

Analyzing the Risk/Rewards of D-I-Y Vs Teaming With Others in Mixed-Use

[By Don Briggs]

Mixed-use is the newest buzzword in real estate, but developers looking to build these projects should understand one basic underlying fact: combining different uses in one development is more complicated than simply stacking office or housing space over a store.

Developing mixed-use projects requires expertise in multiple formats: residential, retail, office, hotel and infrastructure, and only a few companies have the expertise to build all or most of these formats. In addition, the development process for these projects is longer, the construction more expensive and the prioritization and integration of uses more complex than building each individual element separately.



Pentagon Row in Arlington, Virginia, consists of 296,000 square feet of gross leasable area. It was built in 1999.

Mixed-use developers must carefully analyze the elements in each project and match them with their own capabilities, so that they can make the determination to bring in others or go it alone.

Having developed many mixed-use projects over the years, Federal Realty has learned to adapt its development models to suit each project. For decades, the company was an owner of neighborhood and community retail centers. In the early 1990s, it became involved with mixed-use through the development of Bethesda Row in Bethesda, Maryland. A strong move back to the urban core was taking hold in the country, as empty nesters no longer needed large homes and young professionals were seeking social interaction. The company began by integrating individual urban buildings and retail streets, but soon found that these projects were more complex than a typical suburban retail center. What we needed to do was to design our own street.

The Bethesda Row site is located near a Metro stop, with existing infrastructure - including a county-owned parking garage -- and it was also close to company headquarters in Rockville, Maryland. As a result, Federal Realty could build the project -- office space over ground-floor retail -- on its own.

That project was so successful that the company ventured into two more mixed-use complexes almost simultaneously, but approached them differently. For Pentagon Row in Arlington, Va., Federal Realty built the retail development and Post Properties built the residential portion. In contrast, the company decided to build Santana Row in San Jose, California, alone, learning a great deal about mixed-use development, risks and rewards, as part of the process.

Lessons Learned

Theoretically, developing in conjuncture with another group should mitigate financial risk, while adding expertise to a particular format. Post's experience in multi-family housing certainly helped Pentagon Row, which consists of more than 500 apartments above 296,000 square feet of retail.

But the development arrangement has to be structured properly. By being co-owners directing the general contractor, Federal Realty ended up sharing timing and cost risk from the other party's development. Pentagon Row has a solid yield now, but Federal Realty believes that the project taught them that one company should build the structure and deliver it to the other party.

Santana Row was an even greater lesson in the risk/reward relationship. The company's \$500

and minimizes risk.

Sharing the Risk

Bringing in third parties, however, does not fix all of the difficulties of mixed-use development. In fact, it creates a new set of challenges, including selecting the third party, structuring the deals and then prioritizing and coordinating the different elements. Picking the right third party is the most important part of a joint development. Each group has different objectives and the keys to success are mutual trust combined with complementary skills.

Federal Realty has been very selective in choosing its development team; these companies have proven to be worthy of trust and respect. Federal Realty notes that they have walked away from projects when they felt that the structure wasn't practical, or that the other parties didn't have realistic timing or yield expectations.

The public component must always be involved. Municipalities must be part of the team, not adversaries, particularly since the best projects are being built in infill areas. Indeed, the input from the public participants improves the projects for their citizens. Once the third parties are selected and the deal is structured, the question becomes: how do you prioritize the uses and ensure they work together? This may be the greatest challenge of all.

Making It Work

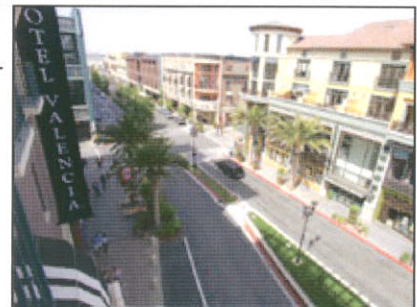
Perhaps this is a bias reflecting the company's retail background, but Federal Realty believes retail developers should be the master developers because their concern is making the other elements work. A critical mass of retail is the catalyst for street interaction. It supplies the necessities of living and creates a culture that will draw residents and office users.

Successful retail developers must know how to balance the needs of the residents with those recreational elements that drive retail spending. For example, even though parks do not generate income in themselves, they can increase retail traffic because people tend to linger and spend more time in the centers. Civic buildings, like libraries and cultural arts facilities, also stimulate traffic. The ground-level retail is the glue that binds the other elements.

Residents require the services typically found in any neighborhood: supermarkets, dry cleaners and banks. An entertainment component, with restaurants, a bookstore and a movie theater, will draw from a somewhat larger radius, from three to five miles away. Lifestyle retail, focused on soft or hard goods -- depending on the market's needs -- is a regional draw.

In addition, coordinating the very specific architectural needs for disparate elements, including the location of loading docks, design of parking garages and even soundproofing and HVAC needs, requires a true specialist in master planning. Because of the extensive experience needed to deal with these many features, Federal Realty generally prefers to serve as the master planner, structure the deals and sell off portions of the entitlements, and at completion, own and operate the entire retail environment.

