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Rethinking real estate

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“We cannot solve our problems with the same thinking that we used when we created them.”

— A. Einstein

The housing bubble collapse and subprime mortgage meltdown have expanded into a worldwide financial crisis. The urgency of the crisis required immediate action, but there remains a risk that we addressed the symptoms instead of the cause. These sectors should not use bailout funds to continue business as usual; we need to question which of our assumptions and business practices created these problems.

The financial crisis should force the real estate sector to recognize the need to operate more efficiently and more strategically. A strategic approach ensures that a single investment can benefit multiple bottom lines.

The real estate sector is slow to adopt new ideas under the best of circumstances, but necessity could require us to innovate. Below are a number of best practices of small but significant changes that could benefit multiple bottom lines.

Commodity developments are forced to compete on price.

The real estate sector is notoriously averse to change. Many developers do formulaic projects to reduce costs and to increase predictability. Because this model has been financially viable, it has been a strong disincentive to innovation. Going forward, the risk is going to be in not adapting to changing circumstances.

Most developers are producing generic product. There is little to differentiate one development from another, and like any commodity, these generic developments are forced to compete on price. Few developers have a brand name or an identifiable style that could command consumer loyalty or a price premium.

There is an opportunity to create more interesting housing. Good design does not necessarily cost more, and can even reduce expenses. Innovative developers will reap bottom-line benefits: consumers will pay a premium for what they cannot get elsewhere.

Noncash incentives can benefit both cities and developers.

Cities and developers need to structure incentives that benefit both parties.

Many cities have traditionally imposed historic preservation and sustainability as requirements. Most developers naturally resisted these mandates: no one wants to reduce their ROI to provide a unilateral benefit to another party.

At the same time, other cities have eased design and development guidelines because they are afraid of being regarded as places that are unwelcoming for development. The result of these lax policies tends to be the lowest common denominator of development. These cities are compromising the architectural qualities and natural environments that make them distinct and desirable places.

Too many of the existing incentives are structured to make cities developable rather than desirable. These places remain the kinds of cities that people live in because of financial necessity rather than by choice.

Cities can encourage the sort of development which will actually be congruent with their master plan and long-term revival through noncash incentives such as expedited permitting or higher floor-area-ratios (FARs) provided that a building meets the historic preservation or sustainable development requirements. Developers may even find that these projects will command a price premium over commodity developments.

While these incentives cost the city nothing to grant, they have a direct bottom-line effect for the developer. Assume that green projects received expedited permitting. For example, reducing the permitting process from 180 days to 30 days significantly reduces the developer's holding costs and moves a project toward revenue generation more rapidly. Or assume that projects which meet stricter design guidelines for a historic district also receive higher FARs, thus making the project more profitable.

In each case, both parties benefit from the restructuring of the incentive.

Sustainable development can address several problems at once — if it's done correctly.

The real estate and auto industries are two of our nation's biggest users of energy. We should consider aligning the bailout of these sectors with requirements to adopt more efficient alternative energies. This would help the United States make simultaneous progress on several critical goals.

Buildings that run on local, renewable resources — such as geothermal exchange, solar, or wind — reduce our dependence on foreign oil. Geothermal exchange provides lower and more predictable costs compared to the volatile prices for oil and gas. Lower and predictable utility costs will help free cash for investment, savings, or consumer spending. Above all, there is an opportunity for the United States to create products that could be manufactured domestically and licensed or sold worldwide, creating high-paying jobs and helping to reduce our current account deficit.

In most parts of the United States, the cost premium for installing a geothermal heating and cooling system over a convention fossil fuel system is negligible, yet the savings are significant and the payback period is short. Despite these benefits, very few homes or buildings incorporate geothermal. Most developers are greenwashing their projects with bamboo flooring and compact fluorescent bulbs; at the same time, wind and solar energy are receiving much more media and policy attention despite their longer payback periods.

Similarly, why not tie the bailout funds for the auto industry to the goal of having the entire U.S. auto fleet be independent of oil and gasoline within five years?

Rethink affordable housing.

There is a difference between 'affordable housing' and 'housing that is affordable.' This crisis is a good opportunity to rethink our approach to affordable housing.

Senior citizens and low-income residents are particularly vulnerable to rising utility costs. Energy-efficient and resource-efficient

features can ensure that not just housing but utility payments remain truly affordable. Going forward, these should be required features for affordable housing.

At the same time, our zoning laws need to be overhauled to permit the creation of market-rate affordable housing in the form of 'accessory units.'

Instead of conventional three-story townhouse developments, consider switching to a triple-decker that has an owner's duplex above a floor-through rental unit? Each townhouse would be sold as a unit. This would solve several problems. It creates housing that is affordable rather than government-mandated and subsidized "affordable housing." The income from this rental unit could be used to offset the mortgage for the owner, or could provide income in lieu of social security. It also keeps money flowing within the community, rather than relying on a series of transfer payments and subsidies between the states and affordable housing developers.

This housing style also provides owners with an annuity that will become more attractive if social security ceases to exist down the road.

Sadly, current zoning laws in many cities and towns don't permit this sort of development.

Going forward

Much of the privatization and deregulation of the past decade was ostensibly to "increase competition," "reduce government," and encourage "free markets." These policies were largely shaped by lobbyists, with disastrous results. Many companies that prided themselves on being the most efficient were simply the best-connected; their business models would not be profitable or in some cases even viable in a truly free market. Instead, this ostensible push towards deregulation and a reduction of the role of government led to one of the biggest federal bailouts in our nation's history.

The policies designed to stimulate homeownership instead resulted in record numbers of foreclosures. Our commercial mortgage-backed securities (CMBS) market was supposed to reduce risk, and instead magnified it. The ratings agencies were essentially doing the job of a privatized watchdog organization — and failed in the most basic oversight.

The policies and incentives that were structured ignored the potential alignments of higher private sector profits with greater benefits for the public good.

This crisis presents us with an opportunity to rethink our approach. As the markets stabilize, it will be interesting to see how things are different going forward, if at all.

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