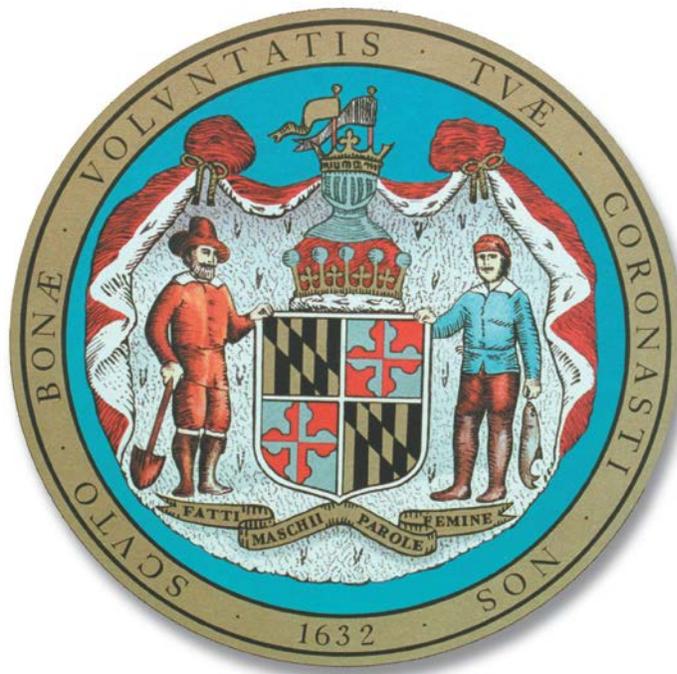


INVESTING IN SMART GROWTH

*A report of the Smart Growth
Investment Fund Workgroup*



Consultants to the Workgroup:

University of Maryland National Center for Smart Growth Research and Education
George Washington University Center for Real Estate and Urban Analysis



MARTIN O'MALLEY
Governor
ANTHONY G. BROWN
Lt. Governor
RAYMOND A. SKINNER
Secretary
CLARENCE J. SNUGGS
Deputy Secretary

December 26, 2013

The Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis MD 21401-1991

The Honorable Thomas V. Mike Miller, Jr.
President of the Maryland Senate
State House, H 107
Annapolis, Maryland 21401-1991

The Honorable Michael E. Busch
Speaker of the Maryland House of Delegates
State House, H 101
Annapolis, Maryland 21401-1991

Gentlemen:

On behalf of the Maryland Smart Growth Investment Fund Workgroup, I respectfully submit the report of recommendations as required by Chapter 592 of the 2013 Laws of Maryland (Senate Bill 965/House Bill 1170). The Workgroup was charged with making recommendations for design and creation of an investment fund that would encourage and support smart growth projects in targeted areas such as Transit Oriented Development and Sustainable Community Areas.

The Workgroup first convened on June 13, 2013 and met three additional times in person and several times by conference call, including interviews with the leaders of similar funds located in Cincinnati, Pittsburgh, San Francisco Bay Area, Michigan as well as international funds such as the USAID Enterprise Fund. This research was facilitated by a consulting team from the University of Maryland's National Center for Smart Growth Research and Education and the George Washington University's Center for Real Estate and Urban Analysis.

As you know, Maryland's Smart Growth toolbox includes an array of grants; loan and tax credit programs aimed at helping older communities attract new investment. These programs have proven to be effective in advancing the growth and revitalization goals of local governments, small businesses, and nonprofit organizations in targeted revitalization areas. However, the Workgroup concluded that more opportunity exists to marshal public and private sector resources to invest in high impact projects that further Maryland's smart growth. This report provides recommendations as to the model for the organization and structure of a potential investment fund and suggests next steps for the implementation of the Fund.

I wish to express my appreciation to all members and participants of the Workgroup (Appendix I). Their involvement in meetings and discussions was significant and critical. Thank you for attention to the report and for your ongoing leadership in creating a smart, green and economically growing State.

Sincerely,

A handwritten signature in black ink that reads "Raymond A. Skinner". The signature is written in a cursive style.

Raymond A. Skinner
Secretary

OFFICE OF THE SECRETARY

100 Community Place • Crownsville, MD 21032 • www.mdhousing.org
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Investing In Smart Growth:

A Report From The Smart Growth Investment Fund Workgroup

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Background and Charge of Workgroup

In its 2013 session, the General Assembly of Maryland passed, and Governor O'Malley signed, SB965, which created the Maryland Smart Growth Investment Fund Workgroup (“the Workgroup”). This Workgroup was composed of Senator James Rosapepe, Delegate Stephen Lafferty, Secretary Raymond Skinner (Department of Housing and Community Development (DHCD)), Chairman Jon Laria (Sustainable Growth Commission), agency representatives from the Departments of Business and Economic Development, Budget and Management, Planning, and Transportation, and representatives from local governments and members of private sector with expertise in real estate investment and development.

The Workgroup was tasked with exploring the creation of an investment fund that would play a role in the acceleration of Smart Growth, revitalization, and sustainable development in the State while also being soundly managed for financial returns to investors. Specifically, the Workgroup was tasked by legislation to:

- Review national and international experience in analogous fund creation, management, and governance;
- Design a management and governance model to advance development in areas of the State such as sustainable communities and transit-oriented developments;
- Identify criteria for how fund resources would be invested;
- Examine potential funding sources;
- Examine investment instruments;
- Examine the benefits of developing “sidecar” funds; and
- Design an investment and management model for the fund.

