Essential Information For Downtown Revitalization
May 15, 2008
Downtown Idea Exchange

*Perspectives*

# Manage risk of TIF bonds for mixed-use and retail projects

*By G. Lamont Blackstone*

If we accept the premise that cities are mechanical systems and, as such, are vulnerable to having their parts wear out or become obsolete, then capital is needed to retool these mechanisms. Sewer systems and other infrastructure assets built generations ago do not have eternal design lives and are subject to the ravages of depreciation and functional obsolescence.

For several years, the American Society of Civil Engineers has been sounding alarms over the deficient state of this republic's infrastructure. These warnings come at the same time that smart growth imperatives encourage central cities to leverage past investments in infrastructure by densifying urban land assets through upzoning and the rush to mixed-use development.

As 'mechanical systems,' blighted downtowns and neighborhood business districts are analogous to classic automobiles that still have years of productive utility — but whose batteries have run down.

Instead of towing those 1960s-era Jaguars off to the junkyard, many traditional downtowns and neighborhood business corridors simply need a jump-start of public investment to unleash the flow of private sector capital. In other instances, more substantial reconditioning is needed to break the cycle of disinvestment that keeps such areas sidelined while other districts lure developer interest.

Accordingly, tax increment financing (TIF) has been used to provide the vehicle for making transformative investments that drive redevelopment strategies. With the exception of Arizona, this popular form of revenue bond financing is now authorized in every state of the Union. Tax increment financing allows municipalities to be entrepreneurial in how they reinvent their downtowns.

Like any entrepreneurial endeavor, however, the use of this tool can be fraught with risk.

Developers should be cognizant of this when petitioning municipalities to invest tax dollars as partners in concert with their development projects. Developers should also be mindful that public sector actors are often more motivated by the avoidance of risk than the achievement of gain — perhaps a fundamental difference in culture between the development community and government. This is even more crucial in current times when we are faced with convoluting markets for municipal debt in the wake of the ripple effects of the subprime mortgage eruption of 2007.

Risk spreads have widened across a diverse cross section of asset classes including municipal debt. The effect is to increase the cost of borrowing and decrease potential funding amounts for a given stream of projected tax increment. Since the risk pricing of a developer-driven TIF deal will be influenced by the perceived risk of the underlying development program, prudence dictates that public sector agents proceed with a risk management strategy for implementing the use of TIF.

Such a strategy is comprised of the following seven layers:

**1. No users; no increment.** No buildings; no users. Ensure that the various project components are

This article was reprinted from the May 15, 2008 issue of *Downtown Idea Exchange*.
Interested readers may subscribe to the twice-monthly newsletter by visiting http://www.downtowndevelopment.com or phoning (973) 265-2300.
© 2008 Alexander Communications Group, Inc. All rights reserved.
No part of this article may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying or otherwise without the prior written permission of Alexander Communications Group.

leaseable or saleable. Evaluate the marketability and feasibility of the project to ensure that the project is built. Incorporate conditions precedent clauses for key development milestones into the development and disposition agreements and other project documents involving a public-private nexus.

**2. Don't over-borrow.** Don't borrow beyond your means. Make sure that the bonds are appropriately "sized" commensurate with the stability of the tax increment stream. Seek input from bond underwriters and feasibility consultants who are knowledgeable about underwriting parameters such as debt service coverage ratios.

**3. Fund when the project is done, i.e., to the extent practical.** Defer as much of the public investment as possible to the back end of the construction period. However, although this mitigates government risk, this often is not achievable given the timing of required uses for public sector investment, e.g., underground infrastructure improvements and site assemblage programs. While opportunities should be sought to synchronize public investment so that it is not "walking the point," it defeats the project purpose to impose conditions that cripple the developer's ability to finance the project. And institutional lenders often insist that public dollars must be funded first.

**4. See all the pieces of the puzzle.** Now regarding those institutional lenders (and equity investors as well), make sure that the developer has all his/her funding in place to complete the entire project. Review drafts of commitment letters and other funding documents as early as possible. In an era of tightening underwriting standards, stay alert for lender funding conditions that may conflict with the execution of the TIF bond issue.

**5. Time is the common enemy of both public and private sector partners.** Minimize the risk that the development or components of a mixed-use project will "miss the market." Strive to compress the time frames for deal approvals and execution. Although public investment may be essential to close a project-funding gap, an efficient approval process is as important as those dollars. If projects take too long to come together, anchor tenants critical to project execution can go elsewhere or developers may be forced to sell or lease when the market has turned downward.

**6. Reinforce your foundation to support the debt load.** Incorporate credit enhancements that protect against "increment growth failures," e.g., letters of credit, bond insurance, etc. But be sure to understand the credit strength of the credit enhancer. And be careful of how this might affect the tax-exempt status of the bonds.

**7. Don't let appeals peel away the increment.** Incorporate waivers of property tax appeal rights clauses into the development and disposition agreements and, by extension, into the underlying commercial leases, commercial condominium documents and residential sales contracts, wherever possible.

This is your tax increment bond issuer's recipe for a financial seven-layer cake. It is possible to have satisfactory levels of protection if one or two of these layers are missing key ingredients or include less palatable elements. But if largely followed and negotiated with your developer partner, you should be able to have your cake and eat it too (in the back seat of a restored sedan) — with little fear of indigestion!

*G. Lamont Blackstone is a real estate consultant and developer for retail and mixed-use projects. He can be reached at urbancorerealty@aol.com.* ◆

© 2008 Alexander Communications Group, Inc. All rights reserved.