Changes in Real Estate Finance and Their Effect on Retail Development in Urban Areas

Kenneth T. Rosen

Grace J. Kim

Rosen Consulting Group

www.rosenconsulting.com

Capital Markets and Inner City Retail Investment – Who's Opportunity?

Overview:

- Changes in capital markets
- Where is the money going?
- Opportunities and challenges to inner urban development
- Public policy recommendations

Findings: Capital Markets
Sea Change in Real Estate Finance

- Equity: REITs are the largest institutional holders of real estate, increasing market share to 42.5% in 2002, from less than 3% in 1990. Opportunity Funds have also exploded in the 1990s to about half the size as REITs

- Debt: Securitization has created significant new sources of debt for real estate development – Representing over half of new debt flow to commercial real estate

- Much of the new capital is skipping over under-retailed urban markets

RCG

Findings: Urban Retail Development

- Top tier markets are targeted for investment - both urban and suburban
- Risks, real and perceived, constrain active investment in tertiary urban markets
- Players in under-retailed urban markets include socially conscious funds, opportunity funds, national and local developers with high costs of capital, and some national retailers

Findings: Opportunities and Challenges

- Land availability and location, demographics, public infrastructure all very favorable…

- . . .however, soil contamination, land assembly, security costs, community resistance and plodding entitlement process require a rare level of patience (and patient money).

Findings: Policy Recommendations

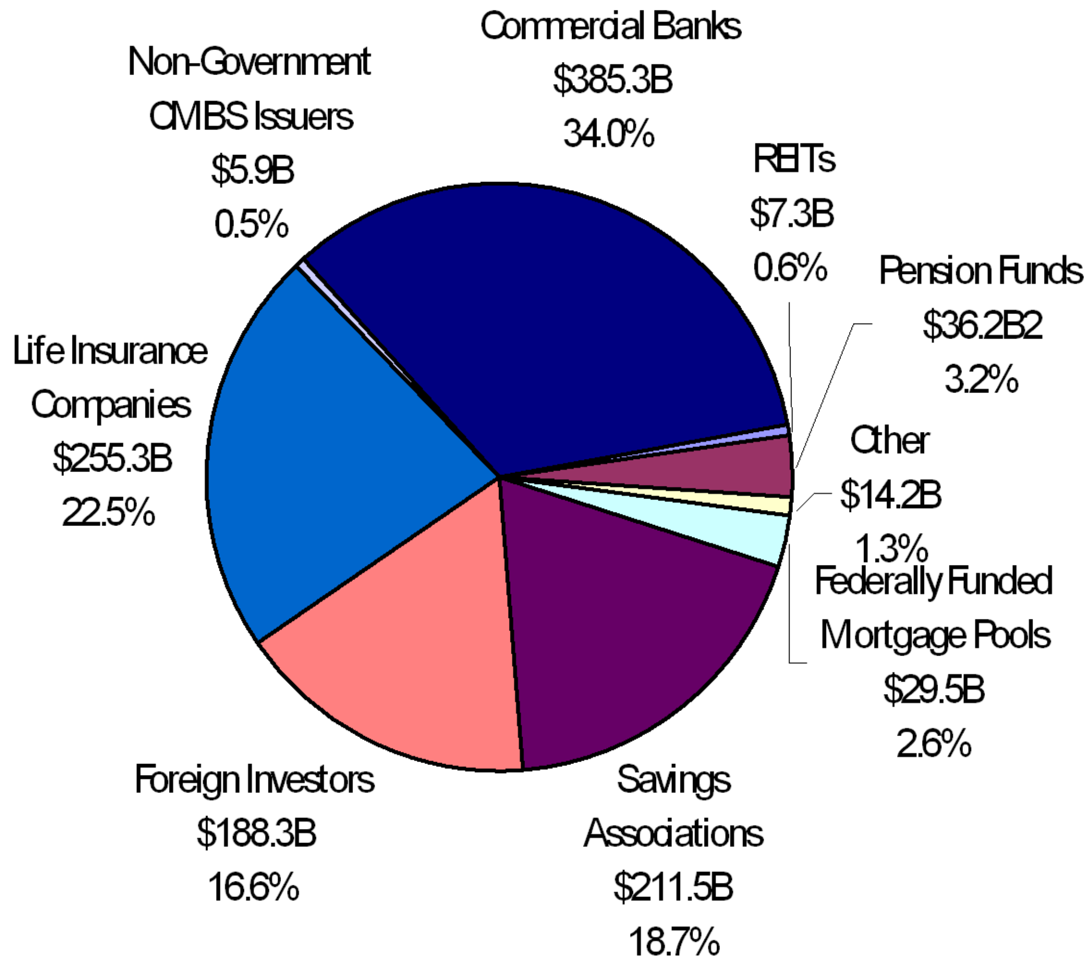
- Federal, state, and local government policy must help to mitigate real and perceived risks of inner city urban development
- Government must take an active role in providing data and increasing market transparency, which would thereby remove some of the barriers to development and bridge the gap between real and perceived risks
- Tax incentives and public subsidies continue to be important in facilitating development, particularly in extremely distressed urban locations

RCG

Blight or Opportunity?

Bronx, NY

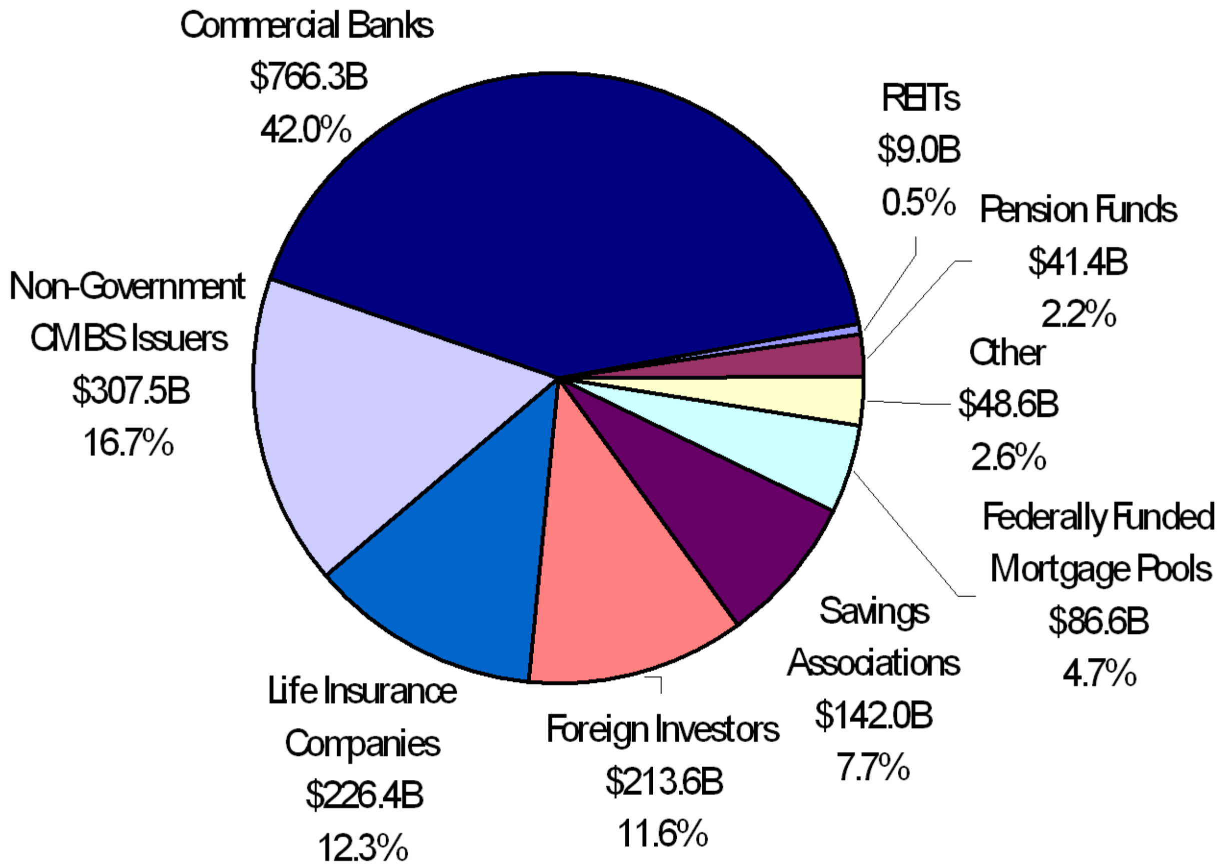
Capital Sources: Total Debt at $1,133.4 Billion
- 1990 -



