Commercial Real Estate

Lesson 11

Commercial Real Estate - II

45 Hour Louisiana Post-Licensing

10/14

Commercial Real Estate – II

Office Commercial Space

Office commercial space is very different from retail space, but in many instances is impacted by many of the same forces relevant to warehouse and industrial space. While support for retail space is driven by household income growth and consumer preferences, demand for office and industrial space is inseparably linked to economic and employment growth in local regional and even national markets. Like retail space, office buildings also come in a wide variety of sizes, locations and qualities, serving a diverse mix of users requiring a range of amenities. In essence, the characteristics of office buildings tend to run the gamut and are categorized by a series of characteristics or qualities that are not always mutually exclusive. Generally, office buildings are categorized according to their class (i.e. A, B, C), location (CBD, suburb, etc.), size and flexibility (multi-story, multi-tenant vs. single-story, single tenant), use and tenure (owner versus renter) and features and amenities.

Class

The class into which an office building is placed is typically determined by assessing its age (both chronologic and actual), its location, the quality of its finishes (particularly in its common areas), its systems for climate control and security, amenities offered, services provided, lease rates and its tenant profile. Based on these criteria, office building inventories in local markets are classified as A, B or C. It is important to note that while the criteria are somewhat specific, how they are applied in evaluating buildings is largely a matter of personal interpretation and thus somewhat subjective. As such, what one person rates as a Class A building might actually be closer to a Class B in another's estimation or vice versa. This has also led some to attempt a finer tuning of the classes by applying plus or minus signs to the letter grade. Whether this adds anything useful to the evaluation is subject to debate but at least it makes the nitpickers in the business satisfied if not entirely happy.

Class A space includes professionally managed office buildings in an excellent location with superior access that are occupied by prestigious corporate and professional tenants. Increasingly, Class A buildings are characterized by environmentally sensitive or "green" building materials and operational systems that save on energy and water costs, while providing a more healthy work environment for workers. Most, but not all, Class A buildings are under ten to twenty years old or they have been extensively renovated to bring them up to current market standards. Building materials and amenities are high quality, and the property communicates a high-status image for its tenants. In essence, Class A space is the best available space in a local market in that it is the best building available at the time in the best location. It is a relatively new building with modern architecture that projects an image of success with a large open entrance, often with a dramatic eye catching atrium. Class A buildings also have amenities such as shops or restaurants, health clubs, child care facilities, a cafeteria, package delivery stores and the like. Security will be obvious and the building will be exceptionally well maintained. Tenants in Class A buildings are typically paying the highest rents in the local market and thus for the prestigious image that the building projects. Tenants are making a statement to their customers and want to impress their clients and their competitors. Companies typically locating in Class A space include law firms, office of Fortune 500 companies, corporate office of banks and insurance companies, stock brokerage firms, and large advertising, public relations and lobbying firms.

Class B buildings are generally once Class A buildings that have good locations, are professionally managed, are of high quality construction, and have an impressive tenant mix. Although they are not new, these properties usually show very little deterioration, but may lack state of the art HVAC, lighting, or mechanical systems. Generally, they suffer from modest functional obsolescence that can be feasibly cured within current market rent levels. In essence, Class B buildings are the "tired" Class A buildings which time has not entirely treated fairly. In one way or another, every Class A building becomes a victim of the passage of time and thus subject to the intrusion of functional obsolescence which reflects changes in market needs and preferences as well as the march of new and ever-changing technology which renders some building systems inefficient and marginally useful. Since Class B rents in many local markets are not significantly lower than Class A rents, insufficient HVAC systems, for example, could very well produce higher monthly utility charges and thus result in total occupancy costs comparable to Class A buildings. Many Class B buildings can be restored to Class A status by reducing their effective age and introducing strategic improvements that represent money well spent on efficiency and tenant occupancy cost reductions. Class B buildings cater to corporate and professional businesses that need to impress clients and customers and that require locations in good relative proximity to the concentrations of Class A building tenants in the same market. In many cases Class B buildings are able to accommodate the needs of those in the medical professions as well as consolidated concentrations of local, state or federal government agencies.

Class C buildings are typically the oldest and most functionally obsolete structures within a local market's office space inventory. They also suffer from locational obsolescence and usually are found in portions of urban areas and cities that have as they say, "seen better days". They tend to be isolated from cores of primary business activity along aging commercial corridors desperately in need of a major facelift. Many very old Class C buildings (i.e. 50+ years) are sometimes architecturally attractive and even historically significant. This is particularly true in the traditional cores of many older cities and major metropolitan areas. Having passed their prime as office buildings and being too functionally obsolete to feasibly be brought up to current market standards, many Class C buildings have become (and continue to be) prime candidates for adaptive reuse. This process preserves the architectural and historic significance of the building's exterior and possibly being rewarded for doing so with federal and state preservation tax credits, while repurposing the interior space for new uses such as apartments or hotel rooms. In many cases, adaptive re-use strategies have also taken advantage of Low Income Housing Tax Credits (LIHTC's) by including a mix of various affordable housing products in the development plan.
Class C buildings can also be modestly refurbished to make them more appealing to tenants who are not so much interested in an image as they are in a cost-efficient place to do business. This could very well include new business startups graduating from the spare bedroom in the home as well as those who typically do not meet with client/customers at their place of business. This would include, but not necessarily be limited to back-office support operations of larger corporate enterprises, bank processing centers, telemarketing companies and sales offices of manufacture representatives, brokers and the like.

Location

Location in the office building world can very often communicate as strongly as building class. A high quality Class B building in a prestigious CBD location, for example, can and often does, communicate the image presented by a Class A building. Downtowns or central business districts (CBDs) are usually characterized by tall office buildings and high rents. Major business and professional service providers in law, accounting, architecture, engineering, and consulting find downtown locations most attractive, as do many corporate and regional headquarters of firms with a wide domestic and international presence. Government offices are often concentrated in CBDs, but rarely occupy Class A space. Although downtown locations once dominated office inventories, about two-thirds of multitenant office space is now located in the suburbs. This is largely attributable to the forces of suburbanization discussed in regard to retail space as well as the evolution of air travel and development of very large airports on the fringe of the suburbs in many metropolitan areas.

Outside the CBD, but still within urban settings, are secondary office nodes that cluster near hospitals, universities, or other facilities which may be shared with public good such as courthouses, research institutes or specialized government installations. Also, many mature suburban communities, especially those located near mass transit, have their own concentrated "downtown" or edge city office cores that can rival the CBD. Other suburban office districts are more linear, typically lining major highway corridors with larger concentrations at major traffic network interchanges.

The inventory of high-quality office space has expanded in suburban downtowns since the mid-1990s, with much of this new space, and some retail. Small suburban office buildings can be found along major traffic corridors, adjacent to retail centers and multifamily residential complexes. These properties appeal to a diverse group of users including branch offices of corporations, as well as firms providing services to small businesses and households in nearby communities such as insurance and real estate agents, banks, medical practitioners, small law offices, mortgage companies and the like.

Size and Flexibility

Size and flexibility of office space is generally categorized by the vertical nature of the structures themselves. In this regard, office buildings general fall into three size categories: high rise (16 stories or more), mid-rise (four to 15 stories), and low-rise (one to three stories). Floor plate or footprint size is an important consideration, with some tenants requiring large floor plates so that they can occupy fewer levels, thus reducing the time employees spend traveling from one level to the next. Others prefer smaller floor plates so that workers have more natural light. Floor space flexibility is important as more tenants opt for open-floor layouts and more efficient use of space. Interior columns or odd angles that make it difficult to lay out space will render a building less desirable and contribute to its loss of functional usefulness more quickly. Office floor plates in new Class A buildings generally range from 18,000 to 30,000 square feet with 20,000 representing a safe design target for most tenants.

