Memo

To: Nate Carlson, Northfield Economic Development Authority

From: Nick Anhut, Ehlers

Date: August 12, 2019

Subject: **Rebound Real Estate's 5th Street Lofts Pro Forma and TIF Analysis**

The City of Northfield requested that Ehlers review the updated development pro forma and subsidy application request from Rebound Real Estate for the proposed redevelopment of property at the Southwest corner of 5th and Washington Streets. The proposed project, referred to as 5th Street Lofts, will facilitate in-town relocation of an existing banking institution, demolition and preparation of the existing downtown site, and construction of a new 79-unit apartment building both with and without public parking included within the development footprint.

We reviewed information provided by the developer as well as County property information and property tax assumptions to analyze potential tax Increment available to help assist the project. We have reviewed the project based on general industry standards for construction costs, land acquisition, rental income, operating expenses, developer fees, underwriting and financing criteria, and project cash flow. Based on this analysis, we view the project inclusive of public parking demonstrates a conventional financing gap of $5.2 million. Without the public parking, the reduced gap is $4.3 million.

Project Cost

The total development cost presented is $14,972,000. This equates to just over $189,000 per unit, which is within the range of outstate urban redevelopment costs we have reviewed elsewhere. For purposes of this evaluation, we have included in the above total a few cost items the developer requests be bourn by the EDA, namely: $212,000 EDA land requested for grant to the project and $10,000 blight study.

1. **Acquisition Costs:** The total acquisition costs of approximately $10,911 per unit are slightly above the typical range of $7,500 to $10,000 per unit found in similar projects. A lower than average acquisition cost helps limit the project's gap. The costs net of the EDA land (if contributed) reduces costs to $8,228 per unit.

2. **Construction Costs:** The construction costs of approximately $144,304 per unit are typical for these types of multi-family residential projects that include some at-grade enclosed and/or underground parking. The developer indicates removing public parking reduces $1 million of costs moving to structured parking at-grade.

3. **Developer Fee:** The proposed developer fee is 4.3% of the modified total, which is within the typical industry range of 4-6% for similar projects. Under the proposal, the Developer is not deferring a portion of their fee to help reduce the project gap. Any deferred portion of the fee would instead be paid to the Developer through future project cash flow.

4. **Total Development Cost (TDC):** The TDC of approximately $189,500/unit is within the typical range of $175,000-$225,000 for new multi-family construction projects with underground parking. The developer indicates removing the public parking component reduces the TDC to $175,658.

5. **Rents:** The building is proposed to include a mix of 33x studio, 38x one-bedroom, and 8x two-bedroom units. 8 units are proposed to be restricted as affordable at 60% Area Median Income. The affordable rents are within the regulatory maximum allowed under existing HUD criteria. The remaining market-rate units average rents are slightly above $2.00 per square foot. The Developer cites the engagement of Maxfield Research for a study of the Northfield housing market.

6. **Vacancy:** Vacancy is underwritten at 5% per typical industry standards in this market.

7. **Operating Expenses:** The operating expenses of $2,814 per unit per year (before management fees, property taxes, and replacement reserves) is within industry standards. The proposed management fees of 5% of income is also within industry norms for this project type of 3% to 6%.

8. **First Mortgage:** The Developer anticipates obtaining a fixed-rate permanent mortgage with a 25-year term at a forward-locked 5.0% interest rate. The underwriting anticipates a debt coverage ratio of 1.20x. The financing terms are reasonable for the product type in today's market. Construction and permanent financing fees equate to over $8,500 per unit or 4.5% of the TDC. A 20 to 25% equity raise is commensurate with what we are seeing from credit-worthy investors.

9. **Public Assistance:** The developer requests $222,000 in EDA land and cost grants, $250,000 EDA subordinate loan, financing to offset the public parking stall costs, and 25-years of TIF assistance to assist in offsetting the private financing gap. In total, we estimate this $3+ million request at over 22% of the TDC. Public assistance is commonly in the range of 7% to 10% of total project costs for typical redevelopment projects. Removing the public parking component, the request is reduced to 18%.