That doesn't mean that a developer should never assume full development responsibility for a mixed-use project. Size is one deciding factor. Most competent developers can place 40,000 square feet of service-oriented retail under one residential or office building. It may not be perfect, but it



Santana Row, in San Jose, California, was built in 1997. It consists of 563,000 square feet of gross leasable area. Four years after opening its first phase, the development proved to be a good investment.

million investment in Santana Row equaled approximately one-quarter of its total capitalized value at the time, a huge amount for any single deal. The initial phase of Santana Row comprised approximately 400,000 square feet of retail, more than 500 rental residential units and a boutique hotel. The company believed that the upside in the residential portion would more than make up for the risk. When it began the project in 1997, the Silicon Valley housing market was booming.

But Santana Row was a challenge from the beginning. Problems well beyond the company's control, including the dot-com bust and the September 11 attacks, resulted in a major drop in residential and hotel values. In August 2002, a devastating construction fire delayed the opening. What Federal Realty underwrote in 1997 wasn't anywhere close to market rents in 2002, when the first phase opened. Time also is a challenge. Projects such as Santana Row and Pentagon Row take years to assemble, develop and build, and real estate sectors operate in their own market cycles. Retail may be hot during a residential slump; hotels and offices might be out of favor. A company must have expertise in multiple formats because stacking office, residential and/or retail is much more difficult, and certainly more expensive, to build than if the uses are in separate buildings. As a result, a company that builds multiple uses also takes on exponentially greater risk. The tradeoff for 100 percent control is 100 percent of the downside when something goes wrong. And something always goes wrong.

Four years after opening its first phase, Santana Row has proven to be a good investment. But the problems encountered there and at Pentagon Row led the company to reassess how it develops future projects. The development model has been changed to mitigate risk.

Public Involvement

Santana Row and Pentagon Row also taught another lesson - the need for public involvement in terms of master planning, land assembly and mass transit. Bethesda had existing public infrastructure, including a public parking garage owned and operated by Montgomery County, which Santana Row and Pentagon Row lacked. Building the needed utilities and parking decks at Santana Row and Pentagon Row was a huge investment.

The upcoming Rockville Town Square is a public/private partnership with the city of Rockville, Maryland, Montgomery County and RD Rockville LLC (a partnership of Ross Development and DANAC Corp.). The project will include 180,000 square feet of lifestyle retail and restaurants topped by 650 residential units, a cultural arts center and a county library.



Bethesda Row, built near a Metro stop in Bethesda, Maryland, in 1994, consists of 477,000 square feet of gross leasable area.

The complex, on a 12.5-acre site, applies many of the lessons learned. Federal Realty structured the agreements that apportioned the financing and development responsibility. The company contributed 6.5 acres through its ownership of an existing shopping center on the development site and is being paid a fee for master planning and developing the infrastructure. The city of Rockville donated 4.5 acres behind the Federal Realty property and assembled the rest of the acreage. It also will build the cultural arts facilities and supply the infrastructure, including streets, water and parking structures. The residential development rights were transferred to RD Rockville, which will build the vertical buildings and sell the ground-floor retail back to Federal Realty at a fixed price. Rockville's retail is expected to open in March 2007, with the residential properties opening in May of the same year. Federal Realty's \$40 million investment in Rockville is less than one percent of the company's total value. Federal Realty has structured its expansion of the Village at Shirlington, in Arlington, Virginia, in a similar manner. That project is a joint development involving The Bozzuto Group, Trammell Crow Company and Arlington County, and includes neighborhood retail, residential, office and civic development. Bozzuto and Trammell Crow will expand the residential portion of the project, the county will add civic components, and Federal Realty is handling the retail, with the bulk of the project opening late this year. Using experts in each area benefits all

should enhance the street environment. Federal Realty is now building Phase 7 of Bethesda Row, adding residential and more retail to the project, all on its own. Phase 7 is expected to open in spring 2008. But Bethesda is a special situation - The company feels that they know it so well that in this case, they're very comfortable with doing this themselves. But this is certainly not true in most instances.

Mixed-use projects are growing larger and more complex, as the population grows, and people seek more interaction with their neighbors. They are now small cities and require a sense of place and skill sets that often are beyond one individual company. Even with this company's experience in all of these uses, it recognizes that it is smart business to work with other developers. That's critical not just to Federal Realty. As more of these complexes are built, some projects will fail. Some developers will underestimate the intellectual and financial risk of these projects, especially as construction costs continue to rise. Others will build in the wrong location - Federal Realty believes that mixed-use complexes are more likely to succeed in an urbanizing suburb of a major market. Mixed-use is about density, and if the project doesn't have real streets, it's not really mixed-use.

Mixed-use requires the right team in the right place at the right time. Such projects can create entirely new communities, bring new life to suburbs and reconnect its residents, workers and visitors.