This document presents the consensus findings and recommendations of the Workgroup. One important finding is that, based on the experience of others who have created analogous funds, more work is required before many of the above tasks can be addressed definitively. Nevertheless, the Workgroup made important progress in understanding the need for and potential benefit of a Smart Growth-oriented fund. The Workgroup also arrived at a set of general guidelines for the fund, specific questions that require further analysis, and recommendations for next steps, which are outlined at the conclusion of this report.

Smart Growth Development Concept

Since 1992, Maryland has adopted “Smart Growth” as a guiding principle for many of its transportation, infrastructure, housing, and economic development programs and policies. Smart Growth, an opposing concept to “sprawl,” describes a framework whereby new development and redevelopment is concentrated in areas that have existing or planned infrastructure. As described by the Maryland Department of Planning,

“Smart Growth” is characterized by compact, transit-oriented, bicycle-friendly land use, with neighborhood schools, walkable streets, mixed-use development and a wide range of housing choices. Its purpose is to conserve valuable natural resources through the efficient use of land, water and air; create a sense of community and place; expand transportation, employment, and housing choices; distribute the costs and benefits of development in an equitable manner; and promote public health.

Smart Growth has four straightforward goals:

- Support existing communities by targeting resources to support development in areas where infrastructure exists;
- Save our most valuable natural resources before they are forever lost;
- Save taxpayers from the high cost of building infrastructure to serve development that has spread far from our traditional population centers; and
- Provide Marylanders with a high quality of life, whether they choose to live in a rural community, suburb, small town, or city.

While Maryland has achieved impressive outcomes from these Smart Growth policies, there are many areas of the State where these development patterns have been slower to take root. The aim of a Smart Growth Investment Fund (the Fund) would be to increase investment for and help overcome some of the major financial, social-economic, and political barriers to high quality, compact development in existing communities.

Key Barriers to be Addressed

The Workgroup identified a number of barriers to the development of Smart Growth projects. The Fund would address three main barriers to development that transcend simple needs for gap financing.

Lack of Patient Capital

By its very nature, the real estate development process necessitates major upfront investment in predevelopment and land acquisition, followed by a significant time delay before any income from sales or rents flows from that investment. Most real estate equity funds require that their capital investments are returned after three to seven years. In this typical development framework, projects are often sold after the project has stabilized its cash flow, generally before year five, within the time constraints imposed by equity fund investors.

However, this timeframe is often inadequate for the increased complexity and longer term aims of urban infill and Smart Growth development. These projects take longer to go through the predevelopment phase, require more up-front infrastructure and soft costs, generally have higher construction costs, and often include a variety of real estate product types with different timelines for occupancy. These projects are perceived as having a higher risk and are undertaken by members of a relatively smaller pool of developers. As such, it often takes longer to offer a financial return that is acceptable for equity funds, as a result, there has been less capital available for Smart Growth development deals.

Patient capital is an alternative model of investment on a time horizon that more closely matches the financial requirements and maturation period of Smart Growth development. By setting the investment horizon of capital to 10-15 years, developers are able to take the market and timing risks and make the increased upfront investments that are necessary to make these projects successful. These investments include land acquisition and assembly (which are often both expensive and time consuming in infill areas), the development of shared and/or structured parking, and off-site infrastructure improvements.

While the timeframe for the return on the investment is longer than is acceptable for most equity funds, examples throughout the world demonstrate that when given a longer time-horizon, walkable places tend to mature into places with significantly appreciating land values and superior economic returns, far exceeding communities where there is less density and greater reliance on automobiles. Consequently, with patient capital, an investor accepts a diminution of the liquidity of their investment in exchange for the potential of a much greater financial return in the mid-to long-term, generally five to fifteen years.

The expansion of the availability of patient equity should be a key objective of the Fund. If the Fund is successful financially, future investors will see the potential profitability of this framework and, thus, the Fund would not only directly support Smart Growth development, but also help to “educate the market” to engage in this investment strategy and foster additional such investment activity.

Political Risk of Real Estate Development

The predevelopment phase is fraught with risk in any development context, but this risk is often heightened in Smart Growth development. Generally occurring in infill areas, developers often face a complex political landscape with a greater likelihood of opposition than they would on a greenfield site with fewer neighbors, property owners, and other competing interests. Some communities have little experience with mixed-use, walkable development, which can result in hostile reactions to it. The fact that pedestrian-oriented, mixed-use development may change the character of a neighborhood means that neighbors living in a low-density, conventional development may be particularly opposed to it. The risk of community or competing developers’ opposition could deter equity investors and banks from committing to a project.

In addition, as Smart Growth development often supports more compact, higher density, and mixed-use development with lower parking ratios, it often requires complex zoning decisions. Infill development also often encounters unresolved issues regarding impacts on public facilities, such as schools, roadways, and sewers. This exposes the developer to further political risk when there is less familiarity with this development framework. Negotiations with policymakers and community members, design revisions, and additional legal processes are time consuming and can have negative impacts on the solvency of projects, even if they are allowed to move forward.

