing and affordable housing in particular.[132] There is a small but growing market for multifamily mortgages already in place, with Fannie Mae, a government sponsored entity – as the biggest investor. Furthermore, there are incentives for affordable housing developments also in place, through Fannie Mae's central city lending goals.

But, as described in Chapter 5, smaller neighborhood mixed-use projects have difficulty accessing the secondary market. The structure of the secondary market introduces several new obstacles to financing these projects. The secondary market requires a standardized mortgage product, which is difficult to achieve with smaller scale, neighborhood mixed-use projects. As the case studies in Chapter 4 illustrated, these projects can vary widely in terms of size and type, and they are shaped mostly by the existing neighborhood building stock and context. Fannie Mae's underwriting criteria are rather conservative, especially with regard to commercial tenants in a project. As a result, most mixed-use projects do not meet the credit quality standards required for securitization. Finally, because of the high transaction costs associated with accessing the secondary market, many smaller projects are not eligible. Fannie Mae's Delegated Underwriting and Servicing (DUS) program, which serves as its principal line for purchasing individual multifamily loans, has an average mortgage amount of $5 million.[133]

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[132] DiPasquale and Cummings, " Financing Multifamily Rental Housing," p. 113.
[133] Fannie Mae, " A DUS Primer" (1998), www.fanniemae.com.

Recommendations

Based on all these requirements, it is unlikely that secondary market will be a major source of loan capital for neighborhood mixed-use projects. The market is still small and developing, but neighborhood mixed-use development does not really fit the market's current standards. However, because of the potential of the secondary market, and because of its impact on underwriting standards in the primary market, federal policy should encourage more research on the performance of this development prototype. This kind of research will give investors more information on the risks and determinants of default in mixed-use development, which will in turn help Fannie Mae and other secondary market players to streamline the underwriting process and more appropriately price debt. Such research will also help developers by providing more detailed information on development and operating costs, which will improve planning efforts.

Role of Portfolio Lending

Portfolio lending remains a more important source of loan capital for neighborhood mixed-use projects.[134] This type of lending is better suited to the small size of these projects and the non-standard mix of housing and commercial space. Portfolio lenders also have more flexibility in terms of negotiating loan terms and underwriting standards. In terms of knowing the neighborhood market, smaller community banks are perhaps best positioned to do such lending, although larger regional banks have replaced local banks in many communities. Regardless of the type of lender involved, information costs associated with lending to mixed-use projects are high because lenders must understand and underwrite multiple markets.

Despite these advantages, there are many obstacles to portfolio lenders financing multi-use projects. Obviously, information costs are higher because the lenders must underwrite multiple uses. Mixed-use is also a burden because of risk-based capital requirements under FIRREA regulations. Commercial real estate is considered to be more risky and therefore banks are required to carry greater amounts of capital for commercial loans held in their portfolios.[135] This is clearly a disincentive to lend to mixed-use projects. Unlike the secondary market, portfolio lenders are not well equipped to provide the long-term capital needed to give stability to these

[134] MacDonald, "Expanding Access to the Secondary Mortgage Markets."

projects, because of interest rate risk and potential mismatch between assets and liability. And finally, portfolio lenders are less able to address credit risk, since their ability to diversify risk is limited by size of portfolio. The credit risk of the commercial component of mixed-use projects is a particular concern for lenders, because these projects typically rely on small business or start-ups as tenants. For private portfolio lenders to play a greater role in financing neighborhood mixed-use development, there must be mechanisms to address these risks.

Recommendations

There are several policy interventions that could help address these obstacles and provide private lenders with greater incentive to provide financing to mixed-use projects. One possibility is for the Federal Home Loan Bank system to take a leadership role in helping banks access longer-term capital. As explained in Chapter 5, the FHLB has access to longer-term, low interest loan funds through the Federal Reserve, which can be passed on to its network of smaller, member banks. The FHLB's Community Investment Program, which offers banks this opportunity, has been ineffective because member banks are required to take on the entire risk of particular projects. To make the program work, the FHLB therefore must develop a risk sharing strategy. This could take the form of a regional credit enhancement pool or mortgage insurance program. Another possibility would be to partner with the Small Business Administration on its small business guarantee program. This partnering could work particularly well for mixed-use development and the type of commercial tenant it attracts.

Another policy recommendation that comes out of this research has to do with risk-based capital requirements. As they are currently structured, these requirements have a negative impact on community development lending. However, bank regulators could provide an incentive for private institutions to do more lending in inner-city neighborhoods, and to mixed-use development projects, by relaxing the risk-based capital requirements for "community development" loans. In theory, risk-based capital rules should reflect actual loss experience. Yet, as discussed above, lenders and investors do not have good information on the performance of

[135] Commercial real estate loans are assigned a risk weight of 100%. which mortgage-backed securities carry a weight of 20% and one- to four-family residential properties carry a weight of 50%.

and determinants of default for mixed-use development projects. At a minimum, research should be done to ensure that risk-based capital rules are assigned fairly.

