

Victor B. MacFarlane, MacFarlane Partners

Urban Real Estate: From Investment Fringe to Mainstream Strategy

Twelve years may not be a long time to pension plan sponsors and other investors with long-term cash needs. For the relatively new concept of institutional investment in urban properties, however, that same time span seems like an eternity.



Victor B. MacFarlane

When the California Public Employees' Retirement System (CalPERS) jostled the institutional investment world in early 1995 by committing \$50 million to an unheard-of strategy—investing in retail properties within underserved urban areas of California—the move was considered by many in the investment community to be little more than social investing. *Urban* equated to *inner city*, which meant charitable grants, limited investment potential, and bleak prospects for achieving anything close to a market return.

Few saw CalPERS's gambit as a legitimate investment strategy that stood on its own merits—even with the ancillary benefits derived from urban property investments, such as job creation and community revitalization. Yet a dozen years later, we can safely say that the urban real estate concept has moved from the fringes of pension strategic thought to the investment mainstream.

A funny thing happened on the way to the inner city. Over time, investors and businesses began to awaken to the unfulfilled potential of low-income neighborhoods. Meanwhile, changing socioeconomic, demographic, and land-use trends began shifting some demand for real estate from the suburbs to existing urban areas, as well as reshaping suburban development patterns to make them more urban-like.

The result: a broadened definition of urban real estate that has expanded the number of options available to investors savvy enough to navigate the urban terrain. Urban no longer is strictly limited to inner city. It includes a wide range of investment and development opportunities awaiting those with an eye on developing, redeveloping, or repositioning properties in urban and high-density suburban

areas. It also captures the best of what investors mean when they talk about smart growth and green investment.

Density, Density, Density

The urban story, stripped to its essence, is a simple one: Density drives demand. The high population densities of urban neighborhoods (and increasingly, those in the suburbs) create significant aggregate demand for goods, services, and housing. This is true even in areas with the lowest income levels.

For example, a 0.5-square-mile, inner-city neighborhood represented by four contiguous Census tracts just west of downtown Oakland has a population of 6,100 (85% of whom are racial/ethnic minorities) and an annual per capita income of just \$13,200, less than half the Oakland metropolitan area's median of \$32,500. Looking at income in the aggregate, however, the total buying power of the neighborhood is \$148 million per square mile.

Thirty miles to the east, a 2.7-square-mile Census tract in suburban Pleasanton has 10,100 residents (38% of whom are minorities), an annual per capita income of \$41,000 and, by multiplying the number of residents per square mile by per capita income, an aggregate purchase potential of \$155 million per square mile.

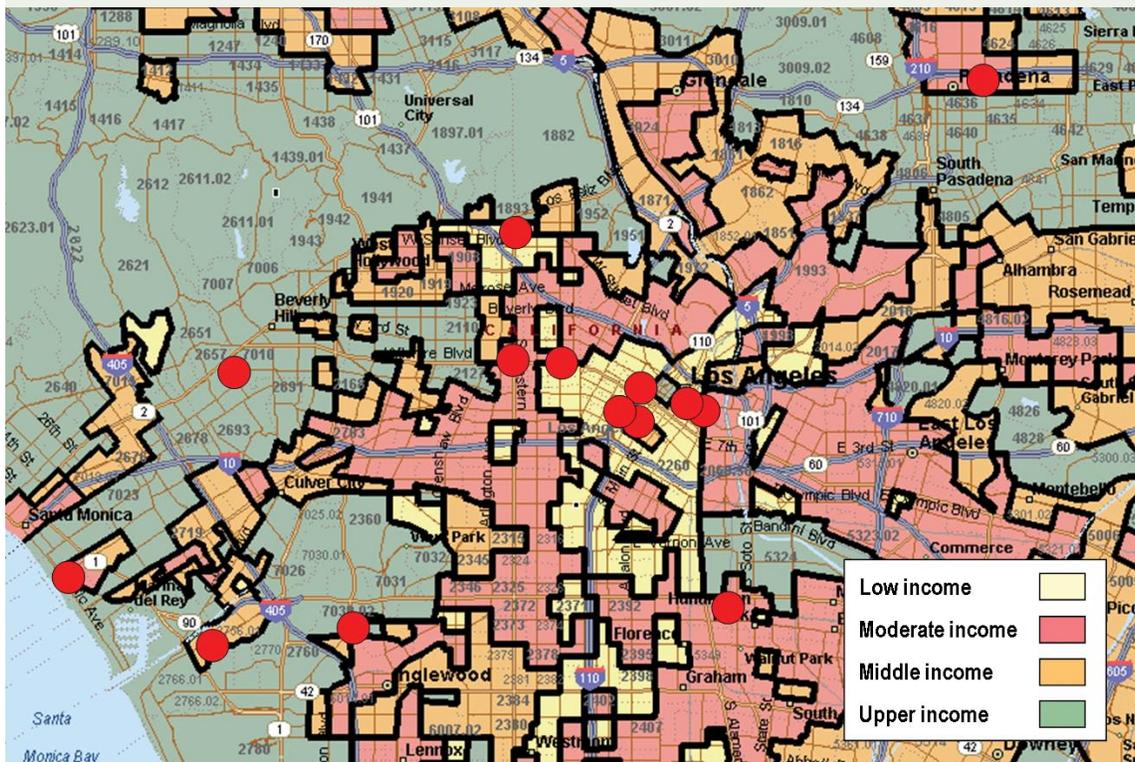
Thus, with a population density that is three times greater than its wealthier suburban cousin (11,200 people per square mile vs. 3,800), the West Oakland neighborhood has nearly as much aggregate buying power on a per-square-mile basis. Guess which area has more supermarkets, restaurants, and drugstores? Guess which has seen little new investment from retailers and property developers over the past 40 years?

