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# MIXED-USE DEVELOPMENTS

## ...Don't Get Mixed Up!

By

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The increasing popularity, urban development opportunities and potential profitability of mixed-use projects should not be confused with their degree of complexity. On the contrary, it is easy for a developer to underestimate the variety and intricacy of issues in such projects; simply put “it’s easy to get mixed up about a mixed-use project!” Accordingly, we provide this overview of the essential considerations in facilitating successful project outcomes for developers as well as future owners.

Developers should begin by setting objectives and focusing on goals. If the goal is building—and then selling—the project to unit owners, then decisions made could differ from situations in which the developer anticipates maintaining a long-term interest in some, or all, of the project. Accordingly, for projects involving “for sale” units, the developer must:

- Be clear about its needs and goals as well as the extent and duration of desired involvement and component retention
- Allocate expenses—which involves a balance of:
  - 1) Minimizing allocations for retained units, resulting in higher fees for residents
  - 2) Burdening commercial units with higher expenses in an effort to reduce the maintenance fees allocated to residents

The appropriate approach is project-specific and should be viewed as a financial and development marketing decision.

With this background, there are three broad categories of issues for consideration, requiring expertise to conduct a thorough evaluation of the opportunities, risks, and tradeoffs that determine the project’s ultimate success. They are:

- Financing/Project Planning
- Organizational Issues
- Budgeting/Financial

### FINANCING/PROJECT PLANNING

This involves researching and evaluating the specific opportunities/issues that can make the project appealing to the municipality, maintain regulatory compliance and ensure a suitable profit. These issues include:

#### • Municipal

- Determine the potential of securing an agreement from the municipality for a tax abatement
- Ascertain the extent to which the Municipal Services Act provides for services or an offset to any specifically relevant operating expenses.

#### • Regulatory

- Fulfill the necessary registration requirements with the Division of Community Affairs and comply with any other filing/legal requirements indicated by counsel.

#### • Budgeting

##### ▫ Condominium Association

Consult with the accountant preparing the budget and the designated management company as early as possible in the process to ensure consideration of the financial and operational impacts of the lifestyle being marketed and to address relevant issues before and during construction so that they do not become problems later

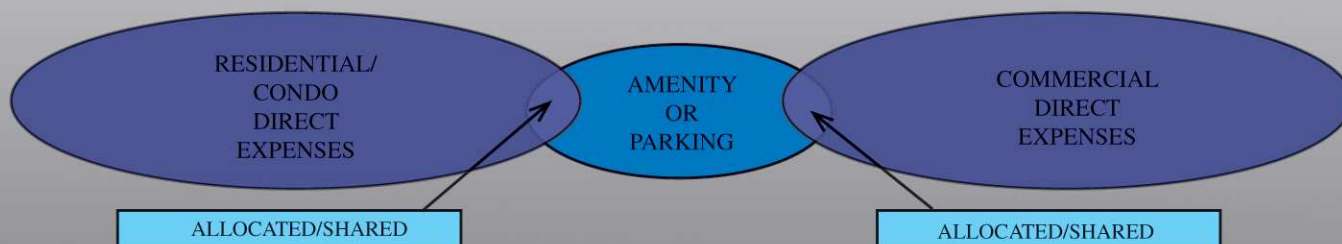
##### ▫ Project

Budget for the developer’s requirement to pay its proportionate share of expenses while the association is under developer control; we advise the developer to stay current on these obligations.

The developer must be pragmatic “Beware of the Great Idea”—because it can delay the project’s completion, reduce profitability and greatly increase future operating costs.

#### • Other

- Identify/quantify potential rehabilitation credits for qualified expenditures.



