feel when they get there. Ideally, the best way to incorporate protective measures into a building is to design them in from the start. Designing a structure to work with the site allows for greater control over points of access and building setbacks. Security measures for ventilation and structure are now standard design considerations, as is a system of redundancies for power, telecommunications, and data.

Among hotels that have stepped up their investment in security, spending has gone into increased staff training, security equipment, and extra security guards. Guest room security is critical to protecting a hotel’s reputation, and its newest iterations depend on technology, such as biometric sensors that are linked to access control software, which can record all comings and goings, permit access to certain areas, and facilitate the guest check-out process.

Of late, hotels in Africa, Asia, and the Middle East have been targets of terrorists. “It’s a fine line hotels must negotiate to ensure guests feel safe without locking up a property like it’s a military base,” notes Frederic Prasack, loss prevention chairman with the American Hotel and Lodging Association, based in Washington, D.C. While there is no perfect way to prevent a terrorist occurrence, hotels are relying on constant vigilance on the part of employees, coupled with security-minded design.

A glimpse into the future: housing and hospitality. Demographic and consumer trends that will affect the future design of destinations and travel experiences indicate one overarching common denominator at work—“mass customization.” A customer service trend that is already gaining significant momentum in virtually every field, it is now having an effect on hotel design as well. Veering away from standard rooms and offering different layouts affords greater variety to returning visitors. “More sophisticated travelers want more diverse experiences, fresh ideas, and different products,” notes Mike Panzer, vice president of design and construction for Rosewood Hotels & Resorts in Dallas, Texas.

Offering choices is the very thing that makes some projects financially viable. Specifically, integrating timeshare and condominium units within a hotel development—whether in an urban or a resort setting—can create large upfront returns generated by residential sales. It also gives developers the option of using unsold units as hotel rentals. More and more, two- or more hotel brands are being included in new developments, appealing to different sectors of the market. Multiple financial benefits of this approach include amortizing the costs of infrastructure and development, spreading the risks, creating instant critical mass, and generating increased operational efficiencies. Guests can benefit as well, with a range of choices designed to meet their tastes and budgets.

Hotel design is being driven by psychographics (values and belief), demographics (age and income), and economics (price and value). When the trends that are having an effect on the design of hotels are analyzed, it becomes apparent that—above all—today’s travelers are looking for three things: connection with people and places; comfort—both physical and psychological; and choice—options and possibilities. Owners, operators, and developers who understand these changing desires stand the best chance of capturing a greater share of business in these challenging times.

Christopher B. Leinberger
"DON'T FALL IN LOVE WITH YOUR PROJECTS AND ‘KNOW YOUR EXIT STRATEGY BEFORE YOU INVEST’ ARE TWO PRINCIPLES MOST DEVELOPERS LIVE BY. THESE RULES IMPLY THAT REAL ESTATE DEVELOPMENT IS A COLD, RATIONAL BUSINESS WITH NO ROOM FOR EMOTION, AND THAT ONLY PROJECTS THAT CAN EASILY BE SOLD SHOULD BE BUILT—PREFERABLY AFTER AS SHORT A HOLDING TIME AS POSSIBLE. THESE IDEAS HAVE BEEN THE FOUNDATION FOR THE FORMULA-DRIVEN REAL ESTATE DEVELOPMENT INDUSTRY, THE MULTIBILLION-DOLLAR PUBLIC EQUITY MARKET, AND THE MULTITRILLION-DOLLAR SECONDARY DEBT MARKET—AND ARE RESPONSIBLE FOR THE FACT THAT WHAT IS BUILT HAS A SHORT-TERM ECONOMIC AND PHYSICAL LIFE.

Building for the long term
The way projects are underwritten today virtually guarantees that they will never meet the standards and longevity of pre–World War II buildings.

Howard J. Wolfe, Chairman of Howard J. Wolfe, Inc., and former vice president at Whiteman Allison Tong & Guldian International, architecture, design, planning, and consulting firm specializing in hotel and resort design.
Developers have become builders of disposable boxes that function as stand-alone, modular billboards to grab the attention of passing motorists rather than as architecture and components of complex urbanity. Costs for controlling the land and performing the required design, legal work, and financial packaging.

