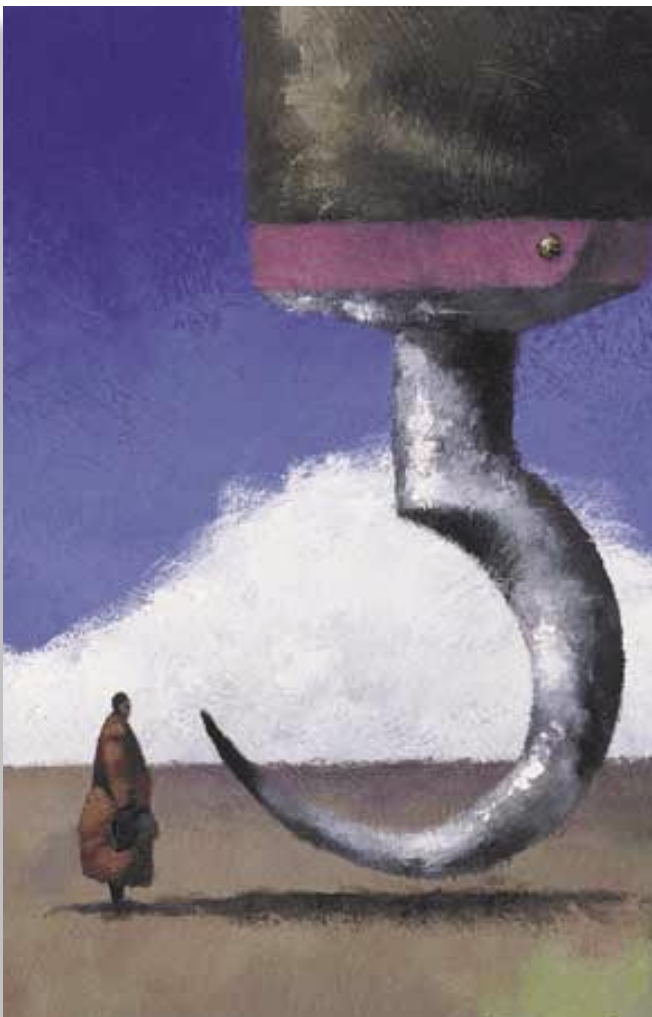


Investing in Urban Real Estate

For Profit or Not for Profit

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The U.S. real estate markets have changed dramatically over the past 30 years. We have witnessed an exponential growth in the suburban markets coupled with a similar neglect of the urban markets. The exodus of middle- and upper-class families from the urban markets led to a deterioration of the urban infrastructure and a resulting disregard for its commercial and residential properties. During this period, the institutional investment community declined to invest in the urban market for the following reasons:

- Poor quality of building or improvements;
- Non-investment-grade rent roll;
- Short-term leases of tenants occupying space;
- Perception of high crime; and
- Lack of market coverage by national real estate brokerage houses.

As the demographics of the urban community have changed, so has the opportunity. However, institutional capital has been slow to recognize what national retailers and housing specialists have—that the urban market's population density, mismatch between consumer demand and supply of goods and services, substantial shortage of affordable housing, and concentration of spending power have created an excellent real estate opportunity.

In fact, far too many investors still perceive urban investing as either a social service or a tax-credit-driven investment thesis. Consequently, before one can fully appreciate today's urban opportunity, it is important to differentiate among the various urban investment opportunities. There are,

in fact, three different urban opportunities, each with a very different objective, risk profile, and return expectation. The three categories include these:

LITC and Social Investments: This opportunity primarily focuses on investing in low-income/tax-credit-driven housing projects in low-income communities. The two primary objectives of this strategy are social service and tax credits.

Regentrification: This opportunity attempts to change the character of an urban community and typically involves the displacement of the community's existing residents. Examples include the Rouse Company's Harborplace in Baltimore, Faneuil Hall in Boston, and Trizec Hahn's Hollywood and Highland project in Los Angeles. Demand for these projects is often difficult to quantify, and consequently, risks are high.

Revitalization: This opportunity focuses on investing in densely populated, ethnically diverse communities characterized by a large, existing mismatch between supply and demand of amenities such as housing and retail.

This third area—urban revitalization—we believe offers unusually attractive risk-adjusted investment opportunities (on both a relative and risk-adjusted basis versus other real estate opportunities of the last 40 years).

