

# ON THE MONEY

## Can a Texas developer and Qatar's sovereign wealth fund create a little miracle on 10th Street?



STEVEN PEARLSTEIN

Across most of the country, commercial real estate development has pretty much come to a halt. After a decade of debt-fueled overbuilding, there are too many hotels and too much retail space. With the economy generating precious few jobs, there isn't much need for new office space, either. Debt financing has all but dried up.

But if you wander down to Mount Vernon Square in the heart of Washington and look in almost any direction, you'll see a new center city under construction — several billion dollars' worth of it.

To the east, in a rapidly gentrifying triangle known as NoMa, thousands of apartments and even a "spec" office building, built without any tenant commitments.

To the northwest, the beginnings of a monstrous 1,200-room, \$600 million convention center hotel.

And to the southwest, you'll see a four-square block hole in the ground from which will rise one of the most ambitious and exciting mixed-use development projects to come along in years. It will house nearly 700 residences, two glass-clad office buildings, a hotel and space for the kind of upscale downtown retailing that city planners have talked about for years but never really materialized. Total cost for the two-phase CityCenter development, including streets and utilities: \$900 million, all of it private.

Planning for this project began 15 years ago, when the city decided it would build the new convention center on the other side of Mount Vernon Square, demolish the old one and lease the land to a developer who could help make good on then-Mayor Tony Williams's vision of downtown. In his vision, downtown would not just feature offices and restaurants catering to weekday suburban commuters, while becoming deserted at night and on weekends. Instead, it would become a 24/7 place where people would live, work, shop, have fun and walk their dogs.

I admit that I always had more than a little skepticism when I heard my friend Rich Bradley, head of the Downtown Business Improvement District, talk about the "liveable downtown." It seemed to me then a classic chicken-and-egg problem: Without the amenities, there would be no residents, and without the residents, there would be amenities.

But in the past decade, something has changed. As a result of the revivals along 7th Street, 14th Street and U St. NW and H Street NE, downtown Washington has become hot the way lower Manhattan has become hot and the old downtown has begun to take off in Los Angeles. Young and not-so-young professionals not only want to live in or near the city center, they are insisting on it, even if they have to reverse commute out to jobs



In a rendering of CityCenter, the interior courtyard of the residential part of the project can be seen: two condo buildings on one side, two apartment buildings on the other, with restaurants on the ground floor facing the plaza.

in the suburbs.

In Washington, this demand is fueling a little apartment bubble; about 7,000 apartment units are under construction in or near the downtown area. With that, it's a good bet that what was once a chicken-and-egg problem can be turned into just the opposite — a virtuous cycle in which an increase in the number of residents leads to more stores and amenities, which in turn leads to even more residents.

The spectacular success of the News-eum project on Pennsylvania Avenue and Boston Properties' new project on Washington Circle in the West End suggest that the tipping point may have finally been reached.

What's noteworthy about CityCenter is not only its scale and ambition, but the fact that construction began in the midst of a commercial retail downturn without commitments from any major tenants. It was also financed without any debt.

In truth, this project was on life support for a couple of years while one of

the developers, Houston-based Hines, scoured the world looking for investment capital. Since the bursting of the commercial real estate bubble in 2008, investors and lenders in commercial real estate have been focused on salvaging the many troubled pieces of their portfolios. This spring, there were signs that the moribund market in securitized commercial real estate loans had begun to revive, but since July, that market has collapsed once again as the economy slowed and investors began to demand higher risk premiums than owners and developers were willing to pay.

What saved CityCenter was an investment of \$622 million by the government of Qatar, whose sovereign wealth fund likes the visibility and perceived stability of investing in downtown Washington. It is no coincidence that the convention center hotel is also financed by an equity investment from a sovereign wealth fund — Abu Dhabi's — creating something of little OPEC colony here in the middle of Washington. Other projects

under construction in NoMa are also financed completely with equity, either from cash contributed by the developers themselves or from private-equity funds raised at the height of the real estate frenzy.

One advantage of financing a project with equity rather than debt is that there is less financial pressure to have half the space leased before construction begins, or to lease the rest to any tenants willing to pay enough to cover interest payments. Such pressures are particularly damaging to mixed-used projects such as CityCenter, where the economics really depend on creating a whole greater than the sum of the parts. When such projects are successful, the office buildings are more attractive than other offices because of the proximity to stores and housing, just as the stores are more valuable because of proximity to residents and office workers, and so on. That synergy only develops, however, when developers have the time to get just the right tenants.

