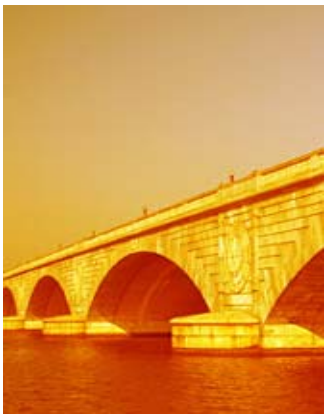

# 900 New Hampshire Mixed-Use Project

City of Lawrence, Kansas

4-Story Need For Assistance Analysis

Final June 12, 2012

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*Mission Statement*

Springsted provides high quality, independent financial and management advisory services to public and non-profit organizations, and works with them in the long-term process of building their communities on a fiscally sound and well-managed basis.

# 1. Executive Summary

The City of Lawrence retained Springsted to review the need for assistance for a four-story project located at 900 New Hampshire Street, to determine if the proposed project would not reasonably be anticipated to be developed without the adoption of the requested financial assistance. The project analyzed includes the construction of a four-story mixed-use, hotel, commercial and apartment building, with corresponding site improvements, and an underground parking structure.

Springsted reviewed project costs, operating revenue and expense information, and the requested assistance revenues to determine the need for assistance for the four-story project. Springsted reviewed 10-year cash flow projections provided by the Developer, and tested the revenue and cost assumptions prepared by the Developer and determined the following:

- The projected Internal Rate of Return (IRR) without assistance to the Developer falls below the current range expected within the marketplace, and the Developer's own return expectation. Based on the projected level of return without assistance we conclude the project is unlikely to be undertaken without the requested public assistance.

- The development would have to realize either; significant savings in project costs, significant increases in project revenues, or a combination of the two for the project be undertaken without the requested assistance.

- The base return without assistance is illustrated below, along with the rate at which project assumptions would have to change for the project to be considered feasible, without assistance.

**Internal Rate of Return (IRR) – Return Analysis**

| Analysis | Change Necessary to be Feasible | Return with Subsidy |
|---|---|---|
| Base Developer Return | N/A | 2.64% |
| Decreased Costs | 20% Decrease | 5.50% |
| Increased Revenue | 25% Increase | 5.69% |
| Combined Cost Savings & Increased Revenues | 12% Decreased Costs<br>12% Increased Revenue | 5.84% |

## 2. Purpose

The City of Lawrence has retained Springsted to review the application for a mixed-use project to be located at 900 New Hampshire Street. The project proposes the construction of a four-story structure, consisting of commercial retail space, a restaurant, apartments, and an extended-stay hotel; along with underground parking. The underground parking structure is deemed to be necessary based on the design and limited size of the site. The Developer is requesting the City Commission approve financial assistance in the form of Tax Increment Financing (TIF) and a Transportation Development District (TDD).

The City has requested this analysis determine the need for the requested TIF and TDD assistance of the project, based on the project cost and operating pro forma information provided by the Developer. The analysis that follows will examine the determination that the proposed project would not reasonably be anticipated to be developed without the adoption of the requested financial assistance.

We have approached this determination based on the proposed projects plans regarding development costs, outcomes, financing sources, and timing, to develop a measure of the Developer's expected return when compared to the amount of risk. If a project is owned and operated as an investment, a measure of return is calculated considering the time value of money, and involves an assumed sale of the property at a price appropriate in the market place. The final determination is based on whether or not the potential return is reasonable without the requested assistance, within the current marketplace and at the present time. The assistance request includes TIF (Ad valorem property taxes & sales tax rebate), a TDD Sales tax (1.0% sales tax), and the issuance of an Industrial Revenue Bond (IRB).

# 3. The Project

The 900 New Hampshire project includes the construction of a four-story structure with underground parking. The Developer indicates the four-story iteration of the project will include an approximately 81-unit extended stay hotel, 8 rental units (total of 7,130 leasable square feet), approximately 7,021 square feet of first-floor retail, and a 4,578 restaurant on the building's roof. In addition to the construction of the multi-use structure, site improvements will be completed. The site improvement costs include; street lights, landscaping, paving, site utilities and utility feeds associated with the development. In addition a 114-space underground parking garage will be constructed. The project costs include the following:

| **Item** | **Cost** |
|---|---|
| Land Acquisition | $695,000 |
| Site Improvement Costs | $845,287 |
| Parking Garage | $2,507,472 |
| Hotel/Apartment/Retail Structure | $10,157,300 |
| Soft Costs | $1,320,351 |
| Financing Costs | $200,000 |
| Developer Fee (4%) | $540,402 |
| Furniture & Fixtures – Hotel | $891,000 |
| Legal Fees | $100,000 |
| **Total Project Costs** | **$17,256,812** |

