EHLERS
LEADERS IN PUBLIC FINANCE

Memo

To: Janine Atchison, Northfield Housing and Redevelopment Authority

From: Nick Anhut, Ehlers

Date: February 20, 2019

Subject: **Potential TIF Assistance for Schrom Townhouse Development**

This memorandum includes our findings relating to Schrom Construction's proposal to build 28 new townhome rental units located in the City of Northfield. We reviewed information provided by the developer on the proposed form of private financing, revenue/expenditure assumptions and expected returns on investment for consistency with industry standards for similar projects. We also reviewed County property information to review the property tax assumptions and potential tax Increment. Upon review, the project costs and operating performance appear to be in line with general standards. Based on our analysis, without assistance the annual project net operating income demonstrates a financing gap of approximately $540,000.

As long as the developer proposes to meet the City's Housing TIF qualification standards, it appears that public assistance to fill this gap would meet "But/For" criteria required by TIF Statutes. The developer proposes to designate six (>20%) of 28 units as affordable to persons at or below 50% of Area Median Income (AMI). The developer will seek 4d classification as such. 4d classification requires certification by Minnesota Housing Finance Agency that the designated units are appropriately rent and income restricted.

Project Gap

The gap for the project is the difference between the costs of development and the funds that can be raised to pay for those costs. Private debt and equity are the two sources that must first be maximized. The developer has presented a assumption of financing 80% of the cost. This means the developer is expected to fill in at least 20% equity, depending on an appraisal. The stated loan amortization would be 25 years. It should be discussed whether the intended equity amount is comprised of cash, equity partnership, or some other form. In order to substantiate the equity raise or achieve adequate debt service coverage for the primary financing, the developer is requesting 15-years of Tax Increment Assistance.

We were provided summary information on the project's anticipated costs and the expected net operating revenues. Given the developer's estimates and applying conventional underwriting criteria observed in the marketplace, the development appears to have a potential gap in financing due to debt service coverage constraints and inadequate cashflow.

We have estimated the potential gap to be $440,000 as shown below:

$2,800,000	(supported by project net operating revenue at 1.20x coverage)
$ 835,000	equity (20% of total cost)
$ 540,000	financing gap
$4,175,000	total project cost

Adding potential Tax Increment Financing (TIF) revenue created from the taxable value of the project could help eliminate the financing gap. This could occur either by assigning the potential TIF to the lender to improve project's debt service coverage or to the developer in order to justify a higher equity raise. Before commitment, the developer or Ehlers will initiate a discussion with the Rice County assessor to review the site plan and finishes of the project to determine an updated estimate of the potential taxable value and local property taxes anticipated. Alternatives to TIF to eliminate the project gap are reductions in project costs, increased rent levels, local secondary loan or grant programs, or tax abatement with county and/or school district participation.

Project Cost

The total development cost presented is $4,175,000. This equates to just over $149,000 per unit, which is in line with costs we have reviewed elsewhere. The developer reports construction costs at $3.45 million ($123,500 per unit). Land costs are $120,000 or $4,286 per unit, which is reasonable for this type of development. Soft costs represent only 5% of the total, and developer fee represents just under 10%. For similar projects, we typically review developer fees at 5 to 6% of the total development cost. We have requested additional information on whether the budget includes placeholders for contingencies, as well as what portion of the developer fee represents overhead versus profit.

SOURCES	Amount	Pct.	Per Unit
First Mortgage	2,900,000	69%	103,571
Equity	835,000	20%	29,821
Gap Financing	440,000	11%	15,714
TOTAL SOURCES	**4,175,000**	**100%**	**149,107**

USES	Amount	Pct.	Per Unit
Acquisition Costs	120,000	3%	4,286
Construction Costs	2,717,500	65%	97,054
Eligible Site Improvements / Foundation Work	738,500	18%	26,375
Financing And Soft Costs	199,000	5%	7,107
Developer Fee	400,000	10%	14,286
TOTAL USES	**4,175,000**	**100%**	**149,107**

Adding in land, site improvements, and soft costs can increase outstate development costs to levels between $110,000 to $165,000 per unit. The developer's assumptions are within these overall levels. Given the size of the proposed developer fee and the expectation for public assistance, we recommend a deferral of the portion above 6% of total project costs, with the remainder to be collected from the initial project revenue.

