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Second Generation Development: The New Sunbelt Frontier

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The redevelopment of obsolete inner city buildings and blighted areas is nothing new to the older cities of the Northeast. The urban areas in cities such as Boston and Philadelphia have been redeveloped several times over the past three to four centuries. But in today's high-growth Sunbelt cities, second generation development is just beginning. Cities such as Atlanta, Dallas, Phoenix, Las Vegas, and Denver are a couple of hundred years younger than some of their eastern counterparts and are just beginning to mature as urban environments. However, the recent population shift to the South and West has made these areas some of the hottest real estate markets in the country. As their outward expansion has extended beyond reasonable commuting distance, redevelopment of urban areas is becoming a viable if not necessary concept. For investors, developers and other real estate professionals interested in the Sunbelt frontier, creative redevelopment of strategic locations presents excellent opportunities as well as unique challenges.

IN WITH THE NEW, OUT WITH THE OLD

Second generation development challenges both developers and cities to balance the new with the old. For developers, while the initial development of a parcel of land offers a blank slate for a master-planned design, second generation development requires additional flexibility and creativity to work within the confines of existing streets, buildings, utilities and zoning regulations. For

cities, the need for redevelopment and progress is often in conflict with ideals of historical preservation and yesterday's zoning ordinances. For example, the zoning codes of many younger cities in the Sunbelt still require commercial establishments to provide large numbers of parking spaces to accommodate a population that has historically relied very heavily on automobiles. However, with the recent increase in population density, many Sunbelt cities are now implementing mass transit systems, such as light rail systems, for the first time. In addition, more mixed-use developments are allowing residents to live, work and play in the same area, thereby reducing further the reliance on automobiles. As more people take advantage of public transportation and new urban lifestyle developments, fewer parking spaces are required to service these developments. Yet, some cities are reluctant to adjust their zoning codes to reflect these new realities.

In order for inner city redevelopment projects to become successful, developers must work together to create an environment that is attractive to residents and business owners. In that regard, developers who want to take advantage of the benefits of second generation development may need to exercise patience and persistence in working with cities. Cities in turn must be part of the solution and create a business-friendly environment for the developers who can help them avoid the "dough-



nut effect”: Blighted urban areas surrounded by affluent suburbs. It’s a matter of civic pride and in the best interest of both developers and cities to bring new life to declining urban areas.

Recognizing this, many cities have created tax abatements and other economic incentives to encourage investment in urban areas. However, economic incentives alone won’t be enough to lure developers to otherwise undesirable areas. Cities must also ensure developers these locations will be safe and that public improvements surrounding the developments will be maintained at a level that supports the developers’ investment.

NEW URBANISM FOR YOUNGER CITIES

Two interrelated innovative trends in urban redevelopment promise lucrative opportunities for developers and investors. One is mixed-use development, i.e., developments that mix a variety of uses, such as office, retail, hotel, entertainment, and residential space in a single building or complex. Typically, a building may have retail space on the ground floor, offices or a hotel on the next few floors, and condominiums or apartments on the upper floors. Common in the Northeast, it’s a new concept for younger Sunbelt cities.

In many cases, mixed-use development coincides with a second trend – “new urbanism” or the “live/work/play” concept that allows people to live within walking distance of work, restaurants, shopping, and entertainment. Long established in many of the older cities, new urbanism is now gaining favor in younger cities as density increases. Residents like the concept, particularly young, single professionals and “empty nesters” who enjoy the low-maintenance lifestyle of a working, living, and playing urban dweller. An example of new urbanism is Dallas’ 72-acre Victory development, a brand-new urban center that combines office space, retail centers, dining, residences, hotel, and entertainment venues in urban Dallas. What was once a brownfield on the edge of downtown Dallas has been redeveloped into a vibrant and novel mixed-use urban district and the hottest spot in the city. It includes the American Airlines Center – Dallas’ state-of-the-art sporting event, entertainment and performance venue and home to the NBA’s Mavericks and the NHL’s Stars. By 2010, new development on the Victory site is expected to reach \$3.5 billion.

The maturing mass transit infrastructure of younger cities plays a key role in redevelopment, centering on public transportation access. For

example, at one of Dallas Area Rapid Transit’s (DART) light-rail stops, is Mockingbird Station, a luxury complex of residential lofts, plazas, film center and over 90 shops and restaurants. An unattractive location turned “in” spot, Mockingbird Station was the first project in Dallas developed on the rail line and is phenomenally successful.

