EDNow Economic Development Now
INTERNATIONAL ECONOMIC DEVELOPMENT COUNCIL

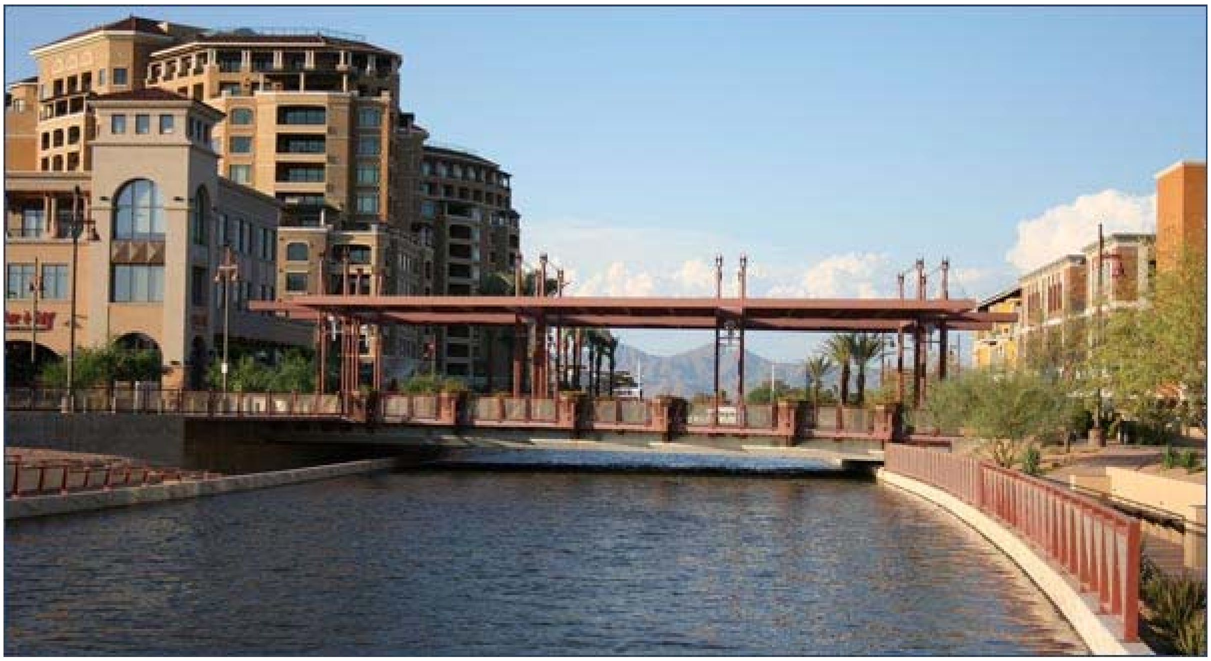
March 18, 2013 / Volume 13 / Issue 6

March 18 ED Now **ED Now FAQs**

Download this issue (PDF)

Avoiding Pitfalls of Public-Private Partnerships

By Aaron N. Gruen, Gruen Gruen + Associates



GG+A provided the initial redevelopment plan for the downtown Waterfront Focus Area in Scottsdale, Ariz., and worked with the city over many years on its implementation. The historic Arizona Canal was turned into a blend of shopping, dining, lodging, housing and cultural attractions, along with related infrastructure and amenities.

Public-private partnerships hold multiple pitfalls for public-sector entities soliciting property development and redevelopment.

Frequently, by the end of the solicitation process that follows from a vision-based plan, the public sector entity has accumulated hard-won experience, while the private-sector developer has accumulated a not immodest and not necessarily warranted "contribution" from the public-sector entity. In other contexts, such contributions would be considered risk capital or equity investment for which the capital provider would be given a share of any future cash flow and profits the project generates.

Even with such contributions and other "incentives," the solicitation process can result in infeasible projects or plans that do not get implemented - or worse, plans that do get implemented with unintended, adverse results.

Pitfall #1: Inadequate information

A primary pitfall relates to the premature issuance of the solicitation without a sufficient information framework.

This pitfall results from the frequently unjustified faith that developers, without assurance of selection, will expend the time and money to conduct market research and pre-architectural programming analysis and related due diligence, all in order to identify the scale, mix, and phasing of uses likely to maximize supportable land values and investment returns while concurrently satisfying municipal objectives.

Such faith also relies on the unrealistic assumption if developers do expend significant resources, they will volunteer the results of the real estate economic analysis. This would allow the public-sector entity to know the maximum dollars the developers can afford to pay for the land needed to site the proposed development, redevelopment, or reuse alternative.

Pitfall #2: A weak negotiating position

A pitfall related to pursuing a public-private partnership without a sufficient information framework is the weak negotiating position from which the public-sector entity must attempt to structure the transaction.

