Special Report: Smart money in real estate is on smart growth

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Maryland (Reuters) - This suburb of Washington, D.C. inspired R.E.M.'s 1984 song about the soul-sucking blandness of a suburban adolescence that has been a staple of rock and roll. "(Don't Go Back to) Rockville" described a town of empty houses, "where nobody says hello."

But some experts in the real estate business believe that in the future, more and more of us will be going back to places like the revamped Rockville -- quite happily, in fact.

"They had a point at the time," Sally Sternbach, the head of Rockville's economic development arm, says of R.E.M.'s quiet anthem. "We got it wrong. We built a mall that never found its anchors. It languished for 40 years. It was like the biblical 40 years in the desert."

Then, 15 years ago, Rockville convened hearings and forums to discuss its lackluster downtown, deciding in the end to replace it with a town square lined with shops, restaurants and apartments, all steps away from a subway station -- in other words, more of an urban experience.

The citizenry wanted vibrant street life both for the fun of it, and to attract business. So far, it's worked. Teenagers use Facebook to signal spur-of-the-moment breakdance sessions on the town square's bandstand because, as Dominique Estrera, 17, explained, it's really the only place they can "hang out and break."

Adults like to socialize there, too. "I love the Town Square because I can't walk more than a couple feet without seeing someone I know from doing business," said Robin Wiener, president of Get Real Consulting, a firm that helps healthcare providers put their records online.

Rockville's renaissance over the past four years shows how the shift toward urban-style living has reached the suburbs. And urban planners insist the trend has legs.

Dubbed "smart growth," the movement favors the development of a mix of housing and businesses in and near existing cities. At the same time, it discourages the Topsy-like growth of peripheral suburbs, known disparagingly as "sprawl."

The unexpected revival of a number of cities, from Rockville to Sacramento, stands in contrast to plunging home prices in the suburbs. "America is catching on to this trend," said Peter Calthorpe, who co-founded the Congress for the New Urbanism in 1993 to create alternatives to the conventional suburb.

He says the previous model was based on the assumption that the United States could prop up the single family home in a distant location by keeping the cost of oil and mortgages low.

But that era is over. "The true cost of transportation and housing is going to start to surface," he warns.

LIVING FOR THE CITY

If the trend persists, as many expect, it would be a sharp rejection of the preferences and policies that have shaped U.S. housing since World War II.

The suburb as we know it today -- open, low-slung, car-dependent -- was born with the post-war baby boom. All of a sudden, there was a desperate need for housing. By 1950, single-family housing starts had soared from around 286,000 a year in 1945 to 1.6 million, according to Census Bureau data. And as the car became more widely available, and roads spread, so did the suburbs.

During the most recent housing boom, homebuilders started 6.3 million detached single-family homes between 2003 and 2006. By 2007, single-family homes accounted for 63 percent of U.S. housing units.

The baby boomers whose arrival kicked off the postwar housing frenzy fed this latest expansion, too. This time, they sought space for their own families, said James Chung, president of Reach Advisors near Albany, New York, whose clients include developers. "Suburban developers did a fantastic job riding that wave," he said.

But today, aging boomers are growing out of the suburbs and their children have not yet grown into them -- and may never do so to the extent their parents did. This demographic shift, more than anything else, is driving consumer demand for compact, walkable neighborhoods, Chung said.

Born between 1946 and 1964, baby boomers represent about a third of the U.S. adult population, and will do so through the next decade, said demographer Dowell Myers of the University of Southern California.

Boomers are eager to liberate themselves from the maintenance of house, lawn and car now that their children have skipped the nest, said Mollie Carmichael of John Burns Real Estate Consulting, an Irvine, California-based firm that advises homebuilders. They want necessities within walking distance because they know they will not be able to drive forever.

After a divorce, real estate agent Kim Merrell, 51, found her ideal community in Sacramento. It has a grocer and neighbors who go "porching" to drop in on each other and chat. A local lounge, Mix Downtown, caters to people like her by waiving cover charges for the 40 and older crowd until 10:30 p.m..

In Sacramento, the 55-74 age bracket will expand by 50 percent by 2020, according to the Sacramento Area Council of Governments, which created a plan to reduce congestion and expand housing choices to accommodate that growth. The group aged 35 to 54, which is when people tend to buy single family homes, will shrink slightly.

Of course, not everyone can afford urban life and its pleasures, especially during this period of fitful recovery from the worst recession in nearly eight decades. Building costs in the urban core are double that of the suburbs, said Mark Friedman, president of Fulcrum Property, a developer in Sacramento's midtown.

Developers pass those costs onto buyers. Meanwhile, the housing bust has cut the cost of Sacramento region homes 46 percent from their peak, so suburbia is still a draw for many.