Pro Forma Review

In addition to reviewing the potential financing gap, the following summary compares this project and its future operating revenues and expenditures (pro forma) against industry standard ranges that we typically see for projects of this nature. We have updated the developer's assumptions to include a projection of the TIF available ($45,802 annually) based on estimated property taxes for a hypothetical taxable value for the 28-unit development of $3,360,000. This value must be reviewed with the local assessor prior to any public commitment.

- First Mortgage Financing. A debt coverage ratio (DCR) of 120% is a common market rate range. At the presented rent levels inclusive of the six affordable units, the developer shows only 101% coverage against a $3.34 million (80%) mortgage. This assumes 5% vacancy as an assumption within the developer's revenue expectations as a standard measure used in underwriting a project of this type. Available revenues would be able to afford debt repayment, but likely below underwriting standard for that high of a financing amount. A 20% equity contribution is commensurate with what we are seeing from credit worthy investors. It should be noted that, without assistance, the remaining annual cashflow after debt payment represents a 0.2% return on equity.

- Rents: the project includes a mix of 14 two-bedroom and 14 three-bedroom townhome units. The market rate rents anticipated are $1,300 for a two-bedroom unit and $1,350 for a three-bedroom unit. To qualify for TIF assistance and 4d property classification, the developer has proposed to designate at least 20% of units for occupancy by low and moderate income individuals or families.

- Non-property tax operating expenses are shown at $2,700 per unit are lower than expected levels for new affordable housing projects. Expenses exclude electric, gas and cable/internet. Management fees are set at 5% of effective income, which is within standards for affordable housing projects.

Affordable Units

Providing TIF assistance does not limit the rents a property can charge directly. Rather, the statutes require a minimum level of units be occupied by individuals or families at or below median area incomes. Either 20% of units occupied by families at or below 50% Area Median Income (AMI), or 40% of units occupied at or below 60% AMI. However, 4d classification does require rent restriction. The developer's proposal suggests 20% of unit be designated at 50% AMI. This would require 6 of the 28 units be designated. We have adjusted the developer's pro forma to apply the rent restriction on the designated affordable units.

The 50% AMI affordable rent levels for Rice County established by HUD and Minnesota Housing in 2018 are $878 for a two-bedroom unit and $1,015 for a three-bedroom. These levels are adjusted annually and the 2019 levels are expected later this Spring. The developer's pro forma assumes a project with all unit rents at market levels, but after discussion the developer proposes to restrict six of the three-bedroom units to HUD levels.

TIF Assistance

A Housing Tax Increment Financing District can be established by the City to support a qualifying project. The district can collect tax increment for a maximum of 26 years or the term designated within the TIF Plan, if less. Assistance can come in the form of up-front equity from City as cash or bonds issued and repaid from future tax increment at the City's risk. A favorable alternative which minimizes the City's risk is to provide assistance on a pay-as-you-go basis only as property taxes are paid and TIF revenue is received. Generally, the pay-as-you-go form minimizes the City's risk and places it appropriately on the developer to deliver a project that produces the necessary tax increment. Pay-as-you-go can be set as a not to exceed amount and limited to a specific duration. Regardless of the form of assistance, the affordable housing occupancy standards must remain in effect for as long as the TIF revenue is collected.

For this analysis, we have assumed tax increment would provide pay-as-you-go assistance to reimburse eligible project expenses the developer will incur up front. We recommend the City issue a Note payable from available tax increment upon completion of the project and once the developer has proven it has incurred the actual costs and achieved 4d classification. Using a taxable value estimate of $3.36 million ($120,000 per unit) for the development, 90% of the tax increment available each year is $45,802. This assumes a 10% allowance is retained for the city's own expenses in administering the TIF district ($5,089 annually). The cumulative amount available over the requested 15-year term is $687,035. All or a portion of this amount could be utilized to offset the project's financing gap in concert with any other forms of assistance available. We recommend the terms of assistance be negotiated in advance of the time the TIF District is presented for final approval by the City Council.

We will provide an update to this memo with new TIF estimates once the developer has received a market value estimate from County Assessor. Please contact me with any questions.