Use and Ownership

Use and ownership of buildings typically address the issue of single versus multiple tenants and whether occupants lease or own their space. Most office buildings are occupied by multiple tenants who lease their space. However, a relatively small number of office condominiums also exist, primarily in low-rise, multi-building properties in outlying suburbs. Office condominium tenants tend to be professional practices, such as physicians, attorneys, accountants, as well as other small, locally owned or franchise businesses. Very often the owners of these condominium offices live in a nearby subdivision and may operate from multiple locations. Some office buildings are configured to appeal to distinct market niches such as medical and laboratory space, university-affiliated institutes, nonprofits, financial services, or back office functions involving date processing, customer service, and order taking. Large multitenant office buildings are often owned by real estate investment trusts, pension funds, partnerships, family businesses or individuals. A building constructed for a specific tenant is called *built to suit*, whereas a building constructed for unknown tenants is a *speculative* or *spec* building. The latter is typically more challenging to finance with most lending institutions.

Corporations often occupy an entire office building and may own it or lease it from an investor-owner. Single-user buildings are typically not included in a market's office space inventory until they are vacated and marketed for multitenant occupancy. Documenting the extent of owner occupancy in office buildings is made difficult by the widespread use of sale-leasebacks, whereby a corporation sells one or more real estate assets (usually to an institutional investor such as a pension fund or REIT, and then leases them back from the new owner. These transactions allow corporations to free up capital by removing expensive assets from their balance sheets and generate what might be some strategically needed liquidity with which to operate the core functions of the business. Also, as tenant corporations receive the tax benefit of being able to show rent as an expense, at the same time the new owner/investor obtains a high-quality property leased to credit-worthy tenants usually for a period of at least ten years and possibly longer. Sale-leasebacks are also popular with owners of manufacturing, warehouse and distribution space.

Features and Amenities

Features and amenities offered by office buildings include tangible elements such as parking and proximity to transportation as well as less tangible items like cleaning, maintenance and security services that are equally important for the tenant's use and enjoyment of the space occupied. Very often, the issue is not only whether or not a feature or amenity will be offered but how will it be paid for and by whom. These are issues usually negotiated and embodied within a signed lease agreement and can be somewhat complicated depending on the location, type, size and age of the building.

The availability and cost of parking, and accessibility to mass transit in urban cores are important features when developing and marketing office buildings. Auto-oriented suburban locations typically provide surface parking lots with most spaces usually available at no cost to tenants and visitors. In older suburbs with high office space demand, vacant and infill sites are being redeveloped to include garages and other forms of decked parking. Parking ratios that worked in the 1980s at three spaces per thousand square feet of office use are no longer sufficient as floor space per worker shrinks due to changes in the way office users occupy space (i.e. hoteling, shared quarters, etc.) and in efforts to squeeze more efficiency from fixed occupancy costs. As a result, suburban tenants want five or six parking spaces per thousand square feet of rentable area. Also businesses that operate multiple shifts need to be assured that available parking is sufficient to accommodate shift changes. Shuttles to nearby transit stations are also increasingly common, and makes it easier for employees to leave their cars parked at home. In many dense downtown locations, new buildings may provide no on-site parking space with the exception of garages with limited and expensive space. Employers-subsidized transit cards encourage workers to use buses, trains and other forms of public mass transit. Those who may need to drive must park in public or privately operated garages, both of which can be expensive even with monthly contracts.
The need for high-capacity computer and voice-mail systems is another key feature in the modern office environment. All professional and business service firms require high-speed Internet, flexible telecommunications systems, both on- and off-site storage capabilities as well as secured wi-fi networks

Security is critical for government agencies and many private firms in the lobby, at the entrances to individual office suites and in most publicly accessible rooms. New buildings are equipped with key-card entry systems, coded keypads, as well as with extensive security camera and monitoring networks. Larger buildings usually provide a staffed security desk along with scanning equipment. Smaller buildings typically provide voice intercoms and possibly cameras as well.

Energy-saving and environmentally sensitive "green" features are becoming even more essential in Class A office buildings. Tenants are attracted to buildings with design features that reduce water and electricity use that lower utility bills that are typically passed through to them and that foster a healthy workplace for their employees. Indoor air quality, temperature and noise controls, and the use of non-toxic building materials have become, in some cases, more important than dramatically designed lobbies. New buildings are being developed and built to satisfy one of several Leadership in Energy and Environmental Design (LEED) ratings. These ratings require specific design attention to site planning that maximizes natural light, installing windows that actually open, using recycled carpet and incorporating under floor heating and air conditions systems. Focusing on securing LEED certification requires close attention to evaluating anticipated benefits (i.e. energy savings, possible tax credits, etc.) against the somewhat higher initial cost incorporating LEED design features and products. Existing buildings where possible, are being retrofitted with conservation and even LEED certification in mind. Doing so also requires close evaluation of the benefits versus the cost, but in some cases can help move an older building up from say Class C to Class B and thus make it more competitive within the local market. Improvements would include, but not necessarily be limited to using non-toxic paint, replacing traditional lighting with low energy-use fixtures, installing better controls for HVAC and interior lighting systems and possibly changing windows and roofing materials to reduce energy consumption. Some

research has shown that making such improvements enhance worker productivity and reduce illness-related absenteeism.
Many changes may be achieved with limited additional cost to building developers and owners, particularly if the building is relative new. To encourage lowered emissions, particularly in EPA watch-listed urban areas, some suburban property owners are assigning close-in spaces to workers who commute in hybrid vehicles or carpool.

Market Forces

The forces affecting the office space market are many, somewhat complex and extend across multiple geographic levels – local, regional, national and global. The demand for office space is directly linked to and dependent upon national, regional and local economies and their ability to grow, diversify and create jobs, particularly those where workers require some type of office accommodation. Multiple market forces fuel demand for office space and are not necessarily mutually exclusive. This includes net job growth through the creation of new businesses, expansion of existing businesses, in-migration of new businesses and relocations or intra-market migrations of existing businesses within a local or regional market. Economic growth and vitality, however, are at the root of all of these interactive and interdependent forces including intra-market relocations since such moves usually create demand/absorption at one location at a cost (increased vacancies) to other locations/buildings within the same market. Without sustained office employment growth vacated spaces remain so for longer periods of time producing downward bias on asking rents and increasing reliance on discounts, concessions and incentives to attract new occupants. This market phenomenon has certainly played itself out in many local markets over the past four to five years with many recession-battered companies downsizing and consolidating locations in an effort to become more operationally efficient while hopefully remaining profitable. This is a cyclical phenomenon that repeats itself regularly during recurring periods of economic expansion and contraction that is not likely to change anytime soon. As such, CRE brokers and agents are well advised to keep abreast of macro level trends and forces that are likely to impact the sale or leasing of office space.

At the national level, for example, the office space market continues to show signs of recovery and absorption of excess inventory left by the “Boom/Great Recession” cycle that produced significant supply/demand imbalances. Net absorption helps reduce the nation’s average vacancy rate bringing it closer to balance. The national office market recovery has generally been driven by technology-heavy and energy-rich regions in the U.S. These trends bode well for markets which have emerging technology sectors and which have historically hosted a wide array of firms engaged in various facets of energy exploration, production, processing and distribution. Going forward, the coalescing of these forces could fuel sufficient demand to absorb excess inventory in such markets and move rents to levels that make new construction a financially viable option. Going forward, national and regional office markets face a mix of challenges and opportunities that either dampen or ignite demand for space. Among the major challenges is the highly uncertain nature of future economic expansion and the significant fiscal, monetary and regulatory black clouds hanging over the business community regardless of size or sector. An economic recovery which never gains significant job creating momentum does not provide the underlying foundation for sustained demand for new office space.

Other challenges facing national and regional office markets are a mix of forces and practices that are greatly altering measures of space utilization per worker and firm. One of the most obvious is the influence of telecommunications and computer technologies that allow people to work wherever they are and not necessarily within the confines of a physical office. Technology, particularly communications, has in essence killed distance and created a 24/7 work platform of global proportions. A rapidly evolving variety of handheld devices (i.e. cell phones, smart phones, pads, tablets, etc.) permit and facilitate interactive visual communication without the time, cost and frequent inconvenience of travel. These “meetings” allow for almost unlimited possibilities for information sharing in secured modes that enable and encourage decision making and action without the traditional interpersonal contact.

