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Quest for a United Sustainable Society

Excess Capacity and the Legacy of the Auto Industry

Ready, Steady, Go!

Michigan Paces Redevelopment

Give Developers Their Due

By Todd S. Davis, Esq.

It's the first day of business school at thousands of the world's colleges and universities. Students, peering behind walls of laptops in amphitheater seats, hyped on caffeine, await the first pearls of wisdom from bowtied professors (O.K., for political correctness, female professors with those funny scarf-like things, too). Those same professors quickly scribble across white boards the most fundamental investment principle, an investment paradigm that will ring in each student's ears for the rest of their lives:

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The key to all investment decisions is balancing risk and return.

Corollary 1: The greater the risk, the greater the return must be to attract capital to the transaction.
Corollary 2: The lower the risk, the lower the return.

Essentially, business students spend the next two years exploring this risk/return paradigm. In fact, if they didn't need the credential, once students master this concept they could probably skip class until graduation. Simply stated, this basic formula is the universal foundation for all investment decisions.

Unfortunately for brownfield developers, many stakeholders in the brownfield redevelopment process, including the media, never attended the first day of business school. Even more surprising, I have been told by many brownfield stakeholders—particularly those professionals formerly in the public sector—that they view the motivations of any for-profit entity with great skepticism. This philosophical clash has truly become a barrier to brownfield redevelopment and makes absolutely no sense either for developers or for those communities trying to effect complex brownfield projects.

Complex brownfields, by definition, fall into the high risk/high return category. And there are all kinds of risks: environmental, legal, market, and political, to name a few.

Obviously, if the market did not perceive real risk, investors would flock to these brownfield bargains like it was the 4 a.m. "Day After Thanksgiving Extravaganza" at WalMart. But they don't. So how do we bridge this great perceptional divide regarding the absolute need to create a profitable market for brownfield deals?

It's Just Good Business

Keeping the fundamental tenet of all investment decisions in mind (see above), somebody please explain why there seems to be a widely held belief, primarily in the public sector, that if a brownfield developer makes a great return on a transaction, a public sector stakeholder has been somehow screwed in the process. This is absolutely, positively wrong.

I admit that this is a self-serving argument. I also admit that trying to evoke sympathy for Armani-wearing, Porsche-driving, just-took-a-bunch-of-lessons-to-fix-my-slice developers, is like Elliott Spitzer begging forgiveness from Wall Street. Yet, the logic is undeniable.

Given the fact that risks associated with brownfield deals are arguably among the highest associated with any real estate investment, a brownfield developer's job is to earn the best possible rate of return for his/her investors. In fact, the developer has a fiduciary duty to do so. By definition, most brownfield sites have been underutilized for years due to the site's inherent risks. Consequently, a number of government programs and/or incentives have been created to reduce these risks and attract developer/investor capital (which must be measured in terms of both time and money).

Additionally, basic economic theory dictates that capital only flows where the interface between risk and return meet. In other words, if a developer invests a tremendous amount of time, effort and capital to rehabilitate a complex brownfield site, and there is a high risk the developer will lose the firm's investment, the return must be potentially tremendous to encourage the investment. Otherwise, in brownfields, like any other investment, capital will flow to other projects where perceptions of risk and return meet.

Assuming these truths to be self-evident . . . why do developers often have to endure the wrath of the uninformed if the developer actually does well, remediates a site and earns a rate of return commensurate with the risk on investment? Is it because those critics never went to the first day of business school? Is it due to a difference in philosophy regarding capitalist free-market society versus those who believe government ownership makes more sense? Or, is it simply because those critics have never invested their own capital—not only in a brownfield deal—but in anything? (Not to go too far on a tangent, but when the critics invest their hard earned pension funds, do they hope to get the most return from their investment or the least?)

Focusing on the Bottom Line Is a Win-Win

The bottom line is that brownfield investments demand non-traditional returns to attract capital and to compensate investors for their risk. The public sector's role should be to support those transactions and to mitigate the risk to all parties. These combined efforts result in the remediation that returns these long-fallow sites to productive use. If those goals are accomplished, it is not only a great deal for the community, but squarely consistent with the community's economic development role. If a brownfield developer and its investors are financially successful in the process, you have a true win-win.

The extreme alternative is to have no brownfield program and have the public sector or nonprofit sector serve as the only drivers in brownfield projects. While this approach would take the profit motive out of the picture, it certainly would substantially decrease the number of deals completed, given already tight public budgets.

The better approach is to use public incentives to leverage private investment. I have argued for years that applying the low-income tax credit approach to brownfield development would be the best way to increase deal velocity and to meet community goals for redevelopment.

I'm holding my breath until the next election.

Brownfield Developers Are Just Beautiful

Catherine DeNeuve panting, "Don't hate me because I'm beautiful," scrolls through my brain when I think about this tenuous relationship between brownfield developer and public sector stakeholders. In other words, you should be glad, no, thrilled, if a developer does well on a complex brownfield investment. If you're ill, don't you go to the best (often financially secure) doctors? If you're sued, don't you want the best lawyer (often billing $400-plus per hour)? Consequently, if you have a complex brownfield, you should want the best possible brownfield development team to accomplish your transaction. And, you should cheer for the developer's returns, not bemoan them. Remember, the better a brownfield developer does in your community, the more capital you will attract to do the toughest of all real estate deals in your town.

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