Mixed-Use Development and Financial Feasibility:

Part I - Economic and Financial Factors

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INTRODUCTION

MIXED-USE DEVELOPMENTS ARE GROWING IN POPULARITY AS they reportedly can create additional value and outperform standard single-use real estate developments. The synergy and appeal of a quality mixed-use development can increase office and retail prices, rents and occupancy rates as well as accelerate absorption rates. Retail tenants may be willing to pay higher rents because of the increased customer traffic generated by the compatible and complementary uses. Residents and hotel guests are attracted by the convenient location of dining, retail and entertainment venues on the site. However, some locations are not well suited for mixed-used developments, and careful consideration must be given to the financial feasibility of each specific project.[1]

Financial feasibility of mixed-use development occurs when the return on the investment meets or exceeds the required return of the developer and/or the investor. Evaluating financial return on a mixed-use project is more complex than with a single-use development. While some economies of scale may be achieved, the complexity of multiple uses may raise development and operating costs. On the other hand, the synergy of complementary uses may increase cash flows. Financing development is complex and can be more costly than for single-use developments. Measurement tools for such financial success are expressed in different ways. Discounted cash flow analysis generating an internal rate of return is one important tool. Debt service cover and cash-on-cash are also considered useful tools.[2]

Some developers believe that a mixed-use project diversifies risk across the multiple uses.[3] Other developers believe that the added financial and physical complexity of a mixed-use development, in addition to longer development timelines, heightens the uncertainty associated with the project and thereby increases the level of risk.

Factors influencing the financial success of a mixed-use development can be grouped in the categories of economic and market, financial, physical and public issues.[4] This article will focus on economic and financial factors in the professional literature.

ECONOMIC AND MARKET FACTORS

The Local Economy

A general economic precondition for the financial success of a mixed-use project is a strong local economy. Employment, population and consumer disposable income should be growing. This growth benefits both tenants and customers for the uses on the site. A mixed-use project developed in a stagnant or declining local economy can have problems attracting quality tenants, an adequate number of customers and rent levels high enough to ensure financial success. A stagnant or declining local economy can be perplexing for a community that wants a mixed-use development to serve as a catalyst for urban regeneration. However, it may be possible for a certain geographic market area to grow within a larger stagnant local economy. A possible scenario is a high-income geographic market area within a stagnant local economy. The population base of high-income consumers could be underserved (excess demand) for high quality retail goods and convenient personal services such as medical and dental services, accountants, insurance agents and attorneys. In addition, the "empty-nester" portion of the population base desires

FEATURE

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to remain in the area but also wants to downsize to luxury apartments or condo units. This situation could support a mixed-use development of retail, office and residential units. Another possibility is that a strong tourist component could offset some lack of local economic vitality, especially if hotels and entertainment venues were incorporated into the development.

If the geographic market area is depressed or distressed, whether in a stagnant or declining local economy, public sector assistance, incentives and/or participation need to be considered. Because of the positive externalities that such projects are expected to generate and the risk that developers are taking by investing in a depressed area, these projects will rely heavily on public/private partnerships and financial support. Examples include tax abatement for reimbursement of infrastructure costs,[5] tax increment financing for parking structure construction,[6] and acquisition of land that is then leased to the developer.[7]

Market Analysis

Market analysis for a mixed-use development is important in determining the demand and supply of each use on the site. It should be used in the same manner as in analyzing a single-use project. The analysis should demonstrate sufficient net demand from both on-site and off-site consumers for each use that comprises the development. This is because "… many tenants' businesses will depend on demand from the surrounding area."[8] In addition there are other matters that the mixed-use market analysis should consider.

Market factors are not static; they change with time and other influences."[9] A market analysis should examine trends and forecasts to capture the influence of changing economic, demographic and psychographic factors of demand. "Two keys to success are to do your homework upfront, and to revisit it regularly at every phase and after build-out. These market analyses need to be fine-grained and tailored enough to your locale for you to identify both shifts in preferences and niches that aren't served. This requires a dual-pronged approach to evaluate the market at that point in time and the other to assess how well you're meeting it. As the market changes, so should your project."[10] Market research should be performed early in the developmental process and in some cases, depending on the timing and absorption, updated throughout.[11] These statements apply to single-use as well as mixed-use developments, but the complexity of the analysis increases when the number of uses increases.