Source: Rosen Consulting Group and Lend Lease Real Estate Investments

RICG

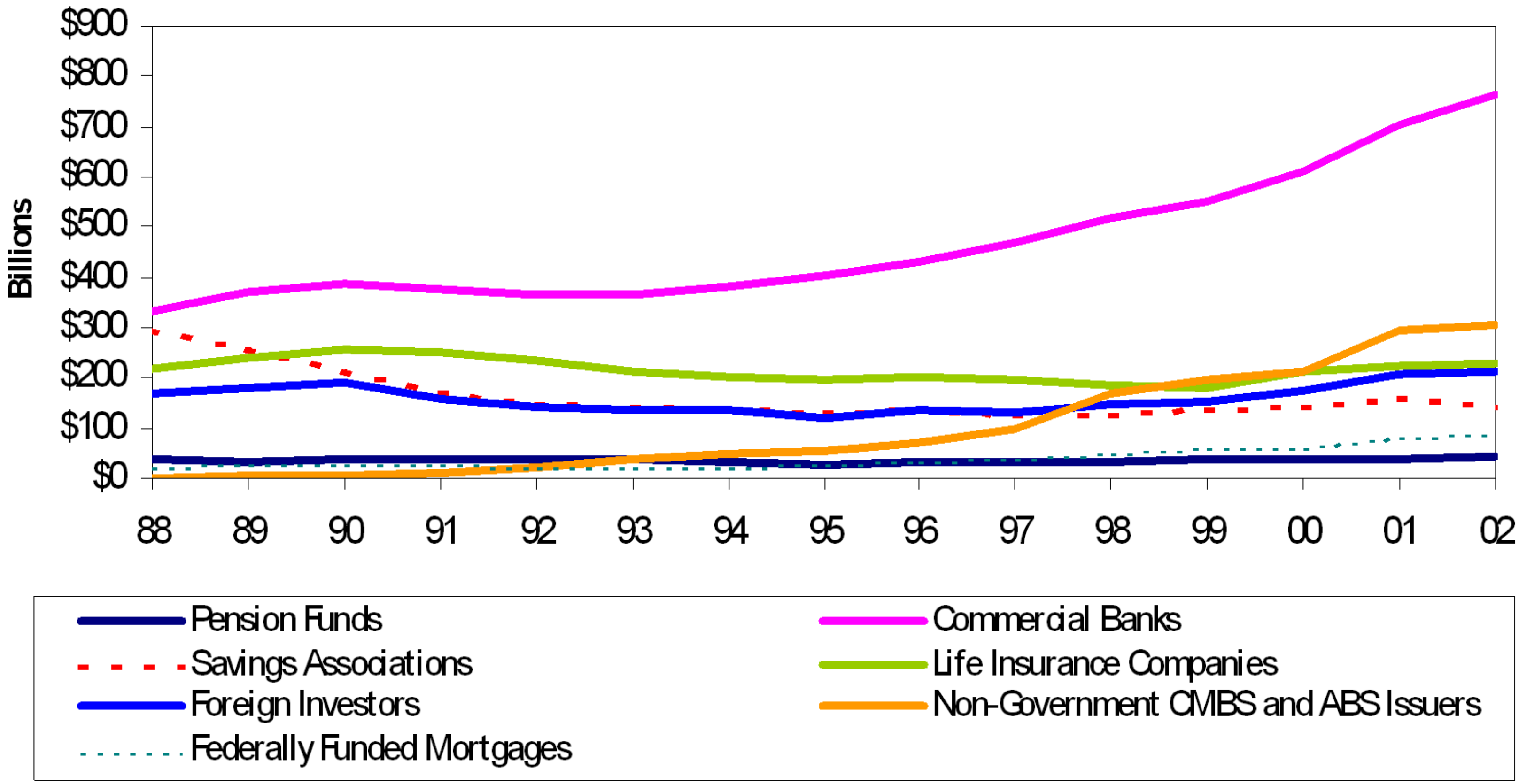
Capital Sources: Total Debt at $1,841.4 Billion
- 2002 -



Source: Rosen Consulting Group and Lend Lease Real Estate Investments

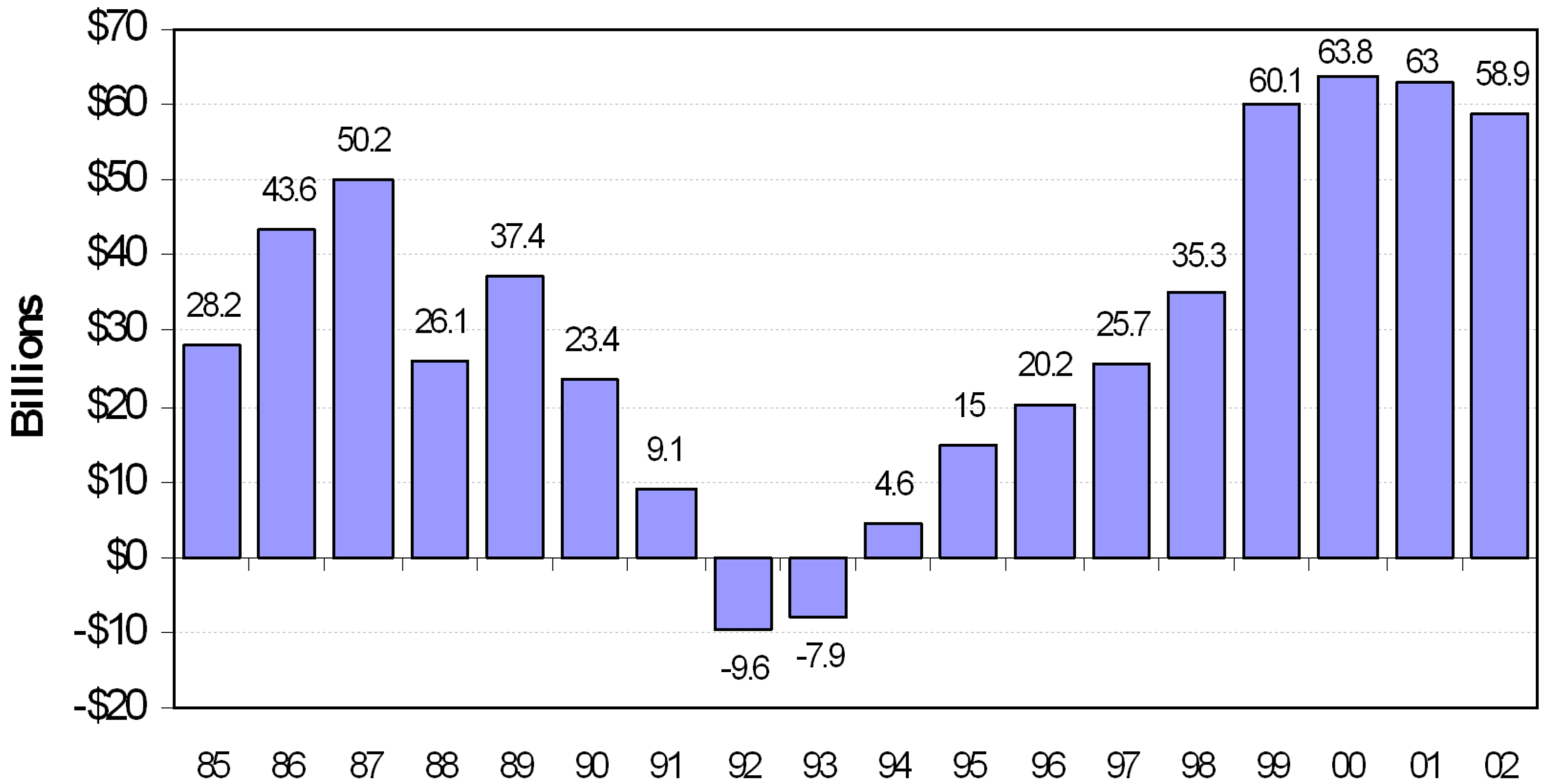
RICG

Real Estate Capital Position: Debt



Source: Money Market Directory, National Association of Real Estate Investment Trusts, Federal Deposit Insurance Corporation, American Council of Life Insurers, Bureau of Economic Analysis, Federal Reserve, Lend Lease Real Estate Investments, Rosen Consulting Group

