Chronic Oversupply in the Suburbs?—Why Dirty Urban Property Might be the Land of Opportunity!

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Baby Boomers are becoming empty nesters. Gen-Xers are having families. Gas prices continue to rise and demand is predicted to soon exceed supply. More manufacturing jobs are being lost overseas. The price of steel is at record levels. And you can't eat the fish. What do these things have to do with each other?

Real estate investors looking to round out their portfolio with higher reward/higher risk investments are having to look in different places as we face a changing real estate market. There was a time when land speculators were buying up agricultural land, anticipating the continued push beyond the suburbs. But the next opportunity may be in the form of an environmentally sustainable diamond in the rough—the redevelopment and repositioning of distressed and dirty properties, brownfields, and blight. For those willing to work with a more patient investment, the next land of opportunity may be the shuttered factories of the Boom generation.

For investors willing to pursue patient rewards, why gamble on infill and brownfield redevelopment? How can the risks be managed adequately for the investor? Do these properties make sense within a broader portfolio?

As a starting premise, these niche or opportunistic investments often require commitments of five to 10 years to come to full fruition, and may come in the form of entity-level investments in specific projects or in businesses pursuing a regular pipeline of projects. So these opportunities are well suited for only a small part of any portfolio and are not for every investor.

CHANGING DEMAND

"Gas prices," "carbon footprint," and "environmental sustainability" are terms in every daily newspaper. The demand for gas is predicted to exceed supply in the next decade. Gas prices and congestion on the roads will affect individual decision making about where people choose to live, while immediate concerns over carbon footprint will steer public policy to push back on urban sprawl and promote more efficient and pedestrian friendly compact development. Public policy will also look to make better use of our existing infrastructure, rather than building new.

Growth in the downtown housing market in cities across the country has remained stronger than other sectors of the market, thanks in part to our growing population of empty nesters. Our overall population is aging, and the elderly are not the best suited for living in large homes in car-preferred communities. We may find ourselves overbuilt in the outer ring suburbs and beyond, while demand for housing stock convenient to our cultural facilities, in walkable neighborhoods and convenient to mass transit will strengthen.

CHANGING SUPPLY

We are losing manufacturing jobs overseas and obsolete industrial properties are often assets in distress and available at fire sale prices—either as a result of bankruptcy, foreclosure or when they are orphaned as a result of mergers and consolidation. These old factories are located on waterways, convenient to transportation and along old rail corridors. Not often pretty. But frequently with good or great location attributes. With rising steel prices, rather than being left idle, factories are being dismantled to reclaim the value of the structural steel.

THE POINT OF CONVERGENCE

At a time when there is a resurgence in residential housing close to the cultural institutions of our downtown areas, and as infill locations are gaining in popularity, we are also witnessing the conversion of old railways for transit or recreation. And what you don't read about in the newspaper is the focus now taking place on our polluted waterways. Our rivers and lakes were to be fishable and swimmable by 1983. That remains an elusive goal, but in 2002, Congress authorized $270 million to clean up our contaminated waterways, principally in the Great Lakes basin. This is not enough to get the job done, but it has been enough to provoke action from the states and these waterway cleanup projects are beginning.

At the same time, investors and fund managers are demanding that we give attention to environmental sustainability. The US Green Building Council and Congress for New Urbanism have formally recognized the importance of infill brownfield redevelopment as essential to sustainability through their LEED-ND rating.[1]

HOW CAN THE RISKS BE MANAGED ADEQUATELY FOR THE FUND INVESTOR?

Managing risk for an investor, or a developer, requires a combination of practical methods backed up by legal transactional tools. Brownfield and redevelopment projects are often characterized by extraordinary costs relating to geotechnical issues, failing dockwalls, environmental contamination, and demolition. The perception of risk, however, may be greater than the actual risk. Considerable changes have been made in the last decade to our system of environmental laws and under federal and many state laws, buyers can now acquire contaminated property and be exempt from liability. Furthermore, municipalities are often motivated to spend money when it will restore and enhance their tax base.

With a credible developer, local governmental support serves as a practical backstop to many of the risks inherent in redeveloping distressed and dirty properties. Infill and turnaround projects have an essential ingredient—the ability to recycle property that is or will become a drain on a municipality's tax base into a considerable asset to the tax base. Projects of investment grade magnitude will generally have enough mass to influence, or even create, a neighborhood. The greatest challenge is often securing an inventory of property. The municipality then needs to be sold on the vision for the redevelopment, but with that accomplished, the economics affecting the tax base will compel most local governments to do what it takes to realize the turnaround. The will of a municipality to get a project done can overcome some of the most daunting of challenges. If the investment is on a project specific level, it is important to evaluate the sense of moral commitment the municipality has made to a project, but it is as or more important to evaluate the level of formal and written commitment a municipality is willing to offer.

Oftentimes, on a project level, the best way to practically manage the risks inherent in redevelopment is through information, but it is important for the investor to have some degree of independent evaluation by technical professionals with appropriate expertise.

Managing risk from a transactional standpoint often depends on the nuances of each project. The role of the legal professional goes beyond drafting the necessary documents and extends specifically into the allocation of risk between the technical professionals, investors and the investment – and often the municipality that benefits from the project. Redevelopment projects present a complex set of relationships and partnerships between the developer, the financial community, the municipality, and the end user of the real estate. The issues run the gamut from zoning, entitlements, environmental, tax, and public affairs. Properly navigating environmental regulations can significantly improve the bottom line returns, and failing to do so can cause calamity. Aside from actual issues affecting what can be built and at what cost, projects may also have complex financial structures to maximize tax credits, tax benefits, and tax enhancements and this can dictate the structure and form of the investment. Caution is needed to assure that the benefits pass through properly to the investor and comply with Internal Revenue Service rules and rulings.

Credibility, innovation, and vision of a developer are important pieces, but local relationships and an understanding of the local market can influence the success and profitability of any project. That said, whether the investment is on a business level or project level, the track record and reputation of the individuals involved is critical, including the consultants, lawyers and tax professionals. These are inherently sophisticated transactions and require adequate horsepower to get them done!

DOES AN INVESTMENT FEATURING DISTRESSED AND DIRTY PROPERTIES MAKE SENSE WITHIN A BROADER PORTFOLIO?

We have been involved in projects that delivered stunning returns and fully redefined hundreds of acres of urban land into sustainable, environmentally friendly neighborhoods in as short as five years time. The timing may be right to cut a diamond out of what is now distressed and dirty real estate. So if there is room in an investors portfolio for an environmentally friendly opportunistic investment, brownfields and infill real estate may be the right opportunity.

NOTES

1. *See* www.usgbc.org/leed/nd.