These existing and rapidly emerging technologies allow people to share office space (i.e. hoteling), work from home full or part time, use temporary office suites and any number of other arrangements. The common denominator in all of them, however, is that they lower per worker space utilization requirements and thus lower aggregate demand for office space.

Adding to this downward bias for net office space demand is the emergence of “collaborative office consumption”. This emerging force in the office market is a response of usually major building tenants who have come to realize that on any given day, 30% to 40% of the space they lease is vacant because employees are either traveling on business, working from home or otherwise away from their assigned office or cubicle. The collaborative consumption strategy focuses on short term (sometimes very short term) subleasing of space to temporary users on very small scales with leases of very short durations. Leased space can range from a single desk or sparsely used conference room to an entire floor footplate. Assuming security and access issues can be adequately addressed, this approach to space use increases intently without increasing quantity. As such, per worker square footage usage is reduced while “excess” space is more efficiently and economically put to use. By one estimate, there are over 5,500 collaborative consumption spaces marketed on various websites throughout the U.S. and the number of spaces being advertised is growing rapidly. These and other trends are important for those brokering office space.

Warehouse and Industrial Space

Warehouse and industrial space more closely parallels office space than it does retail space in terms of physical characteristics, classifications and market forces. In fact, some would argue that the line between office and industrial space continues to blur since many businesses now require increasing qualities of flexible space to accommodate a growing range and mix of activities. Industrial building types range from research and development (R & D) facilities, which can closely resemble single story office space to unfinished warehouse space and then to space used for a variety of manufacturing and assemble activities. Hybrid space mixes are characteristic of office and industrial properties and do not necessarily fit neatly into one category of use. Newer industrial buildings tend to be built in business parks, most of which are dominated by warehousing and distribution facilities rather than production and assembly. Warehousing and distribution activities are characterized by relatively low ratios of employment to building square footage, which is an important factor to consider in site selection and planning with regard to parking and traffic access and control. Buildings located in business parks are usually bound by covenants and restrictions that dictate design standards, building placement, signage and other features intended to maintain an attractive and safe working environment. Like office buildings, many industrial space developers and investors are increasingly being drawn to environmentally and eco-system friendly design standards such as those required for LEED certification. Among other things, this very often affects site design to ensure ecologically sensitive treatment of storm water run-off and drainage, the discharge of effluents, restrictions on the storage and use of toxic and potentially hazardous materials and the like. As such, not all businesses are necessarily good fits for such business park locations and the CRE broker or agent must be aware of this reality.

When it comes to classifying and grouping industrial buildings, the criteria are very similar to those used for office buildings with the exception of somewhat rigid classes (i.e. A, B, C). Although some warehouse/industrial brokers have devised some grading scales for local inventory, they have not been widely accepted or adapted to multiple local or regional markets. For CRE brokers and agents experienced in this sector of the market, visual inspection and knowledge of a building’s basic design characteristics are usually sufficient to determine how and if it meets current market standards and thus the extent to which it may or may not serve the needs of one or more prospective tenants, users or buyers. So, when evaluating warehouse and industrial facilities the three key features on which most would focus are the building type, its ownership or tenure status and its various design features.

Manufacturing, Warehouse and Distribution, Flex Space, and Research and Development Space

Industrial space building types usually fall into one of four categories. These are manufacturing, including light, heavy and assembly; warehouse and distribution, including very basic to highly mechanized and automated; flex space which combines office and showroom or display area space; and research and development (R & D) space which may include wet labs, clean rooms and other technology-specific areas. Additionally, some would include wharf space and sheds usually found in major port locations involving significant freight forwarding and handling activities. These spaces, however, are generally publicly owned and used exclusively by firms operating within the confines of property controlled by a port authority, transportation district or some other government or quasi-governmental entity responsible for managing the facilities. Given the increased mandates for security and counter-terrorism as well as the significant investments required for cargo handling (i.e. cranes and forklifts for containers), only publicly enable authorities have the financial resources to support such infrastructure. As such, this type space is not generally counted as part of a local market's warehouse and industrial building inventory. Each of these four categories are very different from one another and serve very specific needs within the realm of industrial space users. R & D space, for example, might very well be located in close proximity to major research universities or federal government research laboratories and in a highly secured, restricted access business park campus set off distantly from major transportation arteries. Warehouse and distribution space, on the other hand, is almost inevitably positioned to ensure convenient access to major highway networks as well as other modes of transportation such as rail and port facilities. These buildings may be located within a planned business part environment or they could just as easily function well as free standing facilities.

Ownership, Tenure and Management

Ownership, tenure and management of industrial buildings is another way to distinguish among various product sectors. Most new manufacturing buildings, for example, are designed and constructed to meet a particular users specifications and are usually owned by the company engaged in the manufacturing process or by one of its related entities. Such buildings do not typically enter the inventory of available space in a local market unless the operating/owning company ceases to use the facility or goes out of business. Liquidation of such corporate assets can in some cases overwhelm the supply of industrial space on the market at any given time, particularly if the structures are divisible for smaller users. R & D laboratory and warehouse/distribution facilities can be either single user or multi-tenant buildings and either built to suit or part of a market's speculative inventory. Highly specialized product handling of food, for example particularly that which must remain refrigerated at some level throughout the handling and transfer process, usually requires state of the are designs for very large company owned facilities strategically positioned to efficiently serve a given geographic region. These facilities are specifically designed to meet the particular needs of one company for long periods of time and thus rarely enter the speculative space inventory.

The same might also be true of many R & D buildings which require significant investment in special equipment and building finishes to satisfy the needs of technology based enterprises. Since technology changes rapidly, some R & D buildings may be vulnerable to functional obsolescence fairly early in their chronologic life. As retrofitting and adapting it to new uses might prove to be costly and thus marginally feasible. Also, some technology based processes sometimes have the potential of creating environmental or biohazard risks. In such cases, the cost of remediating contamination might very well prove to be cost prohibitive. At a minimum, such buildings, along with many other commercial and industrial structures, would need to be subjected to at least a Phase I environmental inspection following federal (CERCLA) and appropriate state guidelines. In fact, most lenders, investors and prospective purchasers would require at least a Phase I report that would involve a visit to the site and surrounding neighborhood, a review of the site/property's past and current uses, an examination of local, state and federal regulatory filings noting any contamination and a recommendation as to whether or not any further action would be necessary (i.e. a Phase II or Phase III inspection).

Very large retail chains also tend to operate their own warehouse and distribution network. This usually involves a series of very large facilities being built at strategic locations to serve large geographic regions in which the firm's retail network is present. These facilities are also built to suit the specific product handling needs of the retail outlets in a timely manner and may include significant investment in logistics technology within the structure itself that relies on heavy doses of electronics and robotics. In some cases, these facilities may be managed and operated by a third party logistics services company.

Industrial Space Design Features

Industrial space design features are generally described in terms of eight key elements. These are: building size, site coverage, loading capability, car, truck and trailer parking, ceiling height, space build out and extent and quality of office finishes, power capacity and load capacity and levelness of floors. These will be addressed in the discussion which follows.

Because industrial space is low rise and much of it is unfinished, warehouse buildings require less time to build than office buildings as well as many types of retail space. Consequently, smaller warehouse markets may quickly become imbalanced. Despite the relative ease of constructing bulk industrial space, the warehouse market has traditionally been less volatile than both the office sectors. Rents and occupancy generally experience slow but steady rises during periods of economic growth and expansion, and relatively modest declines during recessions or periods of slow to no growth.