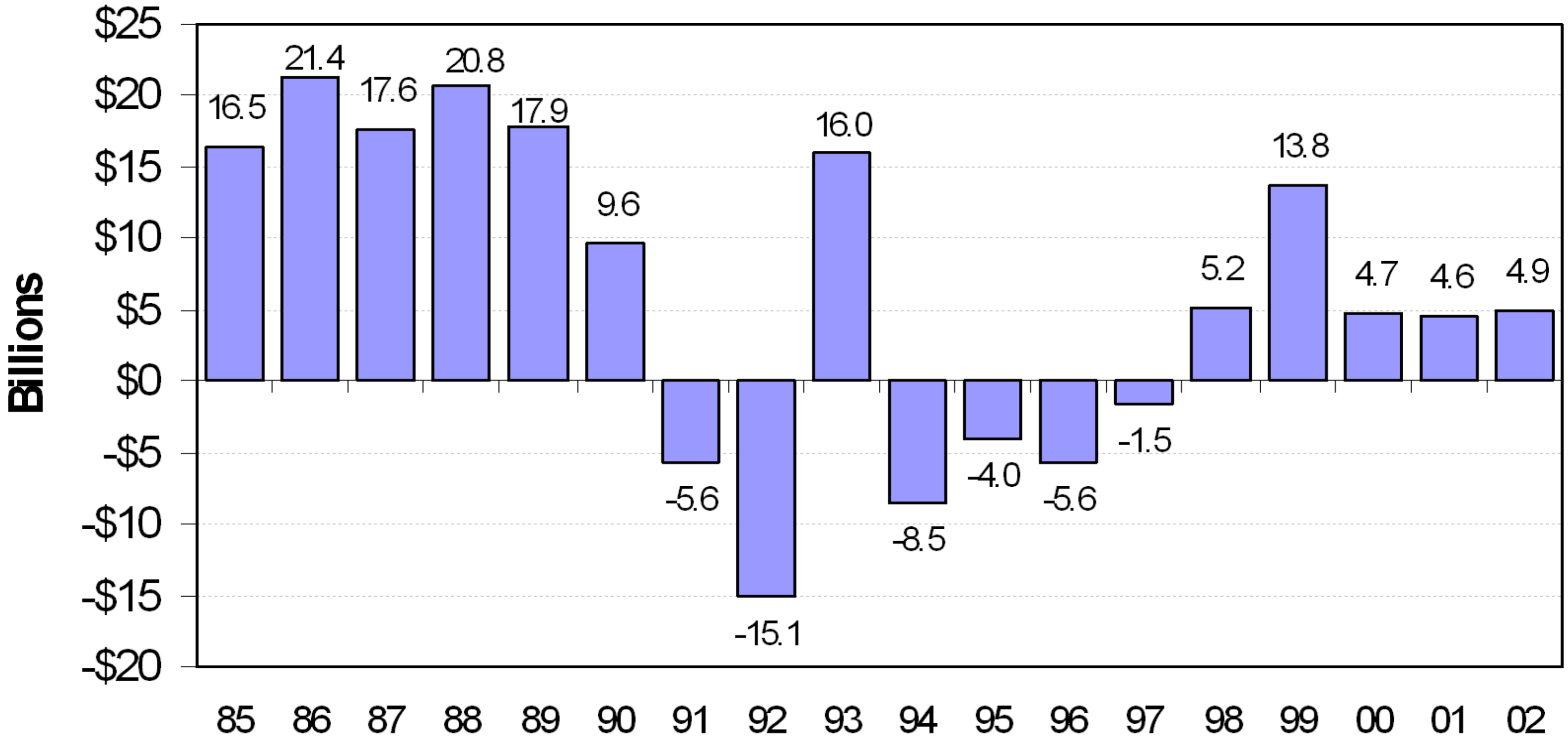
Flow of Funds to Commercial Mortgages from Commercial Banks