In addition to the constant pressure to build and flip, developers are under extreme pressure to obtain early cash flow from their projects because conventional underwriting cannot discern cash flows beyond five to seven years, no matter how healthy that cash flow might be. The major place to impose the cost cutting necessary to obtain early cash flow is in the construction budget, making the goal to build the project "faster and cheaper." So what if only a seven- to ten-year roof is used or if much of the so-called architecture is plastic or sprayed on. If the building is functionally and physically obsolete in seven to ten years, what motivation is there to care, since by then it will be someone else's problem? Building for the long term requires an understanding of how buildings were built before discounted cash flow, single-use zoning, and automobile-oriented sprawl began to dominate real estate development.

J.C. Nichols (Country Club Plaza in Kansas City, Missouri), George Merrick (Coral Gables, Florida), and Robert Davis (Sea Isle, Florida) were all motivated by both love and money. They built special places for the long term—places that gained value over time and produced substantial cash flows. These "town founders" were committed to a specific location and to enhancing its quality of life. The lessons learned from these developers could help those who want to build for the long term.

Location. Real estate value has always been determined by location. Yet, conventional development has had to contend with a constantly changing definition of a good location due to ever-sprawling metropolitan areas. Over the past 20 years, for every 1 percent increase in population, most metropolitan areas have seen a 5 to 12 percent increase in land consumption. Many locations with high market demand in 1980 have been left behind as sprawl has moved outward, leaving mile upon mile of low-occupancy or abandoned strip malls and downwind pressure on adjacent single-family housing values. As sprawl continues to move demand to the ever-extended fringe, the market in 2020 will probably leave behind today's good locations. This is why the label "edge city" cannot be applied to an area for long: the edge is continually and rapidly moving outward. Reflecting this, Robert Lang, director of the Metropolitan Institute at Virginia Tech, titled his new book about metropolitan development trends "Edgeless Cities.

Car-dominated, modular, conventional real estate development will always produce sprawl and placelessness. It also produces good walkable, small-town cash flow in exchange for poor medium- to long-term financial performance. If sprawl has not pushed market demand beyond the location of the asset when it needs complete real development in ten years, the investment community will only commit for a subsequent seven to ten years. And even if conventional underwriting could see beyond those years, no investor wants to bet long term on a place when sprawl can torpedo market demand. The value created and cash flows tend to peak in seven to ten years. If sprawl has not moved demand farther out, the project could be redeveloped, generally for as much as it took to build it in the first place, and go through the same seven- to ten-year cycle.

In essence, there are only two forms of metropolitan development:

- Suburban development, with a floor/area ratio (FAR) of 0.2 to 0.4 percent, and semiformal development, with an FAR of less than 0.2 percent, both dominated by the automobile;
- Urban development, with an FAR generally over 1 percent, which relies on multiple transportation options such as car, bus, transit, bicycle, and walking.

Suburban and semiformal development has been by far the predominant pattern since the 1950s, and, according to Lang's book, the even lower-density suburban pattern has overtaken relatively higher-density suburban development.

The solution for long-term investment is to pick the polar opposite car-dominated sprawl walkable urban or urbanizing places. Of all real estate types in a metropolitan area, urban development generally has maintained the highest rents, land values, and property values—if there has been a visible urban place in the area. Between 1990 and 1995, as American development sprawled, there have only been a handful of vibrant urban places in the country: Manhattan, downtown Chicago, San Francisco, Boston—and Main Street Disneyland, which one has to pay to experience. To enjoy urbanity, many Americans go to Europe on vacation.

However, that began to change in the 1990s as downtowns after downtowns began to revitalize itself. Today, 60 percent of America's downtowns are being revitalized from San Diego to Raleigh, and from Seattle to Chattanooga. It is probable that by the end of the decade, nearly all of them will be on the way back. Even downtown Detroit is showing signs of life with 20 new rental and for-sale projects on the market. And many suburban downtowns are beginning to thrive, including Reston and Ballston (both in the Washington, D.C., metropolitan area), Birmingham (Detroit), Pasadena (Los Angeles), Buckhead (Atlanta), Bellevue (Seattle), and many others. There are also many smaller-scale places such as Short North (Columbus, Ohio), Nob Hill (Albuquerque), Five Points (Oakland, California), and most universities that are taking on an ever more urban life and developing a regional brand.

