EDJ
The IEDC
Economic Development Journal
734 15th Street, NW Suite 900 • Washington, DC 20005
Volume 17 / Number 4 / Fall 2018

From Mall to Mixed Use

By Larisa Ortiz and Heather Arnold

THE ROLE OF THE PUBLIC SECTOR

Retail real estate is in a period of significant disruption, leaving many owners of legacy retail real estate assets struggling to find solutions that address the cash flow challenges brought on them by the loss or downsizing of many of their traditional tenants. Many owners are now looking to alternative uses that push the envelope and embrace a mix in tenancy that requires considerable planning and in some cases, financial or institutional support from public sector partners. This article will explore the ways in which the private and public sectors will increasingly come to rely on one another to address a host of complicated design, regulatory, and monetary hurdles that will differentiate successful projects from those that fail.

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OVERVIEW

Warnings of a pending retail apocalypse are flashing red, with traditional shopping malls drawing a lion's share of the worry. Credit Suisse projects that up to 25 percent of malls will close by 2022. Left undeveloped, these hulking structures will become blighted properties that undermine property values and the tax base in their local communities. The impact doesn't stop there: Retail real estate accounts for roughly one in six jobs nationally, and about one-fifth of U.S. gross domestic product, according to the International Council of Shopping Centers (ICSC), the nation's leading shopping center trade association. These properties collectively contribute $195 billion in combined sales and property taxes. Cities can ill-afford to sit back and watch them struggle.

While the demise of retail has certainly been exaggerated, the problems facing shopping malls are very real. Look no further than the mall's original purpose – collecting tenant types (apparel, electronics, home décor, bookstores) that turned out to be the ones hit hardest by changes in technology and spending habits as the ecommerce economy grew. There was a time when entire wardrobes were purchased at one or two stores. The Millennial and Z generations, by contrast, do not care about labels or brands, and do not shop that way. In addition to competing against their own online presence, more brick-and-mortar stores are now splitting the same amount of consumer spending. For many companies, it hasn't been or won't be enough to stay afloat.

These challenges have been a long time in the making. The U.S. is overbuilt with retail square footage – more than 13 billion square feet of it. At 23 square feet per person, the U.S. has the most retail space per capita in the world; Canada, for the purpose of neighborly comparison, has 16 square feet per person. And shopping habits continue to shift. Ecommerce purchases are accelerating rapidly. Over the past year, traditional mall tenants such as Williams-Sonoma have sold more online than in stores. Then there's the inevitable lifecycle decline of many malls, particularly Class B and Class C malls constructed in the last 20 to 40 years, which will likely constitute an outsized portion of

The Cross County Shopping Center in Yonkers, NY now includes a Hyatt Place hotel and an extension center for Westchester Community College.

Source: Larisa Ortiz

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Mall owners are pursuing strategies to evolve along with the retail environment. The good news is that the fundamentals of many of these mall properties remain strong. Most are located in mature markets, with minimal direct competition, at locations with proximity to a strong customer base, and access to robust regional transportation networks, including state and local highways.

mall closures. Communities that have come to depend on property taxes paid by these centers will see reduced assessments *and* reduced sales taxes.

MALLS TO MIXED USE?

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We analyzed almost 400 malls that have closed since 1980. None have been resurrected in their former incarnation. Nearly a third have been renovated and comprehensively re-tenanted with a wide variety of outcomes. About 18 percent were demolished and replaced with new retail stores, most often big box power centers. (We're looking at you, New Jersey, with nine of these sites). And 11 percent have been integrated with other uses to boost occupancy levels, therefore becoming "mixed-use." These non-retail tenants commonly include offices, data centers, schools or universities, libraries, hospitals, and quite a few churches.

Mall owners are increasingly exploring non-traditional retail uses to drive new revenue streams and respond to changing customer preferences. Non-retail and non-restaurant space in malls increased 3.9 percentage points (from 19.2 percent to 23.1 percent) between 2012 and 2018 (CoStar). Space dedicated to food and beverage (F&B) also grew, nearly doubling from 5 percent a decade ago. According to a 2017 joint report by JLL and ICSC on the integration of F&B within retail real estate, by 2025 that sector will account for 20 percent of total space and up to 25 percent of space in destination properties.

