

Redevelopment in the Twin Cities A Developer's View

Prepared by Stacy Becker for the Family Housing Fund and ULI Minnesota

Introduction

The Family Housing Fund's "Rethinking Housing" series of community discussions focuses on the impact of economic and demographic shifts on the Twin Cities housing market. These discussions, and the consensus emerging from them, make clear that rethinking housing requires rethinking *how* housing is created. And central to how housing is created is the process of redevelopment.

A number of reports have been issued on the topic of redevelopment over the past several years. However, few carried the momentum to actually influence change, and many were short on implementable specifics. The objective of this report, which was commissioned by the Family Housing Fund and ULI Minnesota, is to build on these earlier efforts by offering greater detail about the challenges of redevelopment, and using this knowledge to create an action plan for metro area leaders.

This report was compiled from private interviews with ten developers who routinely do redevelopment projects in the Twin Cities metro area. The developers were asked about their decision-making processes: What do they look for in determining which projects to pursue? What incentives or disincentives are important to them? Their views were not unanimous, but nearly so, and the following summary represents a composite view of their perspectives.

This report presents a one-sided view-- that of developers. It became clear over the course of the interviews that a new type of interaction between developers and public officials is necessary if redevelopment is to be made easier and less costly. As such, this report is meant to foster a discussion among public officials, and between public officials and the development community, with these findings as *a starting point*. It is not intended to serve as a definitive, or even objective, statement of redevelopment challenges. Nor is it a statement of the views of the Family Housing Fund or ULI Minnesota, who commissioned this report. The views expressed in this report are solely the interpretations of the author's.

It is possible that many city officials and other non-developers will take exception to what are listed as "findings" in this report. However, these findings are indisputable in the sense that they only purport to portray a developer's point of view. The findings are not put forth with the expectation that city officials should agree with developers' assessments. Rather, it is important that city officials be aware of these views. The views of developers may be dismissed, but to some degree they will stand; for this is the basis on which developers decide whether or not to pursue projects in Twin Cities communities.

Findings

Current market conditions: don't expect much development in the next five years

Most developers agree that not much building is likely to place within the next five years. This holds true for the light rail corridors as well, although conditions on any given parcel may be conducive for development.

In greater detail:

- There currently is too little demand and too much market risk to expect much building, including housing, over the next five years.
 - The single-family market is saturated, and even market rate rental is financially marginal.
 - Rents will need to go up to an estimated \$1.85 to \$2.00 per square foot to spur significantly more housing development. This is roughly the range at which new units can be constructed without subsidy. A

- lower unemployment rate will also be needed to induce more housing development.
- Fewer people are being qualified for home loans.
 - Banks won't finance infill retail.
 - There is essentially no office market.
 - Senior housing and student housing are really the only things working in this market.
- Access to capital is a big problem now. Traditional sources of equity from private investors have dried up, cities' financial resources are strapped, and lenders are imposing stringent new requirements. For example, lenders are requiring 65% loan-to-value on their loans, so developers must put more cash into deals and therefore can't do as many projects. Personal guarantees are required. Also, for some, HUD is the only financing available, and HUD is notoriously difficult to work with (i.e., time-consuming, inflexible, and slow--as long as a year to obtain approvals-- with outdated underwriting requirements such as standard parking near light rail and existing parking ramps).
 - The capital markets will finance only the "tried and true" in housing, even though we are at a point where we need to move forward with very different models, such as different types of units, or units without parking. It is not clear how the "new" can be financed.
 - Affordable housing is being done in this market because it's one of the few sources of capital.
 - Banks are imposing difficult terms on new and existing developments that erode the developments' financial viability.

Future market conditions are expected to look quite different, and we must be receptive to what this implies for redevelopment

Developers talked a great deal about future market conditions-- driven by both economic and demographic changes-- and how this shapes their calculations of what to build. One developer stated, "The world of planners is dominated by autos and suburbs; while the future is one of the Internet and electronics. Will we make decisions based on a general population that is less affluent and older? What do people think is going to be the income, population, and transportation of the next 50

years?" Specifically, developers foresee smaller homes, more rental housing, and more housing in the urban core and developed suburbs.