The above costs were estimated by the Developer. Additional detail is provided below:

- The land acquisition costs are related to the purchase of the site, and are based on the Developer's contracted cost.
- Parking garage estimated at approximately $21,995 per stall for a total of 114 parking stalls and includes engineering and professional services, and a 2% contingency;
- Site improvement costs are related to the development of the site and include costs for permits, landscaping, paving, site utilities, and utility fees amongst other costs;
- The hotel/apartment/retail structure costs are related to the construction of the four-story structure. The Developer provided a cost estimate for the four-story project based on a cost estimate prepared by their engineer. The building cost estimate equates to a per square foot cost of $135. This cost estimate does not include architecture and engineering fees associated with the development of the site, but does include a contingency line-item;
- The soft costs are for line-items related to the architecture and engineering costs ($715,351) of the project and is based on 5% of total

hard costs, and interest carry costs ($605,000) based on the construction loan interest of 5.5%;

- The financing cost of $200,000 is an estimate provided by the Developer;
- The Developer Fee is based on 4% of the building, site work, and underground parking structure;
- The hotel furniture and fixture line-item is an expense estimate provided by the Developer and is based on an $11,000 per unit cost estimate; and
- The legal fee line-item is an estimate provided by the Developer.

The permanent financing for the project includes, permanent private debt, partially supported by public subsidy revenues and Developer equity as follows:

| **Sources:** | |
|---|---|
| Permanent Financing [1)] | $12,942,609 |
| Permanent Developer Equity | $4,314,203 |
| **Total Sources** | **$17,256,812** |

*1) The permanent financing assumes 25 year debt with a 5.5% interest rate (estimated by the Developer). The revenue from the TIF and TDD would be provided on a pay-as-you-go basis -- revenue received would be used to offset the private debt of the Developer.*

The Developer anticipates the with assistance project will also include the issuance of an Industrial Revenue Bond (IRB) which will result in a project cost savings of approximately $497,820 through sales tax savings on purchases associated with the construction of the project. Therefore the with assistance scenarios have a slightly lower total project cost of $16,758,992, with the savings evenly split between the equity and financed amounts.

# 4. Assistance Request

The Developer has requested TIF and TDD assistance of $3,352,759 plus interest. The principal amount of the requested assistance is tied to the site development and underground parking structure costs. In addition to the principal amount the Developer is seeking reimbursement for interest expenses. For the purpose of reviewing the proposed TIF and TDD revenue, we adjusted the reimbursement interest rate to 5.5% based on the Developer's borrowing interest rate. The Transportation Development District (TDD) would be authorized by the City to levy a 1.0% sales tax on the subject property.

The Developer prepared TIF revenue projections based on market value assumptions of $1,110,895 for the apartments, $1,759,147 for the commercial space, and $4,000,000 for the hotel. The apartment and commercial market values are based on 7.0% and 7.5% cap rates respectively, while the hotel market value is based on a comparison to existing hotels within the City.

The Developer estimated annual sales from the commercial portion at $2,808,400 annually, which equates to $400 per square foot; annual sales of $1,000,000 from the restaurant, which equates to $218 per square foot; and annual sales of $1,770,809 from the Hotel, which equates to an occupancy of 66% and an average daily rate of $91. The Developer is not seeking to capture the hotel guest tax rate in their assistance request.

The annual TIF revenue is projected to be $155,784 from ad valorem property taxes, $142,270 from sales tax rebate, and $55,792 from the TDD for total annual assistance of $353,846. The Developer projects the annual TIF and TDD revenue is capable of repaying the principal amount of $3,352,759 over a 16-year period, at an interest rate of 5.5%.

The TIF projections utilized in this analysis were prepared by the Developer, and do not take into account considerations for project timing and the lag in receipt of ad valorem property taxes following project construction. Additional City required TIF expenses may be included in the final amount of the TIF assistance, which may affect the rate at which the Developer is repaid or potentially the interest rate applied. Changes of this nature would have the affect of lowering the rate of return realized by the Developer in the with-assistance scenario and do not have an impact on the finding of this report.