To be successful in supporting Smart Growth development where it might otherwise be absent, the Fund should focus on opportunities where community support for such development has already been cultivated by elected officials and use its role as a state-affiliated investor to further build credibility in these communities. A fund manager with specialized expertise in bridging private sector and public sector interests to advance development can help to address this challenge. By working cooperatively with motivated local decision makers and drawing upon the processes embedded in the State’s recently-implemented FastTrack program, the Fund may be able to materially reduce the time and risks of the entitlement.

Lack of Focused Expertise in Target Markets

While Smart Growth development often includes increased risks that are very real, many of the risks associated with infill development are more closely related to negative perception and lack of expertise. Lower-income areas are especially susceptible to this issue, with financiers unwilling to invest where there are few recent examples of profitable development. This problem also exists in areas with “emerging” markets, such as gentrifying neighborhoods in cities and the urbanizing suburbs where potential exists for mixed-income development. While those with focused expertise and experience in these areas are often able to identify projects with significant potential for both social and economic returns, lack of access to financing often frustrates the funding and development of these projects.

By ensuring that the Fund’s management entity is one that possesses deep market expertise in these geographies, this barrier between developer and financing can be dissolved. As an early investor in projects of these types, the Fund can help attract other investors whose risk is mitigated by taking a smaller share of the project’s funding.

Recommendations

Goal of Fund

The Fund is envisioned to advance the goals of Smart Growth, encompassed by Planning Visions outlined in 2009 Smart, Green, and Growing Legislation (see Appendix III of this report). The Fund should invest in projects that, given the deployment of needed financial instruments and the application of specialized experience and expertise, will achieve a *double bottom line*, realizing socio-economic and environmental benefits while also generating a reasonable financial return to investors and catalyzing additional private sector development.

Fund Concept

The Fund will play an active role in development finance, seeking out potential deals and opportunities in addition to inviting proposals from developers, investors, public officials, and others. As a “double-bottom line” fund, it should be oriented toward achieving both a positive financial return and social environmental returns, such as the advancement of affordable housing, retail and commercial development, community revitalization, environmental enhancement, and job creation. **The Fund should be a true public-private partnership, bringing together the expertise of government officials experienced with entitlement issues, issues of public benefit, and working closely with communities, with private sector investment skills, discipline, and resources.**

The Fund should be of a sufficient size and scope to provide gap financing for fully conceptualized projects and also drive innovative deals and encourage Smart Growth development that may otherwise not be considered. Although, generally speaking, the Fund should have a long-term orientation in its investments, its managers should have a great deal of flexibility in deal selection and terms. Within the bounds of any Smart Growth-oriented constraints and double-bottom line goals set by the Fund’s sponsor or management entity, investment decisions should be made primarily with respect to the projected financial performance of projects. It is anticipated that this

distinctive orientation, which aims to return both private financial and public socioeconomic /environmental benefits, should help to make the Fund distinctive and attractive to investors.

While the State should have a role in the creation of the Fund, its operations and investment decisions should be made on a substantially independent basis. By maintaining this independence and market-orientation within a Smart Growth framework, it is anticipated that the Fund can attract significant private resources and lead those resources to high impact Smart Growth projects.

Geographic Focus

As articulated in the enabling legislation for this Workgroup, a core goal of the Fund is to support development in areas of the State “such as sustainable communities and transit-oriented developments.” It is central to the values inherent in Smart Growth that development be concentrated in the core of Maryland’s metropolitan regions and in the town centers statewide. Focusing new development in these existing communities is not only aimed at supporting vitality and accessibility in these areas, but also at preserving Maryland’s agricultural lands and other natural resources.

The Workgroup recommends that, in support of these goals, Fund investments be focused on State-designated Sustainable Communities. Other than Transit-Oriented Development (TOD) and Base Realignment and Closure (BRAC) Zones, which are automatically considered Sustainable Communities, places that attain this designation have been identified by local governments as being desirable for revitalization and new development.

Sustainable Communities are also places with defined boundaries for which local governments have developed a plan and set of initiatives to support revitalization in accordance with the goals of the Sustainable Communities Act of 2010. Focusing in these areas would enable the Fund to address both the lack of specialized expertise and political risk, two of the major barriers to Smart Growth development noted above. The Sustainable Communities designation also makes these areas eligible for a range of supportive State tax credits, loans, and grants, thus providing opportunities to coordinate multiple State programs and local/plans priorities to support private development.

Investment Focus

The Workgroup recommends that the Smart Growth Investment Fund primarily be a real estate-oriented fund. The Workgroup also recommends that, in the next stage of research for the Fund, the potential of making investment in businesses that will be occupants of the planned real estate products, such as business and consumer service firms, retail stores, restaurants, business incubators, etc. be evaluated as a means of reinforcing the real estate investments. Mechanisms that facilitate the inclusion of local retailers may also be considered as a means of increasing local acceptance of new development and of contributing to local economies.

A strategy that is concentrated on real estate development would enable the Fund to be structured in a manner that is more familiar to potential investors, offering more clarity and security. Narrowing the range of potential investments permits focused expertise by the management entity, further enhancing the appeal to potential investors.

State Role

A key task for the next phase of research is to determine the State's role in the Smart Growth Investment Fund. The Workgroup has identified three potential options to be assessed:

State as Fund Organizer Only. Under Option 1, the State or State-affiliated organization provides funding for the development of the Fund. The required funding would be approximately \$500,000 which could be repaid at the closing. While the State would be encouraged to invest as the Fund is established, there would be no commitment, either explicit or implied, for it to do so as the capitalization work progresses. This option requires the least financial commitment from the public sector. However, without more State involvement, the need to satisfy the risk and return requirements of private investors may constrain the Fund's design or limit the degree to which it can exclusively focus on meeting double bottom line goals.