Some noted that the Twin Cities remains an auto-oriented culture. For developers, who must have tenants or buyers to get financing, this means that a project will only be financed if it includes the parking associated with an auto-oriented culture. Others expressed concern about the rising costs associated with owning housing--that is, sewage, water fees, and taxes. If these fees continue to rise faster than income, will it make the housing market even tighter?

Finally, questions arose about the right land use mix for the future. "Who wrote the book that says everything has to be housing? We should be asking 'What is a sustainable economic mix for cities... more housing?' Maybe we should have land uses that don't require so many schools, police and firemen; housing requires more services. Our obsession with population numbers is less sustainable." Another developer observed, "Most of the best neighborhoods-- most popular with the most resilience in property values-- are the ones that have all kinds of uses mixed in together."

Project decision-making is based on minimizing risk and uncertainty

Development is a business filled with risk. Developers choose projects where the risks are fewer and/or more manageable. They look at how many variables, how many unknowns could make a project fail. The key questions they ask when deciding whether or not to pursue a project include:

- How many risky variables are there? Can we effectively mitigate these risks?
- What amenities exist near the site, such as parks, transportation, retail?
- Is the city really committed to this project?
- Does the city have the necessary resources to make its vision a reality?
- Is this a city that trusts us and will establish a positive working relationship?

Light rail is certainly considered an amenity, but some developers point out that it alone is an insufficient reason to pursue a project. This is especially true in certain markets such as commercial/office, where the mindset of tenants is that parking is

mandatory (and free in most suburbs). Others suggested that it would help if there were more certainty about how the transit system will be built out (a few lines don't make a system); until then development is still too risky. As one developer said, "Some areas along light rail will be stark and dark; some will be very good."

The biggest challenge is political uncertainty

Developers routinely deal with risks such as market demand, interest rates, site contamination, historical renovation, and construction schedules. These types of risks go hand in hand with redevelopment, but developers feel they are simply part of the skill set required of an experienced developer. The biggest challenge, cited over and over again, are political risks. As one developer stated, "I can deal with known risks, but I have a hard time with the political process."

Perhaps political risk rose to the top because it is seen as an unnecessarily huge challenge in a business already fraught with challenges. In terms of risk management, they have little control over this area of their business. Moreover, the rules are so unclear, in their minds, that they can't take effective steps to manage political risk. A more detailed exploration of developers' views of political risk follows.

Distrust leads to poor working relationships. For the most part, developers characterized the attitude toward them as hostile. They regret being regarded as unscrupulous, greedy and not to be trusted. Developers want to work in partnership with cities; indeed some see it as essential to a successful project. As one developer said, "There are so many hurdles, a positive working relationship really helps." Another said, "I see clearly how differently public officials respond to me in my roles as planner (trusting) vs. developer (distrustful)."

Nearly everyone spoke of how challenging redevelopment/urban infill is, using words like "brain damage" and "heroic" to describe the process. Yet many relish the challenges, and take pride in their skills to successfully conquer the challenges. Some developers see the expertise they've gained doing redevelopment as a competitive advantage. Local developers, especially those willing to undertake redevelopment, spoke of being driven by motivations beyond monetary gain. Many

expressed the desire to help improve the communities in which they grew up and/or are now a part of. And reputation is important for any developer intending to stay in business.

Distrust of developers often leads to subpar outcomes from a developer's point of view. When cities contract with engineering or master planning firms, for example, cities understand that they are contracting for certain types of expertise and experience. Cities are clear about what they want, and if not, they understand that part of what they are paying for is to arrive at that clarity. The relationship is straightforward, and the expertise of the consultant is respected.

Developers, on the other hand feel that city officials do not respect their expertise and are not forthcoming about their objectives, which means that developers must second-guess what a city is looking for. This can prolong and increase the cost of pre-development, which a developer cannot recoup if the project does not proceed. From the developer's view, it is a wasteful way to conduct business.

Developers are looking for clarity and commitment. This starts with leadership from the top. Most developers agreed that the type of clarity most helpful to them is rarely forthcoming. One in fact, says that the only case of clear vision he has witnessed in the last twenty years was St. Paul Mayor Kelly's goal of 5,000 units of housing.