In addition to these policy recommendations, there are certain strategies that banks could adopt to make lending to neighborhood mixed-use projects more feasible. One strategy that would help address the higher information costs associated with mixed-use loans is to take on multiple lending roles, which would make more efficient use of the time and effort spent underwriting these projects. For example, a bank could finance the construction loan, permanent loan, and small business loan for a mixed-use project, thereby spreading information costs across each of these transactions. Smaller projects in particular would benefit from this approach. Larger banks could develop a specialized community development lending unit to take on this work; Bank Boston has shown that this approach can be lucrative.

Smaller banks are at a disadvantage in terms of developing the in-house expertise needed to become involved in lending to neighborhood mixed-use projects. These banks could benefit from the experience and expertise of community development finance institutions. CDFIs could provide technical assistance to smaller banks. They could even originate and season loans for banks that are interested in this kind of lending.

By advocating for greater private sector involvement in lending to mixed-use projects, I am not suggesting that CDFIs be eliminated completely. There is still a role for CDFIs in lending to neighborhood mixed-use projects. The government support these institutions receive can allow them to make long-term loans to projects that private institutions are unable to make. These institutions also have developed valuable expertise in dealing with more risky and unusual projects liked the case study projects in Chapter 4. However, CDFIs should not be competing with private banks for business in inner-city neighborhoods; this fundamentally contradicts the reason for CDFIs – to address market failures. When this occurs, CDFIs need to refocus their lending on areas where market imperfections are still an obstacle.

Role of the developer in creating a successful mixed-use project

In the discussion of neighborhood revitalization in Chapter 2, I presented mixed-use development as a combination of housing and economic development. While this is still an accurate description, the case studies in Chapter 4 have shown that, ultimately, the success of a mixed-use project depends on the success of its commercial component. The residential component gives the project stability, but it is the commercial element that gives it vitality. At the same time, it is the commercial component that is the more difficult to finance and develop.

Many opportunities exist to develop mixed-use projects in inner-city neighborhoods, and especially in neighborhood commercial districts, because the infrastructure for such projects already exists – in terms of buildings, customers, and residents. Given these opportunities, and the scarcity of public resources for mixed-use development, developers need to be strategic about which projects they choose and how they implement them. This requires a clear understanding of both the commercial market and its relationship to economic development goals of community. What types of tenants or businesses is the community trying to attract? How can the project address these needs? How will this commercial component of the project affect the financing of the project? The case study analysis in Chapter 4 offers some insights into what elements are needed for a strong commercial component.

Recommendations

- *Finding the right commercial tenants.* The type of commercial tenant targeted for a mixed-use project will ultimately determine the size of project, how it is financed, and the level of economic impact it will have on neighborhood. Developers must decide which type of tenant is appropriate for the project. Larger tenants – either major office tenants or national retailers – typically require relatively large amounts of space. Office tenants can also take advantage of difficult-to-market second floor commercial space. Larger tenants that can sign long-term leases will help finance a project, since banks will generally be willing to lend on the guaranteed cash flow from the lease. Larger tenants that can attract many customers or

workers throughout the course of the day will have a greater economic impact on a neighborhood, as was evidenced with the Lithgow project in Codman Square.

A typical neighborhood mixed-use project, however, looks more like Taylor's Market. Smaller projects are more common because the available building stock in most neighborhoods is small. A typical commercial tenant in this kind of mixed-use project is a modest retail business or professional office. These tenants are still critical to the project's financing, but they are more of a challenge to underwrite. One banker interviewed compared underwriting the commercial component of a smaller mixed-use project to underwriting a small business loan.[136]

- *Identifying the right location.* Again, the choice of location will depend on the type of commercial tenant the project hopes to attract. Projects that will incorporate retail tenants should focus on areas where economic vitality already exists. Projects that will incorporate larger office tenants have the potential to generate new economic vitality if it does not already exist. In both cases, the project needs a prominent location for which tenants will be willing to pay slightly higher rents. As a rule, the newly constructed or renovated commercial space found in neighborhood mixed-use development projects is more expensive than existing neighborhood commercial space.

- *Attracting the right partner.* Partnerships with banks or other institutional partners can benefit projects immensely by providing credibility and financial backing, as we saw in the case studies. Partnerships can also bring expertise to non-profit developers who are less experienced with commercial development. For example, one Boston CDC recently partnered with an experienced commercial real estate developer to create a mixed-use project with a major retail component.

[136] Gibbons interview

Final Remarks

This thesis has argued that mixed-use development can be an integral part of neighborhood revitalization strategies. However implementation of these projects is frequently blocked by various obstacles to financing. This thesis has recommended several changes in the way these projects are financed in the hopes that lowering the bar for financing mixed-use development projects will result in increased projects of this type and thereby improvements in the urban fabric of our neighborhoods.

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