State as Initial Minority Investor. As in Option 1, the State or State affiliated-organization would provide funding for the development of the Fund. However, unlike that option, the State also would provide initial seed capital (approximately \$10-20 million) to help leverage the rest of the funding (\$80 million), which would come from private sources.

State as Sole Initial Capital Source. In Option 3, the State or State-affiliated organization provides all necessary funding to capitalize the Fund. The State would provide significant capital funding to make initial investments with the intent that private capital sources would invest in subsequent funds as its track record is established. This option has the greatest potential for flexibility in investment decisions and for focus on the Fund's bottom double line goals, but requires the greatest financial commitment from the public sector.

Regardless of the role that the State takes on with regard to capitalization of the Fund, the State could also serve a variety of supporting functions, such as providing credit enhancement.

Investment Tools

Another task central to the next phase is to determine the range of investment tools that will be at the fund manager's disposal. While the Workgroup recommends that the Fund be given as much flexibility as possible, the tools will ultimately be selected based on a combination of three factors: 1) how the Fund can best fill any gaps that are currently inhibiting Smart Growth investment and development; 2) how the Fund can best offer its investors a financial return; and 3) if private investment is to be a significant component of its capital stack, which tools meet the legal and financial requirements of private investors.

Equity: In equity instruments, investors earn a return that is commensurate with the profitability of the real estate product itself. Because of the inherent risks, private investors require higher projected returns than they would for a debt investment and/or guarantees that their investment will be partially or fully protected from losses.

As noted above, it has been observed that the lack of access to "patient capital" is a significant barrier to Smart Growth development. The Workgroup envisions that the Fund will address this need, with public and/or private investors keeping equity in deals for up to twenty years or until the land value associated with projects has matured in its appreciation. However, it is likely that private equity will be initially unwilling to commit to such time horizons. In addition, because the anticipated returns are so far in the future, it will be difficult to demonstrate the success of the

strategy in the short run. As such, there must be a range of investment strategies to fit investor needs and the Fund's liquidity including both short-term deals and long-term deals.

Debt: In debt instruments, investors earn a fixed rate of return based on a negotiated interest rate. While these instruments carry the risks associated with default or bankruptcy, debt investors are typically paid before any profits are returned to equity investors. Thus, for any given investment, debt investors typically require a lower projected return for their participation than do equity investors. However, debt structures with high fixed returns can be used as an alternative to equity under some circumstances. Since debt typically does not have an ownership interest, it is less useful than equity for driving deals, which would be a key goal of the proposed Fund.

Loan Guarantees and Credit Enhancement: A loan guarantee is a promise to a debt issuer that its capital will be returned and debt service will be timely paid regardless of the outcome of the project in which it has invested. Because this transfers the risk of loss to another entity, lenders are typically willing to offer larger and/or lower interest loans if such guarantees are provided. Typically, entities that offer loan guarantees do so either for their own projects or in exchange for a negotiated fee. However, deals may also be structured such that outside loan guarantors are offered a share of the investment's profits.

Developers interviewed as a part of the Workgroup's research have indicated that increasing the availability of loan guarantees and credit enhancements, would be extremely valuable in the advancement of Smart Growth development. In general, loan guarantees and credit enhancements may reduce financing costs by allowing developers to attract equity and debt on more favorable terms.

Loan guarantees are typically given by entities with strong balance sheets and their pricing needs to reflect the scale of their risk, which can be substantial. Since the Fund's balance sheet will be relatively small and limited by the capital contributions of its investors, the size of its loan guarantees would be small as well. A separate state-funded loan guarantee vehicle could be a useful compliment to the Fund but pricing of its products would need to be carefully designed.

In general, it is recommended that the Fund have broad authority to tailor its investment using the combination of equity, debt and loan guarantees which it believes is most appropriate to the needs and capacity of each project and which will achieve the best possible risk-adjusted investment return.

Sidecar Funds

While the Fund should operate in communities across the State, there are some potential investors (such as foundations, family offices, banks, large corporations, or local governments) that would only be interested in investing within a more limited geography. To address this potential barrier to attracting these resources, the Workgroup recommends that the ability to create local "sidecar funds" be a part of the Fund's governance and management structure. These funds would be directed by the statewide Fund's management entity, but with more restrictive investment criteria, such as being limited within a specific set of municipalities, real estate product types, and/or social impact standards.

Fund Sponsor and Management Entity

A critical task in the next phase of research is the selection of the Fund's sponsor. This sponsor will conduct the next stage of research and select the management entity, structure the Fund, and determine the investment criteria and instruments to be offered by the Fund. The sponsor would be the link between public and private sector interests, help to raise capital, and assist in building the pipeline of investment candidates.

It is the recommendation of the Workgroup that the Maryland Economic Development Corporation (MEDCO) be asked to lead the next steps to design and launch the Fund. MEDCO has significant relevant project finance and development experience in the State and has both worked with and invested in many of the State's municipalities. In addition, MEDCO is State-related, but not State-controlled, giving it a good balance of access and independence to be successful in executing the "next steps," outlined below.