In some places, shopping malls are being demolished to facilitate new mixed-use development. Colorado has seen three major demolition-to-mixed-use projects. In 2004, the former site of the Villa Italia Shopping Center in Lakewood became Belmar, with stores, restaurants, apartments, offices, and a hotel around a newly created street grid. The Streets at SouthGlenn, with 202 apartments, 140,000 square feet of office, and over 900,000 square feet of retail, replaced the Southglenn Mall on a site that was cleared in 2006. Downtown Westminster has broken ground on a hotel, movie theater, apartment buildings, and park system, all around a JCPenney that is one of the last remaining pieces of Westminster Mall.

PUBLIC SECTOR INTEREST

What can economic development organizations and their public sector partners do to ensure these mall-to-mixed-use concepts are well planned and contribute to a community's overall economic well-being?

Some of the challenges that developers face are the result of decades-old zoning and regulatory policies that prevent mixed-use development. Many malls were developed under Euclidean Zoning policies that encouraged the separation of what are deemed incongruous uses. So sites where residential development could flourish and catalyze other opportunities couldn't do so because of regulatory constraints that prohibited non-commercial uses – essentially retail, office, and sometimes light industrial/warehouse. (Amazon and Walmart have targeted several mall redevelopment sites for distribution centers across the country.)

Traditional parking requirements, specifying a minimum number of parking spaces that must be provided per use, further deepen the challenges of mixed-use development. Space demands that ignore opportunities for shared parking or alternative transportation options can result in unnecessary and costly parking decks or underground garages that limit development opportunities. In some communities, parking requirements as high as 10 spaces per 1,000 square feet of retail remain on the books; even four to six spaces per 1,000 square feet is considered high. Mixed-use environments can get away with as few as one to two spaces per 1,000 square feet of retail (or even less in high density communities) for some compatible mixes.

For all these reasons, rezoning and/or master planning old mall sites are critical for mall-to-mixed-use redevelopment efforts. Regulations must be updated to allow for residential development and other uses; parking requirements must be revisited in light of the new ways people get around. (Uber drivers don't need to park.) Also required is more flexibility in what constitutes the use group known as retail. This may mean allowing for small-scale light manufacturing: Micro-breweries, for in-

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stance, fall into the category of manufacturing but are welcome additions to many retail projects. In many cases, these substantive zoning changes require public approval, which in turn requires a working public-private partnership between the developer and the governing entity.

New mixed-use projects on old mall sites also require significant investments in infrastructure. Acres and acres of impervious surface need to be razed, new streets and utilities laid, public spaces constructed. The planning process must consider connections to existing street networks to be accessible to prospective customers arriving on foot, on bicycles, and – yes – even on electric scooters.

Many lenders have little experience in financing mall-to-mixed-use construction and historically have stayed away from these projects because of their inherent complexity and prospects for rising costs. Retail developers unaccustomed to the challenges of mixing uses cringe at the thought of having to pay extra to accommodate things like columns or elevator shafts for the uses above their spaces. Will those investments bring a higher rate of return or help attract stores and restaurants? For their part, architects trying to accommodate multiple uses must grapple with different building code requirements for different uses, as well as the need for taller ceiling heights and optimal column spacing. These are some of the reasons why banks can be reluctant to lend to mixed-use projects.

Economic development agencies and their public-sector partners have to strike a careful balance. The cost of a thoughtful and contextual redevelopment for a large mixed-use project may exceed return-on-investment for developers, requiring some form of public-sector support in order to turn it into reality. Doing nothing is simply not an option for communities whose tax base once relied on these commercial properties.

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As a result, more and more communities are coming to the conclusion that they must step up and support the catalytic redevelopment of mall sites to ensure they remain productive contributors to the tax rolls. In 2007, the Virginia city of Hampton formed a special taxing district, known as a Community Development Authority (CDA), to finance $92 million in infrastructure improvements to facilitate the conversion of Coliseum Mall into Peninsula Town Center, an urban-type office, residential, retail, and structured parking development. More recently, the project was awarded a $17 million "grant" (funds will be repaid through recordation of several forms of taxes) from the state's Tourism Development Financing Program to the Peninsula Town Center developers. Administered through the Virginia Tourism Corporation, this investment will be directed to the completion of the project's latest addition, a 120-room Element hotel. Financing tools like those deployed by Hampton will become more common as mall redevelopment continues.