# 5. Return Analysis

Utilizing the operating pro forma prepared by the Developer we evaluated the need for assistance for the proposed four-story project by comparing the potential return with and without assistance. The Developer provided a 10-year operating pro forma for the mixed-use hotel, apartment and commercial property, which included all operating revenue and expense assumptions for the development, along with the appropriate inflation assumptions. The Developer's pro forma included TIF or TDD projections, so we prepared an alternate pro forma without TIF or TDD to illustrate the potential return to the project without the requested assistance.

To demonstrate the potential return available to the Developer, an internal rate of return (IRR) calculation was performed. In order to complete an IRR analysis, a hypothetical sale of the asset is assumed in the tenth year of the pro forma by estimating the fair market value of the property. The fair market value of the asset is estimated based on the net income in the tenth year and an estimated capitalization rate. The Developer utilized a 7.0% capitalization rate for the apartment portion of the project, a 7.5% capitalization rate for the commercial portion, and a 9.5% capitalization rate for the hotel portion. These are reasonable assumptions based on current trends.

An adjustment was made to the Developer's submitted pro forma to estimate the potential IRR on an unleveraged basis. This conversion was done, in order to compare the potential return to the Developer based on the *Price Waterhouse Cooper (PWC)/Korpacz Real Estate Investor Survey, First Quarter 2012*, which provides a market comparison on which project feasibility can be judged.

**Internal Rate of Return (IRR)**

| With TIF/TDD Payments | Without TIF/TDD Payments |
|---|---|
| 5.73% | 2.64% |

*The PWC/Korpacz Real Estate Investor Survey, First Quarter 2012*, reports discount rates (IRR) for the national selective service hotel segment ranged from 10.00% to 15.00% with an average of 11.65%.

While both projected returns, with and without assistance fall below the desired return rage as illustrated by the *PWC/Korpacz* study, there is a significant spread in the returns with and without assistance. Based on the marginal return without assistance, it can be interpreted that the project would be unlikely to be undertaken, given the current market conditions.

In order to understand the rate at which project assumptions would have to change for the project to be feasible without assistance, we performed a sensitivity analysis. Using the with assistance return of 5.73% as our feasibility

benchmark, we calculated the rate at which either; project costs would have to decrease, project revenues would have to increase, or a combination of the two for the project to have a rate of return equal to the with assistance return of 5.73%.

**Internal Rate of Return (IRR) – Sensitivity Analysis**

| Rate of Change | Return without TIF/TDD |
|---|---|
| 20% Cost Savings | 5.50% |
| 25% Increased Revenue | 5.69% |
| Combined 12% Savings & Increased Revenues | 5.84% |

For the project to meet or exceed the benchmark return of 5.73% without assistance, the development would need to realize significant project cost savings or increased project revenues. Given our review of the Developer's proposed assumptions, we believe changes of the magnitude necessary for the project to be feasible without assistance are unlikely to be realized.

# 6. Conclusions

This project involves the development of a vacant site. The Developer will bear all the risk until project completion and permanent financing is in place, and continued operating risk thereafter. This level of risk demands a positive return with a comparable national market range of 10.00% to 15.00% as indicated in the *PWC/Korpacz* study. Based on the Developer's submitted pro forma, it appears a return of 5.73% with assistance is their level necessary for the undertaking of the project.

As detailed above, the projected IRR to the Developer without assistance, falls below the current range expected within the marketplace, and in comparison to the return with assistance. Therefore, Springsted concludes that the proposed project, without assistance would not likely be undertaken at this time without the requested assistance.

# 7. Qualifying Statements

The above conclusions are reliant on preliminary information regarding many assumptions. These assumptions include the total cost to construct the project, the timing of Developer equity, the projected income and expenses during operation of the building, and the projected offsetting tax revenue.

We did test the project cost and revenue assumptions, and noted the level at which project assumptions would have to change for the project to be considered feasible. However, actual project costs and revenues differing from the initial assumptions would result in changes to the rate of return realized by the Developer.

The above conclusions are based on projected property tax and sales tax increment revenue generated by the three story project, as well as projected TDD sales tax revenue from the commercial operations. The Developer is requesting assistance equal to the cost of the site improvements and parking structure, which total $3,352,759. The Developer is requesting 100% of the TIF property tax revenue, 50% of the TIF sales tax revenue , and 100% of the TDD revenue as reimbursement, plus interest. For the purpose of our analysis we assumed a reimbursement interest rate of 5.5% based on the Developer's borrowing interest rate. A higher reimbursement interest rate would result in a corresponding increase in the Developer's return.