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January 05, 2010

## MIXED-USE DEVELOPERS WEIGH SALE OF RETAIL COMPONENTS

The following is Part One of a two-part article on retail condo sales. Check back on Thursday for the second half.



Carlos Lopez

In the past decade, a wave of high-density mixed-use development has swept the country. The activity was fueled by a demand for more housing, historically low interest rates and escalating land prices. Developers took action by building mixed-use projects and converting old apartment buildings, office buildings and hotels into predominately residential condominium developments. During the process of converting a building into individual residential condos, the evolution of the street-level portion of the development into a retail condominium was born. The retail condominium has become a phenomenon that has now emerged as a popular and alternative real estate investment platform to sell and acquire real estate.

Traditionally found in major metropolitan cities, retail condominiums have now appeared in suburban markets throughout the country. Developers have mainly sought to profit from the sale of a project's residential component, but selling the retail space can result in the developer obtaining a higher cost per square foot for the individual residential condominiums. The sale of the retail condominium portion of the project has represented a substantial opportunity to add to the overall profit of the project from the development proceeds.

Retail condominium sales are generally structured for sale in one of two formats. The first is a sale to an investor of retail space as a leased investment. The income stream is structured similar to a traditional retail building or shopping center. The second format is a sale to a single user. Due to the significant slowdown in leasing and attractive SBA financing for business owners, this has been a growing trend taken advantage of by an individual user or smaller entrepreneurial retailer. International Longshore & Warehouse Union Local 13 recently purchased the 18,864-square-foot ground-floor retail component of Centre Street Lofts, a 116-unit residential condominium building in downtown San Pedro, California. The retail portion was only 6 percent occupied at the time of the sale, allowing the buyer to occupy the building as its corporate headquarters.

For individual investors, retail condominiums have a tremendous advantage. The structure allows the buyer to purchase a stabilized investment typically in a prime location that may traditionally have been unavailable previously to private investors. Due to the location and component of other types of real estate uses in the development, this would have required an investment of tens of millions of dollars. Now it has opened it up to an investment market attractive to 1031 investors looking to acquire properties to satisfy a tax-deferred exchange.

The individual condominium sale to private users remains not only an alternative source of sale to developers, but also to potential tenants or purchasers. Due to the softening real estate market and the contraction of national and chain retailers in the current economic climate, the absorption period to lease retail space is now much longer. As a result of this longer time period, individual retailers can find more spaces in which to move their businesses and also may find the opportunity to acquire their own retail unit.

Additionally, due to the larger supply, downward pressures on pricing may allow an individual retailer a chance to negotiate a favorable price in purchasing their own individual condominium. From a financial markets perspective, while the credit markets may remain in a state of constriction in general toward lending for commercial real estate, many successful retailers have strong private banking relationships. These relationships often can open the door toward obtaining the financing to acquire real estate for their own use. Moreover, the SBA financing market remains healthy and also offers a source to finance and purchase an asset with

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minimal down payment, thus freeing up the working capital necessary to devote toward retail operations.


While many mom-and-pop retailers are more likely to purchase their commercial condominium, there have been instances when national chain retailers have acquired real estate for their own retail operations in retail condominiums. As an example, in 2006, Staples acquired an 18,873-square-foot retail condominium in downtown Chicago for \$5.67 million. In areas that may have a predominately large Asian community, many Asian retail businesses have expressed a strong demand toward purchasing their own retail stores. While many individual attributes make the retail condominium an attractive investment and offer an attractive possibility to acquire commercial real estate in prime urban markets, investors need to be aware of certain considerations.

— *Carlos J. Lopez is President of Hanley Investment Urban Retail Advisors based in Irvine, California.*

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January 07, 2010

## MIXED-USE DEVELOPERS WEIGH SALE OF RETAIL COMPONENTS

The following is Part Two of a two-part article on retail condo sales. The first half of the piece was published on Tuesday.



Carlos Lopez

During the past 6 years, we have witnessed an unprecedented sales volume of more than \$20 billion in retail condominiums in major metropolitan cities across the United States, according to Real Capital Analytics. Last year, the trend slowed significantly. In August, a 5,223-square-foot retail condominium sold for \$7.4 million in San Francisco. Occupied by Wachovia Bank and a small pastry shop, the sale was a portion of the Ritz Carlton development and was only the eighth commercial real estate transaction between \$7 million and \$25 million in San Francisco since September 1, 2008. Moreover, the rapid decline of residential condominium prices and sales has created pressure for some developers to sell the retail condominium portion in response to declining sales proceeds and overall profits. In other cases, some developers have been seeking to sell the retail portion in order to pay down or pay off existing debt of particular developments that were constructed during the past 2 to 3 years.

### Condo Association and CC&Rs

First, while the purchaser will own his individual piece of real estate, the overall real estate is most likely subject to being governed by a condominium association and CC&Rs. While each development has its own nuances, the condominium association may not be attractive to certain investors, as this association has control of operational expenses that affect the commercial condominium owner. The retail condominium owner may have little control over the implementation, control or management of these expenses. While many of the leases may be structured as NNN leases and will be subject to pass through of these expenses, the condominium owner may be unable to pass through additional expenses to the tenants. If the owner of the retail condominium is also an operator of a business within the development, the cost increase in operational expenses would be passed on directly to his cost of business operations.

Also, some developments may have restrictions on the uses that may occupy the retail component and/or be subject to the approval of the association governing the development. In the sale of a retail commercial condominium in San Pedro, California, this past fall, a professional office user was seeking to purchase a portion of an 18,000-square-foot retail condominium beneath 116 residential condos that was 94 percent vacant. The association had a restriction subject to the CC&Rs that prohibited an office/professional use to occupy the ground floor component of the development. As such, it was necessary to gain approval and a modification of the CC&Rs from the association in order to purchase and occupy the premises prior to the close of escrow.

One final drawback may be defining the responsibility, liability and pure ownership obligations of the different portions of the physical make-up of the development, such as parking garages, common-area walkways and lobbies, storage and maintenance responsibilities between the parties, etc. To positioning the property as an attractive opportunity for sale, developers should work in conjunction with legal counsel experienced in drafting CC&R/condominium association agreements in high-density mixed-use developments, whether it is positioned for sale or retaining ownership of the retail component.

Retail condos can present a tremendous opportunity to own and operate real estate in some of the most dynamic markets in the country. While market forces may have limited the ongoing development of high-density mixed-use developments in the short term, land scarcity as well as municipal forces seeking to develop pedestrian-oriented developments will continue in the long term. As a result, the retail condominium will be a product in the marketplace as common as multi-tenant apartment buildings, multi-tenant shopping centers and single-tenant investments.



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