Source: Federal Reserve

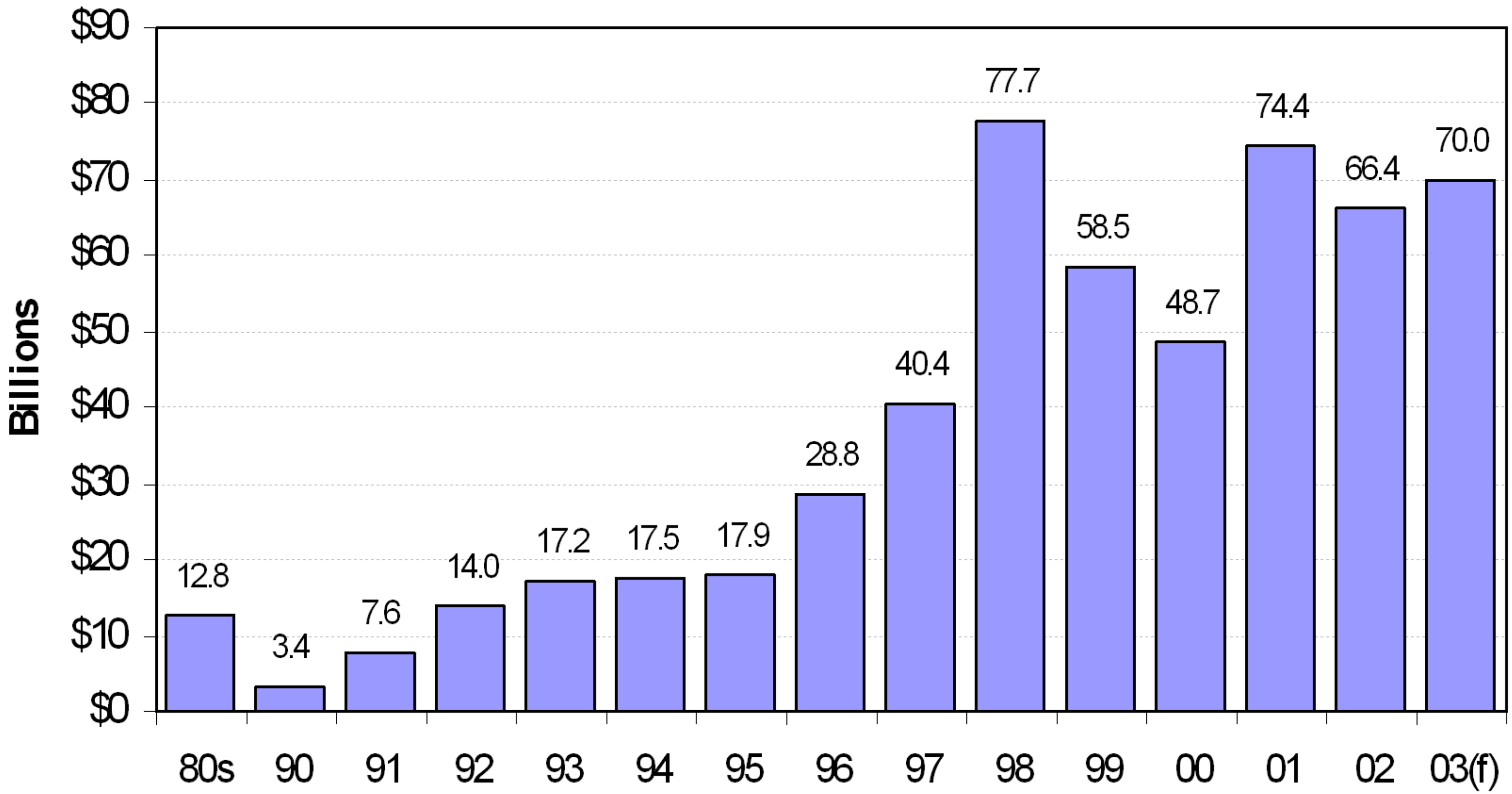
RCG

Flow of Funds to Commercial Mortgages from Life Insurance Companies



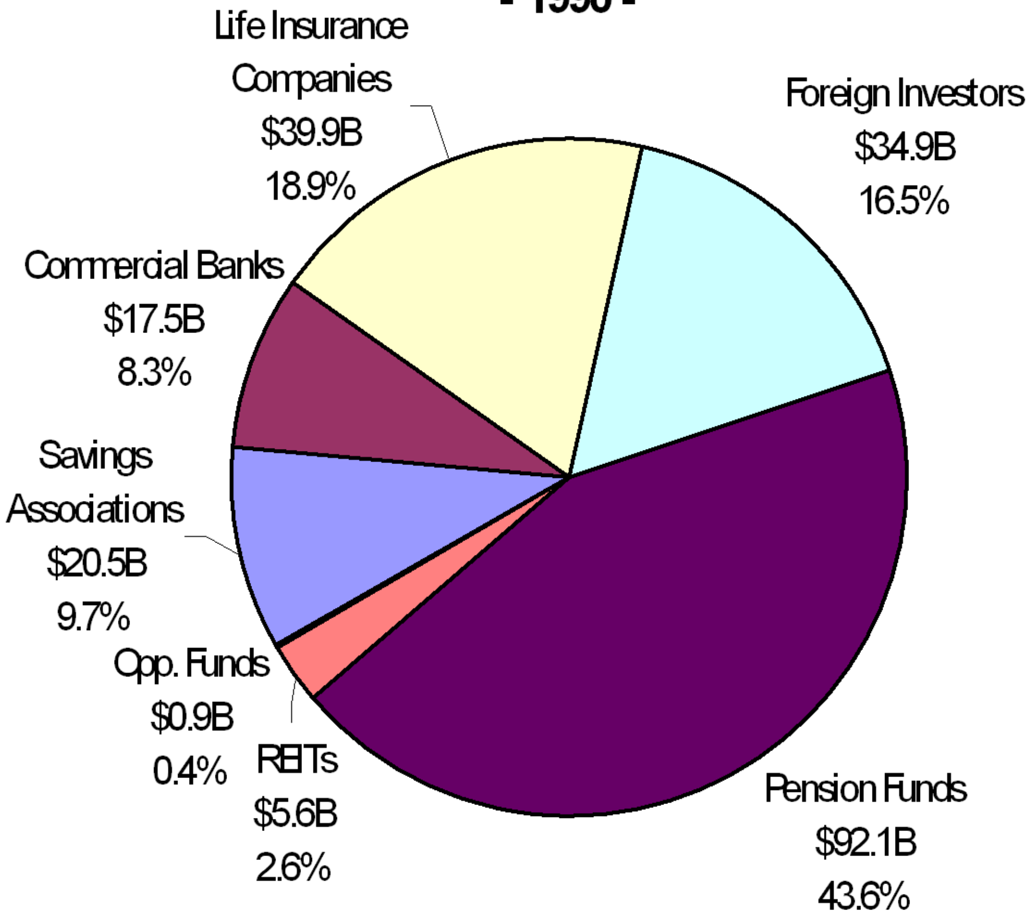
Source: Federal Reserve

Domestic Commercial MBS: Gross Volume Issued



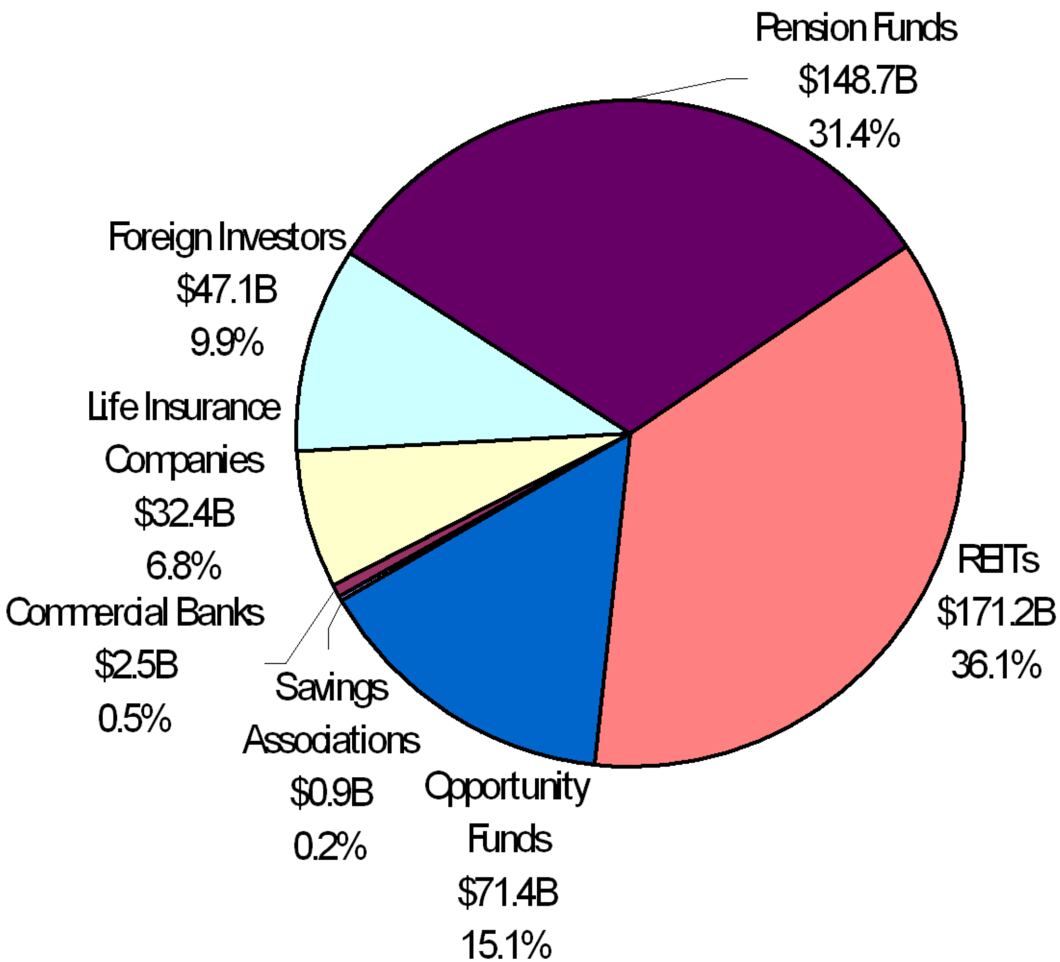
Source: Commercial Mortgage Alert, Rosen Consulting Group

Capital Sources: Total Equity at $211.3 Billion
- 1990 -



Source: Rosen Consulting Group and Lend Lease Real Estate Investments

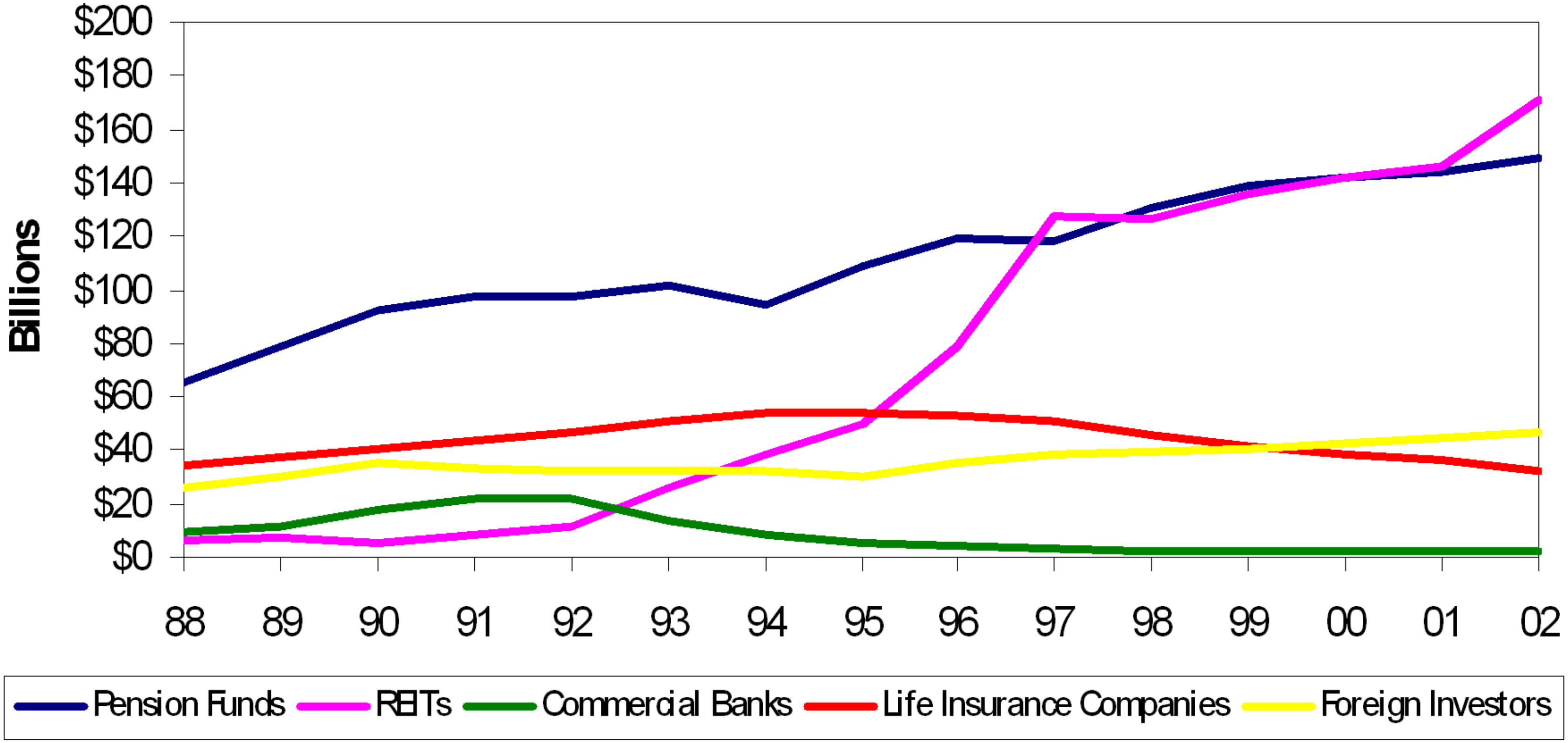
Capital Sources: Total Equity at $474.2 Billion
- 2002 -