For others, it's the only option, said Henry Cisneros, the former Secretary of Housing and Urban Development who now runs CityView, a developer of housing within the range of average families. "Cities need to understand that a great city needs a mix of housing. It creates dysfunction when workers are required to live at great distances," he said.

But developers will make the most money building for those who can pay a kind of virtue premium, they say. The gas-sipping Toyota Prius set the precedent: people buy it despite a price tag that is at a minimum $3,000 more than a comparable conventional car.

"It's looking for the prettiest buyer, a person who is going to pay more for their car because it is important enough to express their values about the environment," Friedman said.

That lucrative market explains why he and others believe the potential reward in urban development is well worth the risk. "You have to be very careful not to wind up with an obsolete business model in rapidly changing times," said Eneas Kane, chief executive of DMB Associates, an Arizona-based developer of upscale neighborhoods.

The firm is shifting its focus toward smart growth, including a 1,433-acre Silicon Valley-style industrial salt site with a variety of homes, open space and streetcars.

ALL POLITICS IS LOCAL

Until very recently, a real estate agent like Merrell might have been the last person to trade the suburbs for the city. After all, her profession had bought and sold the notion that homebuyers should stretch to invest in the biggest and most expensive they could afford because prices could only go up.

The housing crash changed all that. Size and value were decoupled as prices fell farthest fastest in the far-flung suburbs, said Stan Humphries, chief economist at real estate website Zillow.com.

Now citizens with real estate savvy are honing in on the cities. Unlike the suburbs, and despite the downturn, homes closer to downtowns tended to retain their value, according to a 2008 Zillow report which analyzed the change in value for 1.65 million homes between the first quarter of 2007 and the first quarter of 2008.

In 15 of 20 major housing markets, such as New York City but also Milwaukee, Wisconsin and Durham, North Carolina, higher home prices correlated with proximity to the city center and its restaurants, parks and libraries.

More specifically, walking distance to those amenities generates a home price premium in the range of $4,000 to $34,000, according to a 2009 study of 90,000 homes conducted by CEOs for Cities, an urban advocacy organization.

Americans are willing to invest in that lifestyle just as they were willing to pour money into their homes during the boom. Residents of communities like Sacramento and Rockville are ponying up for the urban privilege of public transportation in their own backyards.

"In one of the worst economies in a generation, people have actively chosen to raise their own taxes to support public transportation," said Jason Jordan, the director of the Center for Transportation Excellence, which supports ballot initiatives that fund transportation.

In general, 35 percent of ballot initiatives pass. But in 2008 and 2009, 76 percent of ballot initiatives raising taxes to fund transportation did, Jordan said.

People are increasingly pushing for policy that supports an urban lifestyle, and leaders from the White House to town halls are listening, said Alexander von Hoffman of Harvard University's Joint Center for Housing Studies.

This year, President Barack Obama created the Office of Sustainable Housing and Communities to coordinate federal housing and transportation funding with local development. He designated $2.1 billion in grant money for projects like streetcars in Tucson, Arizona and bike trails in Philadelphia. And the House of Representative's version of the Surface Transportation Act would nearly double funding for public transportation.

The president "is helping to coordinate and reinforce a movement that was already gaining momentum. He's helping those local and state leaders," von Hoffman said.

In California, for example, Governor Arnold Schwarzenegger signed Senate Bill 375 in 2008, requiring each region to adopt a "sustainable communities strategy" to reduce greenhouse gases and give transportation projects top priority for funding.

"It was the coalition of the impossible," said Darrell Steinberg, president pro tempore of the California State Senate. "The builders, the local governments, the environmental community and the affordable housing advocates had been at odds for decades on these issues."

Of course, some critics oppose government's role in "engineering" neighborhoods in cities. During debate over the California bill, conservatives mocked government's promotion of urban development. "Hasn't everyone always longed to live in a dense, crime-ridden urban neighborhood, right next to the nearest railroad hub?" said one Internet ad, of Steinberg's bill.

If anything signals smart growth's newly mainstream status, it's the embrace of Salt Lake City, Utah, said Christopher Leinberger, a developer and Brookings Institution fellow. "It's a Republican state. It's a Mormon state. It's fallen in love with blueprint planning," Leinberger said.

Two-thirds of the residents in the two-county region surrounding Salt Lake City voted to raise $2.5 billion for more miles of commuter and light rail track by hiking their sales tax, said Chamber of Commerce spokesman Marty Carpenter. "70 miles in 70 years!" is the rallying cry.

Salt Lake City itself will receive another $5 billion. A la Rockville, the Mormon Church is replacing two indoor malls with a walkable housing and retail complex.