With greater automation in warehousing activities, the newer generation of warehouse buildings is very different from those built even 10 to 15 years ago. Buildings with 100,000 square feet or more are common with 300,000 square foot warehouses becoming increasingly more evident in many local inventories. Warehouses at logistics hubs where containers move from ship to train and truck or from train to truck typically exceed 1 million square feet. At the same time, businesses that do not handle large quantities of perishable items are gravitating to fewer but larger warehouse buildings. New "high cube" structures have ceilings at least 24 feet tall, with 32 to 36 feet the norm with some now moving as high as 45 to 60 feet. High ceilings require more costly, high end racking systems, sprinklers, sophisticated lighting systems and special high reach forklifts. Technological capabilities are increasingly important since storage and distribution are now highly automated operations driven by just in time inventory controls. Also, more highly durable concrete floors are being required to accommodate taller stacking systems, heavier pallets and new automated equipment. In high bay buildings, these floors are expensive to build since the surface must be precisely level, so materials that are stacked high remain stable while stored or being moved from one location to the next within the facility. Warehouse facilities now feature more truck docks that essentially line the two long sides of a building. A one million square foot distribution center, for example, will be 500 feet wide and 2,000 feet long, allowing simultaneous loading or "cross-docking" activities. Previously, the standard was one dock door per 10,000 square feet of warehouse space. New buildings now are providing one dock door for every 5,000 square feet of warehouse space. To better handle trucks, site plans now provide for wider turning radii and longer parking bays and may include space for security and other inspections. Additionally, users may require both high docks and drive in bays, although the latter are more common in flex (office/warehouse or office/showroom) buildings.

Although these design standards may imply that much of the standing older inventory of industrial space is functionally obsolete, it is important to note that these standards generally apply to major corporate users. Local and regional companies can usually be fairly well accommodated by much of the middle aged facilities (i.e. those built since the 1980s) unless they have specific ceiling height or technology related requirements which many such buildings could not satisfy. Very often older buildings can be economically retrofitted to meet the needs of small to medium sized businesses which primarily need space for product or equipment storage, light manufacturing or assembly activities or vehicle repairs and maintenance. In many cases, adjoining vacant or underutilized land or buildings can be used to expand a local business' footprint without having to endure the cost and inconvenience of relocation.

Market Forces

Like the office space market, conditions affecting the demand for and absorption of warehouse, distribution and industrial space are significantly dependent on economic growth globally, nationally, and locally. Nationally, relatively strong supply/demand dynamics help reduce the warehouse vacancy rate and thus restore balance to the market. Some of these improvements and the growing absorption pace can attribute to a spike in demand for big box distribution and logistics space for users requiring 400,000 or more square feet. Very often these facilities are state of the art distribution centers with over 750,000 square feet of space. Such build to suit development is expected to fuel warehouse/industrial space activity in major markets throughout the U.S. over the next several years.

Several other forces are also at play that will influence warehouse/industrial space market dynamics over the next two to three years. One is the resurgence of interest among foreign investors. Once again foreign capital is searching for safe harbor investment opportunities that provide attractive yields with fairly predictable risk profiles. Warehouse and distribution facilities occupied by strong credit tenants on long term leases with favorably structured conditions provide an attractive alternative to such investors. Initially, major port markets on the West Coast (Los Angeles, San Francisco, Seattle-Tacoma) and in the midlands (Dallas and Chicago) are likely to attract the most interest. But if past history is any indicator, this interest will spread to other coastal markets (both Gulf and East) as well as to inland intermodal areas such as Atlanta and Kansas City. The Gulf Coast region could very well attract a fair share of this foreign investor interest with the unfolding effects of the expansion and anticipated sharp increases in cargo/shipping volumes fueled by the opening of a much improved and wider Panama Canal. The canal is undergoing a $5.2 billion upgrade and expansion to allow greater traffic flow and to accommodate the new generation of “Super Post-Panamax” vessels that generally exceed the size limitations of the existing canal system. These new vessels carry significantly large quantities of cargo, usually containers, and will fuel demand for both improved handling facilities and more storage and distribution space in a variety of physical environments and security contexts.

Another major force impacting demand for warehouse/industrial space over the next few years is the unfolding “re-think” of the global supply chain and the return of U.S. manufacturing to the U.S., rising labor costs throughout Asia, particularly China combined with volatile fuel costs and monetary exchange rates, are forcing U.S. companies to re-evaluate their supply chain networks. When these forces are considered within the context of spreading hostilities focused on U.S. interests by radical extremists of various types and dispositions and the rapidly growing supply of readily available natural gas to power manufacturing facilities, it is becoming increasingly apparent that bringing production capacity home is an attractive alternative. This puts U.S. manufacturers in closer proximity to their customers thus accelerating speed to market times, reduces inventory carrying and freight costs, helps reduce overall levels of operating risk and improves customer service. This return or re-shoring of manufacturing combined with the resurgence of rail transportation has significant implications for warehouse/industrial space throughout the U.S. but particularly along traditional rail corridors that also serve intermodal infrastructure hubs. This will include both coastal and inland intermodal distribution facilities which service existing and emerging manufacturing centers throughout the U.S.

The explosion of e- and m-commerce (mobile) in the U.S. and globally is also a force that will fuel demand for warehouse/industrial space for the foreseeable future. According to recent surveys, industrial sectors accounting for the largest share of increased demand for warehouse and distribution space include food and beverage, e-commerce and traditional retail, with an estimated one-third of demand for big box space (400,000 SF) linked to the multi-channel retailers or e-tailers. The emergence of e-commerce and m-commerce is revolutionizing the sector as retailers increasingly tap into multiple channels to sell merchandise. It is, for example, more cost effective to increase on-line logistics operations as opposed to opening more traditional stores. This trend necessitates an entirely different distribution network and has obvious implications for the retail space sector going forward. Retailers opening new outlets are in many cases shuttering a like number in marginally productive locations while at the same time evolving their regional distribution networks to include e-commerce distribution centers.

In some cases these are cutting edge facilities encompassing the latest technologies including increased reliance on robotics to handle merchandise movements and order fulfillment. This allows these facilities to operate with more predictable cost structures, particularly labor, side-stepping many expenses associated with healthcare and unionization. Robots do not go on strike nor do they call in sick.

Financing Complexities of Commercial Real Estate: A Primer on Economic Development Gap Finance

A trend that has become increasingly apparent in CRE over the past 15 to 20 years is that many transactions now include and basically require some form of non-traditional gap financing that creatively draws upon sources within the public, private and nonprofit sectors. This layer of financing and incentives typically fills a gap between what traditional financing sources would normally provide in funding and the total amount actually needed to complete the transaction or move a project forward. The discussion which follows is not intended to make you an expert in this ever evolving area of development finance, but it is focused on presenting terms and concepts that are sufficient to familiarize yourself with the process and be relatively well informed to ask appropriate questions. This part of the course assumes you have already read and feel comfortable with the finance module and will not revisit that material in any significant way. It should also be emphasized that this is a very specialized and somewhat complex field of finance requiring additional expertise not typically found on the CRE broker or agent's resource team. This is particularly true of financing structures involving bond financing, tax credits and establishing special tax exemption or directive mechanisms at the local level. At a minimum, these elements require participation of attorneys well versed in the legalities of bond financing as well as CPA's and financial analysts experienced in using and possibly selling certain types of tax credits.

A common thread in using these gap financing techniques to facilitate a CRE project or transaction is the fact that they are in some way directly linked to a local community's economic development and growth. This can be true for any number of CRE investments ranging from revitalizing retail space to building new office or warehouse/industrial space or to constructing affordable workforce housing. In each case, the ability to use and deploy development finance resources will be evaluated in terms of community benefits such as jobs, new private investment or improved quality of life. Linking CRE development and investment opportunities to these criteria opens the door to a host of potential funding mechanisms that might not otherwise be available from traditional or conventional sources.

Overview

Community economic development encompasses a wide range of activities and initiatives that are intended to build wealth and value at multiple levels – neighborhood, city and state. These activities very often focus on creating an environment that encourages economic expansion through job growth and capital investment. Job growth usually occurs through a combination of efforts to attract and retain employers or to nurture new entrepreneurial activity that results in businesses that create new employment opportunities while diversifying the local economy.

The mix and range of economic development initiatives pursued by communities are often articulated as part of some planning effort. In an ideal world, initiatives are prioritized with input from a cross-section of the community within the framework of a strategic planning process, a topic discussed in greater detail in another training module. Suffice it to say, that the strategies selected and ranked as top priorities were chosen after careful consideration of current and anticipated future conditions in the community and that they were regarded as those most likely to achieve their intended purpose (objective) within a reasonable timeframe and with measurable results.

