What Detroit Tells Us about Conventional Financing and Economics of Revitalization.

The continuing revitalization of downtown Detroit is an international story. It is hard to believe that the General Motors bankruptcy was less than a decade ago and the city's bankruptcy was less than five years ago. The region that once served as a prime example of a Rust Belt manufacturing economy subject to heights of the late-2000s recession is now in the midst of an urban renaissance that has not only transformed the Motor City's skyline, but also completely changed the way people think about Detroit. The city is now one of the hottest national markets for stadiums, office, retail, residential, industrial, restaurants, and mixed-use development. With all of this activity, a long list of developers and investors are quite literally banking on Detroit.

One of the hidden economic dimensions behind the renaissance is the evolving financing dynamics behind the developments that are both making headlines and raising the bar.

According to the U.S. Bureau of Labor Statistics, unemployment in the Detroit area (as of February 2018) has dropped from 4.8 percent to 4.2 percent over the past year alone. As more people reenter the workforce, the need for more and better housing becomes essential.

Understanding how and why groundbreaking multifamily communities are securing the financial commitments required to become reality is an important first step in appreciating how a city's economic and development landscape evolves throughout the course of an accelerating growth cycle.

Making Conventional Work

At the intersection of Washington Boulevard and Park Avenue, construction is underway on City Club Apartments, a 288-unit apartment and penthouse community. The $70 million community features 13,000 square feet (1,200 sq m) of retail space, including a restaurant, theater, gourmet market, and specialty pet store. The apartments and penthouses, which range in size from 400 to 1,700 square feet (37 to 158 sq m), will provide 24/7 concierge service and resort-caliber amenities that rival those found at some five-star hotels. It is appropriate, given the fact that the development is on the site of the iconic Statler Hotel—originally built in 1915 and demolished by the city in 2005. Construction began on the development in fall 2017 and it will be completed this fall.

While City Club Apartments CBD Detroit is the first ground up, mixed-use high-rise in Detroit in more than 30 years, what makes the development particularly noteworthy in the context of Detroit's reemergence is the fact that it is being conventionally financed.

The majority of Detroit's new multifamily developments have received U.S. Department of Housing and Urban Development (HUD) funding—HUD serves as both the construction lender and the permanent lender—in conjunction with a range of grants and other alternative/nontraditional financing mechanisms. Conventional financing—through traditional construction lenders, commercial banks, pension funds, or a life insurance company, and securing equity through wealthy individuals and families, pension funds, life insurance companies, or real estate investment trusts—is a lagging indicator: a sign of a healthy development climate that often becomes reestablished only once a city is well on its way to an economic recovery.

Numbers and Timing

So why are we the first significant mixed-use development that has not sought to take advantage of those extra layers of incentives? Part of the answer is simply timing. Downtown Detroit's rental market has been on the upswing—a trend that really picked up in 2014, when the city came out of bankruptcy protection. Today, rents are around $2.25 to $2.50 per square foot ($24.22 to $26.91 per sq m), an important number for conventional financing to work.

Once the rental numbers work, the next challenge is the ability to get high-quality asset valuation. That poses a significant challenge in a market where everything is either "on sale" because it needs so much work, or the revitalization is so new that there are no comparables available in the market.

Detroit is not a merchant builder city and that is reflective of its low turnover rate of performing assets. Consequently, developers must identify lenders that are able and willing to get creative. When we built the first market-rent high-rise in Ann Arbor, Michigan, in more than 25 years, US Bank and Freddie Mac used comps from another city. But the bank—and the credit committee at that bank—obviously had to be willing to do that. It takes leadership and vision to make it all work.

In other words: while the market dictates financing to a large extent, you also need a developer willing and able to push for conventional financing—and financial institutions and business and credit committees that are willing and able to make decisions based on excellent fundamentals.

Our goal from day one was to prove that it could be done conventionally.

We made the case for conventional financing to Mayor Duggan, City Council, and the Detroit Economic Growth Corporation. They were confident that the market had matured enough and that rents were strong enough to make the math work for conventional financing while also ensuring that 20 percent of the apartments would be affordable.

While City Club Apartments is using available brownfield and tax abatement programs, those are incentives that are typical for urban developments. Civic leadership is also an important and often underappreciated factor in the financing equation. The political and economic dysfunction we saw in Detroit under the last administration just did not inspire trust or confidence—and that has an enormous impact on the availability of financing. From a leadership standpoint, the climate in Detroit today is both positive and highly creative.

A Familiar Pattern

This progression is typical of the upward evolution of the Midwest. Cities like Pittsburgh and Cincinnati were both in a similar place five to six years ago, Minneapolis in the early 2000s, and even Chicago back in the late 1980s and early 1990s. Indianapolis, Kansas City, Cleveland; the list goes on. And Detroit is no different.

For those early developments in a recovering market, the lack of both rent and sales comps is a challenge. That creates a financing funnel where developers often rely on HUD loans, grants, and other incentives, which, in turn, puts more pressure on the equity side of the equation in conventional deals. Having to come up with 25 to 35 percent cash/grants/incentives equity instead of 15 to 20 percent means a lot of deals simply never get done. These are particularly turbulent waters for younger and smaller firms to navigate.

Leaning into It

Civic officials in Detroit and elsewhere are more strategic and proactive today with respect to financing. Cities should leverage alternative financing tools strategically to help those neighborhoods that are lagging somewhat behind the redevelopment curve. In Detroit, for example, this approach would push for conventional financing for projects in Detroit’s CBD and Midtown areas, while “next” neighborhoods like Livernois, Corktown, Grand River, and Eastern Market would be the natural beneficiaries of grant monies or alternative financing tools.

In order to fuel Detroit’s momentum, developers and civic officials in Detroit need to continue to encourage more banks, pension funds, and life insurance companies to pay attention to and participate in investing in the city’s renaissance. Getting more institutions involved helps disperse the risk. Banks have lending limits, and they are going to put only so much money into any one city—no matter how much positive economic and development momentum has been established.

Urban Land Magazine

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March 26, 2018

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