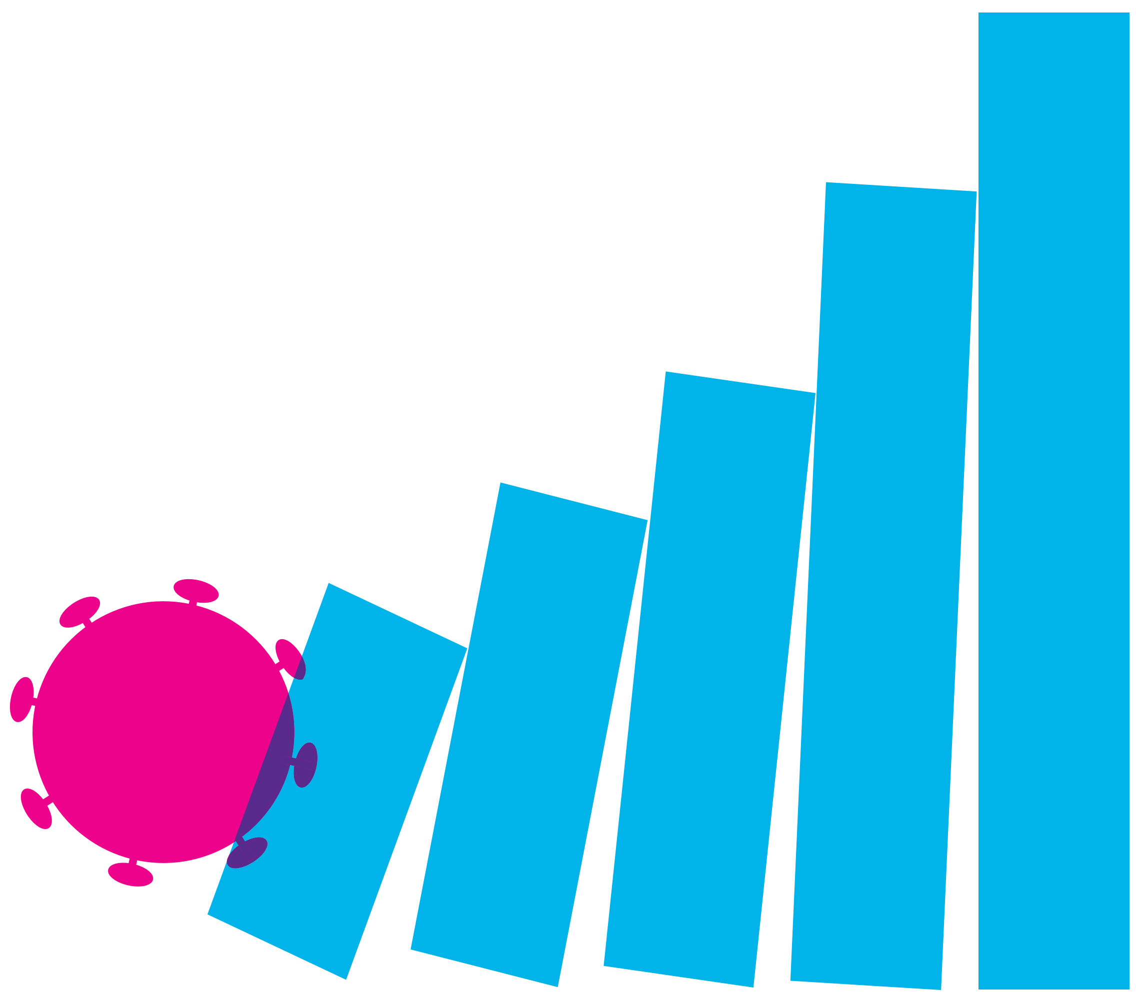
DOWNTOWN DISRUPTION



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The pandemic-driven changes to downtown areas and central business districts are changing the geography of institutional investment. What else changes because of this?

As the US continues to muddle through the COVID-19 pandemic, downtowns and central business districts (CBDs) have emerged as the urban and metropolitan geographies most vulnerable to structural changes in where and how Americans work.

By all accounts, the rise of remote work and the broadening of the term "flexible work" appear to be permanent rather than temporary phenomena; structural rather than cyclical. It is now commonplace to acknowledge that the loss of office workers—and prospect of empty office buildings—threatens the long-term fiscal health of many cities, the small businesses that depend on office workers, and the vitality of America's downtowns.