As a point of reference, the average population density of the 360-odd metropolitan areas nationwide is 272 people per square mile. Pleasanton, an East Bay suburb at the end of a widely used light-rail commuter line, is fairly densely populated in its own right. Accordingly, the comparison would be even more stark in a more typical metropolitan area.

The Breadth of the Urban Property Market

Investors once took *urban* to mean “inner city,” but a look at MacFarlane Partners’ urban real estate investments in Los Angeles over the past decade reveals the true breadth of the urban real estate market. The firm’s assets (red circles) include properties located in low-, moderate-, middle-, and upper-income Census tracts, as defined by the Federal Financial Institutions Examination Council (FFIEC), and range from downtown/urban-core locations to more suburban settings.

The FFIEC defines “low-income” Census tracts as those where the median family income is less than 50% of the metropolitan-area median family income; “moderate-income” as those with 50% to 80% of area median income; “middle-income” as those with 80% to 120% of area median income; and “upper-income” as those with more than 120% of area median income.



Before my firm—then working in partnership with Johnson Development Corporation—launched the urban real estate program to which CalPERS directed that first \$50 million allocation, we researched retail supply/demand fundamentals within California’s major markets. We discovered several predominantly minority neighborhoods in Los Angeles and the San Francisco Bay Area that had an aggregate purchase potential of more than \$120 million per square mile but little retail space—in some instances, as little as 2 to 5 square feet of shopping center space per person at a time when the national average was 19 square feet per capita.

It was as clear a picture of undersupply as could be painted, but few investors back then were willing to

venture into those neighborhoods. In fact, we were the only firm that responded to CalPERS’s request during the fall of 1994 to propose an urban real estate investment strategy. In the aftermath of the Los Angeles riots two years earlier, the Sacramento-based pension plan was looking for a market-driven strategy that provided a “double bottom line,” earning competitive returns while revitalizing urban communities that consisted of primarily racial and ethnic minorities.

We felt we had a compelling case, one that was supported by sound research that, in many ways, was an extension of broader work on inner cities being done at the time by Michael Porter of the Harvard Business School. Porter since has gone on to found and lead the

Initiative for a Competitive Inner City, which has continued to do significant research in this area.

However, when CalPERS made its urban commitment, others saw it differently. The editors of *Barron's* derided the move: “CalPERS claims that it will receive market returns on its investment. On its face, the claim is silly.” They argued that, if there truly were a market for urban retail properties, then capital would be available through traditional channels.

Theoretically, in a class- and color-blind, public-markets world, the *Barron's* editors had a point. But my own experience—bolstered by our initial research—told me something different. More comprehensive research by The Boston Consulting Group completed in 1998 confirmed our view. Inner-city residents at that time represented an \$85 billion annual retail market, roughly the same size as that of Mexico. However, one-quarter of that demand (\$21 billion) was not being met.