Source: Rosen Consulting Group and Lend Lease Real Estate Investments

RICG

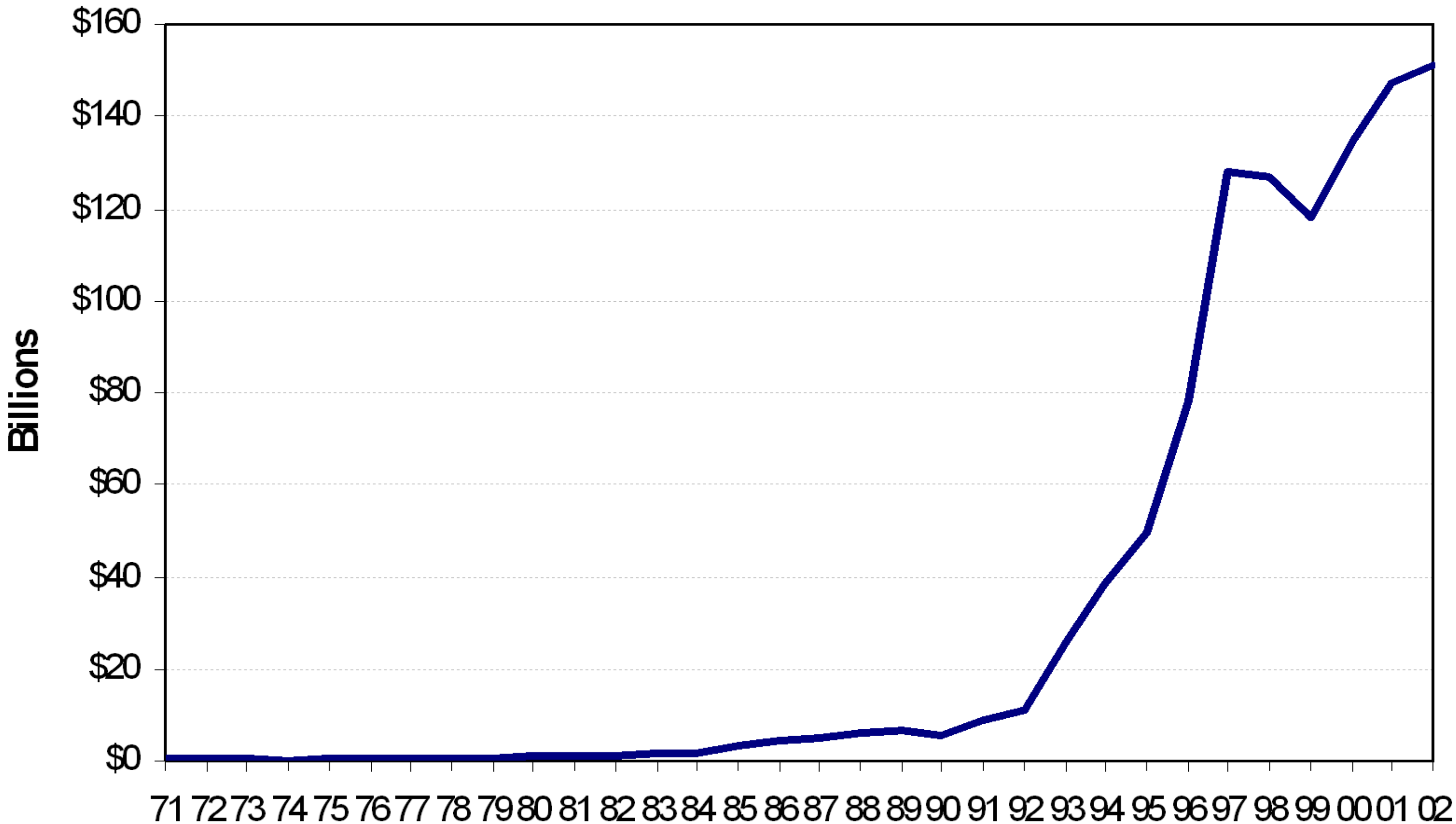
Real Estate Capital Position: Equity



Source: Money Market Directory, National Association of Real Estate Investment Trusts, Federal Deposit Insurance Corporation, American Council of Life Insurers, Bureau of Economic Analysis, Federal Reserve, Lend Lease Real Estate Investments, Rosen Consulting Group