Urban Revitalization: The Opportunity

The United States now enjoys what is in many respects the healthiest economy in its history, and many real estate markets are experiencing record occupancy rates. However, unlike previous boom cycles, the capital markets have appropriately constrained new development so that the absorption rate is commensurate with the delivery rate. As the overall real estate market appears to be in equilibrium, the sprawling of the suburban real estate market coupled with an anti-growth environment have resulted in fewer suburban investment opportunities for value-oriented, event-driven investors who attempt to capitalize on market inefficiencies. As a result, a number of real estate opportunity funds are seeking returns, typical of those found previously in the suburban markets, through investments in commercial mortgage-backed securities (CMBS), real estate derivatives, real estate operating companies, and international transactions.

Industry Outlook Versus Urban Revitalization

Although the general real estate market is in equilibrium, the urban markets have experienced neglect; they have not attracted the significant amounts of debt, equity capital, or market information necessary for real estate development. Investors have failed to capitalize in any significant way on the concentrated spending power of the large number of residents, available trainable labor pools, excellent central locations at the hub of metropolitan transportation networks, underutilized land, and pro-growth environments.

As noted in a Pension Consulting Alliance memorandum on urban investment programs to the investment committee of the California State Teachers' Retirement System, "Due to market inefficiencies and negative perceptions, it appears that urban areas have been largely overlooked by mainstream investors, including the traditional real estate advisory community, despite being attractive investment opportunities."

Revitalization: The Investment Thesis

The mismatch between supply and demand in urban markets and the lack of available capital are the fundamental characteristics of the urban thesis. The densely populated, ethnically diverse inner-city neighborhoods of the United States possess an estimated \$331 billion in retail purchasing power, according to a 1999 U.S. Housing and Urban Development study titled *New Markets: The Untapped Retail Buying Power in America's Inner Cities*. However, as a result of the decades-long focus by institutional capital on the suburban market, many cities now face a large retail gap, failing to capture significant percentages of their own residents' buying power. In a study completed in 1998, the Initiative for a Competitive Inner City (ICIC) and the Boston Consulting Group concluded that in many inner-city areas, more than 25 percent of retail demand is unmet, amounting to billions of dollars of potential sales and hundreds of millions of dollars of profits. The study goes on to note that unmet demand approaches 30 percent in Boston, 40 percent in many areas of Chicago, and 60 percent in Harlem. In fact, according to a comprehensive survey by Claritas Inc. for HUD, a \$75 billion gap exists citywide in 85 urban areas.

Some of the underlying fundamentals of the opportunity include the following:

1) A significant mismatch between supply and demand of retail and housing

- The top 44 U.S. cities have more than \$1.1 trillion in retail purchasing power of which more than \$331 billion is located in ethnically diverse inner-city neighborhoods.
- Despite generally lower incomes, high-density urban populations contribute to a collective spending power up to six times that of suburban areas.
- The gap between retail buying power and total sales exceeds 40 percent in many urban markets.
- Inner-city residents have 75 percent fewer retail options than suburban counterparts.
- These top cities are short more than 2.5 million units of affordable housing.

2) A growing ethnic population

- Ethnic-minority populations now represent more than 35 percent of the U.S. population and are heavily concentrated in urban communities.
- U.S. ethnic populations are growing seven times faster than the general population.

3) A lack of competition

- Analysts estimate that less than 2 percent of U.S. domestic private equity capital is currently targeted to real estate or business investment in these markets.

The Retail and Housing Gap

Examples abound of the opportunities posed by high population density and retail supply-and-demand gaps. The ICIC study points out that Harlem's estimated retail demand for food and apparel of \$116 million per square mile is more than twice the New York metro rate of \$53 million. Even so, a 2001 study prepared for the Brookings Institute's Center on Urban and Metropolitan Policy concluded that "retailers ignore some of the strongest markets in metropolitan areas because of misconceptions about central city income status, persistent urban legends about the absence of workers in inner-city neighborhoods, racial and class-based stereotypes, and the emphasis on average household income promoted by commercial marketing firms."

However, what some retailers are discovering is that when they stake out a presence in inner-city markets, they typically see a corresponding outperformance relative to the general market. The ICIC study noted that "Footlocker's store in Harlem is among the company's top stores, recording sales in excess of \$1,000 per square foot, and Pathmark's new Harlem store is generating sales in excess of \$800 per square foot." In fact, about half of Pathmark's stores are now located in low-income communities and its development strategy is clearly urban. Why? Pathmark says, "... because that is where the people are."

The study continues by noting that retail demand per square mile in inner-city Boston is six times as great as in the Boston metro area as a whole, and the Super Stop and Shop store in Boston's inner city is the highest grossing of that company's 186 supermarkets. Drugstores tend to do especially well in inner-city neighborhoods, in part because they meet special medical needs and offer a product mix that must be frequently purchased by a wide range of households. For example, according to the study, the Rite Aid outlet in Harlem fills more prescriptions per day than any other Rite Aid in New York City.