A word of caution appears in the following statement: "Just because you have high-end retail doesn't mean you have a high-end condo market."[12] Each use needs to be analyzed with regard to its own demand and supply situation and its relationship to the other on-site uses. Each use on the site must attract sufficient market demand to make it financially feasible. The financial success of one use should not be expected to carry a weak market performance by another use. The contributory value of one use should not subsidize the other uses on the property. The denotation in these statements is clear but connotations are also present. First, while the development is planned and evaluated as a whole, the analyst must also consider the risks of all phases of a multi-phased project not being completed as planned, and some anticipated uses not opening. For example, the project could have retail with residential on top planned for phase one, and offices in a separate building planned as phase two. Over time, the office market could weaken and phase two is either scrapped or changed to more retail and residential.

Second, the completed phases and the active uses should be financially viable. In some situations these phases and the active uses may be financially feasible but not attain the return that was anticipated from the mixed-use project that was planned. The problem/solution partially depends on which use is curtailed or lost. The key retail tenants are those that draw strongly from the traditional retail trade areas but also draw customers from outside traditional trade area boundaries; these tenants cannot be lost. The key residential units must match the demand from the market. If the development plan calls for equal numbers of one-, two- and three-bedroom units in each phase of the project while the market demands only one- and two-bedroom units, vacancy in phase one will be high, making that mix of residential units financially unsuccessful. The planned units must change if phase two is to be built.

The geographic extent of the retail trade areas of each of the anchor tenants and the majority of the non-anchor tenants needs to be considered.[13] Several points to recognize are:

- The retail trade area for each retail tenant is not the same. Some of the shops will attract customers from a greater distance than other shops. Therefore, a three- or five-mile ring could be too much geography for some stores and not enough for other stores.
- The retail trade area for the most prestigious retail store or the major anchor store is not the retail trade area for the project.[14] The anchor store might draw customers from five miles away but the non-anchor tenants may only draw from a two-mile radius because of competition in other retail facilities.
- A properly developed mixed-use property has the potential of attracting customers from outside conventional trade area boundaries. Adding components such as parks, walking trails, playgrounds, ball fields, community centers, and even municipal buildings can create habitual or repetitive traffic flow from outside the traditional boundaries. These elements will give customers more than one reason to come to the development and can ensure that they visit the development on a regular basis. Boutique shops and soft goods retailers, which make mixed-use developments more enjoyable and not just functional, rely on regular visitors from greater distances who are likely to patronize these shops.
- Entertainment venues may draw customers from a geographic market area beyond the market area for the retail uses.

The residential market area for the mixed-use project will more than likely not be the same geographic area as the retail market or trade area, and the office market area may differ from both the retail and the residential areas. The market analysis for a mixed-use development may need to consider a different geography for each specific on-site use.

On-site Synergy

On-site uses need to be compatible, complementary and mutually supportive for synergy to exist. If synergy is achieved, it increases customer patronage, rent levels, sales volumes, and both the investment value and the market value of the project; thus, the mixed-use project has the potential for creating greater total value than if each of the uses were developed in separate locations. Generating synergy in a mixed-use development requires that each on-site use serve as an amenity for the other uses and the tenants add to the revenue the uses would otherwise generate from the surrounding neighborhood. Occupants of the office space can generate additional sales for the retail facilities and restaurants beyond what would be expected from area residents. Office tenants are likely to use hotels located in close proximity to service their clients. Office and retail workers may speed lease-up of the residential units. To encourage this synergy, the price mix of residential units should provide options for the categories of workers expected in and near the project.

Some of the financial benefits of mixed-use development emanate from the close proximity of a variety of uses with different peak demand times, increasing the hours that facilities are generating income. The development needs to balance night and day activities so that everything on the site does not shut down at the end of the workday.[15] With a "24/7" vitality as an ideal goal, bringing together users who will use facilities at different times of the day or days of the week increases the potential revenue tenants can generate. While office workers might dominate the weekday luncheon crowd at restaurants, residents and hotel guests could form the majority of the dinner and weekend trade.

A clear relationship exists between the prospect of synergy and the size of the mixed-use project. This is a definite direct or positive relationship but it is not known whether the relationship is a straight line, a curve that increases at a decreasing rate, or a curve that increases at an increasing rate. At the low end of the spectrum there is very little or no synergy in a mixed-use development consisting of a single residential unit, a single small-scale retail store and a small-scale office structure located adjacent to each other on a single site. However, as the number of residential units increases, a synergistic effect can benefit the retail store. Then, if the most desired tenant mix in the retail space is achieved, it can benefit the residential units by generating higher rents.

Relationships with the Surrounding Market

A successful mixed-use project must be compatible with its neighbors and integrated into the community to maximize its economic effect. Strong linkages among on-site and off-site land users are important. Off-site residential growth leads to an increased demand for on-site commercial activity such as retail stores, restaurants and personal service establishments. The on-site users such as restaurants need to serve potential customers (residential users and office space users) living or working in close proximity to the project.