Beginning a big project when nobody else would dare to could also be an advantage; when it is finished, there won't be any other new projects to compete with. That won't guarantee success if the economy is still in the dumps in 2014. But if it is on the rebound, the developers — Hines Interest and Colorado-based Archstone — could luck out and hit the market at the perfect moment.

With a location hard by the convention center, five blocks from the White House and within easy access to Metro, Hines shouldn't have too much trouble renting out the two office buildings designed by British architect Norman Foster, even at the asking rents of \$80 per square foot. At one point last year, Bill Alsup, the head of Hines's Washington operation, had Skadden Arps, the blue-chip law firm on the hook before it decided to renew its current lease. The latest reports are that Hines is competing for the venerable Arnold & Porter.

Snaring a big law firm is to a Washington developer what snaring an elephant is to a big-game hunter. If Alsup really wants to distinguish his product, however, he might consider declaring his small community a "lawyer-free zone" and court high-tech companies, architectural firms, advertising agencies and media companies more likely to appreciate the attractive Norman Foster design and more likely to have young employees eager to live downtown.

Given the restaurant revival already going on downtown, CityCenter probably won't have much trouble filling the dozens of spaces set aside for wine bars and eating establishments. (Islamic investors frown on saloons.) The test will be whether Hines and Archstone can get beyond the all-too-familiar national chains that can afford high rents, but bring little pizzazz or personality.

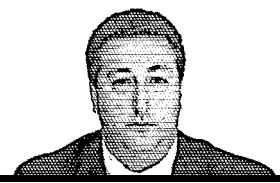
The bigger challenge will be to attract the upper-end clothing, home furnishing and other retailers that would not only serve downtown residents but would have offerings unique enough to lure older and richer shoppers from suburban enclaves. Over the years, many developers have tried, but aside from Anthony Lanier in Georgetown, none has succeeded. In their place, bank branches dominate the prime corner locations.

But it should say something about CityCenter's potential that Apple, reportedly, is considering a flagship store for the project. And it is noteworthy that Hines and Archstone have gone to the considerable expense of providing continuous retail on both sides of the project's pedestrian-friendly streets and alleys, with the kind of two-story spaces and an underground delivery bays that create a much livelier and more-efficient retail environment than what is offered by the typical downtown office building.

It will be a few years before we know whether CityCenter ushers the "liveable downtown" into Washington. In the meantime, several thousand of our neighbors will have good jobs for three years building the project. For this little miracle on 10th Street we can thank the foresight of former mayor Tony Williams, the patience and persistence of Bill Alsup and his colleagues, and the good sense of the Qataris to invest when nobody else would.

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## The public investment we need to make now, for our competitiveness, our jobs and our safety



BARRY RITHOLTZ

On Investing

If you have spent much time traveling around the United States, you likely have noticed that our infrastructure looks a bit worn and tired and in need of some refreshing. If you spend much time traveling around the world, however, you will notice that our infrastructure is shockingly bad. So bad that it's not an exaggeration to declare it a national disgrace, a global embarrassment and a massive security risk.

Not too long ago, the infrastructure of the United States was the envy of the world. We had an extensive interstate highway system, deep-water ports connected to a well-developed rail system and a new airport in every major city (and most minor ones). Electricity was accessible to the vast majority of the nation's residents, as was Ma Bell's telephone network.

That was then. In the ensuing decades, we have allowed the transportation grid to get old and out of shape. Our interstate highway system is in disrepair; our bridges are rusting away, with some collapsing now and then. The electrical grid is a patchwork of jury-rigged fixes, vulnerable to blackouts and foreign cyberattacks. The cell system of the United States is a laughingstock versus Asia's or Europe's coverage. There are very few things that are done better by government mandate than by the free market, but cell coverage is one of them. Broadband, almost as laughable as our cell coverage, is another.

Consider that we consume more than 34 billion liters of bottled water a year — about 50 billion bottles — at a cost north of \$8 billion dollars. What does that say about America's confidence in its water supply?

Don't take my word for it. The American Society of Civil Engineers recently issued a U.S. Infrastructure Report Card (which you can see at [infrastructurereportcard.org](http://infrastructurereportcard.org)) that reviewed key civil engineering projects on their quality and state of repair. The society graded aviation, bridges, dams, drinking water, energy, hazardous waste, inland waterways, levees, public parks and recreation, rail, roads, schools, solid waste, transit and wastewater.

Overall, America's infrastructure GPA was a "D." We earned our highest grade in solid waste — a C+ (insert your own infrastructure joke here).