Finance: The Fuel to Facilitate Programs and Projects

In most cases, a community's list of prioritized strategies and action steps will include a mix of programs and projects. Programs typically focus on creating a structure or process to carry out a range of activities. They typically extend over longer timeframes and encompass multiple initiatives or specific projects. Projects are usually place-based and typically better defined with respect to start and ending dates and measurable benchmarks. However, both programs and projects require the necessary funding "fuel" to launch and sustain them.

The charge for community economic development leaders is to identify and match possible financial resources with the risk profile of the strategic investment opportunity that has been selected. In all likelihood, the mix of resources could very well be drawn in varying degrees from the private, public and nonprofit sectors. In fact, it would be a very rare community development initiative that did not draw from resources from at least two of these sectors. The actual mix and amount from each source will be directly related to the risk profile of the strategic opportunity; its feasibility and value; the extent to which conventional private sources can and are willing to invest; and the size of the resulting unfunded gap when compared to total costs.

Why Community Development Finance?

It is a rare community development opportunity that has all of the financial resources to fund its conceptualization, creation and on-going operation. Like a new or emerging entrepreneurial business, economic development projects go through various life stages from very early gestation, to growth and ultimately maturity and stabilization. As projects progress from one stage or phase to the next, the stakes get higher in terms of financial commitments and risk. Also at each stage, there are likely to be different players or sources of financial support on the field. Who these players are and when they are most likely to enter the community development funding process will be discussed later. Suffice it to say that in all likelihood most community development projects, no matter what stage they are passing through, will face resource and funding gaps that will have to be filled by one or more possible resource players.
It is not uncommon for community leaders to become very frustrated and sometimes overwhelmed by these resource gaps and the difficulty they inevitably face in trying to attract funding to fill them. Unfortunately, frustration can very easily become an excuse to do nothing or to procrastinate while an opportunity evaporates. In many cases, the frustration can be the result of community leaders seeing an opportunity when many others see problems or worse yet, nothing. It is important to maintain perspective and understand that by definition virtually every community development loan or investment will have a social or broader community-wide mission. This can range from providing affordable housing for low and moderate-income persons to revitalizing distressed commercial districts or residential neighborhoods and to establishing loan pools to assist small businesses.

However, it is critical for community leaders and elected officials to understand one very fundamental truth: By its very nature community development lending and investment activity is financial, not social. In short, the project must "pencil out"; it must be a fundamentally feasible investment. If it is not, then the project may represent a good idea, but it is <u>not</u> an opportunity that can effectively attract capital. CRE professionals can be instrumental in evaluating a project's feasibility and parameters for success.

What is Community Development Finance?

Before answering this question, it is probably important to address what community development finance is not. Most fundamentally, it is not a mechanism, tool or strategy for making a poor, fundamentally flawed project a good one. All the community development finance enhancements or incentives available cannot fix a faulty business model; a dismal location; or a concept with low to no possible market support. In short, community development finance cannot fix a project with an unreasonably high risk profile. This is called "putting lipstick on the pig" and hoping nobody notices it is not a beauty queen.
The market generally punishes these kinds of attempts and does significant damage to the community that may take many years from which to recover. The damage can be financial, in that, the community may be saddled with non-performing assets or financial obligations that create a serious drain on its operating resources. More importantly, manipulating conditions to ignore stark market realities creates credibility gaps for community leaders. This erodes public trust and confidence; impedes future efforts as potential financial partners steer clear; and fosters a sense of frustration and hopelessness. In essence, forcing a poor or ill-conceived project through a community development process is a "no-win" proposition. The goal of community development finance is to take those fundamentally sound projects that almost but not quite work and make them a "win-win" proposition for the financial stakeholders and the community at large.

Since community development lending and investment activity is governed by fundamental financial considerations, every project requires a sharp pencil and careful due diligence. Without these, very few projects will make it off the ground or sustain themselves over the long run. Conventional lenders/investors typically gauge their interest in a project by looking carefully at three components of every deal or opportunity: 1) the dollars or cash equity already committed; 2) the collateral or value of the assets (including the revenue streams that will be used to secure their investments; and 3) the expertise and capabilities of the individuals or entity requesting their financial commitment. Community development finance enhancements are typically needed because one or more of these components is not quite up to their typical or normal expectations and requirements. These expectations or requirements are driven from the inside (i.e. policies and guidelines adopted by the organization) and the outside (i.e. regulatory oversight, particularly in the case of depository institutions such as commercial banks, federal savings banks or credit unions).

The primary focus of community development finance is fundamentally twofold: 1) To fill the all but inevitable private capital market gaps and 2) To ensure capital availability to viable projects when private sources are either unable or unwilling to provide the full extent of the financial resources needed.

What is the Role of Finance in the Community Development Process?

Finance, although crucial, is only one component of local community economic development effort focused on creating jobs, capital investment and wealth creation. Financial resources are necessary by not sufficient by themselves to create new economic activity in a local community. There are many other factors that help produce successful community development outcomes and they are typically environmental or locational attributes that influence the risk profile and basic feasibility of an individual project or initiative. Although most of these factors are addressed on one or more of the other modules, several are worth noting because of their influence on gap filling financing decisions.
Community development finance decisions are more easily made in areas where the surrounding economic dynamic is stable or showing signs of at least slow to moderate growth. This dynamic creates demand for goods and services that community development projects may be positioned to provide, even if indirectly. Growing economies allow for new entrants that can gain market position without the necessity of taking business away from existing goods and services providers. Having to take market share from established businesses to render a project feasible raises its risk profile significantly and begs the question of its ability to be supported in a competitive market environment.

Successful community development projects, particularly those creating new or expanded business opportunities, usually require access to a trained, well prepared workforce. Using financial incentives to create new facilities and positions that cannot be filled with capable and prepared workers is a misuse of community development finance tools.

Infrastructure speaks volumes about a local area's ability to support and sustain community economic development projects. In fact, community infrastructure – physical, technical, financial, institutional and intellectual – is the very foundation upon which economic development strategies are built to attract new businesses, retain existing ones or to nurture home grown entrepreneurial enterprises. At the same time, actual or perceived infrastructure deficiencies are quite often the very focus of community development initiatives requiring some form of creative financing intervention or enhancement. This is what makes local infrastructure issues such a "chicken and egg" dilemma in the world of community economic development. It lies at the heart of difficult decisions that require careful thought, reliable information and leadership willing to consider trade-offs that might not be popular with some members of the community. In many cases, there are no easy solutions and the answers typically are not couched in terms of "either/or" but "both/and". That is, a community not only needs to move forward with a significant project, but it also needs to move forward with infrastructure improvements to increase the project's likelihood of success and sustainability. Increasingly community development finance challenges involve identifying and securing resources for a specific project (i.e. building construction) as well as the infrastructure needed to enhance its likelihood of market acceptance and support (i.e. street, sewer, water, technology improvements). While enhancing infrastructure can improve a project's chances of success, it can also increase its risk profile due to the longer time period over which the project will unfold. Again, these are difficult choices that require strategic thinking, prioritization and trade-offs.

Alternatives for Filling Funding Gaps

The presence of institutions in a local area that are willing and able to participate in financing economic development projects is a critical element of a community's infrastructure. Generally, larger communities with significant regional or national bank presence have a well-diversified mix of institutions, most of which are comfortable with and have experience in using community development finance tools and strategies. However, this is not to say that smaller communities cannot tap into these resources as well. Many regional or national banks have extensive branch networks that extend over large geographic areas encompassing many small to medium size communities. These branches are an entree' to the resources these institutions have to offer.

Community development finance interventions generally take two basic forms. The first involves working with private financial institutions to adapt their conventional lending and investing activities to the challenges of financing community development projects. This is done in one of several ways. One is to help reduce what are known as market imperfections. By their very nature, financial markets are somewhat imperfect, particularly the private markets that characterize lending and investing at the local level. Pubic financial markets, on the other hand, tend to be more efficient due to the active trading of financial instruments on public exchanges (i.e. stocks, bonds, mortgage backed securities, etc.) Although local community development projects may involve some form of bond financing that touches the public markets, the majority of local development finance interfaces with the private financial market populated by banks, thrifts and other depository institutions. Reducing market imperfections for these institutions usually requires preparing good project level and local market area information that can be used in performing the institution's due diligence.