The Fund's sponsor would evaluate and select the most appropriate management entity for the Fund. The Fund manager should have relevant project finance and investment experience and expertise.

Next Steps

The Workgroup recommends that MEDCO develop a detailed plan for creation of the Fund within the next 18 months. The MEDCO Board, at its November meeting, agreed to commit up to \$250,000 to this effort subject to a matching commitment from the State. Activities would include:

Phase I: Market Research and Assessment

- Analyze the socio-economic and demographic statistics in Sustainable Community areas which would be served by a Fund
- Assess the financial and capacity hurdles faced by developers relative to Smart Growth development.
- Determine potential deal flow for the Fund
- Identify potential Fund Managers
- Select the Fund Manager
- Identify potential investors
- Develop a preliminary business plan for the Fund
- Design of the Funds preliminary term sheet
- Determine the roles between the Fund manager and the Fund sponsor
- Develop a governance model for the Fund manager

Phase II: Development of the Business Plan

- Preliminary Fund Terms

- Fundraising Strategy
- Identification of Potential Investors
- Pre-sale of Fund Concept to Select Key Prospects
- Revise, Finalize Fund Terms

Phase III: Capitalization of the Fund

- Development of Fund legal documents
- Formal Marketing of the Fund

Appendix I: SGIF Workgroup Participants

Raymond A. Skinner, Workgroup Convener

Secretary

Maryland Department of Housing and Community Development (DHCD):

Maryland General Assembly Representatives:

Honorable James C. Rosapepe

Senator, District 21, Prince George's and Anne Arundel Counties

Honorable Stephen Lafferty

Delegate, District 42, Baltimore County

State-affiliated Members:

Thomas S. Dann

Maryland Department of Business & Economic
Development

Teresa A. Garraty

Maryland Department of Budget &
Management

Jenny B. King

Maryland Department of Planning

Andy Scott

Maryland Department of Transportation

Jon Laria, Esquire

Maryland Sustainable Growth Commission

Robert C. Brennan

Maryland Economic Development Corporation

Private Sector Members:

Donald Manekin

Seawall Development

Robert S. Kaufman

Maryland National Capital Building Industry
Association

John M. Prugh

Alex Brown Realty, Inc.

Rod Lawrence

The JBG Companies

Joan J. Millane

Millane Partners, LLC

Local Government Representatives:

Brenda McKenzie

Baltimore Development Corporation

David S. Iannucci

Prince George's County

Richard Griffin

City of Frederick

DHCD Staff to the Workgroup:

Carol Gilbert, Lead Staff

Assistant Secretary

Steve Silver

Chief Financial Officer

Peter Dolkart

Legislative Director

Kevin Baynes

Director of Office of Community Programs

Consulting Team:

Gerrit-Jan Knapp

University of Maryland, National Center for Smart Growth

Margaret McFarland

University of Maryland, Colvin Institute of Real Estate Development

Chris Leinberger,

Center for Real Estate and Urban Analysis

George Washington University School of Business

Mason Austin

Center for Real Estate and Urban Analysis

George Washington University School of Business

Appendix II: Text of SB965

MARTIN O'MALLEY, Governor

Ch. 592

Chapter 592 (Senate Bill 965)

AN ACT concerning

Maryland Smart Growth Investment Fund Workgroup

FOR the purpose of requiring the Secretary of Housing and Community Development to convene a workgroup to examine creating the Maryland Smart Growth Investment Fund; requiring the workgroup to include certain representatives; prohibiting a member of the workgroup from receiving certain compensation, but authorizing the reimbursement of certain expenses; requiring the workgroup to evaluate and make recommendations regarding certain matters; requiring the Secretary to report the findings and any recommendations of the workgroup on or before a certain date; providing for the termination of this Act; and generally relating to creating the Maryland Smart Growth Investment Fund.

SECTION 1. BE IT ENACTED BY THE GENERAL ASSEMBLY OF MARYLAND, That ~~the Laws of Maryland read as follows:~~

(a) The Secretary of Housing and Community Development shall convene a workgroup to evaluate and make recommendations relating to creating the Maryland Smart Growth Investment Fund.

(b) The workgroup required under this section shall include:

(1) one member of the Senate of Maryland, appointed by the President of the Senate;

(2) one member of the House of Delegates, appointed by the Speaker of the House;

(3) the Secretary of Housing and Community Development, or the Secretary's designee;

(4) the Secretary of Business and Economic Development, or the Secretary's designee;