Why has the market changed? There are two major reasons. The baby boomers started to become empty nesters in the 1990s, with many willing to consider a lifestyle that does not include mowing the lawns. Then their Generation X offspring, raised in the suburbs, did what many up-and-coming generations have done: they rejected how they were raised. As a result, they have been flocking to the cities. An easy way to see the evolution of American lifestyles is through television. While the favorite TV shows of the 1950s ("Leave it to Beaver"). 1960s (The Dick Van Dyke Show), and 1970s (The Brady Bunch) were all set in the suburbs, today, the most popular Gen X-oriented shows—"Sex in the City, Friends, Frasier, ER," are all set in the city. Hollywood, which does more consumer research than any industry, reflects the desire for urbanity among a major part of the market.

Consumers research also shows that 25 to 40 percent of household in most metropolitan areas want walkable, urban real estate. However, real estate professionals, for the most part, only know how to build urban or suburban product. This means tremendous pent-up demand for urban product. Because too much competition and overbuilding are the bane of a real estate developer's existence, building urban product is an obvious choice from a market perspective.

Walkable, urban product has an additional advantage: it limits the competitive product to that which is within about 1,500 feet of the front door, or about a five- to ten-minute walk—the limit most people are willing to walk before they will find another mode of travel. In the suburbs, a five-minute drive from a particular rental...
apartment project can mean thousands of competitive units, and a 15-minute commute can mean tens of thousands of competitive units. In an urban setting, a five- to ten-minute walk generally translates into only hundreds of competitive units. Avalon Bay Communities, Inc., the New York Stock Exchange-listed apartment real estate investment trust (REIT), locates many of its assets in walkable areas—such as Ballston in northern Virginia, and Stamford, Connecticut—for this reason. This natural limit on competition also eases the fear of overbuilding—though there is no guarantee that it will be eliminated since developers can overbuild any market.

The great advantage of a walkable urban or urbanizing location is that individual projects benefit from an upward spiral of property values. In a suburban location, besides the probability that sprawl will take market demand farther to the fringe, the addition of more houses, strip retail, and office space diminishes the value of any location due to increased traffic congestion and pollution, and decreased open space. The more that is built, the less the surrounding assets are worth.

In a suburban location, more houses, strip retail, and office space diminish the value of any location due to increased traffic congestion and pollution, and decreased open space. The more that is built, the less the surrounding assets are worth.

The opposite happens in walkable urban or urbanizing places: more is better. More townhouses, apartments, retail, and offices put more people on the street, which leads to higher rents and property valuations. The reason it makes sense to hold assets in an urban or urbanizing location for the long term is that when neighboring property is redeveloped, it makes one's own property more valuable. As the downtown or urbanizing suburban downtown grows, the existing assets gain value from the increased activity.

Have patience—and a larger amount of patient equity in the deal. To be around for the long term and enjoy the rising values provided by successful urban development, a developer must have that most rare of commodities—patient capital. To have patient capital, a developer must take more control over his or her own destiny by taking more control over the equity in the project. This can be done by slicing the equity pie into several pieces, called tranches, that are divided by the time the equity is committed to the project. Many in the secondary-debt market are familiar with risk tranches, such as the A portion and the B portion of a bundled loan package. Time tranches make the assumption that not all equity is the same—that there are different time horizons to consider. For assets built for the long-term, there are at least three time tranches: short term (one to five years), medium-long term (beyond five years), and long term (beyond 12 years).

Conventional equity investors combine all three portions into one investment, looking to take short-, medium-, and long-term returns. However, most conventional equity investors cannot measure the medium- and long-term returns using current underwriting techniques that employ discounted cash-flow methodologies, such as internal rate of return. That doesn't stop them from asking for every type of return available, and most developers from giving it to them. Yet, if conventional investors cannot even measure anything except the short term, why not just give them what they treasure and find other investors, including the developer himself or herself, who value the medium and long-term. Developers need to take more control of their own destinies: they should not give up what conventional investors do not even value.