Depository institutions are highly regulated at the federal and state levels (some at both). In some instances, regulation discourages investments in somewhat risk prone community development projects (safety and soundness), while other regulations seem to do just the opposite (community reinvestment). In short, many institutions find themselves on the horns of a dilemma; they may be criticized if they do a deal and they may be criticized for not doing the deal. Community development finance interventions or enhancements do not eliminate regulatory barriers but they do help to mitigate them by reducing a project's risk profile from the standpoint of the conventional lender. This intervention could take a variety of forms and be drawn from a mix of non-conventional sources. Examples would include tax credits to provide additional equity, third party guarantors and long term triple "A" credit tenant leases to ensure cash flows and enhance debt coverage.

A third approach involves tapping into the secondary mortgage market to enhance capital flows to resource deficient local communities. Although this has long been a staple of housing finance, it has become more frequently used in non-residential lending for community development projects. This can occur through larger banks that use correspondent relationships to secure loan participations from other, usually smaller, banks located in communities they serve.

When these types of interventions fall short of providing the necessary level of resources to fill community development finance gaps, the next approach is to create alternative sources that directly supply capital to make up of the funding deficiencies left by conventional lenders and investors. There is a wide variety of alternative financial sources that will be discussed briefly in the material that follows. Suffice it to say that the menu of such sources has grown significantly over the past twenty years; that stakeholders in these alternative sources include institutional and organizational entities across the spectrum of the public, private and nonprofit sectors; and that they represent a significant volume of financial resources that when tapped effectively and applied strategically can make the undoable deal a doable one.

There is, however, one cautionary comment that community development leaders should take to heart. Alternative financing sources should never be used where conventional sources are more than sufficient to accomplish community economic development goals and execute specific projects or programs. This would be categorized as a substitution of capital through a duplication of effort. The net result is no net gain in economic activity at the local level but merely a reshuffling of resources. As such, there is little to no new value added and thus little, if any, new wealth creation.

Community development finance has emerged as an industry unto itself over the past 20 to 30 years with the proliferation and growth of programs created to fill funding gaps. Although most of these programs are rooted in legislative initiatives at the federal, state and local levels of government, they are embraced and used by community development players in the private and nonprofit sectors. Participants in each sector have their own motivations in community economic development, but they very often converge around issues such as job or wealth creation, capital investment and improving the quality of life. How players in each sector are rewarded for their contribution to and participation in community development initiatives varies with how they are structured and their individual purposes or missions. For CRE professionals, there reward or benefit could very well be measured in commissions for successful transactions.

Public Sector Players

Government roles in community economic development are generally driven by broad policy goals to promote the public good and welfare at the national, state or local levels. These policy goals are typically pursued with legislation and budgetary appropriations that create specific programs or initiatives that address one or more needs related to the policy goals. The legislation and accompanying budgetary appropriations are then carried out in accordance with detailed regulatory guidelines. Although somewhat cumbersome, the process is generally designed to ensure equity and fairness in how community development resources are deployed.

Federal Agencies

Federal agencies that provide direct funding sources for community economic development include the U.S. Department of Housing and Urban Development (HUD), the Economic Development Administration (EDA) of the U.S. Department of Commerce, the U.S. Department of Agriculture (USDA), the U.S. Environmental Protection Agency (EPA), the Small Business Administration (SBA) and the U.S. Treasury. Agencies playing a more indirect role in providing resources for community economic development include the Federal Home Loan Bank System and secondary market intermediaries such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Government National Mortgage Association (GNMA or Ginnie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). In some cases, funding is passed through to states or local communities as a block grant to support development initiatives.

Regardless of how the funding resources find their way to individual projects or programs, the application process to secure agency commitments is competitive; very often intensely so. This usually reflects the motivation and intent of the granting agency to demonstrate that their investment decisions are effective in fulfilling the ultimate goals of the driving legislation and appropriation. In some agencies this effectiveness may be measured by how many jobs were created or saved and how many dollars of non-federal financial resources were attracted to the project investment.

The federal government also directly influences community economic development by offering tax credits linked to certain types of private investment. Most important to community development initiatives are the New Markets Tax Credits (NMTC's), Historic Tax Credits (HTC's) and Low Income Housing Tax Credits (LIHTC's). Each of these tax credit programs are designed to attract equity to community development projects. This is accomplished by allowing the developer/owner of a project to sell tax credits to one or more third party investors who use the credits to reduce their federal tax liability. Very often the purchasers of tax credits are large multi-national businesses or financial institutions such as large commercial banks. In some cases, these banks are also providing a layer of debt financing for a project.

State Governments

State governments play an important role in community development finance, particularly in small towns and rural communities. State agencies serve as conduits for federal block grants from agencies such as HUD with its Community Development Block Grant program. Very often states also offer a wide range of other programs which piggyback on agencies such as the U.S. Small Business Administration (SBA) and the U.S. Department of Agriculture (USDA) in providing some form of guaranteed business loan or with the U.S. Department of Housing and Urban Development (HUD) when offering programs to promote affordable housing. In some cases, state funds are used as credit enhancements when federal program guarantee limits leave a funding gap or take the form of direct loans through a Revolving Loan Fund (RLF) program. RLF's themselves may be capitalized with a combination of resources with funding contributions from federal agencies (i.e. EDA), state appropriations and private banks. Some state programs also provide equity capital and subordinated debt structures to fill financing gaps for economic development initiatives in local communities.

States also encourage community economic development initiatives using target tax credit programs. These tax credits may also be piggybacked with federal tax credits (i.e. HTC's, NMTC's and LIHTC's) or they may stand alone to encourage development and investment in specific industries or clusters such as film and video, performing and visual arts and the like. These sector specific tax credits usually link to the state's economic development strategic plan and are usually limited in amount on an annual basis by legislative mandate. Securing such credits usually requires demonstrating that the state's investment in foregone tax revenues will result in direct job creation and net new capital investment. The use of some state tax credits may also be limited to businesses or projects in state designated Enterprise Zones (EZ's) or other targeted depressed communities or neighborhoods.

States also have the ability to offer favorable (below market cost) financing for community economic development projects by issuing bonds. This is particularly true for Industrial Revenue Bonds (IRB's that are issued by an authorized state agency (including local economic development entities). IRB's are federally tax exempt and thus investors or holders of the bonds pay no federal taxes on interest earned. This results in a lower debt carrying cost for local projects that qualify of IRB financing.

Local Governments

Local governments are generally the beneficiaries and recipients of development finance programs and funding flows that start at the federal and state levels. Like states, local governments through their community and economic development agencies may offer a mix of financing opportunities that piggyback onto federal and state programs. Local efforts may include credit enhancements to supplement other guarantees or direct lending through local RLF's that have been capitalized with federal, state and local dollars. Local agencies may also directly or indirectly provide technical assistance to project developers or serve as a point of contact and referral. The best results are typically produced when the local agency establishes what are known as "One Stop Shops" or where services are directed through business support centers such as incubators with specifically designated teams of local officials charged with expediting a project entitlement process.

Local governments also have the ability to issue bonds that can be used to finance infrastructure and other improvements needed to support an economic development project. This could include General Obligation (GO) bonds that are underwritten based on the full faith guarantee of the issuing municipality or a Revenue Bond (RB) that is tied to a dedicated funding stream for its repayment. GO municipal bonds (municipals) are rated and priced based upon the strength of the local community's general tax base and its ability to service and retire existing and new debt obligations. Major improvements to streets, sewer and water systems and other necessary municipal infrastructure are typically financed using GO bonds. Revenue bonds are potentially more risky since their repayment is very often directly linked to the success of a specific project or group of projects in a particular area. Revenue bonds may also be used in conjunction with another state authorized development finance tool called Tax Increment Financing (TIF).