To see the housing opportunity, one need only refer to the recent HUD study that concluded that the top 44 U.S. cities are short more than 2.5 million units of affordable housing—not low-income housing but affordable, market-rate housing.

Exhibit 1 shows the top 26 cities in the United States and their population density, demand for housing, purchasing power, retail spending, and attractiveness to national retailers. That information starkly illustrates the premise of the urban fund strategy.

Exhibit 1

Market	Population	Retail Gap (in millions)	Housing Shortage (in units)
New York	7,380,906	\$37,000	408,000
Los Angeles	3,553,638	\$ 5,400	401,000
Chicago	2,721,547	\$ 9,800	151,000
Houston	1,744,058	—	64,000
Philadelphia	1,478,002	\$.289	121,000
San Diego	1,171,121	\$.167	74,000
Detroit	1,000,272	\$ 1,400	91,000
San Jose	838,744	\$ 3,900	—
San Francisco	735,315	\$ 1,500	123,000
Baltimore	675,401	\$ 1,200	39,000
Memphis	596,725	—	16,000
Boston	558,394	\$.451	83,000
Washington, D.C.	543,213	\$ 2,700	68,000
Seattle	524,704	\$.248	35,000
Cleveland	498,246	—	45,000
New Orleans	476,625	—	27,000
Long Beach	421,904	\$ 2,800	—
Atlanta	401,907	\$.326	51,000
Oakland	367,230	\$.904	—
Miami	365,127	—	104,000
St. Louis	351,565	—	38,000
Buffalo	310,548	\$.307	—
Newark	268,510	\$.658	172,000
Jersey City	229,039	\$.929	—
Bridgeport	137,990	\$.740	—
New Haven	124,665	\$.597	—

Source: U.S. Department of Housing and Urban Development

Other Factors

In addition to the significant pent-up demand created by the retail and affordable housing mismatch, other factors also favor capital deployment for these areas.

Large Population in Labor Pool: Although the U.S. unemployment rate is less than 5 percent nationwide, a closer look at the top 44 cities reveals a different story. In many states across the country, urban and inner-city unemployment rates are double the national average. As the majority of

the U.S. job growth over the past 40 years has occurred in suburban markets, the neglect of the urban markets has left more than 4 million people actively seeking employment. To support the continued economic expansion in this country, jobs are going to have to be created where the people are.

Significant Supply of Land/Existing Infrastructure: Underpinning all real estate opportunities is the cost of the underlying land and the availability of infrastructure to support the development. Unlike many suburban markets that are experiencing sprawling overgrowth, overpopulated schools, and a lack of open space, the urban markets have more than 5 million acres of abandoned sites available for development or redevelopment. These sites are strategically located near existing infrastructure, including public transportation, utilities, streets and highways, hospitals, universities and trade schools, and museums and other cultural resources.

Government Support/Pro-Growth Environment:

Meanwhile, government is rarely an impediment to urban investment. Unlike suburbia, most cities and older urban markets must rebuild their tax bases. Jobs must be created where the people reside, and state governments risk losing federal aid if they are unsuccessful in moving people off welfare. Federal, state, and municipal government support of private-sector investment in these communities through low-interest loans, infrastructure grants, utility discounts, low-cost and no-cost land, tax credits, tax abatements, wage tax credits, and training grants helps to significantly improve the economic viability of urban investment.

Challenges to Investing in Urban Revitalization

If the urban markets represent such a promising area of growth, why have they not attracted significant amounts of debt or equity capital for real estate development, leaving urban residents with less access to shopping, fewer housing alternatives, and fewer office and manufacturing jobs than their suburban counterparts? The lack of equity and mortgage capital available for urban real

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estate coupled with existing supply-demand imbalances within these markets appear to create a highly attractive, economically viable investment opportunity. In light of such compelling underlying fundamentals, why are so few products focusing on these sectors?

Investment Advisor Challenges

Although it is difficult for most established investment advisors to accept, successful urban investing requires additional skill sets and knowledge that are essential to capturing the urban opportunity. The disclaimer should clearly read: “Past performance in suburban markets is no indication of future success in urban markets!”

Success in urban markets requires a strong knowledge of specific locations within a community; a deep understanding of the specific needs and goals of a community; a working knowledge of urban operations, including security issues, merchandising, and tenancies; and a strong in-house knowledge of the government process and a team of professionals with experience at the local level to obtain community and government support (both regulatory and financial) for the particular urban project. Though an investor may capture government support for an urban project, failure to reach out to the residents within the community and address their specific needs can lead to the project’s failure, as the local community may fail to support the project.