Whoever constructs the real estate model used to simulate the economics of the development, redevelopment, or reuse project and investment returns sets the rules of the analysis and negotiations. Therefore, a public-sector entity considering a public-private partnership should cast the financial aspects of the project alternatives in its own model. The model should not only simulate the investment from the perspective of the developer, but also from the public-sector side, in terms of property taxes and other applicable sources of municipal cash flows.

A project is feasible if the net income generated from the sale or rental of the completed project provides the equity investor with a return on investment that is commensurate with the associated risks. Agreeing on the risk-adjusted "hurdle rate" often is not easy. Providing credible information on the market demand for the project and accomplishing the other pre-development work outlined below is an effective way to reduce investment risk. In addition, prior to commencing the solicitation, the public-sector entity can survey investors and find out the return targets for similar projects.

Before issuing solicitations such as Requests for Qualifications (RFQ) and Requests for Proposals (RFP) or a two-step RFQ/RFP or related offerings for land and real property, the public sector should identify the highest and best use of the property. It also should quantify the value in advance of marketing the property, and obtain entitlement. These critical pre-development actions will significantly reduce the uncertainty about what program constitutes the property’s permissible highest and best use. Therefore, developers will tend to offer "retail" prices rather than "wholesale" prices for the property.

Key pre-development steps

Frequently, the pre-development work required for the public-sector entity to be able to adequately and prudently evaluate and negotiate developer proposals includes:

- Evaluation of physical conditions such as traffic capacities, geotechnical factors, hazardous materials, and if applicable, demolition costs that bear on potential development, redevelopment, or reuse options;

- An "entitlement audit" regarding the potential of securing entitlements or approvals for different land uses than the historical use of the property;

- Analysis of market conditions and potential demand for development, redevelopment, or reuse alternatives the regulatory bodies would approve, including estimates of obtainable rents and sales prices and pace of absorption of building space;

- Preparation of conceptual land-use plans that show the scale and type of real estate products suggested by the results of the market analysis and estimate the development costs; and

- Analysis of the real estate economics and supportable land values of the conceptual land use plans. This is in order to identify which plan or product scenarios are most likely to maximize the value of the property and to quantify that value.

The results of the physical evaluation, entitlement analysis, market analysis, planning, and real estate economic analysis permits an identification of:

• One or more land use programs or development, redevelopment, or reuse options and associated marketing strategies that enhance the value of the land from the perspective of prospective users/buyers/builders/private venture partners. Ideally, more than one set of uses will be identified, so as to evaluate trade-offs in terms of entitlement and market conditions and the ability to preserve market responsiveness in the future;

• The value or revenue-generating potential from alternative land-use programs; and

• Entitlement and marketing strategy, including timing, parcelization, sale, ground-lease, joint venture or other transaction structures and the targeting of both potential users and investors/developers.

This also is the appropriate time to conduct a policy alignment check. Looking at the possible range of products that could be developed, it is important to determine which ones align with the public sector's policy goals. These goals, for example, could include redevelopment that encourages housing close to experiential shopping, restaurants, and entertainment venues in order to create a more lively and diversified downtown that, in turn, appeals to businesses wanting green office space. (Other policy goals that can be evaluated given land use or real estate product options could, for example, relate to generating tax revenue and increasing concentrated linkages between subareas or districts to make an area more walkable and safe).

Benefits of negotiating from strength

With the information base from the iterative process of analysis outlined above - developed prior to issuance of the solicitation - the public-sector entity will be in the position to:

• Develop consensus from key stakeholders and resolve regulatory constraints about the intended scale, type and mix of land uses for the development, redevelopment, or reuse of the site;

• Evaluate the reasonableness and credibility of responses and the underlying market, cost, financial, and physical/site programmatic assumptions;

• Identify a floor of value and risks to realizing that value;

• Identify the amounts of capital and types of non-capital investment the public sector may need to provide in order for the project to be financially feasible; and

• Identify alternative public-private finance/development transaction structures that generate a return to the public sector entity for such "contributions."

As a result, the public-sector entity avoids running up the time and expense of developer respondents and their financing sources. Instead, it provides developers and their financing sources a leg-up on their due diligence, thereby encouraging private-sector participation.

Efficient, rational and fair dealings

By conducting the essential analysis in advance of issuing the solicitation for a public-private partnership, the public-sector entity will be in a position of strength to deal efficiently, rationally, and fairly with would-be private-sector partners.

The public-sector entity will understand the project, including its values and risks from both the public and private sides; be realistic about what it takes to turn the project vision into beneficial reality; provide information that helps the private sector evaluate and creatively improve the project; and come to the negotiation table not blinded, but fully informed and prepared to negotiate to make a "win-win" public-private partnership that enhances the welfare of both the public and the private partners.

Aaron N. Gruen is a principal of Gruen Gruen + Associates, an urban economics, market research, housing and land use policy, and predevelopment services firm established in 1970. www.ggassoc.com.

« **Back to March 18 ED Now**