PUBLIC SECTOR REDEVELOPMENT TOOLS

For public-sector partners, each phase of the redevelopment process brings both opportunities and risk:

Pre-Development Due Diligence

For each failed mall site that was redeveloped into a successful contributor to community life and the tax base, there are three others that resulted in broken promises, loan defaults, wasted resources, misappropriated funds, and the end of careers. Municipalities have the best shot at the successful redevelopment of former malls – particularly if they have come to acquire or control the site before a developer is selected – by understanding project feasibility and market conditions. There is no real shortcut for taking a hard look at market conditions before an investment of this kind. It's surprising how infrequently this occurs.

Developers are not always the most reliable source of information. Just because someone wants to undertake a massive project does not mean they should. Public agencies should find an experienced third-party source to conduct a thorough market study of each real estate asset type currently allowed on the parcel. If residential uses are not permitted, it might make sense to analyze why not – and whether the potential upside might justify jumping over a few hurdles (which, depending on local politics, might be nearly insurmountable). This also involves soliciting public input before developers invest significantly in a site. Too often a project can come to a roaring halt because of unexpected community opposition.

Failed malls can have unexpected sources of hometown support from emotional connections that are far more difficult to address than logical ones. So many people wistfully recall holiday and back-to-school shopping trips to Marshall Field's, Parisian, Kresge's, Hudson's, Mervyns, and Gimbels. Vacant shopping centers, especially their anchors, can carry a sense of loss that is often accompanied by community accusation (rightly or wrongly) that they were permitted to languish for redevelopment purposes. Developers will find it helpful to have an estimate of the level of resistance they might be facing during the pre-development phase, not later.

Public Financing Support

Public financing support is not uncommon among large mixed-use development projects. It can constitute 20-30 percent or more of a project's overall financing package and frequently comes in the form of special purpose districts, which are a tool to raise revenue to support capital improvements and/or operating costs for a project.

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Of these, Tax Increment Financing (TIF) districts are a common form of special district that earmark assessments collected from new development to finance improvements. Assessments are based on the increase of taxes over the existing base tax. This recaptured tax flow is used to repay a bond that is issued at the start of the development process. One such example of a TIF is the Mall Area Redevelopment TIF District in Dallas. The district was designated in 2014 and is made up of two non-contiguous areas – one in northern Dallas and one in southern Dallas, on the locations of two conventional indoor legacy malls, the Valley View Center and the Southwest Center Mall, respectively. While the verdict is out on the success of these initiatives (the Dallas City Council approved in June an additional $22 million city investment towards one of the two malls), plans for the sites over a 30-year period include the addition of approximately 9,000 residential units, 800,000 square feet of new retail/restaurant and entertainment space, 4 million square feet of office space, and 1,000 new hotel rooms. The TIF budget in 2014 dollars is estimated at $182.5 million, which will fund demolition and remediation, public infrastructure and open space improvements, and land acquisition. In Dallas to date, 18 TIF districts have been created to support development of under-performing real-estate assets.

Economic development agencies exploring this option should investigate state enabling legislation to determine the viability of TIF as a financing tool. In New York, for example, TIF legislation was enacted in 1984 and used only twice at the state level in the following 28 years on two relatively small projects. While the law has been revised to address a number of structural deficiencies that limited its utilization, it remains a relatively untested product. As a result, there is limited experience among developers and public-sector partners who are only now exploring this sophisticated financing tool. An economic development entity with limited experience utilizing TIFs will, along with reviewing the enabling legislation, want to speak with knowledgeable real estate attorneys to determine why TIF application has been limited. There may be a good reason.