In addition to the aforementioned skill sets, additional challenges abound, including these:

- A shortage of real estate research from real estate brokers to support investment;
- A misperception of greater risk on the development side (zoning, entitlements);
- An incomplete understanding of government incentives;
- A lack of an investment track record within this strategy needed to attract capital; and
- A lack of proprietary deal flow.

Investor/Pension Fund–Related Challenges

The greatest challenge that institutional investors face is overcoming the misperception that urban investing is riskier than alternative markets. In fact, the risks associated with urban real estate investing are the exact same risks associated with any real estate investment. That being said and unbeknownst to most, the urban investment strategy has many fundamental characteristics that mitigate many of the risks typically associated with real estate investment, as shown in Exhibit 2.

In addition to the misperception of risk, additional challenges abound, including these:

- A misperception of social objectives versus economic objectives;
- A lack of ethnic diversity among senior ranks of advisory community;
- A lack of qualified or “underwritable” sponsors or joint-venture partners; and
- A lack of a track record for consultants to underwrite.

Exhibit 2

Typical Opportunity Fund Risks	Risk Mitigation Expected in Urban Investment
■ Transportation linkages	■ In place
■ Utilities/Infrastructure	■ In place
■ Land costs	■ Subsidized or lower cost
■ Construction costs	■ Process may be aided
■ Zoning risks	■ Entitlements as a right
■ Permitting risks	■ Some costs waived, process aided
■ Interest rate risk during construction	■ Subsidized interest rates
■ Interest rate risk, permanent	■ Subsidized interest rates
■ Parking	■ Public assistance, bonding
■ Real estate taxes	■ PILOT, abatements
■ Labor costs, tenants	■ Job tax credits attract employers
■ Recession	■ Higher sales per square foot + income density
■ Demographics	■ Increasing population and income
■ Repatriation risk	■ Not applicable
■ Nationalization risk	■ Not applicable
■ Currency risk	■ Not applicable

The Future of the Opportunity

The future of urban revitalization will greatly depend upon the success of its early pioneers—the ability of investment advisors to identify opportunities, deploy capital, and most importantly, demonstrate the ability to exit opportunities with solid returns. However, the success of initial investments has highlighted the fact that traditional value-added/opportunistic real estate skills are not enough to ensure success in these markets. Urban investing requires a thorough understanding of variables that are

unique to urban communities, such as merchandising, security, operations, government support, and community outreach.

Eventually, we expect the broader investment community to recognize that urban real estate can provide superior risk-adjusted returns to those generated by traditional value-added and/or opportunistic strategies. At some point, this could even result in a flood of capital (both

monetary and intellectual) and the opportunity may be much diminished due to the elimination of a fundamental tenet of our urban thesis—a lack of institutional capital. At that time, we will find ourselves once again in search of the next “new new” thing. However, at least for the moment, the entry barriers to successful urban investing remain high, and we believe the opportunity will persist for some time. ■

Canyon-Johnson Urban Fund

Case Study

When Earvin “Magic” Johnson and I set out to raise the Canyon-Johnson Urban Fund (CJUF) back in May of 2000, we immediately came across a difference of opinion that came to epitomize the urban investment opportunity. I was convinced that it would only take six months to raise the fund. The facts were simple to me: Canyon was a seasoned investment advisor with billions of dollars under management; Canyon’s real estate track record was in excess of 25 percent per annum; urban real estate was the most compelling investment opportunity we had seen in years; and the Johnson Development Corp. was the perfect partner, as its retail operations (Starbucks, Magic Johnson Theaters, and TGI Friday’s restaurants) had proved that one could make money by providing services to minority communities. Needless to say, Johnson felt quite different; he was convinced that it would take all of two years to raise the fund. The facts were simple to him as well: We were trying to raise money to invest in minority communities, and it was going to require a Herculean effort to break down the barriers of misperception held by the institutional investment community. In fact, at the end of the day, we were both right: It took us two years and six months to finally close the fund. That said, from the day of its first investment, the Canyon-Johnson Urban Fund has been proving that investing in densely populated, ethnically diverse urban communities and their surrounding metropolitan areas can be an incredibly profitable endeavor.



Earvin "Magic" Johnson (left) and Bobby Turner

The Canyon Business Plan

In the late 1990s, Canyon saw urban revitalization to be the most compelling real estate opportunity in decades. Given seemingly insurmountable challenges, how would we position ourselves to seize that opportunity?