The ensuing years have seen a growing awareness of the power of population density and a greater willingness on the part of retailers and real estate developers alike to set up shop in inner cities and other urban neighborhoods.

True, the developers and operators of such properties can face special challenges they do not see when building or managing a property in the suburbs—security, land assemblage, concerns over the displacement of existing businesses and residents—but good money still can be made from their investments. It is just a matter of finding an effective way of

capturing the demand that is already there. (With the growing focus on investing in properties in emerging global markets, is there any doubt that such issues—and more—exist in those markets as well?)

Smart Growth

Recognition of the latent demand in certain urban neighborhoods is only a part of the story about how urban real estate has been brought into the investment mainstream; the smart-growth movement and the growing desire for the “urban living experience” have played as important a role. The two trends are working to increase population densities not only in existing urban and suburban areas but also in new communities being built along the suburban fringe.

Smart growth emphasizes the efficient use and reuse of land and existing infrastructure. Examples include

- developing mixed-income housing near a major employment center;
- redeveloping a surface parking lot or an obsolete office building on an infill site into a place-making, mixed-use project featuring retail shops, office space, and high-density housing;
- building a mix of commercial and residential space around a public-transit station in a well-established suburb; and
- developing a master-planned community that features a variety of high-density commercial and residential land uses in an emerging suburb.



MacFarlane Partners

Smart Growth: Developed on a long-vacant industrial site that required extensive environmental remediation, Bay Street Emeryville is now a thriving “urban village” near the San Francisco–Oakland Bay Bridge that features more than 70 shops and restaurants, a 12-screen movie theater, 284 rental apartments (20% of which are for low-income residents) and 95 for-sale condominiums. It was completed in 2006.

Driving the smart-growth concept is the inexorable growth of the U.S. population, which is expected to reach 364 million by 2030. At current metropolitan-area population densities (an average of 272 people per square mile), those 64 million net new residents would require the development of another 236,000 square miles of land—7% of the nation's total land area.

To accommodate that growth by sprawling beyond today's suburbs in the same low-density, decentralized development

pattern of the past 60 years seems not only unconscionable, but undesirable if metropolitan-area residents are to maintain any semblance of their quality of life. Who wants to lengthen already-stressful commutes, pave over more open space, and further degrade the environment? Smart-growth advocates believe a more attractive alternative is to live more densely within existing urban and suburban areas while developing new acreage more efficiently.

Few of our daily routines affect the quality of life more than the drive to and from work, which, not surprisingly, has grown more time-consuming in recent years. Commuters in the 13 largest metropolitan areas studied by the Texas Transportation Institute at Texas A&M University spent an average of 61 hours stuck in traffic in 2003 (the latest year for which such information is available), more than doubling the 23 hours they whiled away in their cars because of congestion during 1982.

The worst traffic nightmares were Los Angeles (93 hours of traffic-time delays); San Francisco–Oakland (72 hours); Washington, DC (69 hours); and Atlanta (67 hours). Smaller metropolitan areas also were not immune to the problem. On average, commuters in Austin, Denver, Orlando, Riverside–San Bernardino, and San Diego sat through delays of more than 50 hours during 2003.

The 'Urban Experience'

Along with the convenience of shorter commutes, the allure of city living is another factor spurring development in cities and close-in suburbs. The "urban experience" is one filled with daytime and nighttime entertainment options and a panoply of retail and dining choices, all of which are interspersed with rental or for-sale residential uses. It is a lifestyle that traditional suburban developments, with their segregation of residential from commercial land uses, typically have not provided.

In cities throughout the country, a residential renaissance is turning once-staid commercial districts and neglected residential areas into lively, 18-hour neighborhoods where people can live, work, and play. Mixed-use high rises—residential condominiums or apartments built amid lodging, office, and/or retail components—are now being developed in cities such as Dallas, Houston, and Phoenix that are more known for their sprawl than for densely populated urban neighborhoods.