The "evidence" from a pandemic still underway paints a disruptive future. The McKinsey Global Institute's "Future of Work After COVID-19" report estimates that 20–25% of the workforce could work remotely in the future.[1] A plethora of media articles and business surveys report how companies large and small are embracing hybrid work models, enabling their employees to work remotely part of the time. A recent article from the New York Times—"Why the Empire State Building, and New York, May Never Be the Same"[2]—is the common meme for business and general media alike; just change the moniker of the building and the name of the city and you get the emerging conventional wisdom.

As institutional investors struggle to make sense of these shifting dynamics, it is best to look beyond the simplicity of shock headlines and re-discover the complexities that define America's downtowns as well as other urban and suburban districts which increasingly combine a mix of uses including work, residential, education, research, commercialization, entertainment, waterfront or other amenities, and distinctive retail and restaurant choices—uses typically associated with downtown areas.

Such an inquiry forces investors to look at the distinctive market realities that define individual US downtowns rather than group all downtowns (particularly those located in a small subset of cities) in one narrowly drawn asset class. The end result may be that the pandemic may compel an expansion of institutional investment to a broader set of uses and geographies in a broader set of cities.

DOWNTOWNS ARE NOT UNIFORM

Despite a common label, America's downtowns are an intensely varied group of similarly situated districts. As the New York Times recently reported, the share of downtowns that is occupied by office uses varies from 83% in Boston, 74% in San Francisco, and 72% in Washington, DC to 30% in Nashville, 25% in St. Petersburg, and 19% in San Diego.[3] Most downtowns in the country have undergone a dramatic transformation over the past sixty years; first, radical decline as populations suburbanized and employment decentralized, then, rebound and revival fueled by shifting location preferences, changing cultural dynamics, and declining crime. As Emily Badger and Quoctrung Bui recently wrote:

"Downtowns, like investment portfolios, are more sustainable when they are diverse. [. . .] CoStar data going back to 2006 shows that many big-city downtowns have been evolving away from strictly office space, adding college dorms, apartment buildings, and civic attractions. Cities where 'downtown' has increasingly come to mean more than offices are likely to be more resilient as they emerge from the pandemic, researchers and downtown officials say."[4]

Targeted public, philanthropic, corporate, and university investment has also played an enormous role in the transformation of downtowns over the decades. Dan Gilbert's decision to move Quicken Loans (and his family of companies) to the core of downtown Detroit in 2007 started a revival that continues to this day. Duke University is widely credited with acting as the stimulus for the rebirth of downtown Durham; the same can be said of Arizona State University in downtown Phoenix. Similar moves by local investors can be found in downtowns as disparate as Cincinnati, Cleveland, Erie, St. Louis, and Tampa.[5]

Electric Works, Fort Wayne, Indiana

THE RISE OF INNOVATION DISTRICTS

Downtowns are not the only geography of employment density in cities and metropolitan areas. Over the past twenty years, innovation districts have organically emerged near advanced research institutions and health care centers. The Brookings Institution defines these districts as

"Geographic areas where leading-edge anchor institutions and companies cluster and connect with start-ups, business incubators, and accelerators. They are also physically compact, transit-accessible, technically wired, and offer mixed-use housing, office, and retail."[6]

These districts reflect the innovation economy's demand for co-location, proximity, and density so that companies, researchers, and entrepreneurs can share ideas rather than invent in isolation. It is doubtful that the pandemic has disrupted the innovation dividend associated with such co-location. The most advanced districts are in midtown areas such as Midtown Atlanta (near Georgia Tech), University City in Philadelphia (near Drexel University and the University of Pennsylvania), and Cortex in St. Louis (a collaboration of Barnes Jewish Hospital, St. Louis University, and Washington University). However, the un-anchoring of anchor institutions such as Duke University and Arizona State University, described above, shows that "traditional" downtowns have the potential to evolve as innovation districts.

FEDERAL POLICY MATTERS

Downtowns have the potential to harness unprecedented federal investments to mitigate the damage from the pandemic and accelerate the transition to a multi-use future. The federal government is engaged in a multi-act, multi-dimensional effort to spur an equitable economic recovery. The US$1.9 trillion American Rescue Plan enacted in March 2021, for example, provides flexible funds to states, cities, and counties (as well as resources via the Department of Treasury, Small Business Administration, and Economic Development Administration) that can be used to rebuild downtown economies and promote business and neighborhood equity.

Other moving or proposed legislative vehicles go even further. The US$250 billion Innovation and Competition Act, passed with bipartisan votes by the US Senate, would provide resources to expand basic and applied research, STEM education, and technology hubs. A US$1 trillion+ infrastructure bill, also passed with bipartisan support by the US Senate, recommends unprecedented investments in a broad array of infrastructure assets including: transportation (e.g., roads and bridges, public transit, passenger and freight railways, airports, waterways, and ports), buildings and utilities (e.g., affordable housing, high speed broadband, electric grid, public schools), and disaster resilience.