Regulatory/Zoning

Changing the rules of the game will mean addressing the zoning restrictions that prevent the mix of uses so vital to these projects. Local government can anticipate regulatory/zoning issues early on by conducting a review to understand the impediments to redevelopment that are baked into the zoning code and address them before a developer comes on the scene. There are pros and cons to taking care of these administrative tasks before identifying a developer. Doing it without developer input might hamstring the developer into doing things that don't make market sense. But a pre-approved regulatory framework – one that allows for a certain degree of flexibility to respond to on-the-ground market conditions – can be critical in ensuring some degree of predictability with respect to the outcome of discretionary zoning changes subject to the public approval process.

Opportunity Zones

One as-yet-untested financing tool is the federal Opportunity Zone program, part of the 2017 package of changes to the tax code. In such zones, new investments may be eligible for preferential tax treatment. Opportunity zones are focused on areas of high poverty (greater than 20 percent, plus median household income less than 80 percent of the surrounding area, per 2011-2015 ACS data). About 56 percent of census tracts, or more than 41,000, are eligible, though state and local leaders will have a say in which census tracts can try to make use of the program. While final rules from the IRS are expected at the end of 2018, eligible entities, including banks, developers, Community Development Financial Institutions (CDFI), economic development agencies, high net worth individuals, mutual funds, and venture capitalists are beginning to explore the creation of so-called Qualified Opportunity Funds to invest in eligible properties. The verdict is very much still out on this particular financing mechanism, but economic development agencies should consider it a potential new tool in the toolbox to support mall redevelopment projects.

MISTAKES TO AVOID

Restricting uses that make the mall-to-mixed-use conversion viable. It is worth repeating: Residential zoning may be the keystone that allows all other elements to stand. In a strong housing market, the value of apartments, townhomes, and condominiums is often a necessary piece of a financing equation. The other parts simply don't "pencil." A blended return among all uses can be high enough to allow the project to proceed.

Requiring uses that make the mall-to-mixed-use conversion fail. Mandating retail on the ground floor of every building. Maintaining aggressive parking ratios.

Local governments must research a developer's financials and access to capital. Review their pro-formas and confirm that their assumptions for rents and sales are valid. Understand their relationships with lenders, brokers, and other developers. Finally, it is not fatalistic to maintain a Plan B throughout the process – it's just good business practice.

Each of these can unnecessarily trigger a whole variety of issues that have tanked many mixed-use projects. Building too much retail space where it doesn't belong creates ground-level vacancies which can directly impact upper-level vacancies and the walkability of the sidewalk environment. Ranging anywhere from $10,000 to $50,000 dollars a space, unneeded parking can quickly change the color of the bottom line from black to red.

Getting distracted by design. Somehow, starting with the Romans (or perhaps the Greeks, depending on whom you ask), civilization has created and perpetuated a system of blocks supplemented by uses and organized around parks, large and small, that integrate nature into urbanity. From a planning perspective, retailers hate creative flourishes like oddly shaped buildings, curvy streets, and wide medians down the center of a main street. Residential uses will need a mix of options that include quiet streets as well as units above nightlife. Retail and office space will prefer locations with visibility along high-traffic roadways. Far too much time is spent on the design details of buildings and not enough on the site planning.

Lack of experienced partners. From our survey of failed mall projects, more than a handful of municipalities have invested significant funds or sold properties for nominal amounts to private individuals or developers without the background and knowledge to execute complicated projects. Local governments must research a developer's financials and access to capital. Review their pro-formas and confirm that their assumptions for rents and sales are valid. Understand their relationships with lenders, brokers, and other developers. Finally, it is not fatalistic to maintain a Plan B throughout the process – it's just good business practice.

Lack of community engagement. Aside from concerns that the community might object to redevelopment, the residents, employees, property owners, and business owners have project know-how that no one else can provide – what will allow a new mixed-use project to become seamlessly integrated into the surrounding neighborhoods? Infusing the "specialness" of a community, through local retailers, landscape treatments, street connections, and similar integrations must include the neighborhood's input and perspective.

CONCLUSION

As the retail industry confronts a period of significant disruption to its prevailing business model, the challenges facing owners of existing retail real estate assets will only grow more acute. Turning these properties into productive assets will require significant innovation, flexibility, and resources on all sides. The most successful projects will involve significant due-diligence and partnership building that enables both creative and smart experimentation, and results in a winning solution for all stakeholders.