Unlike conventional projects, the financial performance of walkable, urban projects already have more time tranches to work. The short-term cash flow is not as strong as it is for conventional development, but the medium- and long-term returns are significantly better. However, most underwriters are blind to the medium- and long-term performance by two factors. The first is the short-term bias of discounted cash flow methodologies— not being able to see beyond years five to seven. The second is the potential for substantial upside generally is not projected due to its uncertainty. This is the "hope certificate" that many walkable, urban projects can achieve, but it may take time—the enemy of conventional short-term investing.

Investors who can only measure short-term returns and want to be in and out of an investment quickly should occupy the first-tranche

The job of one of the task forces was to create a catalytic development firm to develop projects the market studies demonstrated were viable but that the conventional real estate development industry would not consider building because they were urban in nature. The downtown development had to be integrated and complex, provide mixed uses, employ multiple transportation solutions, and involve expensive structured parking. Therefore, it presented a much higher risk. A new firm named the Historic District Improvement Company (HDIC) was created, made up of Arcadia Land Company, a for-profit developer; the McCune Charitable Foundation, the largest foundation in the state; and the Downtown Action Team.

The capital structure of HDIC was created to ensure a long-term strategy. The McCune Foundation invested $1.4 million in cash from its asset base for 20 percent ownership, as well as $5.6 million in subordinated loans, secured by the various projects undertaken by HDIC. The Downtown Action Team received a 2.85 percent carried, nonvoting interest. Arcadia is the managing member of the limited liability corporation with the remaining 77.15 percent ownership.

The capital—both equity and subordinated debt—was patient, expecting returns after five years. While the management of HDIC did not draw any salary or fees unless bank construction loans would allow for development fees at the project level, which were not forthcoming on early projects. The management of HDIC had to cover its overhead from personal savings—part of its patient equity investment.

Trying to start the upward spiral of value creation that can occur in a downtown, HDIC responded successfully to a competitive request for proposals from the city for a 12-block section of downtown. In addition, HDIC bought six strategic buildings on the main street, Central Avenue. With this, HDIC had more than $150 million of potential development—primarily retail, office, and residential space—under control, much of it without using its valuable patient equity capital for acquisition. The development agreement with the city called for a city investment of $8 million in the 12-block redevelopers district, including the land; two parking structures; seven years of tax abatement; and some infrastructure improvements.

Unique among comparable agreements in other cities, HDIC agreed to pay back the city for this investment by sharing 25 percent of the HDIC cash flow from the projects in the 12-block district in years six to 12, and 50 percent in years 13 to 20, making the city a third-tranche equity investor. The city's fiscal impact study showed that, combining the cash flow share with the net increase in tax revenues from the projects in the district, the $8 million investment would return $42 million over the 20-year agreement.

HDIC's initial strategy was to be the horizontal developer, focusing on land acquisition, parking, tax abatement, and the overall development plan, then turn various joint ventures with building developers for project design, construction, and marketing. Four joint ventures were proposed at various times over the first three years of HDIC's existence, but only one has worked. Three of the proposed joint ventures could not get past the initial feasibility phase and figure out how to develop a financially viable project; the last one is to be in place in 2004 after three years of effort. Despite their concerted efforts, most of the primarily conventional joint venture development partners could not get beyond the need for progressive underwriting of the deals, higher-quality construction, and a roster of unique local and regional tenants rather than national creditworthiness tenants. In these three cases, HDIC assumed complete development responsibility—providing just one of many examples of backward integration—and now has three successful projects to show for it.

The first phase of development, the Century Theater Block, included a 110,000-square-foot project made up of a 14-screen theater and retail and office space supported by a 630-car parking garage, for a total development value of $20 million. The mixed-use theater project initially was going to be a joint venture with a promi-
trend national developer who projected, based on suburban experi-
eence, that the shell construction costs would be $35 per square foot and that tenant improvements costs would be $55 per square foot. HDIC rejected the suburban quality of construction, the partner-
ship was terminated, and HDIC built the project out at $80 per square foot for construction costs and $50 per square foot for ten-
ant improvements. More than doubling the construction budget required a three-level tranche approach to financing. Half of the total budget was equity, and of this equity, the bulk was patient second- and third-tranche equity.