Clarity and commitment are important to developers for a variety of reasons. First, it enables the development community to respond with the types of projects cities are looking for. Second, a strong statement from the top helps create alignment across agencies, and across permitting and financing authorities. Developers routinely experience inconsistency across agencies or across the development process as it moves from staff to the planning commission to the city council. Developers feel that they shouldn't have to broker disagreements between staff, or start all over again with every step in process. Third, clarity and commitment create more certain conditions over a period of years, which is the timeframe for sizeable developments.

Cities, especially planners, need to better understand the market and what is feasible. The flip side of being unclear about outcomes is insisting on certain types

of development that won't work in the marketplace. A major challenge-- mentioned by every developer-- is the mental models of local officials, especially planning staff. Cities redevelop via plans, whereas developers are constrained by the marketplace, both broad market trends and site-specific realities. Developers may indeed believe in and want to create more TOD and mixed use neighborhoods, but suggested that cities need to have a firmer understanding of how strongly the market shapes success. "The light bulb is not on at planning departments," said one developer. Another said, "Things change because of variables, not because planners want it;" and a third, "Cities misunderstand who the demographics are; we must recalibrate our view." Cities plunge forward with plans that are not financially realistic. And while the market is changing fast, zoning and planning don't keep up.

Why is this important?

- Expectations (that can't be met) are raised among residents;
- Projects get scuttled or turned over to new teams of developers, all of which tends to cost cities and developers money;
- Projects end up requiring higher subsidies than budgeted;
- Projects fail economically once developed;
- Projects are delayed (which costs money).

Moreover, the development process becomes a matter of competitive advantage for cities: in a weak market where developers must be selective about which projects to pursue, they'll work in cities where they have strong working relationships (everything else being equal).

Of course, cities are often designing in advance of the market. In that case, developers feel that city staff should familiarize themselves with the increased risk involved and/or the need for subsidies to make a project work financially. It is not unusual, however, for developers to agree to cities' wishes. When asked why developers would agree to conditions they know won't work, one developer said, "They get browbeat into things that don't make sense; or maybe they drink the tea."

A good example is mixed use development. While mixed use and/or small retail is popular feature for much redevelopment, it is often a "drag on the financial pro forma." There are many examples across the metro area where developers ultimately were forced to switch out plans that originally called for small retail,

creating angry residents in the process. While small retail is often desired by nearby residents, these retailers typically can't afford the rents that are inherent in new construction. It is also important to recognize that online retailing is drastically changing how people shop, and the market for in-person retail. And as one developer pointed out, "A project's viability is determined by the weakest link in a project, not the strongest.

Also, most systems, such as financial, zoning codes and building codes, weren't designed to recognize mixed use. With building codes for example, codes vary by type of use, but in mixed-use buildings, the strictest code applies. This means that the use with the less strict code (typically housing) becomes more costly than if it were built on its own.

Another example is pedestrian or transit-oriented development. It may be beautiful on paper, and desirable for residents, but it probably won't work in the market if it's being planned for a major thoroughfare with heavy fast-moving traffic, or in an industrial area. Physical conditions are central to the market conditions, no matter what we may desire.

One developer summed up city planning efforts as "hitting the piñata with your eyes closed."

"The rules are not set up to deliver what we want." Some developers suggested that zoning codes often conflict with the type of development cities really want. Some described city's zoning codes as "archaic" or "rigid" when in fact redevelopment requires zoning that is forward-looking and flexible. For example, one developer described how his firm studies existing housing patterns when doing infill development, and tries to design housing that is appropriate for that pattern. In one case, city zoning and design rules actually precluded housing from being developed in a manner consistent with neighborhood patterns, even though it's what the city said it wanted. Likewise, rules about affordable housing and planning can also work at cross-purpose to cities' end goals for TOD, mixed income or mixed use.

Some comments along these lines included:

- If cities want to proactively spawn more dense development in a cost-effective way, they could plan and zone for a mix of uses that can share parking designed for 18-24 hours of use each day.
- Existing housing is a better fit for affordable housing than new construction because of the cost of construction. Also, mixed income housing can be done, but the lower the incomes, and/or the greater the percentage of units dedicated to low incomes, the harder it is to make the pro forma work and for the housing to work on an ongoing basis (in part because non-low income households will chose non-mixed housing, everything else being equal). If the goal is number of units, it might be easier to get there by relaxing the rules, such as the percentage of affordable units in any development, or the way in which incomes are “mixed” (e.g., by neighborhood versus individual buildings).