First and foremost, we recognized that Canyon needed to add to its proven team of value-added real estate professionals. To position ourselves to successfully capture the urban opportunity, we needed in-house expertise that could add value to every step of the urban-investment process. With this in mind, we set out to build the dream team of specialists by recruiting senior professionals from a diverse set of disciplines that would support underwriting urban real estate. These industries included government and economic development, urban planning/architecture, and urban property management/retail operations. The result was a team of professionals uniquely equipped to create optimally tailored solutions and identify opportunities and strategies appropriate for current urban market conditions.

Second, we recognized the value of working with a partner with experience in the urban marketplace—an understanding of not only *how* to operate within densely populated, ethnically diverse communities but also *where* to operate. Magic Johnson was just such a partner. Through a series of strategic corporate relationships, including partnerships with Loews Cineplex Entertainment (Magic Johnson Theatres), Starbucks Coffee, 24-Hour Fitness, and TGI Friday's Restaurants, the Johnson Development Corporation was in possession of a database of information regarding urban opportunities. Moreover, Johnson's tireless commitment to community-outreach programs to spur economic growth within the communities where his partnerships operated would provide CJUF with an ambassador of "greatwill."

Third, we recognized the need to focus only on investments that would meet underwriting criteria appropriate for institutional real estate investors and thus provide for a natural exit strategy. Similar to traditional real estate funds, Canyon would look to exit investments through single-asset sales, portfolio sales, and debt refinancings; however, CJUF would mitigate the aforementioned "urban" concerns expressed by institutional investors by doing the following:

- Constructing "A"-quality improvements in "A" urban locations;
- Leasing to nationally recognized credit tenants;
- Structuring long-term, capital market-friendly leases; and
- Underwriting to higher, more conservative cap rates in order to facilitate a value-added sale upon stabilization.

The CJUF Results

On November 22, 2002, the Canyon-Johnson Urban Fund had its final closing, with total commitments of approximately \$271.7 million from 21 investors. Since its first investment, the CJUF team has been validating the Canyon thesis that there is indeed a highly attractive real estate opportunity in densely populated urban communities and their surrounding metropolitan areas.

As of March 31, 2004, CJUF had made eight investments requiring approximately \$141.7 million of CJUF capital, or approximately 52.2 percent of the total fund commitments. These investments are facilitating the development of more than \$625 million of new urban projects. Additionally, as of this date, CJUF

had sold two out of the initial eight investments, each generating IRRs in excess of 30 percent. The fund is poised to realize similar or higher rates of return on two additional investments within the next six months; in fact, each of the fund's investments is well positioned to meet or exceed its forecast rate of return.

Finally, as of March 31, 2004, CJUF had committed to four new investments requiring approximately \$60 million of CJUF capital. Moreover, CJUF's active pipeline of opportunities included more than 40 pursuits requiring approximately \$725 million in equity capital commitments. Upon closing the four committed deals, CJUF will have invested more than \$200 million, or approximately 75 percent of the fund's total commitments. The deployment of these commitments will have occurred in less than two years after the fund's final close. ■

CJUF Projects

Midtown Center, Milwaukee, WI

A \$52 million, 606,000-square-foot Wal-Mart and Pick 'n Save-anchored, community-serving shopping center

Sunset & Vine, Hollywood, CA

A \$115 million, 625,000-square-foot mixed-use project consisting of 300 loft-style apartments, 87,000 square feet of retail, a parking garage, and 20 signage opportunities

Park Place Condominiums, Brooklyn, NY

A \$29 million, mixed-use project consisting of 47 residential condominiums, 4,500 square feet of ground-level retail space, and a 25-stall underground parking structure



Midtown Center, Milwaukee, WI



Sunset & Vine, Hollywood, CA

Park Place, Brooklyn, NY





State Place, Chicago, IL

State Place, Chicago, IL

A \$96 million, mixed-use project consisting of 237 residential condominiums, 61,500 square feet of ground-level retail space, and a 500-stall parking structure



Transamerica Center, Los Angeles, CA

Transamerica Center, Los Angeles, CA

A \$115 million, 1.3 million-square-foot office redevelopment comprised of three office buildings, plus an additional 5.48 acres of land, converting it into a premier office and residential complex

Sunset and St. Andrews, Hollywood, CA

A \$7 million, 29,000-square-foot retail project with 95 rooftop parking spaces

Severance Town Center, Cleveland Heights, OH

A \$48 million, 650,000-square-foot retail center redevelopment anchored by Home Depot, Wal-Mart, and Tops Market

Downtown Dadeland, Miami, FL

A \$167 million, mixed-use project consisting of 416 residential condominiums, 125,000 square feet of ground-level retail space, and an 800-stall parking structure



Sunset and St. Andrews, Hollywood, CA