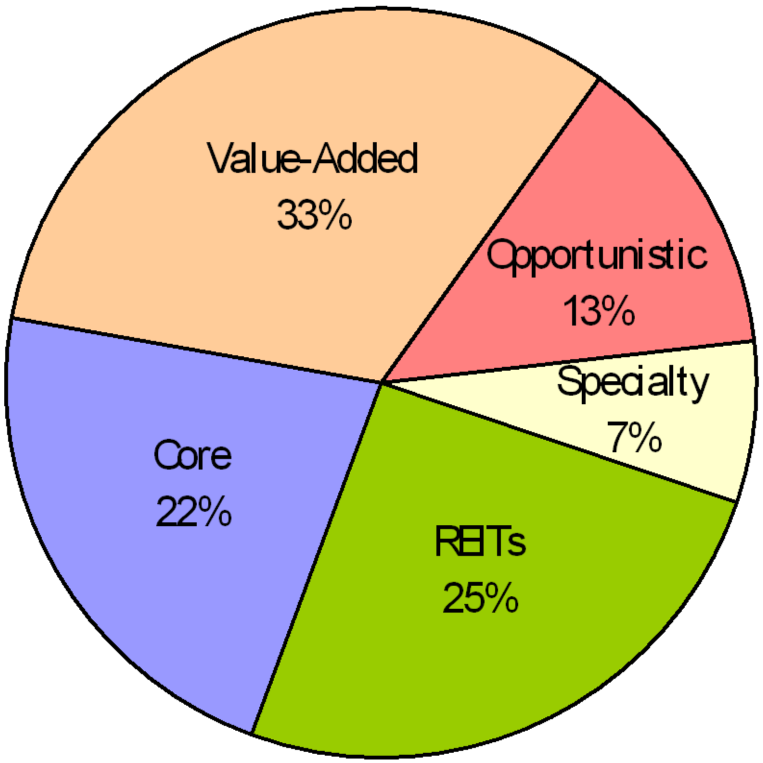
RCG

Market Capitalization of Equity REITs



Source: NAREIT, Rosen Consulting Group

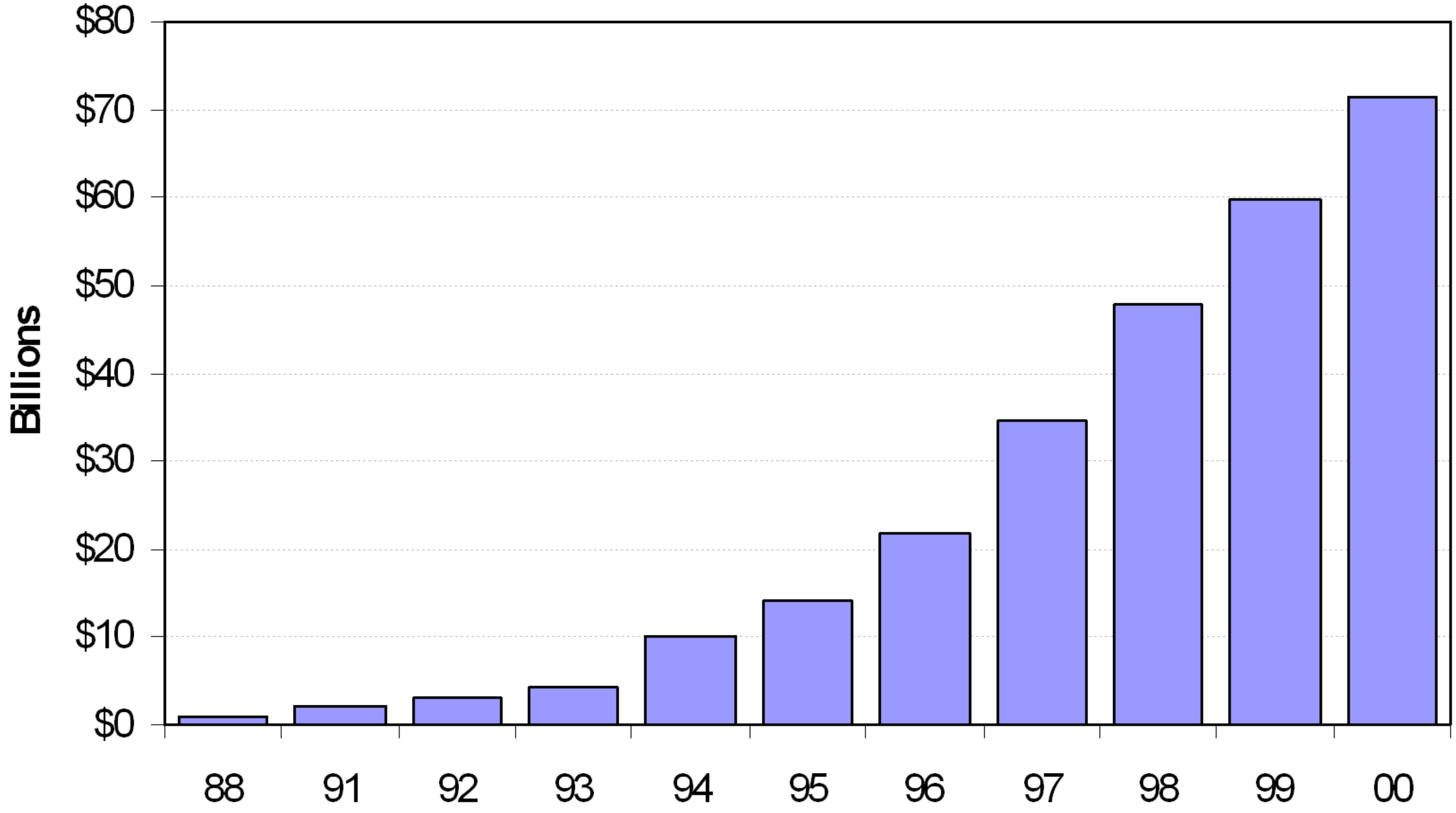
Pension Fund 2001 Allocations*



* As of September 15

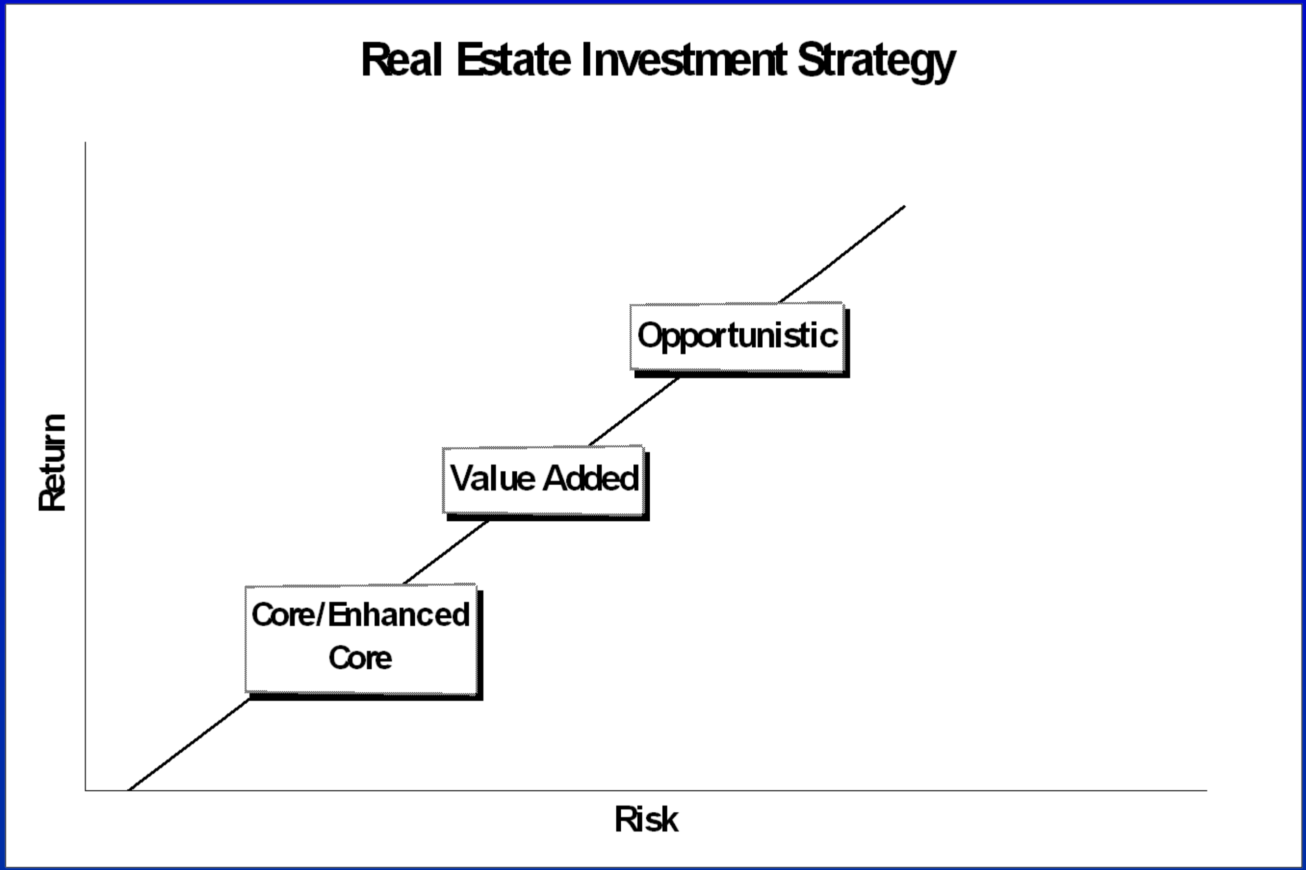
Source: *Institutional Real Estate Letter*, Institutional Real Estate, Inc.

Cumulative Equity Flows to Opportunity Funds



Source: Pension Consulting Alliance, Inc.

Risk-Return Spectrum



- Investors driven by attractive Risk-Return Profile – Assets that will generate the highest possible return with the lowest level of risk on the risk-return frontier

Impact of Greater Securitization on Urban Retail Investment

RCG

- Lenders appear willing to finance urban retail projects, but report low activity in central cities. It is all about debt coverage and tenancy.
- CMBS loans are fairly diversified geographically, but loans tend to be placed in tertiary suburban markets rather than inner urban markets
- Among untested markets, tertiary suburban markets pose less risk and barriers to entry compared with urban markets

Impact of Greater Securitization on Urban Retail Investment

- Equity investors continue to target the top 15-20 markets in the country
  - High Household Incomes
  - Diverse and Stable Economies
  - Liquid Markets

Retail REIT Holdings

RCG

Top Ten Markets by REIT SF Exposure		
Metropolitan Markets	**Total REIT Retail SF**	**% of REIT Assets in Markets**
Houston, TX	18,738,610	3.3%
Atlanta, GA	17,075,690	3.0%
Chicago, IL	14,888,409	2.6%
Los Angeles-Long Beach, CA	13,351,077	2.4%
Philadelphia, PA-NJ	12,186,625	2.2%
Washington, D.C.-MD-VA-WV	11,965,566	2.1%
Dallas, TX	11,525,014	2.0%
Tampa-St. Petersburg, FL	11,099,669	2.0%
Boston-Brockton, MA	10,593,613	1.9%
Orlando, FL	8,650,682	1.5%
Total Top Ten	**130,074,956**	**23.0%**
Top 25 Markets	**227,267,200**	**40.2%**

Source: REIS; SNL Securities; Deutsche Bank Securities Inc. estimates and company information

Top Urban Retail Markets
"24-hour Cities"