Lay out a clear development process. In the development business, time is money. It's important to developers that there is a clear process with firm steps and rules; many spoke of really having no idea when or how decisions would be made. One or two cities were mentioned as being easy to work in, but the prevailing sentiment was, as one developer said, “There's no easy road map. Period.”

Many developers criticized the RFP process often used to select developers. RFPs typically happen too early in the process with too many unanswered questions to develop a feasible proposal. Sometimes cities don't even have site control. Some suggested using a request for qualifications instead, contending that the city will get better results at less cost.

Developers also feel they spend too much money, either through the RFP process or in pre-development, helping cities figure out what they want. One developer stated, “I have personally decided I won't spend or risk much, certainly not \$10-50K to ‘convince’ a city to let me build a Smart Growth project consistent with their comp plan.” Developers prefer that cities tell them what their goals are and what kinds of tools/financial support are available; in turn, they'll work with the city to problem-solve and get as close to the goals as possible. Developers also feel that they should not be expected to pick up the cost of consultants (in pre-development) that cities hire to compensate for the lack of in-house expertise.

Some, but not all, developers see master plans and feasibility studies as a waste of time and money. Developers will defer to their own sense of the market. From the developers' standpoint, money would be better spent on things that help them better assess site conditions (thereby reducing uncertainty), such as soil studies. On the other hand, planning is often an important aspect of laying the groundwork with citizens and creating the clarity discussed earlier. Developers greatly appreciate that, as long as false expectations are not raised, and there is flexibility as the plan moves to reality.

The process of seeking grants is also too amorphous and time-consuming. Redevelopment often requires subsidies because of the complications involved with site contamination, historical renovation or parking structures. The process of acquiring grants is too time-consuming and sequential to allow development to proceed in a timely, cost-efficient and orderly manner. One developer was told, "We only approve the grants twice per year and you cannot start the project before we approve the grant or you will not get the funds." Open application periods and one-stop shopping would be preferred. Another simple alternative would be for granting agencies to make a straightforward decision based on the merits of the project—yes or no—and not make the grant contingent on having all the grant approvals lined up.

Redevelopment tools are outdated and vanishing

While the need and desire for redevelopment is growing, the tools to do redevelopment are disappearing and/or becoming less useful. There are a handful of tools that have been critical to redevelopment in the past, but the utility of each has eroded significantly over time, partly because they were designed for another era, and partly due to legal changes. These tools are:

- Eminent domain
- Variances/zoning
- TIF
- (Fiscal disparities)

Eminent domain, planning variances and TIF, once vital to redevelopment, are of limited usefulness today as a result of legislation and court rulings. But without these or similar tools to support the work of redevelopment, cities will crackle and fade. The fiscal disparities tax system is becoming more of a player in the redevelopment arena, as cities struggle to find the funding for operating budgets.

The need for revitalized tools is not news; it has been identified in a number of previous reports, such as Rethinking Housing Finance Report and the “What If It Was Easier to Redevelop” report of ULI Minnesota. Developers are disappointed that they are continuously asked what they need in the way of tools, but little action has been taken.

Recommendations

For the most part, the three recommendations below are not new; they restate some of the key findings in previous work. In some cases, however, the emphasis is different. The recommendations below also suggest who might take the lead responsibility for ensuring that appropriate follow up action is taken.

There is one important difference between the recommendations below and those of prior reports. Many prior reports focus on administrative changes and the need for added responsibilities and funding at the state and regional level. The recommendations in this report focus on doable changes that impact the practice of development. The barriers to redevelopment, from the perspective of developers, emanate primarily from the relationship between developers and cities. Improvements here require no task force or committee, no legislative authority, no major new funding-- it is within the power of each and every city to reflect on the environment for redevelopment within their city and ask how the process might be made more constructive.

The reformation of development tools presents a tougher challenge. Yet it is within the power of the development community to take leadership on designing a modern set of redevelopment tools that can pass muster with the state legislature.

Recommendation one: Officials within each city should examine their redevelopment processes and improve them with the goal of creating more constructive working relationships with developers.

Such a process is not envisioned to be a one-sided “give” by cities, but a “give *and* take” by developers and cities alike. It is expected that cities too could compile a list of grievances about the development process given their experiences working with developers. Indeed, it would probably be very constructive for developers to hear cities’ views on what developers could do to improve the development process.