The TIF is a mechanism that allows future or incremental growth in property or sales tax revenues generated by development in a defined area to pay for the current and future costs of improvements. TIF related revenue streams can be used to service revenue bond debt issued to acquire land, make infrastructure improvements, build utility, parking and other types of structures and for a variety of development costs that represent enhancements intended to create jobs and attract more private investment. The ultimate goal of a TIF is to generate enough net new private investment to produce gradually rising property values and thus more tax revenues. TIF Districts usually encompass physically or economically distressed areas where private investment is not likely to occur without some public subsidy or other intervention that help reduce the risk profile of one or more development decisions. In the long run, the effects of TIF creation are cumulative in that success breeds success thus creating an environment where development finance interventions and enhancements can be phased out or redirected to other areas or strategic initiatives. Development in these districts inevitably encompasses a mix of CRE investments including shopping centers, office buildings and warehouse/industrial space. Local municipalities may also use property tax abatements to promote community economic development in areas designated as blighted distressed or as an officially established Enterprise Zone. Tax abatements can take two forms. They can be either a complete forgiveness of taxes or a deferral of tax payments until some future date, possibly as long as 10 to 20 years. The net effect of such abatements is to reduce the burden on the income stream being produced by a project and thus reducing the risk of cash flow deficiencies, particularly in a project's most vulnerable start-up and growth stages. Once an income stream is stabilized and the property's likelihood of success has improved, the obligation to pay property taxes will begin. When this occurs is a matter of negotiation with the taxing authority or based upon reaching predetermined operating benchmarks. In many cases, a full or partial abatement is granted with certain limiting conditions. One is that the developer demonstrated benefits to the community in terms of net new jobs created or jobs saved. Another is that the developer/property owner agrees to a Payment In Lieu of Taxes (PILOT) or an annual payment of fees to cover certain municipal services that a tax would normally encompass. These fees are usually much less than the tax payment and almost always less than the actual cost to the municipality to provide these services. In essence, the granting of tax abatements by a municipality is a calculated risk motivated by the prospects of significantly improving its local economic base and quality of life.

Private Sector

The fundamental motive of most private sector participants in community economic development initiatives is quite simple: making money. This occurs as a result of making a profit, creating value and building wealth. Development finance interventions and enhancements are designed primarily to attract private sector players by reducing project risk profiles; raising the likelihood of success; and providing acceptable levels of return on investment. Competitive returns are what attract private capital to various investments and render them a bankable opportunity. Strategically designed development finance interventions typically involve layers of supplemental or gap funding to move projects from the realm of the undoable to the doable. As previously mentioned, however, fundamentally flawed projects fall into the realm of the realistically impossible and are unlikely to attract private capital no matter how many layers of enhancement are added to the mix.

There are three major groups of private sector players: Commercial Banks and Thrifts; Investors, both individual and institutional; and property owners themselves. Although each is driven largely by the profit motive, there are some who understand clearly the benefits and potential value of community economic development.

Commercial Banks and Thrifts

Depository institutions such as commercial banks and thrifts usually have significant vested interests in seeing the areas they serve grow and prosper. Economic vitality is crucial to the profitability of their core business which usually focuses on attracting deposits and making loans. Economically depressed communities create problems on both sides of institutional balance sheets. Declining property values impair loans on the asset side, while weak job growth and business expansion impair deposit growth on the liability side of the ledger. Many local institutions are attracted to community development initiatives because it is good business and because they are strongly urged to do so by regulatory mandates such as the Community Reinvestment Act (CRA).

When attempting to encourage participation by banks and thrifts in financing community economic development projects, it is important to understand several items regarding their basic structure and operating requirements. First, the banking and thrift industry are continuing to evolve and in some ways undergoing significant structural shifts. For the most part this has been driven by continuing patterns of de-regulation and re-regulation and by the globalization of the financial system. The cycles of regulatory change which started in the late 1970’s have repeated themselves on a decade by decade basis. Each time the cycle repeats itself, distinctions that once existed between different types of institutions tend to get further blurred. This gives some institutions more flexibility in the lines of business they may offer and increases competition. This increased competition has in many ways helped community development finance in that it forced many previously disinterested or overly cautious institutions to pursue participation in community economic development projects and programs.

Increased global competition and the proliferation of banking alternatives for customers have further tightened profit margins in an industry that has always been characterized by tight margins on high transaction volumes. The shrinkage of net interest margins (the difference between rates earned on loans and paid on deposits) has reduced many financial institutions’ latitude for making mistakes. Depending on asset size, relatively few bad lending decisions can reduce profits and potentially impair capital (or net worth) of the institution. So even if a local bank is strongly committed to a community development project, its enthusiasm for making a loan or other financial investment will be tempered by its own financial performance and the extent to which risk can be mitigated by the introduction of incentives or enhancements.

The third and perhaps most important factor to understand is that financial institutions must match or attempt to match the term structure of its assets and liabilities. That is, if it obtains most of its loanable funds from checking and other short term demand deposits, then the maturity structure of most of its loan portfolio should mirror this term structure by offering funding over a one to three year period. For those with a high proportion of long term time deposits, longer term loans are more readily justified. This is called asset/liability or balance sheet management and is watched closely by some regulators. Failure to manage the term structure of the balance sheet increases interest rate risk and can potentially lead to liquidity and capital deficiency issues for the institution.

Individual Investors

Individual investors, like banks and thrifts, also usually have vested interests in the community and are thus supportive participants of initiatives that will help them achieve their goal of earning competitive market returns for their capital commitments while building long term wealth. Individual investors typically involve themselves as equity contributors through legal entities such as partnerships or limited liability companies (LLC's). Their appetite for the amount of equity they are willing to invest will be linked to the estimated value of the project and an identifiable exit strategy. Equity investors are rarely willing to provide all of the capital needed to fill the funding gap between cost, value and loan proceeds. The gap is filled by a mix of investor equity and credit enhancements. Very often these equity enhancements are provided through the sale of one or more types of tax credits to the same or another group of outside investors. Those additional equity investors may very well be institutional investment banking entities that see sufficient opportunity in the project or that are motivated by social and broader public good concerns. Involvement of such institutional investors is more likely when they already have a vested interest in the community (i.e. existing significant capital investments) or when significant events such as natural or man-made disasters create a sudden, severe and very visible impact on one or more local communities. Access to these institutions may require networking with locally based financial service providers such as banks and investment bankers or with wealthy individuals or families who are residents or major property or business owners in a community.

Property Owners

Property owners, particularly those who control large land holdings or strategic parcels and buildings in a community may also have a vested interest in the growth and economic prosperity of the area. Growth drives demand for all types of goods and services and thus is the underlying force creating demand for housing and business locations. These all require land or existing buildings that should grow in value over time and thus create more wealth for property owners and rising tax revenues for local government. If property is located in a TIF, the rising values fuel greater incremental tax collections that can be used to finance more infrastructure improvements and target community development projects.

Property owners very often control strategically located sites or buildings that are crucial elements required to execute a community's economic development strategy. This could include buildings in a core business district targeted for redevelopment and revitalization or large vacant land holdings on the perimeter of the community that essentially land lock future expansion unless they are brought into commerce.

Although most private property owners find the prospect of developing or redeveloping their assets an attractive alternative, some communities do encounter resistance and are unable to execute some portions of their plans. Property owner resistance can very often be traced to fear or uncertainty about change or due to legal or ownership restrictions placed on land or buildings by ancestors. This could include deed restrictions or placement of the property into some form of family trust or encumbering it with long term agricultural or timber leases. An essential part of any community development team is good legal counsel that can help address some of these issues and negotiate terms that are acceptable to all parties. This is also an area in which a CRE broker or agent can provide valuable insight and counsel to help move strategic initiatives forward.

Another potential barrier for some property owners is the fear of creating significant income tax liabilities for themselves or their heirs as a result of development. Again, good tax and legal counsel can help mitigate if not eliminate these fears by creating legal and tax strategies that provide protections for the property owner, assure wealth accumulation for themselves and their descendants and allow land or buildings to be used in executing an effective community development strategy. In some cases, this could involve financing structures that include property owners as equity investors in the project. Whatever the structure, the intended end result is a “win-win” outcome for all stakeholders.