Atlanta, Georgia; Boise, Idaho; Minneapolis, Minnesota and others have invited Salt Lake City officials to speak, said Natalie Gochnour, the chamber's chief economist. "They want to know how in a conservative environment like Utah you pass ballot initiatives," she said.

Utah got buy-in from business, Gochnour said. "It goes back to commute times, and the cost of doing business when you're congested," she said.

FOLLOW THE MONEY

Elected officials and bureaucrats like Gochnour and Rockville's Sternbach are also being mindful of the public purse, said Joseph Minicozzi, a real estate developer and city planner in Asheville, North Carolina who has done research there and in Sarasota County, Florida.

His work shows that local governments reap much more in taxes from urban centers than from malls or "big box" retail like a Wal-Mart, but pay more to build suburban infrastructure such as sewers and streets.

In the city and county of Sarasota, for example, 3.4 acres of urban residential development consumes one-tenth the land of a multi-family development in the suburbs. But it requires little more than half of the infrastructure investment and generates 830 percent more for the county annually in total taxes: that's $2 million from the city structure and $238,529 from the suburban one.

What's more, suburban housing takes 42 years to pay off its infrastructure costs. Downtown? Just three. "I'm preaching to Joe and Jane Six-Pack who want to be subsidized. These (city) centers produce a tremendous amount of revenue and then hemorrhage it out to the suburbs," Minicozzi said. "We don't have a rational discussion on the true costs of the way we manage land."

That is starting to change, as cash-strapped governments struggling with the recession's hit to tax revenue are starting to press developers to share the pain of paying for highways and other infrastructure, said Richard Rich, a director for Thomas Enterprises, whose 240-acre redevelopment of Sacramento's abandoned railyards is the largest urban redevelopment project in the country.

As a result, profitability will come to depend on higher-density construction, said Rich, his voice echoing through the cavernous stalls of the former transcontinental railroad being salvaged for a retail plaza. "Just as they evolved to start, they will de-evolve the product," he said, of suburban developers.

Then again, developers of urban-style neighborhoods get some help from the government, too. From the open-plan floor of a former Pontiac dealer strewn with sculpture from northern California artists and mid-century modern furniture, Friedman, the Sacramento developer, has been working to transplant the Broadway loft lifestyle he had in New York City as a Salomon Brothers investment banker.

Ten years after returning to Sacramento in 1991 to rejoin his family's property business, he created the city's first loft in a 1920s era building that also houses his offices. Today he senses more demand for urban life than ever before. In June, he broke ground on a 188-acre industrial site in West Sacramento, using $50 million in public money. The Bridge District's 12 million square feet will include housing, commercial space and a waterfront park.

Back in Rockville's town square, public and private entities split the $132 million cost roughly 60-40. "The public-private partnership is critical to making these work," said Don Briggs, a vice-president of Federal Realty, one of the Rockville Town Square's developers. "I'm talking about municipalities making an investment."

It's paying off, say both sides of the town square partnership. "It's a damn good investment," said Sternbach, whose business cards are in both English and Chinese, which indicates what business she's wooing. "We didn't want to be Anywhere, USA."

Federal Realty's Chief Financial Officer, Andy Blocher, concurs: "From a shareholder perspective, it's been a very strong project," he said.

But it's not all breakdancing on the square's bandstand, as Blocher can attest. Federal Realty's failure to secure a promised grocery store has angered residents. It has also disappointed the city's financial expectations for the project, said Gavin Cohen, Rockville's CFO.

The recession has not helped, hurting both Federal Realty's rental income and Rockville's tax revenue.

And in Sacramento, public funding for The Railyards is now in jeopardy as real estate trust Inland American has accused Thomas Enterprises of defaulting on some $186 million in loans. Without resolution with the lender, California has informed Thomas that it will freeze at least $30 million in construction grants, said Suheil Totah, a vice president at the firm.

"Thomas is working hard to resolve the situation," said Totah, who in an earlier interview noted it was the recession that got his project moving by spurring infrastructure and stimulus programs.

The downturn has dampened Friedman's expectations for his Sacramento project as well. "Moving forward with construction now is more an act of faith than a hard-nosed calculation of future profit," he said. "The early phases of the project are likely to make low single-digit returns -- not enough to independently justify the risk."

But like many other developers and politicians across the country, he is going for it. "The economy will someday improve," he said. "We believe that there is unmet demand for a more urban and walkable style of development."

In the end, however, profits are not the only reason people are creating downtowns and moving into them. Rockville "wanted a vibrant town square and that's what it's become," said Cohen. "They wanted it to be a destination and I think it is that."

(Reporting by Helen Chernikoff in Rockville and Al Yoon in Sacramento; editing by Jim Impoco andClaudia Parsons)