(5) ~~the Secretary of Budget and Management, or the Secretary's designee;~~

~~(5) (6) the Secretary of Planning, or the Secretary's designee;~~

- ~~(6)~~ (7) the Secretary of Transportation, or the Secretary's designee;
- ~~(7)~~ ~~the Secretary of Budget and Management, or the Secretary's designee;~~
- ~~(7)~~ (8) the Chair of the Sustainable Growth Commission, or the Chair's designee;
- ~~(8)~~ (9) up to five representatives from the private sector; and
- ~~(9)~~ (10) up to three representatives from local government.
- (c) A member of the workgroup:
- (1) may not receive compensation as a member of the workgroup; but
 - (2) is entitled to reimbursement for expenses under the Standard State Travel Regulations, as provided in the State budget.
- (d) The workgroup shall:
- (1) review national and international experience in analogous fund creation, management, and governance;
 - (2) design a management and governance model to help accelerate smart growth, revitalization, and sustainable development in areas of the State such as sustainable communities and transit-oriented developments;
 - (3) identify criteria for how moneys *money* in the fund would be invested;
 - (4) examine potential funding sources, including institutional investors, high net worth investors, and public funds;
 - (5) examine investment instruments, including equity, debt, and guarantees;
 - (6) examine the benefits of developing "sidecar" funds that would be funded at the county level and would be coordinated with the Maryland Smart Growth Investment Fund; and
 - (7) design an investment and management model for the Maryland Smart Growth Investment Fund.
- (e) On or before December 31, 2013, the Secretary of Housing and Community Development shall report the findings and recommendations of the workgroup to the Governor and, in accordance with § 2-1246 of the State Government Article, the General Assembly.

SECTION 2. AND BE IT FURTHER ENACTED, That this Act shall take effect June 1, 2013. It shall remain effective for a period of 1 year and, at the end of May 31, 2014, with no further action required by the General Assembly, this Act shall be abrogated and of no further force and effect.

Approved by the Governor, May 16, 2013.

Appendix III: Maryland's 12 Planning Visions

As adopted through its 2009 Smart, Green, and Growing Legislation, growth policy in the State of Maryland is guided by the following 12 Planning Visions. The Smart Growth Investment Fund is intended to add an additional tool for the achievement of these visions. The Fund's investment decisions will be bound by a market orientation, but also by conformance to and support of these visions.

Quality of Life and Sustainability: A high quality of life is achieved through universal stewardship of the land, water, and air resulting in sustainable communities and protection of the environment.

Public Participation: Citizens are active partners in the planning and implementation of community initiatives and are Sensitive to their responsibilities in achieving community goals.

Growth Areas: Growth is concentrated in existing population and business centers, growth areas adjacent to these centers, or strategically selected new centers.

Community Design: Compact, mixed-use, walkable design consistent with existing community character and located near available or planned transit options is encouraged to ensure efficient use of land and transportation resources and preservation and enhancement of natural systems, open spaces, recreational areas, and historical, cultural, and archeological resources.

Infrastructure: Growth areas have the water resources and infrastructure to accommodate population and business expansion in an orderly, efficient, and environmentally sustainable manner;

Transportation: A well-maintained, multimodal transportation system facilitates the safe, convenient, affordable, and efficient movement of people, goods, and services within and between population and business centers;

Housing: A range of housing densities, types, and sizes provides residential options for citizens of all ages and incomes;

Economic Development: Economic development and natural resource-based businesses that promote employment opportunities for all income levels within the capacity of the State's natural resources, public services, and public facilities are encouraged;

Environmental Protection: Land and water resources, including the Chesapeake and coastal bays, are carefully managed to restore and maintain healthy air and water, natural systems, and living resources;

Resource Conservation: Waterways, forests, agricultural areas, open space, natural systems, and scenic areas are conserved;

Stewardship: Government, business entities, and residents are responsible for the creation of sustainable communities by collaborating to balance efficient growth with resource protection; and

Implementation: Strategies, policies, programs, and funding for growth and development, resource conservation, infrastructure, and transportation are integrated across the local, regional, state, and interstate levels to achieve these Visions.

Appendix IV: Examples of other Funds

Develop Michigan Real Estate Fund

Develop Michigan, Inc. (DMI) is a spin-off of Grow Michigan, a state-sponsored investment entity aimed at supporting, expanding, and attracting businesses and jobs throughout the state. While Grow Michigan is focused on business operations, however, Develop Michigan is focused on real estate. The two investment types were segregated into separate loan programs because the fund designers believed that they required different fund structures and specialized expertise by the fund managers in order to function effectively.

The Great Lakes Capital Fund (GLCF), a Lansing-based Community Development Finance Institution, helped design the fund and currently serves as its management entity. Prior to the establishment of DMI, GLCF's core line of business was attracting capital for investment in Low Income Housing Tax Credits and New Markets Tax Credits. This experience helped them to identify a key need in the state: because there are few major financial institutions that have local expertise or specific interest in Michigan, real estate projects there have difficulty obtaining capital, especially when the deal is too small to attract the interest of national investors.

DMI targets projects in the \$3 million to \$10 million range, with a special focus on rehabilitation or repositioning of urban, mixed-use structures. Housing and retail have a higher priority than office. The intent is for the Fund to be applied throughout the state, but it is estimated that approximately 40 percent will be invested in the Detroit metro area, with the next largest chunk invested in the Grand Rapids metro area, and the rest spread among other areas. Because Community Reinvestment Act credit is a major motivation for the banks that have invested in the DMI, the majority of investments are in lower income urban areas.

Criteria for Investment: First and foremost, DMI uses market-based criteria to make investment decisions, generally looking for debt service coverage of at least 130%. Job creation, neighborhood development, and other goals are also considered, but only if an investment is also expected to perform well financially. The local expertise of the fund managers allows them to be pioneering and find good deals in tertiary markets within the state; a broad portfolio allows DMI to spread the risk that is inherent in lending within these areas. In an effort to neither “crowd the market,” nor expend resources where they are not needed, DMI does not invest in deals where financing can be secured through more traditional private sources.