SOURCES	Amount	Pct.	Per Unit
Private Financing	7,870,000	53%	99,620
TIF Supported Investment	1,969,169	13%	24,926
EDA Grants (Land/Fees)	222,000	1%	2,810
Public Parking	805,000	5%	10,190
EDA Loan	250,000	2%	3,165
Unsubsidized Equity	3,855,831	26%	48,808
TOTAL SOURCES	**14,972,000**	**100%**	**189,519**

USES	Amount	Pct.	Per Unit
Acquisition Costs	862,000	6%	10,911
Construction Costs	11,400,000	76%	144,304
Professional Services	450,000	3%	5,696
Financing Costs	1,310,000	9%	16,582
Developer Fee	650,000	4%	8,228
Cash Accounts/Escrows/Reserves	300,000	2%	3,797
TOTAL USES	**14,972,000**	**100%**	**189,519**

SOURCES - No Public Parking	Amount	Pct.	Per Unit
Private Financing	7,738,000	56%	97,949
TIF Supported Investment	1,969,169	14%	24,926
EDA Grants (Land/Fees)	222,000	2%	2,810
Public Parking	0	0%	-
EDA Loan	250,000	2%	3,165
Unsubsidized Equity	3,697,831	27%	46,808
TOTAL SOURCES	**13,877,000**	**100%**	**175,658**

USES - No Public Parking	Amount	Pct.	Per Unit
Acquisition Costs	862,000	6%	10,911
Construction Costs	10,400,000	75%	131,646
Professional Services	450,000	3%	5,696
Financing Costs	1,215,000	9%	15,380
Developer Fee	650,000	5%	8,228
Cash Accounts/Escrows/Reserves	300,000	2%	3,797
TOTAL USES	**13,877,000**	**100%**	**175,658**

Project Gap

The Developer's application 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.

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 underwriting criteria for the private financing. Applying the Assessor's tax assumptions and the Developer's operating assumptions generates a project Net Operating Income (NOI) of $662,539. This amount supports mortgage proceeds of $7.87 million, or 53% of the cost. This means other sources will be expected to fill in at least $7.1 million, depending on a more favorable appraisal. The stated loan amortization is 25 years. In order to substantiate the equity raise or achieve adequate debt service coverage for the primary financing, the developer is requesting various public funding sources, including Land Acquisition, Tax Increment Assistance, and a subordinated loan.

We have estimated the potential gap to be $5.2 million shown in detail in the attached analysis.

$ 7,870,000	First Mortgage (supported by project NOI at 1.20x coverage)
$ 1,840,387	Cashflow Supported Equity (at 6% yield)
$ 5,261,613	Private financing gap
$14,972,000	Total Development Cost

Adding potential Tax Increment Financing (TIF) revenue created from the taxable value of the project helps in eliminating a portion of the financing gap. This occurs either by assigning the potential TIF revenue to the lender to improve project's debt service coverage or to an investor in order to justify a higher equity raise. The developer is also requesting land subsidy and a subordinate loan from the EDA. Even with these tools, we surmise the TDC will necessitate filling the remaining gap with $2.4 of additional equity investment anticipating below-market returns from stabilized project cashflow.

Alternatives to the subsidy request to eliminate the project gap are reductions in project scope/costs, increased rents/unit counts, or public grant programs. Reducing $1 million in costs by removing public parking helps reduce the gap and the city's risk in providing lease revenue for operating a public parking enterprise within the shared site. We also believe that the project is likely to qualify for the Department of Employment and Economic Development Redevelopment Grant Program which could offset a portion of the site and infrastructure costs to complete the project.

Private Returns

Aside from loan underwriting, developers must be attuned to delivering adequate returns to their investors. One measure of a project's ability to leverage adequate financing is a 7.0% operating return on Total Development Cost. The NOI assumption from the building provides capacity for only $9.5 million or 63% of the anticipated costs.

Alternatively, assuming the development is able to find the requested gap financing, the project's equity investment yields only a 3.1% cashflow return, which is below market expectations of 8 – 10%. Removing the public parking component, the equity yield only

marginally improves to 3.2%. An investor at these yields is likely relying on future growth in operating revenues and sale value to offset the initial investment.