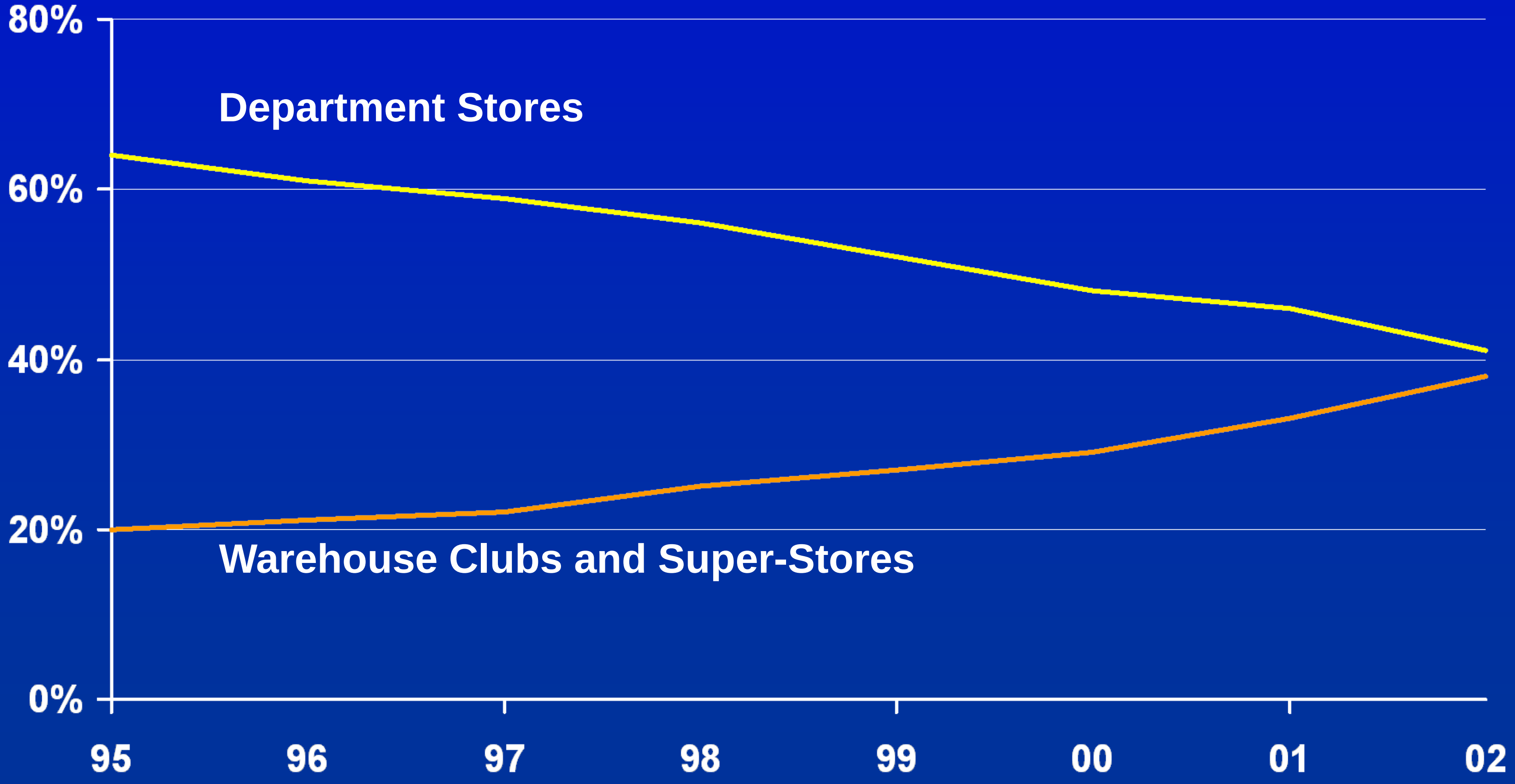
R | C | G

- New York City
- Chicago
- Washington, DC
- San Francisco
- Boston

- Los Angeles Region – "18-hour City"

Super Stores' Sales Cannibalization

Percentage of total warehouse club, super store, department store, Internet and catalog sales



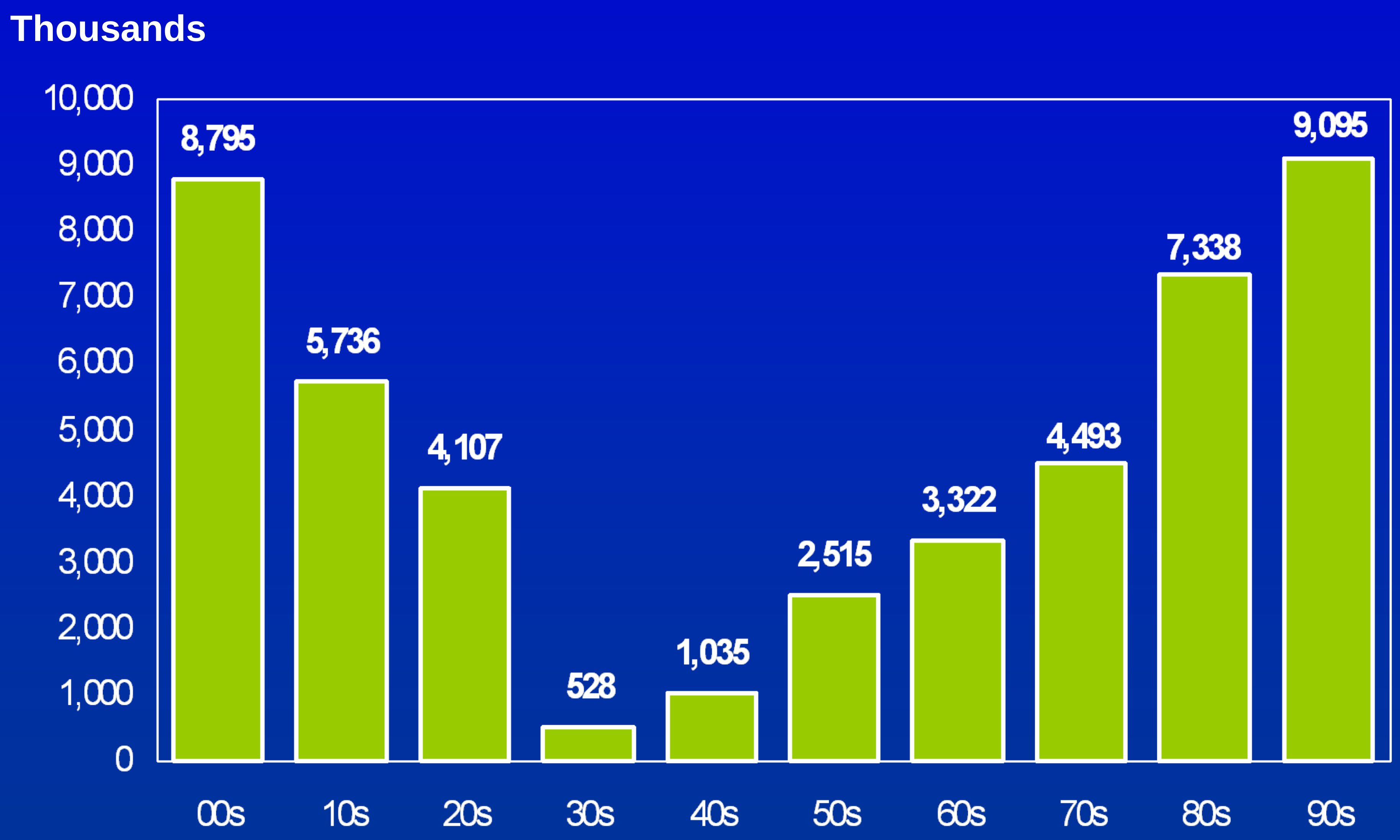
Sources: US Census Bureau

Defining the Opportunity

R | C | G

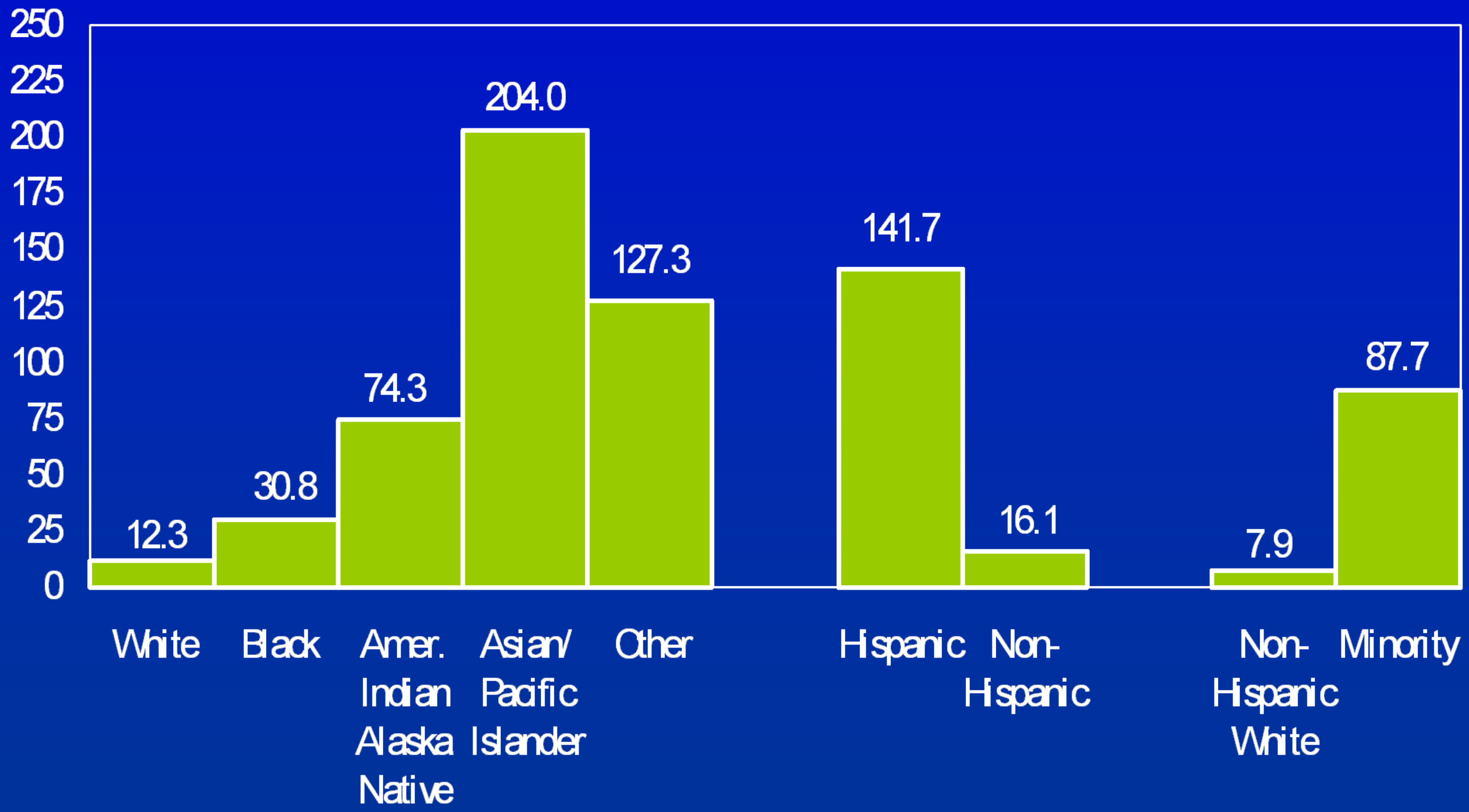
- Central locations
- Underutilized infrastructure
- Lack of competition
- Supply constraints
- High population density
- Strong growth of immigrant populations