The diagram above indicates the potential overlap and distribution of expenses among mixed-use project components

## ORGANIZATIONAL ISSUES

The project's organizational structure must be fully integrated into the planning process. We reiterate the prudence and importance of obtaining expert legal and financial counsel to guide the evaluation of benefits/drawbacks in optimizing project configuration/components. These include:

- **Residential component**—the developer must determine the types/proportion of the units to be included:
  - Condominium only—depending on the physical configuration/characteristics of the project, more than one association may be necessary/desired
  - Rental only—even if the residential units are initially designated for rental purposes, the developer should consider retaining its option for future conversion (from rental units to condominiums), or a
  - Combination of condominium and rental—this may be viable and appropriate; again, the developer should consider retaining an option for a future conversion.
- **Commercial component**—the developer must define its desired ownership and extent of control of any commercial components. There are a myriad of choices, including:
  - Unit ownership—should single or multiple units be owned by the developer—with options to further subdivide and add units to the association in the future?
  - Permitted uses—are enterprises such as restaurants, dry cleaners, etc. allowed by local zoning? (And further, even if the use is permitted, how consistent is the use with the project's marketability?)
  - Utility metering—utility needs and usage for commercial units may be vastly different from residential consumption, and a plan for separate metering of utilities should be considered and implemented.
- **Parking**—if included, a variety of scenarios require evaluation:
  - Garage parking requires yet further discussion, because it presents numerous issues, such as:
    - Municipal requirements for handicap-accessible spaces
    - Expense to maintain the garage, including operating costs for current usage, as well as for long-term capital reserves
    - Ownership of garage spaces. The possibilities are:
      - I. Garage is a common element of the association and spaces are assigned to unit owners,
      - II. Sale of separately deeded spaces to purchasers of residential units, and
      - III. Developer retains ownership of the garage component and leases spaces to residents and non-residents—considered the “garage unit”. Using this approach, the developer should consider:
        - Expense allocation—if various components of the project have use of the garage, these should receive a proportional expense allocation
        - Maintenance responsibilities—an entity needs to be designated whether it is a master association or the developer
        - Future lease/sale rights—the developer must consider and define its ability to sell or lease the garage component based on carry costs and market conditions
        - The municipality's requirements and needs—approvals will often govern the facility's usage

- **Master associations**—the developer may wish to “consolidate” responsibilities and decision-making using this approach. There are benefits and drawbacks, including:
  - Legally permissible entity structures acceptable to the Division of Community Affairs
  - “Isolated activities”—usage of amenities and the garage require appropriate treatment in the association's documents
  - Creation of a minimum of three required entities—one each for the master association, the residential condominium association and the developer-owned commercial and parking components
  - Potential for multiple vendors to provide the same service for the different ownership interests (security, maintenance, etc.)
  - Inclusion in the documents, a requirement of coordination of maintenance activities and standards, and
  - Allocation of voting rights/control among master association members
- **Facility sharing**—by condominiums and rental units may be an intelligent theoretical use of space and resources, but capitalizing on this potential requires planning and coordination. For example the developer must determine the:
  - Entity with the ultimate control of access
  - Reasonable allocation of expenses/revenues (if applicable)
  - Allocation of responsibility/liability for damages
  - Practicality and frequency of maintenance and aesthetics, and
  - Entity responsible for managing building vendors.