Previous reports on this subject have stressed the need to streamline and remove barriers to development. Often, however, they jump to the conclusion that the fix is a uniform development process across all cities. No doubt developers would love this (assuming the single process is an efficient one). But that’s not what developers are asking for. They simply want clarity and efficiency within any given city. Specifically:

- 1) Bring clarity to processes and expectations.
- 2) Ensure, to the maximum extent possible, that there is a commonly understood commitment across all staff and elected officials.
- 3) Incorporate a more realistic understanding of what market conditions permit, and be prepared to subsidize desired developments that exceed typical market risk.
- 4) Review zoning and building codes, as well as planning requirements, to ensure that those rules and regulations are well aligned with the desired end result.
- 5) Identify a way to work in a more collaborative fashion with developers, once a developer is selected.

Many cities, understaffed and financially strapped, are overwhelmed by the development process, and no doubt put forth a development process that they believe to be in the best interest of their cities. It can be very difficult to do an objective self-assessment. Here are some telltale signs that a city’s development process may need improvement:

1. RFPs issued with zero or few responses;

2. The city or another developer had to take control of a development project;
3. Significant project delays;
4. Higher than expected subsidies;
5. Insolvent projects or major changes in use after development is complete;
6. Slowdown in developer interest and/or applications after a new planning, zoning or design requirement is put in place.

Lead: each city

Timeline: immediate and ongoing

Recommendation two. Get smart together. Conduct educational seminars that will help cities better understand and prepare for market, demographic and fiscal realities.

Minnesota is blessed with a mature and experience housing and development industry. This industry has spawned a number of educational efforts, such as the Rethinking Housing series, the monthly meetings of the Sensible Land Use Coalition, and the discussions held by the Regional Council of Mayors. But there appears to be further need, perhaps for more ground level practical information, to develop a shared understanding about the type of development that will be most desirable for current residents and sustainable for future generations.

Possible leads: ULI Minnesota, Family Housing Fund, Metropolitan Council, Opportunity Cities

Timeline: immediate and ongoing

Recommendation three. Work together to reformulate three (or four) key redevelopment tools.

It would be an understatement to say that eminent domain, zoning variances, TIF and fiscal disparities are politically sensitive. Perhaps this is the reason there has been little traction to date on addressing them. But tools such as these are also *needed*. If the whole of the development community (i.e., developers, cities, counties, housing advocates, builders, realtors, nonprofit intermediaries, CDCs, etc.) is not willing to put political capital behind reforming these tools, and to bring some

transparency, objectivity and goodwill to the process, then we should conclude that redevelopment is about to become a very creaky process indeed.

In order to get the job done, it will be important to:

- Develop the leadership committed to bringing these new tools to fruition.
- Convene a broad-based group of interests, to demonstrate to the legislature that these new tools are of widespread value, not simply the want of special interests. These interests should include developers, cities and counties, the Metropolitan Council, the business community, and organizations like the Family Housing Fund and ULI Minnesota, and perhaps good government organizations like the Citizens League.
- *Design* of the newly substantiated tools will be critical. The concerns of the legislature must be dealt with in a straightforward fashion, and integrated to the extent possible into the design of the tools. (A quick review of the literature suggests that the critics of these tools have some legitimate points). It's also important to make sure that the tools are designed with clear objectives in mind, so that in the end, they work to achieve these objectives and are not littered with features that result in many unintended consequences and weaken the tools over time.
- The tools should be designed with an open mind, not based on functions of the past, but on the needs of the future with an appreciation of the past. For example, fiscal disparities considerations have made projects financially more difficult in some communities. Fiscal disparities tax-base sharing was born in a time of concern about the movement of commercial/industrial development across the metro. But it's time to ask whether the same objective is paramount today. If the answer is no, it would be possible to honor the past by drawing a "new line" of tax base that grandfathers the fiscal disparities distribution as it exists today, while moving forward with new rules designed for a new and different time.

Possible leads: Metro Cities, FHF, NAHRO, ULI Minnesota; LOCUS (a national real estate group of smart growth developers)

Timeline: Initiate design effort in 2011; first legislation in 2012, and ongoing as necessary