Competition with existing single-use developments must be considered. For example, building retail space in a mixed-use project near a highly successful super-regional mall surrounded by power centers, community centers and a lifestyle center may lead to high on-site retail space vacancy and a lower rent schedule, while the office and residential components of the project are financially successful. This same reasoning carries over to the on-site housing option. Building more condo units in a saturated local condo market is not a good plan but building apartments could be. Similarly, building a hotel on site could be a problem if the existing market has excess hotel space. Financial success depends on "being able to maximize and mix the uses in a way that responds to market conditions, opportunities and economics…"[16]

FINANCIAL FACTORS AND ISSUES[17]

A multitude of financial factors can contribute to the success or failure of a mixed-use development. From the planning stage through construction, to lease-up and sale, the developer must maintain focus on the integrated finished living and working environment that the development promises. The complications of multiple ownerships, loans and leases, as well as the possible increased cost of construction and time for development make financial planning and oversight essential.

Financial success depends on minimizing the requirement for initial equity funds. Try to find lenders who are willing to provide high loan-to-value ratios, and try to obtain development incentives from the local jurisdiction.

Lending Issues

Financing construction is a critical element of the deal. Most developers will want to minimize their initial equity in the property, trying to find lenders willing to provide high loan-to-value ratios; however, equity requirements may be higher than for single-use projects. Larger capital requirements limit the number of development firms and financial institutions that have the resources to undertake a mixed-use project. Development incentives are often available from the local jurisdiction if the government is trying to attract development into a blighted area or encourage denser development in urban rather than rural areas or at transit hubs.

Even though mixed-use developments have complicating aspects that make them more difficult for which to structure financing, efficiently priced capital is available for well-conceived mixed-use developments. Lenders' willingness to provide funds may be primarily attributable to:

- Financial success of completed mixed-use developments across the nation;
- Increased lender sophistication;
- Profusion of mezzanine capital and other unsecured debt;
- Municipalities providing cash subsidies, property tax abatements or tax increment financing.

Although capital is available for developers, lenders thoroughly analyze the proposed development as well as the developer. The primary lending criteria used are:

- Adequacy of the developer or the financial partner to deal with any cost overruns;[18]
- Unleveraged yield on cost;
- Economic environment of the location—adequacy of consumers' and the project's ability to achieve market thresholds;
- Risk profile of the development—preleasing, sales and absorption time;
- Developer's history and track record—ability to complete the job on time and according to budget.

Lenders have difficulty determining how well the land uses work synergistically as a single development and estimating the varied sources of the components of income. They tend to evaluate the overall mixed-use project as a weighted average of the individual property types, as collateral that could be sold off separately.[19] Underwriting each land use separately adds to the complexity and cost of the deal.

How the financing is structured will influence the ownership structure. If a single lender is financing the construction, then that lender would prefer a single borrower entity that owns all of the project's components. However, if the project is structured such that each of the land uses is in separate ownership with one asset per special purpose entity, the developer has a more flexible exit strategy with the ability to sell pieces at different points in the development cycle and repay each construction loan. Exit strategies are being emphasized more by lenders as the investment cycles are different for different uses.[20] Creative solutions include individual financing of multiple land parcels, each with a separate use, or allowing early partial releases of parcels.[21]

When mixed uses are vertical in a single building, staging/phasing and financing issues are more complex.[22] Also, because many mixed-use projects take longer to develop, phasing takes place over a longer period of time.

When a single construction loan has separate take-outs for the project components, the construction lender is dependent upon each of the permanent lenders to accomplish full take-out of the loan. A large permanent loan on the entire property may be more attractive to many lenders; however, individual loans on each property type parcel will give the owner greater flexibility in exit strategies.[23]

In addition to private financing, a variety of public financing tools may be available for mixed-use developments. Tax abatement may be available for reimbursement of infrastructure costs.[24] Parking structure construction may quality for tax increment financing.[25]

Costs

Several features of mixed-use projects can lead to higher development costs. Initial planning costs are much larger for mixed-use developments because of the complexity and need to integrate varied uses. In addition, the project may require multiple approvals from local regulators under a variety of zoning, conditional use permits and variance requirements.