However, the project's financial performance justified this additional investment even sooner than expected. The prevailing annual retail rents in the downtown in 2000 were $8 to $10 per square foot (triple net) while the Theater Block retail rents were projected to be $18 to $19 per square foot, which made the bank a little nervous. In fact, the retail rents are $22 to $27 per square foot and the office space in the project has obtained the highest rents in the metropolitan area. As a result, the project, at its current 94 percent occupancy, has a debt cover-
age ratio of 1.9 to 1, much better than 1.25 to 1 ratio banks seek. In
addition, the construction loan is nonrecourse. The project has cash flow of $600,000 per year, which would not be the case if the con-
struction quality had been compromised.

A necessary part of the backward integration strategy for HDIC has been to create a source of first-tranche equity. While Fannie Mae's American Community Fund may make this kind of invest-
ment in downtown projects, HDIC officials believed that another source was needed. With private real estate fund manager Ameri-
can Ventures Realty Investors of Coral Gables, Florida, HDIC put together the New Mexico Urban Initiative Fund, an infill, smart growth fund for downtowns throughout the state. It eventually will be a $50 million fund raised from the state's permanent funds, banks, and foundations. Banks will receive Community Reinvestment Act credits for the investment. The fund will invest equity representing 10 to 15 percent of total development costs and up to 60 to 90 per-
cent of the required equity. If the fund invests its capital base twice during its eight-year life, it could trigger $800 million to $1 billion of downtown redevelopment throughout the state.

The first successful joint venture is between HDIC and Phoenix Properties Company, a Dallas-based urban development company working throughout the country focusing on infill and mixed-use projects. The project is a $17 million, 174-unit luxury rental apart-
ment building, which will be the highest-end project in the metropolitan area. Phoenix has agreed to be a second-tranche investor/owner, along with HDIC. The first-tranche investor, either Fannie Mae or the New Mexico Urban Initiative Fund, will be in and out of the project in five to seven years. Phoenix Properties was in-

interested in assuming the second-tranche position so as to obtain medium- to long-term ownership. In the past, many of its projects had to be sold due to the short time horizon of their conventional equity investors.

Another significant initiative is the Downtown Albuquerque Civic Trust. Sponsored by the Enterprise, Ford, andMcCune foundations, the Civic Trust is anticipating the need for affordable housing, arts and commercial space, and additional parks as the downtown be-
comes gentrified. While affordability is not a problem at the moment, revitalized downtowns quickly become unaffordable for most people, the result of the upward spiral of value creation. Such gentrifi-
cation is sought by developers, but social equity and affordable hous-

ing advocates view it as an evil that displaces poor households, as well as artists, who are some of the pioneers of downtown revitalization.

The Civic Trust will use a concept known as "value latching." The city's share of the HDIC future cash flow will be dedicated to the Civic Trust, as will additional cash flow made available by HDIC, the current ownership interest of HDIC held by the Downtown Ac-
tion Team, and other downtown developers. At a minimum, the Civic Trust cash flow will equal 40 percent of the HDIC cash flow until 2021, or $12 million to $15 million. Pledging this cash flow, the Civic Trust will borrow its initial capitalization from founda-
tions, allowing the Civic Trust to implement its business plan for affordable space now, rather than when gentrification moves land and property values so high that the affordability initiative cannot make much of a difference. By latching on to the upward value spiral, social equity and affordable housing advocates will benefit every time a wealthy lawyer buys a loft downtown, because a large percentage of the profit from that transaction will allow the Civic Trust to provide more affordable space.

Helping to start or expand an urban area where the upward spiral of value creation can occur can be extremely profitable, even though discounted cash-flow measures are not sensitive enough to recog-
nize the returns. But this means owning for the long term. And building a special and unique place is even more rewarding. Developing walkable, special places in a downtown, a suburban downtown, or other places can make a real difference in the lives of many people. In this sense, the compensation is priceless.

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