Sources: Twenty percent of the capital for the DMI was provided by the State of Michigan through the Michigan Strategic Fund, which is supplied by revenue from casinos. The remaining 80 percent comes from private sources, primarily super-regional banks such as PNC and Huntington that had a primary goal of capital preservation. The fund managers are looking to attract capital from pension and insurance funds, but have not had success thus far.

Financial Instruments: DMI's loans are split roughly evenly between senior debt and mezzanine debt. They have the capability of structuring their investments as equity on the individual deal level. However, private investors expressed a preference for debt products due to their greater comfort and understanding, as well as the associated security benefits, which led fund managers to focus on those instruments. In addition, the Volker Rule has limited the amount of equity investment in which banks could participate.

Leveraging: There is an implied, but not explicit, relationship between DMI and other state-related funding sources. It is a long-term goal of DMI’s fund managers to consolidate applications for State funding programs into a broad “clearinghouse” with aligned incentives.

Management Entity: DMI is managed by the Great Lakes Capital Fund. While the State has appointments on DMI’s governing board, the loan committee is completely private.

Size of Fund: \$100 million. The fund has closed on the first \$50 million in investment from the State and private sources; the second half of the pool is expected to follow in the near term.

Returns: State funding comes in as Class B investment, providing first loss protection, up to 75% of the value of its investment. The State’s returns are subordinated and projected at 1 percent. Private funding is coming in as a Class A investment, with projected cash-on-cash returns of 8-10 percent.

Key Lessons:

- A statewide fund allowed risk to be spread around multiple real estate submarkets
- Local expertise is essential to the discovery and selection of investment opportunities.
- Significant investment was attracted from private sources, but it involved the state’s provision of a large capital investment that mitigated the risk and subsidized the returns to private investors.
- Banks may be limited in their participation in a fund that is equity-, rather than debt-, focused

3CDC/Cincinnati Equity Fund

The Cincinnati Equity Fund (CEF) was created to address disinvestment in Cincinnati’s central business district and the adjacent neighborhood known as Over-the-Rhine. This Fund has been used to capitalize the Center City Cincinnati Development Corporation (3CDC), a non-profit real estate development and place management organization that focuses on these two neighborhoods. 3CDC has used the capacity provided by its access to the CEF, (as well as subsequently formed equity and new markets tax credit funds), to undertake projects with a strong public sector consensus but without the state and local government expertise and capitalization necessary to execute.

Types of Investments: 3CDC utilizes its funds for two major tools: capital funds and a development operation that can initiate and manage a variety of development projects. Having acquired a significant number of vacant, abandoned, and underutilized parcels early in its history, 3CDC has engaged in residential (including rental and for-sale, affordable, and market-rate) and commercial real estate development, parks and infrastructure development and maintenance, and place management services. 3CDC also invests in the tenants of its commercial spaces, primarily through capital improvements. 3CDC’s structure allows it to intervene in and undertake projects that lay outside the normal, acceptable risk profile of the private sector development community. Its long-term commitment to these neighborhoods has resulted in significant financial returns, which have been recycled into on-going development projects.

Management Entity: 3CDC operates as a non-profit holding company. The Cincinnati Equity Fund makes risk underwriting decisions through a loan committee from each of its two funds (Cincinnati Equity Funds I and II and the two New Market Tax Credit Funds). The loan committees were established by corporate governance documents. Underwriting decisions are made by the two committees, and are then sent to a full board of directors of each fund for final review and a corporate decision. Members of both boards of directors and loan review committees are indemnified by liability insurance and other specific financial controls.

Size and Sources of Fund: The Cincinnati Equity Fund I was initially capitalized with \$44.5 million, raised as investments from the larger corporations in Cincinnati. 70% of the funds were provided by Proctor and Gamble and the local utility company. The CEF II, which included an additional \$41 million was composed of similar investments from many of the same companies, while \$88.5 million was allocated to 3CDC through two rounds of New Market Tax Credits funding. These funds have generated \$717 million of investment in the Cincinnati Central Business District and Over the Rhine neighborhoods.

Returns: The fund's goal was originally to achieve an overall long-term portfolio return of approximately 4%, and to leverage investment by the public and private sector. The fund has yielded 2-4% interest rates, and interest-only payments for NMTC loans. Loans are made on a non-recourse basis to developers, and loan proceeds are revolving and are reinvested in additional projects. Investors receive 5.5% annually from the NMTC loans in addition to the 2-4% interest, for a total of close to 9% annual return. The CEF II receives approximately 4.5% annual return, since it does not yet have a NMTC allocation. Once 3CDC receives a new NMTC allocation for Fund II, returns will probably increase to the level of Fund I.

Key Lessons:

- The funds were deployed in small geographic areas, which facilitated a catalytic impact from investments
- By using funds to establish a development entity, projects were undertaken in a coordinated manner that also enhanced the speed and impact of development
- Investment in land allowed for the generation of significant profits once the development was complete and the value of that land had increased
- New Markets Tax Credits were used to subsidize returns to other investors
- 3CDC invested in key commercial tenants to increase the value of its real estate holdings

Bay Area Family of Funds

The Bay Area Family of Funds was created to address lack of investment in low and moderate income neighborhoods. The Bay Area Family of Funds is a regional effort, developed by the Bay Area Council, to attract private capital into low and moderate-income neighborhoods through double bottom line (DBL) investing. The Family of Funds leverages its investments in these communities through projects that promote Smart Growth, address poverty, support local businesses and clean up contaminated sites with market-based solutions.