U.S. Immigration by Decade



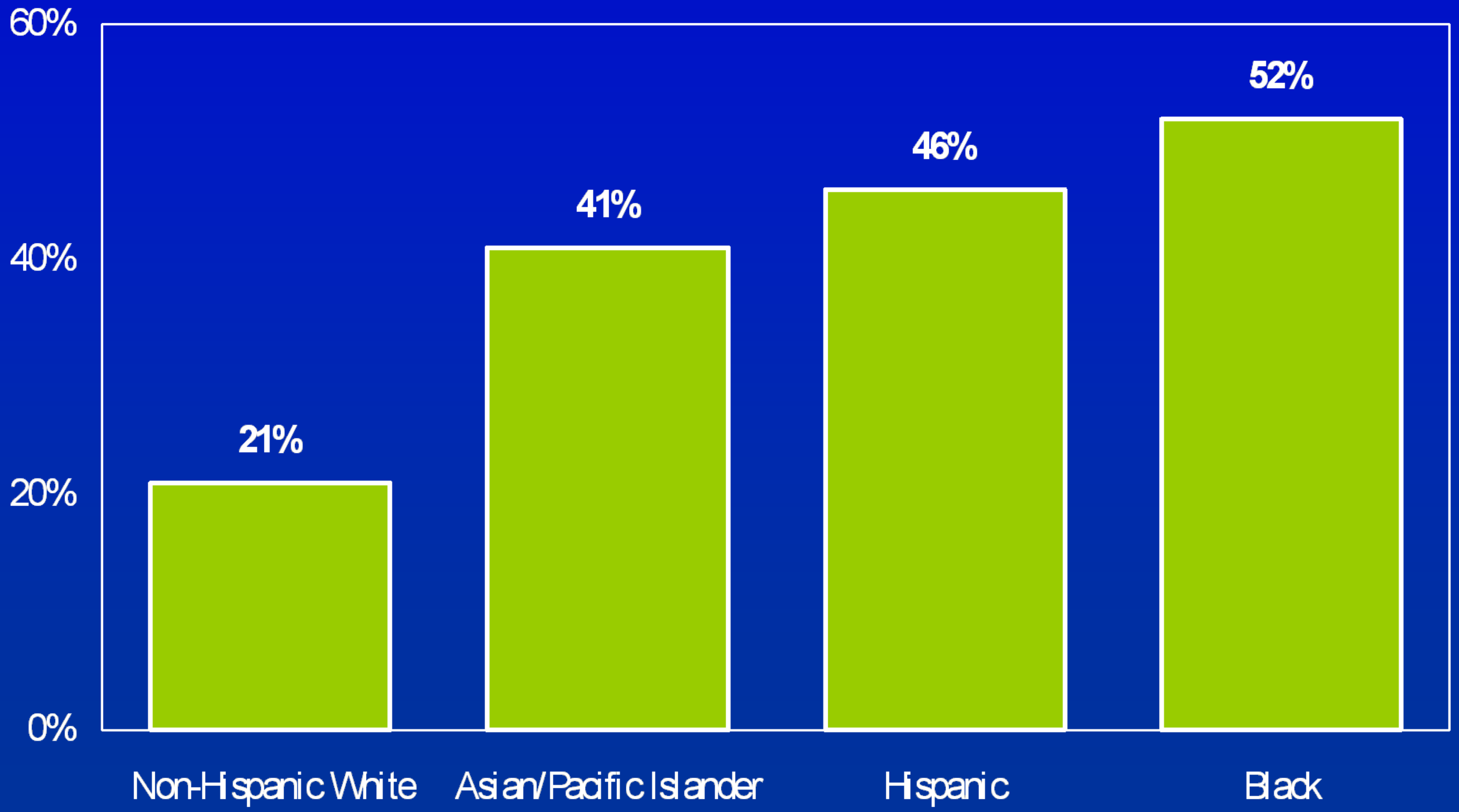
Source: Department of Commerce, US Census Bureau

Percent Change in Population Size by Race: 1980-2000



Source: US Census Bureau

Percent of Population Residing in Central Cities



Source: US Census Bureau

Barriers to Urban Retail Investing

R | C | G

- Real and perceived risks
- Security and “shrinkage”
- Building costs
- Entitlements and approval process
- Land assembly
- Political and community resistance
- Environmental remediation costs
- Securing retail tenants

Some Successes

- Profit-Driven Opportunity Investors
- Socially Conscious Investors and Funds
- National Retailers

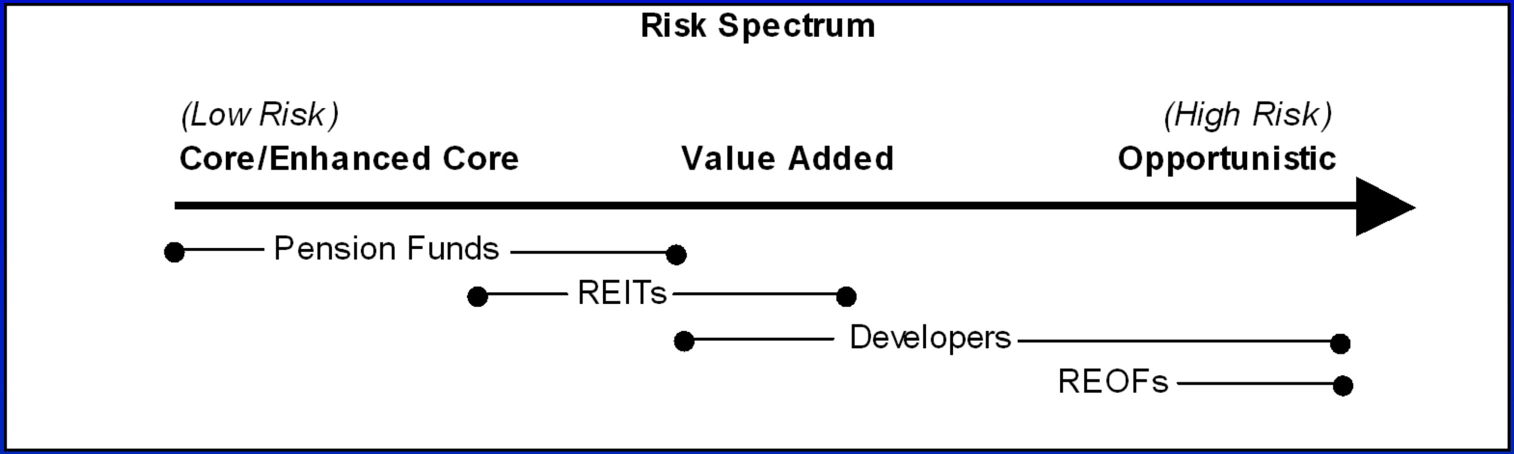
The Right Ingredients for Successful Urban Development

- Tax incentives/subsidies
- Patient money
- Successful track record of public/private partnerships
- High population density and buying power
- Proximity to a diverse economy
- Underutilized infrastructure and central location
- "Fast track" entitlement process
- Assistance with land assembly
- Interested retail tenants

Conclusions

- Mixed implications for inner city retail development
- With the securitization of the industry, there is more potential to do riskier projects in different areas
- However, capital is still resistant to economically disadvantaged areas. Tenancy and sponsorship are key
- Extremely distressed urban areas may be left out without large subsidies

What Can Public Policy Do?



- In order to attract retail development to central cities, policies must focus on mitigating risk

Policy Recommendations

RCG

- **Reducing Real and Perceived Risks**
  - Providing more public information/resources to private sector -- Examples include land parcel database, demographic databases to determine demand conditions, and crime cost information
  - Government Involvement -- Assist with land assembly, provide fast-track approval, shore up community support, and mitigate liability risk of contaminated land
- **Improving Returns**
  - Continue to provide public subsidies to retailers and financiers to mitigate high building costs and security and theft issues

R | C | G

Rosen Consulting

www.rosenconsulting.com