To get to an "A" would require a five-year infrastructure investment of \$2.2 trillion dollars. You can understand why recent proposals of \$50 billion were so underwhelming. That is 10 percent of what is required to return the United States to a competitive level with the rest of the developed world. Even the emerging world outshines us in these areas.

A massive infrastructure program would have numerous benefits, not the least of which would be giving a boost to the economy when it could use one. The big advantage of infrastructure rebuilds is that they create a lasting effect by creating tools and platforms that the private sector can build upon. Consider the vast economic benefits we have enjoyed from the interstate highway system, DARPAnet and NASA, and you have a sense of what a massive infrastructure program can yield.

This sort of a program is in many ways vastly superior to the spending increases and tax cuts we saw in the American Recovery and Reinvestment Act of 2009.

### Failing U.S. infrastructure

The grades from the American Society of Civil Engineers:

Aviation	D
Bridges	C
Dams	D
Drinking water	D-
Energy	D+
Hazardous waste	D
Inland waterways	D-
Levees	D-
Public Parks and Recreation	C-
Rail	C-
Roads	D-
Schools	D
Solid Waste	C+
Transit	D
Wastewater	D-

The limitation of most of the spending increases and tax cuts in the last rescue plan was that they were merely temporary fixes; they had no long-lasting effects. As long as the money flowed, they were stimulative; once the spending stopped, the stimulus stopped as well.

That's the beauty of major infrastructure projects: They leave something worthwhile behind. We still enjoy the benefits of the interstate highway system, which allows goods to be moved cheaply around the nation. Innovations at NASA led to many new products and industries, including innovations in the semiconductor, satellite and mobile computing sectors. And DARPAnet? You might recognize that as today's Internet. All three are massive economic wealth generators, filling a role that is too long term and too expensive for the private sector.

Give me a trillion or two dollars to invest in the economy so the next expansion could proceed, and here is

what I would do:

**Electrical grid refurbishment.** This is both an economic and national security issue. The electrical grid is an unreliable mishmash of public and private ownership, vulnerable to both blackouts and cyberattacks. It needs to be upgraded yesterday. While Congress has approved several billion dollars to begin work on the U.S. grid, it is not nearly sufficient to complete the job.

How to pay for it: A 1-cent per kilowatt-hour grid tax will fund the entire grid upgrade.

**Roads, bridges, tunnels.** We may love big construction projects, but we seem to dislike the maintenance. Most of the transportation grid in the United States is in need of massive repair. It won't take much to bring it up to standards, but if we want to be competitive with places like Germany and China, we need to commit more to maintenance and to better design.

**Smart road grid.** Too many of our roadways are dumb. By that I mean not driven by data and lacking in real-time intelligence. You need only sit too long at a red light in the middle of the night to know that our system can be technologically wanting. Road sensors integrated with lights and other signal controls will move traffic around quickly, more efficiently and more safely. This is just as true in urban areas as it is in the suburbs. Sitting at red lights wasting time and money when no one else is coming should be a thing of the past.

How to pay for it: Infrastructure gasoline tax of 5 cents a gallon; usage tolls on roads, ports, bridges and landing slots.

**Airports.** Older U.S. airports are simply awful, compared with European and Asian facilities. I would say that some U.S. airports look like they are from Third World countries, but I have been in Third World countries, and they eat our lunch in terms of facilities, speed and

gleaming cleanliness. Heaven forbid you have to check a bag on a flight into New York City; you can expect to waste 30 to 60 minutes at La Guardia or JFK.

**Ports.** We are checking too little of the cargo coming into the United States. Since 9/11, we simply have not upgraded our port security sufficiently, and we remain vulnerable to attack by a dirty bomb or biological weapon. As long as we are discussing security, our chemical plants and petroleum processing centers could use a good security upgrade as well.

**Alternative energy.** Gains in the basic science of solar energy conversion, battery storage and biofuels have been incremental. The private sector does not have the patience or money for a decade-long research and development program performing research into fundamental sciences. We should be working on a very fundamental level, aiming for the kinds of scientific breakthroughs that create entire new industries.

How to pay for it: License patents to private sector; tax base improvement from new industries.

Our key economic competitors are spending very heavily in all these areas. Since World War II, both Japan and Germany have had ongoing infrastructure programs. If you prefer a different example, look at the Chinese: They are spending trillions to build out their entire nation.

We in the United States are willing to spend trillions in Iraq and trillions more bailing out reckless bankers. But when it comes to the most basic functions of civilization, we skimp on ourselves. Does that make any sense? Why not spend trillions on the national infrastructure, and generate economic gains instead?

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