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Highest and best use in evolving neighborhoods

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Gratifying results of growing consumer confidence and an improving economy are their powerful impact on the imagination of our confident real estate industry risk takers- the developers. Add tough locations with historical baggage and questionable availability of financing, and the momentum of a good idea can be hard to sustain for most. But, the intuitive analytical ability, drive, determination and occasional dose of overconfidence can drive some developers to really spectacular results. The crux of their success is often an ambiguous, but correct, highest and best use conclusion driven by thoughtful examination of a variety of alternative uses of which many have financial feasibility.

I spent early years in my real estate career in Boston, acquiring experience with some really exceptional colleagues and mentors. Early on, in the mid 1970's, I thought it would be a great idea to move to Portland, that little jewel on the Maine Coast. I checked it out and quickly felt that its time had not yet come, still a bit stagnant and conservative. Back to Boston I went for more debt and equity finance tutelage. In the early 1980s, I headed up the coast once again and took another look. Behold, a stunning renaissance of adaptive reuse and restoration in Portland's Old Port Exchange. What had made the difference? It was all about a small, ardent and mostly local cadre that had the vision, stomach and money to invest, make smart choices and take risks in turning around that small part of Portland on a somewhat sleepy, rundown, industrial waterfront.

So, I did make that move up the coast to Portland and hardly looked back. At the risk of showing too much favoritism for my new home, you should see it now. The highest and best use of the Old Port Exchange was driven by long term belief that feasibility costs and rent for remodeling and major conversions would be far exceeded not just by market rent, but net income and profit as momentum took hold. It started with rehabbing those old industrial buildings on Exchange, Fore and Commercial Streets, at first one by one, and then creating Chandler's Wharf luxury condos next to Dimillo's Floating Restaurant and Marina. It snowballed. The Old Port synergy converted that old enclave of mostly dilapidated industrial buildings on "made land" and wharves into "Ocean Gateway", an impressive evolution of a now nationally recognized waterfront with high end condominiums, rental apartments, hotels, a major cruise terminal and one of the highest densities of good restaurants and entertainment in the northeast.

Success breeds more success! After a long time coming, the eastern entry into Portland's CBD from I-295 has been blossoming into another impressive, successful neighborhood rising literally in many places out of the ashes and waste disposal of two centuries of maritime, industrial and railway use. The area is now known as Bayside Gateway. Witness several new office towers totaling more than 150,000 s/f, big by Maine standards, with major, local credit tenants. The spinoff is the rapidly increasing conversion and adaptation of many former light industrial or manufacturing properties into more intensive commercial and residential use in west and east Bayside, successful models of

urban renewal. Simplified, the crux development hurdle is prospective, capitalized net operating income for converted industrial properties near the end of their economic lives that must exceed the cost of conversion, required entrepreneurial reward and the value of time and costs associated with the marketing period.

Several earlier decades of limited action passed while developers wondered about the future promise of that "sleeper" Bayside location astride a railway serving scrapyards and industrial properties. Those industrial uses, over two centuries, created Brownfields that are seeing resolution as obsolete facilities are relocating outside the city to make way for more compatible uses. Any lingering contamination or stigma impacts on financing or insurance costs and marketability after remedies have been completed is increasingly being accommodated by higher return on investment. Standing on many corners along Marginal Way in Bayside, it's hard to believe that much of the land on which many of the attractive new projects have been erected is industrial-related fill of mostly unknown composition and quality. The adjacent Back Cove water body actually used to extend almost half a mile further inward towards the CBD.

As adaptive reuse has taken hold, declining market risk is constraining capitalization rates. Nevertheless, big challenges are careful, up front evaluation of costs to acquire and remodel (or remove) existing improvements and the weighing of supply versus demand for a finished product. What is the profit associated with the different use alternatives? How do their different risk rates, timing and marketing impact value? What does the market really want and is now the right time?

A matrix is helpful for initial comparisons of the value of alternative uses. Some fundamental components are current and prospective market rent, acquisition costs, purchase price, interim use, development period, operating expenses, and an appropriate discount rate to reflect the time required for development or conversion and marketing. In a recent assignment, I evaluated four plausible alternatives for an obsolete property. Each required a "mini" appraisal to compare values and reach a highest and best use conclusion for the subject property. As a frequent Appraisal Reviewer, I always look for support for a credible highest and best use conclusion. It is usually the make or break fulcrum of an appraisal.

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