Nonprofit Sector Players

The nonprofit sector is sometimes referred to as the charitable, independent, or third sector, experienced significant growth over the past 20 years. The sector’s combined operating budgets now exceed $1.3 trillion and account for 7% to 8% of GDP (as compared to 3% to 4% during the 1960’s). Nonprofit organizations employ over 10.0 million people in the U.S. alone (about 11% of the labor force) and on average engage about 95 million people annually as volunteers. Like the emergence of nonprofits in the early 1900’s, the more recent expansive cycle can be traced to entrepreneurial successes that created substantial wealth for owners and investors during the 1980’s and 1990’s. Nowhere is this more evident than in the proliferation of technology based companies that catapulted their founders into the ranks of the super-wealthy. Some of these newly minted billionaires have transferred large portions of their wealth into foundations that support a wide variety of charitable and philanthropic causes throughout the U.S. and across the globe.

Although these and other large foundations garner much of the attention, the “trench work” of the nonprofit sector is carried out by relatively small organizations, those with generally under $50,000 annual operating budgets. This would include the vast majority of nonprofits focused on community economic development, particularly housing and neighborhood revitalization. Very often these functions are carried out through community development corporations (CDCs) which will be discussed later.

Nonprofits are private non-governmental organizations that are incorporated and governed by a Board of Directors or trustees with fiduciary responsibilities to oversee and manage the interests of those who donate money or otherwise provide financial resources to support the organization’s mission. Although nonprofits are not an extension of the government, their operations are facilitated by the extension of tax exempt status and funding support through a wide range of grant programs, many of which are only available to nonprofits.

Nonprofit status does not mean that charitable or community development organizations do not make money. They can and should generate operating excesses (i.e. profits) and build their net equity (i.e. net worth) position. Unlike corporations organized to make a profit for the benefit of its owners (stockholders), nonprofits are organized for the advancement of a group of persons or community (stakeholders). Because they are mission driven and not profit driven, nonprofits are granted tax exempt status under Section 501 of the Internal Revenue Service Code. Most nonprofits are exempted as 501(c)3 organizations, although there are others that may fall under other parts of the code such as (c)6, (c)7, etc.

Aside from not paying corporate income taxes on net operating excesses, individuals and legal entities can make donations to qualified nonprofits that are deductible for purposes of calculating taxable income. Community Development Corporations (CDCs) act as conduits for public and private investments that are focused on community economic development and revitalization projects. They are very often formed as an outgrowth of work undertaken by community groups at the local or neighborhood level whose focus is improving the public good through housing renewal and commercial revitalization. Their motivations are job creation and the attraction of private and government resources to upgrade the quality of life and build wealth within their target areas of influence.

Neighborhood-based CDCs are very often governed by local residents and small business and property owners. They form alliances and partnerships with other CDCs as well as with local government agencies and private businesses that are willing to financially support the mission of the CDC. Both public and private sector partners usually have vested self-interests in seeing CDCs succeed at their mission. This can range from removing or rebuilding blighted and abandoned housing to reduce crime and restore neighborhood stability to increasing the population and purchasing power of residents to support more retail, banking and other business activities.

Some of the more creative and entrepreneurial CDCs will also create profit-making subsidiaries that can route money into the nonprofit to further its mission. For example, a nonprofit CDC with a major housing and workforce focus can use job training programs supported by private donations and government grants to provide qualified skilled workers for a profit company that provides various contracting services. In addition to job training, nonprofit CDCs may also operate day care centers, community health clinics and other social service programs, while creating profit entities such as local grocery stores, restaurants, auto repair shops and a wide variety of business start-ups that can offer job opportunities for neighborhood residents.

Bank CDCs

Bank CDCs are a special form of community development corporation authorized under two federal banking regulators: the Office of Comptroller of the Currency (U.S. Treasury) and the Board of Governance of the Federal Reserve System. These agencies have established regulations that allow nationally supervised banks to undertake a wide range of investments and activities that advance the public welfare. These regulations permit banks to make one time investments (by grant, loan or equity) in specific projects or entities (called Community Development Projects [CDP]) or to establish and capitalize on-going entities to finance or directly undertake community economic development initiatives.
Bank CDC activities can be structured in a variety of ways. This could include a bank division or business unit; a for profit or nonprofit (usually 501(c)3) subsidiary; a partnership with a community based organization or public agency; a multi-bank organization; or an umbrella entity to pool bank funds with other funding sources.

Bank CDCs are commonly used to provide riskier loans to small businesses such as subordinated debt for business expansions that do not meet conventional credit standards. Sometimes depending on the amount of funds needed, several bank CDCs will pool resources in a participation agreement to make the necessary resources available. Some bank CDCs also combine lending and investment activities with technical assistance and business support services such as incubator facilities or entrepreneurial development programs.

Bank CDCs may also pursue real estate development as part of their mission. This could include acquiring and rehabilitating severely distressed residential and commercial properties in targeted neighborhoods throughout their service area. In this way, bank CDCs are filling a market void where private developers and other lenders see an area as too risky for investment or where the circumstances involving severely blighted properties and neighborhoods are particularly difficult and complex. In the latter instance, many bank CDCs will form alliances with other neighborhood based CDCs, particularly faith-based organizations that have complimentary missions.

Faith-Based Organizations

Faith-Based Organizations (FBOs) are by their very nature and stated missions, focused on making community improvements that permeate not just the social and economic conditions of an area but also to provide uplifting spiritual support and encouragement to people who may have lost hope in themselves and others. FBOs have emerged as vital links to deliver a wide range of social services (i.e. medical, counseling, schooling, etc.) in areas where public and private delivery mechanisms have failed or have been severely deficient. Bank CDCs often partner with FBOs to provide financial support to social services that will improve the quality of life in targeted neighborhoods and thus enhance the chances of success for housing and commercial redevelopment efforts. FBO CDCs are often best equipped to secure and train prospective buyers for affordable housing financed by a bank CDC and to maintain an on-going relationship with new homeowners to assure their success in this new role. Bank CDCs can also serve as conduits to provide financing to FBOs that acquire and renovate properties themselves and provide technical and management assistance to ensure an FBOs long term sustainability. Successful partnerships or strategic alliances such as these produce win-win situations for all parties. The bank CDC makes good investments for which its parent bank receives favorable CRA credit; the FBO takes more steps forward as a viable player in community economic development; and community residents gain access to affordable housing, improved services and a better quality of life.

Foundations

Foundations, both privately-funded and community-supported, have historically been a source of grant funding used to support community economic development projects and programs. Receiving financial support from foundations is typically a highly competitive process that requires the potential grantee to conduct careful due diligence research on potential donor organizations, prepare detailed fully documented applications and nurture relationships with foundation contacts to maintain good communication. Although foundations control a significant asset base, they have traditionally accounted for 10% to 12% of total nonprofit support supplied annually. They are, however, an important player in community economic development for a wide range of initiatives either on a one-time basis or with multi-year commitments.

In addition to making outright grants, many large foundations also make what are known as program-related investments (PRIs). These may include direct equity or equity-equivalent investments in projects such as long term or non-amortizing subordinate debt, usually at below-market interest rates. PRI's are most likely made when they directly and significantly reflect the core mission of the foundation providing the resources. They may be targeted to a range of community economic development projects such as neighborhood shopping centers, commercial district revitalization efforts, small business and microenterprise revolving loan funds and business incubators/accelerator projects. Unlike direct grants, PRIs are financial instruments designed to provide some rate of return to the foundation even if it is below market. PRIs are a strategic way for foundations to accomplish their mission and make money at the same time.

National entities such as the Mott, Ford and Calvert Foundations are important investors in community economic development initiatives. Also, most major corporations have charitable foundations that support community development projects and programs. This includes companies in just about every sector such as banking (Capital One, Wells Fargo and Bank of America), communications and technology (Sprint, Microsoft and AT&T) and insurance (Prudential, Hartford and Allstate). Two excellent sources of foundation information is the Council of Philanthropy (www.philanthropy.com) and the Foundation Center (www.foundationcenter.org).