Traditionally, urban Dallas has had very little residential development, but developments like Victory and Mockingbird Station have set the stage for the city’s new urbanism. Currently, about 5,000 new residential units are under construction in downtown Dallas alone. As corporate relocations from East Coast cities continue to shift populations towards the South and West, people who come from old urban environments make perfect residents for new urban areas transformed into live/work/play mixed-use developments. This migration is creating a huge demand for urban residential development and providing lucrative investment opportunities for the real estate industry.

In fact, the opportunities continue to grow and extend beyond the traditional urban centers and into the surrounding suburbs. Central Dallas is no longer the “hole” of the doughnut. Its property value increase of 8.7 percent last year actually outpaced the growth in the ring of suburbs. The *Dallas Morning News* called it “the stale doughnut effect”¹ As suburbs run out of available land, they start to struggle with urban issues such as decaying neighborhoods and a stagnating tax base. Some have already begun to adopt Dallas’ model of mixed-use development, providing a limitless supply of new opportunities for developers and investors.

COMPLEXITIES AND LIABILITIES

In addition to potential zoning and historical preservation hurdles, mixed-use development also creates challenges to the traditional form of ownership of real property. These developments must accommodate not only the needs of many different types of users, but very divergent multiple uses that must coexist within a single building or complex. For example, if a building combines a hotel with condominiums, condominium documents must address easement rights, as well as include provisions that clearly specify which hotel facilities, services, and amenities will be available to residents of the condominiums. Or, if a building’s ground-floor retail space includes restaurants

or nightclubs, the buildings must be designed and constructed in a manner to prevent cooking odors or noise from reaching hotel rooms or private residential space on the upper floors. Certainly, some of these issues can be dealt with in the design and construction phase, but developers who want to minimize liability and the risk of litigation will need to make sure that the legal documents governing the development carefully define ownership and usage rights.

As non-residential developers venture into mixed-use development, it's important to understand the residential component is a completely different segment of the real estate market. Adding a residential piece to a commercial building creates a whole new layer of regulation, legal complexity, and possible liability. In states where condominiums are more common than in the Sunbelt, developers have in recent years been plagued with construction defect litigation. Mixed-use development can multiply the risk unless developers take great pains to account for the variety of uses with provisions in both the building's structure and governance systems. Sophisticated developers know that entering this world requires the help of specialists. As such, with the help of legal counsel, they tend to have comprehensive risk management programs in place. Although not a guarantee against litigation, this precaution minimizes risk and gives them a competitive advantage.

For vertical mixed-use development, the preferred governance model is the "condominium structure." This approach subdivides a property into individual units, such as a retail unit, a hotel unit and an apartment or residential unit. Since a structure of this type is very flexible, it allows developers to be creative in subdividing their properties vertically for maximum profit. In a 20-story building, for instance, a prospective buyer may be interested in the hotel, but not the retail space or condominiums. Another buyer may want to purchase an apartment on the top floors of a structure, but wants nothing to do with the hotel or retail on the lower floors. The condominium structure allows developers to sell each unit independently, which may be better for the bottom line than selling the entire building to a single purchaser. Provided the governing documents include carefully drafted provisions, the condominium structure also allows developers to obtain loans on each unit independently of the others as if each were a free-standing structure.

The bigger the development, the more complex it becomes. While there are a few common-sense dos and don'ts of second generation development, they are sometimes overlooked. First, design and build safe, superior structures with the help of responsible architects, engineers, and general contractors experienced in redevelopment and mixed-use development. Provide thorough supervision of the design and construction process and, additionally, hire a third-party construction inspector to lower the risk of liability. Craft solid contracts, leases, insurance policies and other documents with the help of legal counsel and insurance agents experienced in second generation development. Take the time to research city government policies and politics and build good relationships with city officials. Second generation development and mixed-use projects are a unique specialty, quite different from the standard suburban strip mall or office park. They are not a sideline hobby for generalists.

NEW LIFE FOR AGING CITIES

Second generation development projects are a viable trend in today's economy. Everyone benefits. Cities can breathe new life into blighted areas and obsolete buildings, while limiting suburban sprawl and attracting new taxpayers to urban live/work/play environments. For investors, urban buildings combine the safety of prime real estate with substantial returns on increasingly scarce land. For developers, the high-growth Sunbelt cities and their suburbs present lucrative opportunities with new challenges, but also great potential rewards. On this new Sunbelt frontier, knowledge is a powerful weapon. Local architectural, engineering and legal professionals can provide developers with expertise on city governmental structures, codes and procedures, as well as establish contacts with city officials and other resources. If those professionals are also experienced with the unique issues of second generation development and mixed-used projects, they can help pave the way for a smooth redevelopment process.

NOTE

1. "The Stale Doughnut: Dallas' ring of suburbs must face aging issues," *Dallas Morning News*, August 2, 2006.

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