Then the builder may be required to comply with different building codes for each use, adding to the complications, costs, and the time required to build the project.[26] Residential uses in mixed-use buildings often have to be designed and constructed to meet commercial standards for handicapped accessibility, fire safety and mechanical requirements. In addition, special design and construction features may be required to reduce incompatibilities between uses.[27] If the development features a pedestrian-friendly design with automobiles relegated to parking structures, then those structures increase cost beyond that of surface parking lots. Alternatively, integration in horizontal mixed-use developments may provide efficiencies in terms of infrastructure, utilities and zoning changes.[28]

The cost of land that is suitable to serve a range of uses is generally higher than sites suitable for just one land use. Land carrying costs could be higher or lower than for single-use properties. The larger site requirements and longer construction period add to development and construction costs.[29] The costs could be less for a mixed-use development than those for a very large single-use project (like an office park or a residential subdivision) because the uses are developed earlier. This can avoid cost increases for subsequent phases in the single-use office park.

Owners hope to reduce operating costs through shared services and facilities, such as common area maintenance, parking, building management and marketing.[30] Separate and duplicate technical systems minimize tenants' impact on each other and make operating expense recovery easier for the manager, but add to construction cost.[31]

Another cost consideration for mixed-use developers is the issue of sustainability. By integrating uses and higher density, developments may be able to achieve the same amount of usable space in a smaller footprint. Some sustainable design elements may require additional cost in terms of materials, but they are expected to pay for themselves in increased rents and lower operating expenses. Estimates are that cost premiums that have been at 5–10 percent may have dropped to 2 percent with the steep learning curve that comes with new construction methods. One study showed no significant difference in average costs for green buildings versus non-green buildings.[32] Another study found that an upfront investment of about 2 percent can yield a life cycle savings of ten times that investment if savings through productivity and worker retention are considered in addition to costs of energy, maintenance and repair, but such estimates are subject to considerable debate.[33] In markets where green buildings are available, there is evidence of rental and purchase premiums in both the U.S. and Australia. These buildings use 32 percent less electricity and 26 percent less natural gas, according to analysis of CoStar data.[34]

Risk

Generally, both lenders and investors have attached a risk premium to mixed-use developments because of the complexity of meshing multiple uses, the increased construction costs, and the longer development horizon.[35] The skill, experience and investment required to develop all components of a master planned mixed-use project may be beyond most firms, but a skilled developer can organize a team of investors, designers, builders and operators who are interested in each component of the project, allowing the developer to transfer risk during the development and operational stages. Investment in a variety of land uses should provide diversification, and thereby reduce risk. A mixed-use development reduces reliance on a single market sector and the amount of space of a single type that must be absorbed by the market.[36]

Decision-Making Process

Lenders, investors and developers have asked if mixed-use project development changes the decision-making process. Mixed-use development is much more complex and complicated than single-use development. The development model has changed from the situation in which one person was the expert on all facets of the single-use development to the need for a committee, group or organization of experts to plan and execute the project. Mixed-use development generally moves the industry away from specialization in a property type to a more sophisticated consortium of planning and development.

CONCLUSION

The professional literature discussing mixed-use development is full of learned opinion about the factors and features that lead to financial success. Much can be learned from these expert opinions. This literature review and its organizational scheme should have revealed some new ideas and perspectives even for the very experienced developer or consultant dealing in mixed-use development. A significant point to realize is that more empirical information is needed. Real estate academics need to determine if there is a statistically significant combination of the factors presented in this article that is strongly associated with financial success of mixed-use developments. ■

Editor's Note: *Part II of this article will be published in the next issue of* Real Estate Issues.

ENDNOTES

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4. Many of the comments and ideas presented in this article were obtained in personal interviews with developers of mixed-use projects. Most of these individuals expressed their desire for anonymity; others insisted on it. See *www.naiop.org/foundation/rabianski.pdf*.

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12. Comment made by Edward M. Kobel in Debra Hazel, "Multi-Dimensional Retail," *Chain Store Age*, August 2006, p. 134.

13. Some mixed-use developers are using the terms "dominant tenant" and "cornerstone tenant." The dominant tenant is the largest store based on square footage while the cornerstone tenant draws the most customers, pays the highest rent and could be the most prestigious tenant but not necessarily the largest tenant.

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16. Comment by Kenneth A Himmel in S. Aygoren, "Ins and Outs of Mixed-Use," *Real Estate Forum*, March 2004, p. 66.

17. The information contained in this section and subsequent sections comes from a review of the published professional literature and findings from an unpublished survey of mixed-use developers. The survey was performed under a grant for the NAIOP Foundation and partial results from the survey appear in an online article on NAIOP's Web page. See *www.naiop.org/foundation/rabianski.pdf*. The bullet point lists appearing in the earlier online article are enhanced and appear in this article.

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