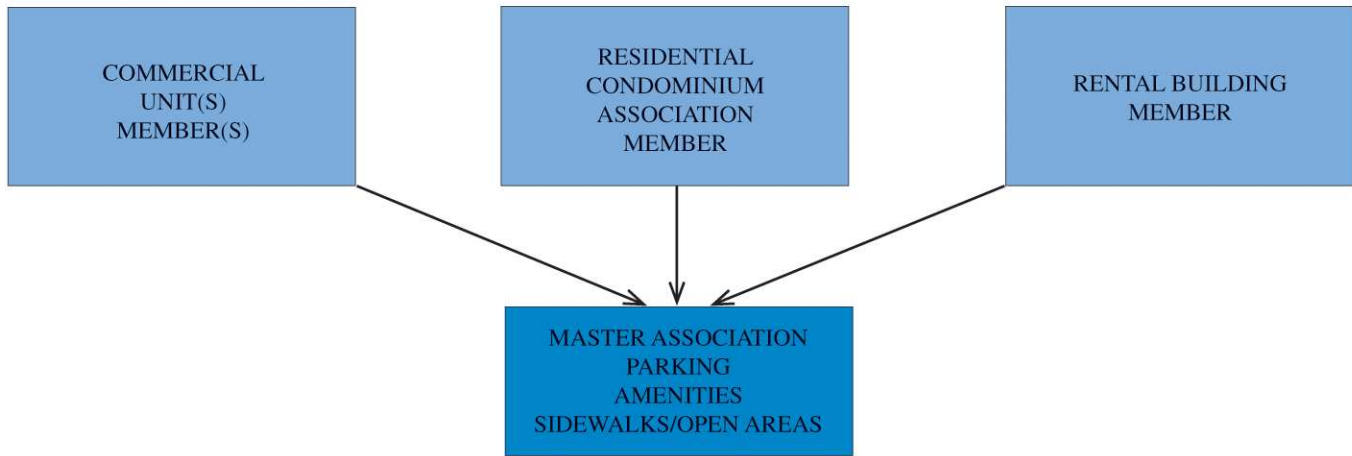
## BUDGETING/FINANCIAL

The most common and fundamental budget considerations specific to a mixed-use project include:

- **Expense allocation among unit types**—it is crucial to be aware of potential inequitable expense allocations. Consultation with the appropriate legal and financial



A sample master association configuration



professionals to be certain that all documents and financial projections, etc. are reasonable and contain necessary disclosures and disclaimers highlighting estimates and assumptions is recommended. Additionally, developers have the choice to define specific percentage allocations of expenses, and/or percentage interest at their sole discretion at project inception. Therefore, it is essential to implement an accounting system that will accurately track, record and report the chosen allocations. The most commonly used methods of expense allocations include:

- Number of units
  - Square footage
  - Market values
  - Direct usage
  - Estimated usage
  - Developer discretion
  - Combinations of the above.
- **Utility costs**—A goal of the budget (and to the extent possible, the design/engineering process) should be to separately meter as many of each component’s utilities as possible. Alternatively, consider sub-metering—a process which can be outsourced to a meter reading company. In such situations, a determination should be made about whether the management company, or the sub-metering vendor is best suited to administer the billing.
    - Cable TV – a provider may be able to contract with the association or provide for individual/unit level billing depending on its technology platform
    - HVAC and other infrastructure systems that are integrated throughout the building – developers need a rational method to allocate these operating expenses to each unit/component.
  - **Services required by municipalities or anticipated by residents/tenants**, particularly in urban locations, which could include:
    - Fire safety/monitoring
    - Environmental inspections for certain sites (such as brownfields)
    - 24/7 security
  - **Reserve and deferred maintenance schedules**—these are critical to long-term planning; therefore they:

- Should be performed by an expert that understands the presentation standards for condominium associations
- Require an understanding of the accounting/budgeting procedures for common and limited common elements so that the financial schedules can be prepared properly and appropriate reserve levels established and maintained.

- **Insurance**—can be a complicated issue for mixed-use projects since insurers will assign different underwriting requirements to different project uses and components. Therefore, insurance costs need to be allocated by unit component type. We strongly recommend that developers use a knowledgeable broker to solicit multiple insurance bids to ensure the appropriateness and adequacy of coverage. Also, given the apparent increasing frequency of severe weather events, developers should anticipate the need for flood insurance for coastal locations.
- **Revenue sources**—always desirable but not always achievable. Additionally, the developer should clearly identify the revenue recipient (i.e., the developer or condominium association). Advance planning can enable project components/property usage to generate additional revenue. These sources include:
  - Roofs/access points for lease to cell or other utilities
  - Laundry facilities, commercial space, or user/move in fees, and
  - Rental/outsourcing of parking or health/fitness facilities

## CONCLUSION

Planning, building and operating mixed-use projects can be a complex, but highly successful endeavor. This increases the sophistication and the burden on developers to have ready access to expertise to facilitate sound decisions, whether the expertise is “in-house” or provided by consultants. Thorough research, well-planned implementation and disciplined project management, can help developers transform unfinished concepts into successful projects. ■

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