A similar phenomenon is happening in the suburbs. High-rise residential and commercial properties are sprouting up in Orange County; Stamford, CT; and other areas where low-rise development has been the norm. In addition, many of the new low-rise developments that are being built



MacFarlane Partners

Building Urban, Building Green: Located in the Battery Park City master-planned community near the World Trade Center site, Tribeca Green has helped bring residents back to lower Manhattan in the years since 9/11. Completed in 2005, the 24-story high-rise has 274 rental apartments with 5,500 square feet of ground-floor retail space and a green building design that features a photovoltaic electrical system powered by rooftop solar panels, a blackwater-treatment system and other environmentally sensitive measures.

have greater densities. Some properties re-create a fashionable neighborhood shopping district by situating commercial and residential uses around a main street or city block (for example, Bethesda Row in Bethesda, MD), and new master-planned communities mix single-family residential, multifamily, and commercial land uses on adjacent parcels, such as Playa Vista in Los Angeles and Stapleton in Denver.

Demographic groups most drawn to urban and “urban-escue” living are those without children: young singles and couples in their 20s and early 30s and older empty nesters who no longer need their large homes and/or have tired of the expense and hassle of maintaining their properties. Both age cohorts are expected to grow in the coming years as more members of the 76-million-strong baby boom generation, born between 1946 and 1964, near retirement age and the number of 20- to 34-year-old echo boomers peaks at 67 million in 2015. Meanwhile, the number of U.S. households without children is at an all-time high (65%) and is expected to continue to slowly increase for the foreseeable future.

Nowhere is the urban living trend more pronounced than in downtown Los Angeles, where a residential community is being built before our eyes. Once a ghost town after 5 p.m., downtown Los Angeles is undergoing a dramatic transformation as people flock to its burgeoning cultural and entertainment scene.

Reversing a long-standing pattern, the population in downtown L.A. is growing more quickly than the Los Angeles metropolitan area as a whole. In the year 2000, 86,000 people lived within the six ZIP Codes that compose the city’s downtown; by 2011, the resident population is expected to reach 104,000, according to DemographicsNow.com. Although those numbers are not eye-popping, they do represent growth of more than 21%, which nearly doubles the forecast growth rate for the U.S. population and exceeds projections for L.A. citywide, L.A. metro (11% each), and the state (16%).

Why the growth spurt? Mainly proximity to work and the attraction of living in an urban setting. Those were the top two responses in a survey of residents who had moved downtown in the last few years that was released this past February by the Los Angeles Downtown Center Business Improvement District. The survey also found that half the new residents were between the ages of 18 and 34 and that 73% were childless.

Widespread Acceptance

CalPERS recognized the significance of the smart-growth and urban-density trends in 2000, when it expanded its urban real estate commitment beyond retail properties in under-

served urban areas to encompass a wide range of property types and urban locations, provided that the investments furthered smart growth. Since then, the \$245 billion pension plan has built a \$4 billion urban real estate investment program that includes 12 real estate managers and has provided an internal rate of return (IRR) of 20.5% since inception.

Other pension plan sponsors and institutions also have moved to capitalize on urban real estate investment opportunities, attracted perhaps by the performance of CalPERS and other early entrants to the market; the 15% minimum IRRs that investment managers still promise to deliver; and the favorable characteristics of urban property markets, which tend to have higher barriers to entry and generally are less prone to overbuilding than their suburban counterparts, where developers can build projects more quickly and at lower cost.

There are also the ancillary benefits that result from urban development and redevelopment: a more efficient use of land and infrastructure; reduced traffic congestion; improved air quality (from shorter commutes); and the revitalization of urban communities through development projects that create jobs, build new housing and commercial space, and give neighborhoods both rich and poor a better “sense of place.” Executed properly, urban investments do often provide a “double bottom line” in ways both quantifiable and immeasurable.

Perhaps as much as \$10 billion in institutional capital has flowed into urban real estate commingled funds and investment ventures during just the past few years—and the appeal of the concept continues to spread. Investors today have a growing number of urban real estate options from investment managers large and small. Some firms dabble in all aspects of urban/smart-growth development, from inner-city properties to high-density, master-planned communities in the suburbs. Others specialize in specific sectors, such as brownfield redevelopment and affordable/workforce housing. There are even strategies that limit investment to a particular city.

Looking back at the past dozen years, we indeed have come a long way. No longer does the investment world view urban investment as a black hole that will suck in capital without providing an adequate return to any investor foolish enough to approach it. Instead, urban has become an integral part of the institutional real estate landscape, an increasingly vibrant sector that (thanks to underlying land-use trends) has grown sufficiently large to give investors access through a variety of strategies—and plenty of reasons for doing so. ■