Affordable Units

The developer has stated an intention to include affordable units within the proposed project in order to obtain favorable private financing. Providing Redevelopment TIF Assistance or EDA subsidy does not necessitate the inclusion of affordable units under existing statute. The developer's proposal suggests 10% of units be designated at 60% Area Median Income. We have determined the rent restrictions on the designated affordable units induces $245,000 of the stated gap versus a 100% market-rate project.

The 60% AMI affordable rent levels for Rice County established by HUD and Minnesota Housing in 2019 are $903 for a studio and $1,161 for a two-bedroom unit. These levels are adjusted annually.

TIF Assistance

A Redevelopment Tax Increment Financing District can be established by the City to support a qualifying project. The project must meet statutory findings requiring the demolition or rehabilitation of at least one substandard building and at least 70% of the area of the TIF District must include improved surfaces. The district can collect tax increment for a maximum of 25 years after the first increment is collected, or the term designated within the TIF Plan if less. TIF can be utilized to finance a variety of redevelopment costs including: land acquisition, demolition, site and public improvements serving the redevelopment, and/or parking infrastructure.

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 is to provide assistance on a pay-as-you-go basis to reimburse a developer's expenditures only as property taxes are paid and TIF revenue is received. Generally, the pay-as-you-go form transfers risk appropriately on the developer to deliver a project that produces the necessary tax increment. The developer is requesting TIF financing for the full 25-year term available.

Using a taxable value estimate provided by the Rice County Assessor's office of $9.3 million ($117,721 per unit), 95% of the tax increment available each year is $134,341. This assumes a 5% allowance is retained for the city's own expenses in administering the TIF district ($7,071 annually). The cumulative amount available over the requested term is $3,492,000, or a present value of $1.9 million at a 5% discount rate. If assistance is deemed appropriate, we recommend the City issue a TIF Note payable from available tax increment upon completion of the project and once the developer has proven it has incurred the actual costs substantiating the stated gap.

Conclusion

Based on the analysis, a demonstrated financial gap remains after maximizing private financing tools available. At the assumed level of expense, the proposed development would not reasonably be expected to occur solely through private investment within the reasonably near future. Due to the costs associated with redeveloping downtown property, including public parking and constructing housing with affordable rents, this project is only feasible, in part, through substantial public financial assistance.

While eliminating the inclusion of public parking within the development footprint does not eliminate the need for assistance, it does reduce the gap and marginally improves the developer's project feasibility even when potential public parking lease revenue is eliminated from the pro forma.

Given the substantial request, we recommend negotiating that the use of any assistance tools include appropriate terms for future lookback and recourse provisions to protect Northfield's risks and ensure assistance levels remain appropriate if costs are lowered or the project achieves above-market performance. Should the City pursue the public parking option, we also recommend negotiating appropriate operating and maintenance agreement terms to govern shared use and appropriately allocate liability risks for the shared-use of the parking facility.

Please feel free to contact me at 651-697-8507 with any questions.

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5th Avenue Flats
City of Northfield
Maximum First Mortgage Evaluation - With Public Parking

	Restated Pro Forma	Modified (does not change proforma)	
	Developer's Mortgage Assumption	Without Assistance	With Assistance (TIF Cashflow)
A. Net Operating Income ***(From Pro Forma Tab)***	$ 662,539	$ 662,539	$ 796,880
Debt Service Coverage	0.87	1.20	1.20
Debt Service	$ 758,506	$ 552,116	$ 664,067
B. Maximum Mortgage Calculators			
1. Mortgage Based on Income Approach			
Interest Rate	5.00%	5.00%	5.00%
Term	25	25	25
Maximum Supportable Mortgage	**$ 10,812,500**	**$ 7,870,000**	**$ 9,466,000**
2. Mortgage Based on Loan to Value (LTV)			
Capitalization Rate	6.13%	6.00%	6.00%
Capped NOI Building Value	$ 10,812,500	$ 11,042,324	$ 13,281,341
Loan to Value	**100%**	**75%**	**75%**
Maximum Supportable Mortgage	**$ 10,812,500**	**$ 8,281,000**	**$ 9,961,000**
3. Mortgage Based on Loan to Cost (LTC)			
Total Development Cost	$ 14,972,000	$ 14,972,000	$ 14,972,000
Loan to Cost	**72%**	**80%**	**80%**
Maximum Supportable Mortgage	**$ 10,812,500**	**$ 11,977,000**	**$ 11,977,000**
Mortgage Result	**$ 10,812,500**	**$ 7,870,000**	**$ 9,466,000**
Diff from Pro Forma:		$ (2,942,500)	$ (1,346,500)