These investments are on top of existing federal programs, such as Historic Preservation Tax Credits, Low Income Housing Tax Credits, New Market Tax Credits, and Opportunity Zones, which have historically been used to diversify uses within downtowns.

As federal legislation proceeds, there are even efforts to focus federal investments directly on downtown disruption. In an effort to revitalize downtown business and urban districts, Senators Debbie Stabenow (D–MI) and Gary Peters (D–MI), along with Representatives Jimmy Gomez (D-CA), Dan Kildee (D-MI), and John Larson (D-CT) have introduced the Revitalizing Downtowns Act. Modeled after the Historic Tax Credit, the Revitalizing Downtowns Act would provide a credit equal to 20% of the Qualified Conversion Expenses in converting obsolete office buildings into residential, institutional, hotel, or mixed-use properties. An obsolete office structure is defined as a building that is at least twenty-five years old, and the bill requires 20% of the units in a residential conversion to be dedicated to affordable housing.

STATE AND LOCAL POLICY MATTERS

Beyond federal investments, states and municipalities also have a role to play through incentive programs such as TIF districts, tax abatements, and PILOT programs, all of which can be utilized to help downtowns and other urban districts rebound from pandemic disruption. Many states and localities, in particular, have specific programs to assist with adaptive reuse of historic structures. For example, North Carolina's Mill Credit program made it feasible to redevelop 1.2 million SF of former R.J. Reynolds Tobacco factory buildings in Winston-Salem, thereby preserving these beautiful buildings while providing a unique sense of place for the Innovation Quarter. Similar programs have been successfully employed in Durham, NC; Providence, RI; Pittsburgh, PA; and Cleveland, OH.

WHAT THIS ALL MEANS

The COVID-19 pandemic could have major implications for institutional investments in downtowns and CBDs. Pre-crisis, these investments tended to be over-concentrated in a narrow group of asset classes in a small subset of US cities.

Post-crisis market dynamics should place a premium on downtowns and other parts of cities that have a broader mix of uses and activities, including innovation-oriented co-location of research institutions, mature companies, and start-ups and scale ups. In doing so, investors would be wise to examine the "good bones" of downtowns in secondary and tertiary cities that have not been the traditional focus of institutional investment. Investors should also track the flow of federal investments that are likely to leverage the distinctive competitive assets and advantages of these places. This will require a commitment to robust market analysis that captures the full growth potential of a broad, geographically diverse set of CBDs, and effectively reimagine the future of "downtown."

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NOTES

[1] Susan L., Anu M., James M., Sven S., Kweilin E., and Olivia R., "The Future of Work After COVID-19," McKinsey Global Institute (2021), https://www.mckinsey.com/featured-insights/future-of-work/the-future-of-work-after-covid-19

[2] Keith Collins, Nikolas Diamant, Peter Eavis, Or Fleisher, Matthew Haag, Barbara Harvey, Lingdong Huang, Karthik Patanjali, Miles Peyton, and Rumsey Taylor, "Why the Empire State Building, and New York, May Never Be the Same," New York Times, September 15, 2021. https://www.nytimes.com/interactive/2021/09/15/nyregion/empire-state-building-reopening-new-york.html (Accessed September 25, 2021).

[3] Emily Badger and Quoctrung Bui, "The Downtown Office District Was Vulnerable. Even Before Covid," New York Times, July 7, 2021. https://www.nytimes.com/interactive/2021/07/07/upshot/downtown-office-vulnerable-even-before-covid.html (Accessed July 12, 2021).

[4] Badger, "The Downtown Office District Was Vulnerable. Even Before Covid."

[5] See Also: Bruce Katz, Jennifer S. Vey, and Julie Wagner, "One Year After: Observations on the Rise of Innovation Districts," Brookings Institution, 2015, https://www.brookings.edu/research/one-year-after-observations-on-the-rise-of-innovation-districts/; Bruce Katz, Karen Black, and Luise Noring, "Cinncinati's Over-the-Rhine," Nowak Metro Finance Lab, 2019, https://drexel.edu/nowak-lab/publications/case-studies/cincinnati-city-case/; Bruce Katz and Jennifer Bradley, The Metropolitan Revolution: How Cities and Metros are Fixing Our Broken Politics and Fragile Economy (Washington, DC: Brookings Institution, 2014).

[6] Bruce Katz and Julie Wagner, "The Rise of Innovation Districts: A New Geography of Innovation in America," Brookings Institution, June 1, 2009, https://www.brookings.edu/essay/rise-of-innovation-districts/

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