

INSIGHT: Multifamily in the Mix

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Due to growing concerns about the cost of gasoline, traffic congestion and pollution, major US cities are revitalizing and repopulating their inner cores. High land costs and the difficulty of obtaining large land tracts make standalone apartment

developments in urban areas financially impractical, resulting in denser mixed-use projects, often with multiple developers occupying intertwining horizontally or vertically integrated parcels. These mixed-use projects raise unique issues for the multifamily developer.

Construction and Operational Cost Sharing—When uses are stacked in a mixed-use project, apartments are normally on the upper floors, and the garage and lower retail, office or hotel floors serve as the platform and structural support for the apartments. Parking spaces, elevator banks, loading docks, generator rooms, drive entrances, utility trunk lines and other back-of-house-type facilities will be shared by the owners to save land use and construction costs. Design, construction, operational and maintenance costs for these facilities must be allocated among the owners. Once the parties have properly determined these allocations, the obligation of each developer to make its contribution to these shared costs must be secured with letters of credit

or other forms of collateral so that the developers, their lenders and equity partners can be assured that the platform and common facilities will be built. These shared facilities will frequently cross over ownership lines, such that use, ownership and maintenance responsibilities are not identical and easements must be created to allow one developer or its users to access the shared facilities located on another developer's property. These arrangements are normally established in lengthy documents, including a cooperation agreement, escrow agreement and restrictive covenants.

Plan and Construction Coordination—Particularly when the development is stacked horizontally, the construction plans for all of the mixed-use components must be highly coordinated, from architectural design to structural and systems support. The hotel, office or retail architect may not be familiar with apartment design issues, and the apartment architect will likely have limited hotel experience. The co-developers should seriously consider hiring one architect for the entire project, or at least granting one of the architects the authority and responsibility to act as lead architect in integrating all of the plans. Sharing some of the critical engineering design firms (e.g., mechanical/electrical/plumbing and structural) will also facilitate plan coordination. In mixed-use projects that are structurally integrated, the co-developers should also agree on one contractor for the entire project to avoid finger-pointing when

construction issues arise, and one of the developers should be designated as the construction draw preparation agent, with approval rights granted to the other co-developers.

Monetary Objectives of the Parties—

Apartment developers tend to be more budget-sensitive than developers of the other components of a mixed-use project, particularly if there are hotel, condominium or other higher-end uses in the development. The finish-out details of the other uses may require a similar quality for the apartment component, driving up the quality of the residential beyond the rate of return parameters that are acceptable to the multifamily developer and its investors, and requiring a rent level to support debt that is above market. Design/construction quality will be significantly elevated when office or hotel uses are part of the mixed-use project, and the other developers may be reluctant to subsidize the apartment developer's share of land and other development costs. However, the location of residential units adjacent to office, retail and other uses provides positive momentum for retail sales, office leasing and the like.

Multiple Lenders and Equity Partners and Timing Issues—

Each of the developers will probably have its own debt and equity financing, all of whom will provide input into the development structure and the agreements discussed above, and the competing concerns of the various financing parties may necessitate heavily negotiated inter-creditor agreements, resulting in significant higher legal costs. Coordinating simultaneous closings can be hampered if non-traditional financing is sought by any of the component uses, such as tax-exempt bonds, low-income housing or new market tax credits or city incentive financing. Given the highly integrated nature of the development, the timing of financing closings will need to be closely monitored to avoid one or more developers being ready to close, fund and start construction while another developer is delayed in closing its financing.

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Securing the Development Obligations—Given the interdependence of the components of the mixed-use project, each of the co-developers (and each of their lenders and equity partners) will want comfort that the other co-developers will perform their development, construction and financing roles, particularly as land is acquired and construction commences. The parties should enter into a cooperation agreement that contemplates the formation of an escrow funded by cash or letters of credit from each developer for their corresponding obligation to contribute to the soft and hard costs of the development that can be drawn upon in the event

that a developer defaults. Without this security, a default by one developer could jeopardize the construction of the platform or common elements of the project and create cost increases for the other developers.

Although urban mixed-use projects can seem dauntingly complex, these very development issues create a built-in barrier to entry to future competitive development, providing a rent premium that ranges from 20% to 40% for the patient multifamily developer willing to overcome these obstacles.

The views expressed in this article are those of the author and not Real Estate Media or its publications.

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