C. Gap Comparison			Diff.
Net Operating Income (Stabilized Pro Forma)	$ 662,539	$ 796,880	$ 134,341
Less: Mortgage Debt Service	$ (552,116)	$ (664,067)	$ (111,951)
Cash Flow	$ 110,423	$ 132,813	$ 22,390
Cash Flow Supported Equity (6% Yield)	$ 1,840,387	$ 2,213,557	$ 373,169
Total Development Cost	$14,972,000	$14,972,000	$ -
Less: Mortgage	$ (7,870,000)	$ (9,466,000)	$ (1,596,000)
Less: Supported Equity	$ (1,840,387)	$ (2,213,557)	$ (373,169)
Gap	$5,261,613	$3,292,443	$ (1,969,169)
Total Equity Required (Gap + Supported Equity)	$ 7,102,000	$ 5,506,000	$ (1,596,000)
Total Equity Yield	1.6%	2.4%	0.9%
Less: EDA Grants		(222,000)	
Less: EDA Loan		(250,000)	
Less: Public Parking		(805,000)	
Revised Equity		$ 4,229,000	
Revised Equity Yield		3.14%	

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5th Avenue Flats
City of Northfield
Maximum First Mortgage Evaluation - without public parking component

	Restated Pro Forma	Modified (does not change proforma)	
	Developer's Mortgage Assumption	Without Assistance	With Assistance (TIF Cashflow)
A. Net Operating Income ***(From Pro Forma Tab)***	$ 651,424	$ 651,424	$ 785,765
Debt Service Coverage	0.93	1.20	1.20
Debt Service	$ 700,894	$ 542,854	$ 654,805
B. Maximum Mortgage Calculators			
1. Mortgage Based on Income Approach			
Interest Rate	5.00%	5.00%	5.00%
Term	25	25	25
Maximum Supportable Mortgage	**$ 9,991,250**	**$ 7,738,000**	**$ 9,334,000**
2. Mortgage Based on Loan to Value (LTV)			
Capitalization Rate	6.52%	6.00%	6.00%
Capped NOI Building Value	$ 9,991,250	$ 10,857,074	$ 13,096,091
Loan to Value	**100%**	**75%**	**75%**
Maximum Supportable Mortgage	**$ 9,991,250**	**$ 8,142,000**	**$ 9,822,000**
3. Mortgage Based on Loan to Cost (LTC)			
Total Development Cost	$ 13,877,000	$ 13,877,000	$ 13,877,000
Loan to Cost	**72%**	**80%**	**80%**
Maximum Supportable Mortgage	**$ 9,991,250**	**$ 11,101,000**	**$ 11,101,000**
Mortgage Result	**$ 9,991,250**	**$ 7,738,000**	**$ 9,334,000**
Diff from Pro Forma:		$ (2,253,250)	$ (657,250)

C. Gap Comparison			Diff.
Net Operating Income (Stabilized Pro Forma)	$ 651,424	$ 785,765	$ 134,341
Less: Mortgage Debt Service	$ (542,854)	$ (654,805)	$ (111,951)
Cash Flow	$ 108,571	$ 130,961	$ 22,390
Cash Flow Supported Equity (6% Yield)	$ 1,809,512	$ 2,182,682	$ 373,169
Total Development Cost	$13,877,000	$13,877,000	$ -
Less: Mortgage	$ (7,738,000)	$ (9,334,000)	$ (1,596,000)
Less: Supported Equity	$ (1,809,512)	$ (2,182,682)	$ (373,169)
Gap	$4,329,488	$2,360,318	$ (1,969,169)
Total Equity Required (Gap + Supported Equity)	$ 6,139,000	$ 4,543,000	$ (1,596,000)
Total Equity Yield	1.8%	2.9%	1.1%
Less: EDA Grants		(222,000)	
Less: EDA Loan		(250,000)	
Less: Public Parking		0	
Revised Equity		$ 4,071,000	
Revised Equity Yield		3.22%	