The Family of Fund's goal is to make market-based investments that simultaneously address economic prosperity and environmental quality in underserved neighborhoods throughout the region. The fund is a Smart Growth program aimed at engaging the Bay Area's disadvantaged communities in capitalizing an underutilized workforce, land, and resources in ways that create wealth for existing low-to-moderate income community residents and contribute to continued regional health and well-being.

Geographic Focus: The Family of Funds serves the entire San Francisco Bay Area, specifically low and moderate income neighborhoods in the region.

Types of Investments: The Bay Area Family of Funds invests in real estate projects and provides venture capital for rapidly growing businesses and environmental clean-up projects. It is comprised of four separate funds. The first, the Bay Area Smart Growth Fund, is a \$66 million fund that invests in projects designed to impact community revitalization while generating favorable financial returns to its investors. The fund invests in retail, office, commercial and industrial projects, and in multi-family and single-family housing development in neighborhoods at or below 80% AMI. The second, the Bay Area Equity Fund, is a \$75 million venture capital fund. It invests in rapidly growing companies in target neighborhoods that can generate high quality jobs and wealth for residents of those areas. Its investments focus on rapidly growing technology, consumer products and services, and health care companies that benefit residents of targeted neighborhoods. The third, the California Environmental Redevelopment Fund, is a \$34 million state-wide environmental cleanup fund that focuses 25% of its investment capital in the Bay Area. The fund invests in developers, businesses and public entities faced with contaminated sites. The fund also lends for acquisition, construction, predevelopment, and rehabilitation for sites with contamination issues. The fourth, the Bay Area Fund II, is an expansion of Bay Area Fund I. The fund invests in retail, office, industrial, and housing (for sale and rental) projects. Investments are focused on mixed-use, urban infill, and transit oriented sites.

Sources: Each of the four funds' investors include banks, foundations, pension funds, insurance companies, individuals, and other corporations. There is no public money in the capital stack of any of the funds. The four funds together have raised over \$215 million for double bottom line investments. The funds are expected to leverage \$1 billion of investment in Bay Area low-and-moderate income communities over a ten year period.

Management Entity: The Bay Area Family of Funds is composed of multiple funds, each with its own management entity. All entities are private and not-for-profit. The Bay Area Smart Growth Funds I and II are managed by Pacific Coast Capital Partners. The California Environmental Redevelopment Fund is managed internally by its own board. The Bay Area Equity Fund is managed by JP Morgan. The Bay Area Council oversees the entire family of funds through a 37-member executive committee.

Returns: Investments from the Bay Area Family of Funds require DBL returns: risk-adjusted market rates of financial return for its investors (the first bottom line) and significant economic, social, and environmental returns for the communities (the second bottom line). The second bottom line objectives are focused on geographic location, community benefits, economic development, wealth creation, environmental performance and community participation. While the exact value of the financial returns is not publicly disclosed, those from the Smart Growth Funds exceed 20 percent, annually.

Key Lessons:

- These funds have been very successful in financial, social, and environmental goals without drawing from public sources
- By taking advantage of strong regional real estate markets, socially-beneficially investments were able to be attracted to lower-income submarkets

International Funds: OPIC Equity Funds and USAID Enterprise Funds

While differing in their specific origins and structures, the Overseas Private Investment Corporation (OPIC) and United States Agency for International Development (USAID) Enterprise Funds share several core characteristics that are relevant to the Maryland Smart Growth Investment Fund. In both of these programs, the agency involved does not provide direct investment into projects. Instead, each has set up locally-embedded and focused funds with independent management entities that invest in their region. In addition, while each of these programs includes public money as a funding source, they have each been explicitly oriented toward attracting private investment in the funds.

Types of Investments: Equity funds formed under each of these programs have substantial flexibility regarding the types of investments they make. The targets of their investments (including both real estate projects and businesses) and the investment instruments they deploy are largely a function of the needs and opportunities in the countries and regions that they operate. A unique feature of OPIC's program is its sale of political risk insurance, which helps attract more private investment and at better terms than would otherwise be possible. While each of these programs has overarching goals, guidelines, and requirements for their partner funds, market-orientation is primary.

Sources: Each of these funds is composed of a mix of public and private investments. USAID Enterprise Funds were initially composed of direct allocations from the federal budget. However, their strong track record has attracted significant private capital investment into the Funds, as well as into the projects and businesses in which the Funds invest. OPIC Equity Funds use loans from OPIC as a significant component of their capital base, but require that these funds be matched at a rate of at least 2:1 from private sources.

Funding Levels: The initial seeding of public funding for Enterprise Funds averaged \$120 million for each of the ten funds. These were used to leverage significant private investment and have returned an average of \$20 million as of 2007. OPIC has committed \$4.4 billion to 63 private equity funds in emerging markets since 1987. These funds in turn have invested \$5.6 billion in more than 570 privately-owned and managed companies across 65 countries.

Key Lessons:

- Public investment in equity funds was critical to leveraging private investment. This was especially successful after the track record of these funds was established.
- Devolution of funds to independent management entities with local expertise was critical to giving the flexibility necessary to seek out and evaluate potential investments.
- The mitigation of political risk was a key tool to foster the success of investments by these funds

