

# Oread TIF Project

**City of Lawrence, Kansas**

Subsidy Feasibility Analysis

Final Version: February 7, 2008

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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 application for TIF assistance for the proposed Oread Project in order to determine the need for the requested level of financial assistance. The Project includes public infrastructure improvements, and the construction of a multi-use seven-story structure with underground parking.

Springsted reviewed material prepared by the Developer and prepared TIF and TDD revenue projections. These revenue projections were utilized to determine financial feasibility. Springsted prepared 10-year cash flow projections based on information provided by the Developer. Springsted tested the revenue and cost assumptions prepared by the Developer and determined the following:

- The projected Internal Rate of Return (IRR) to the Developer if a six-story structure is completed, versus the requested seven-story, falls well below the current range expected within the marketplace and we conclude that the six-story alternative would not be financially feasible if a market return is expected.

- The projected IRR to the Developer if a seven-story structure is completed without any TIF or TDD assistance is at the low end or below the current range expected within the marketplace and we conclude that the proposed seven-story project would not be financially feasible without the projected TIF/TDD revenue if a market return is expected.

- Alternative TIF revenue projections prepared in order to test the affects of the proposed cap result in a de minimus change to the Developer's projected return and we conclude that if the contract with the Developer enables reimbursements based on the costs of the project plus interest with a total cap, the potential return to the Developer would not exceed market expectations and would enable the return to the Developer to reach the upper-end of the range.

## 2. Purpose

The City of Lawrence has retained Springsted to review the application for TIF assistance for the proposed Oread Project in order to determine the need for the requested level of financial assistance. The Project includes public infrastructure improvements, and the construction of a multi-use seven-story structure with underground parking.

The public improvements within the scope of the project are necessary for the proposed redevelopment uses. The underground parking structure is necessary based on the design and limited size of the site.

The analysis that follows will examine the financial feasibility of the proposed project based on current property and sales tax revenue estimates prepared by Springsted. The City has requested that the analysis determine the viability of the project at seven-stories as proposed, and as a six-story alternative. The Developer (Triple T, LLC) has provided a height analysis indicating that through three-years of operations, a six-story building will generate net losses to them of $893,500, whereas a seven-story structure will generate a small profit of $9,649. The Developer's analysis did not include the profit generated by the sale of the condominium units (estimated at $480,000).

We have utilized the following information provided by the Developer to prepare our analysis:

- Total Project Costs of $37,000,000;
- Oread Inn Operating Projections;
- Projected Sales Proceeds from Condominium Units;
- Financing Plan; and
- Projected construction, sale and occupancy timeline.

The Oread Inn hotel project will be owned and operated by the Developer long-term. The Developer will not only inure substantial risk during the construction phase, but the ongoing risk of maintaining hotel occupancy levels necessary to generate a profit. The condominium part of the project will generate an initial profit to the Developer through a sale of the units and offers the potential for ongoing revenue through the use of hotel services by condominium owners. The eventual mix of condominium versus hotel uses within the structure will be determined by the market demand for luxury condominiums, balanced with the requirement for a minimum number of annual hotel rooms.

# 3. The Project

The Oread Inn hotel project includes the construction of a seven-story structure with underground parking. The Developer indicates a current mix of 92 hotel rooms and approximately 14 condominium units (total of 18,000 sellable square feet). The exact number of condominium units will be determined by the individual purchasers. The Developer indicates all units will be sold by the time the hotel opens for business (projected to occur by the end of 2009). In addition to the construction of the multi-use structure, public improvements in connection with the development will be completed. The public improvements include street improvements on Indiana, Oread and 12th Street; water and sanitary sewer improvements; streetscape improvements; site utilities; and site work including demolition, garage excavation and engineering. The project costs include the following:

| Item | Cost |
|---|---|
| Public Infrastructure | $5,000,000 |
| Parking Garage | $6,000,000 |
| Hotel/Condominium Structure | $16,500,000 |
| Pre-Development, Financing and Miscellaneous Costs | $7,125,768 |
| Contingency (6.5%) | $2,374,232 |
| **Total Project Costs** | **$37,000,000** |

The above costs were estimated by the Developer. However, the City provided input for the public infrastructure costs. Additional detail is provided below:

- Parking garage estimated at approximately $28,571 per stall for a total of 210 parking stalls and includes engineering and professional services. The parking garage will be valet only with a charge per hotel room per night for use. Additionally, the condominium purchase will include one parking stall;
- Hotel/condominium construction is the estimated total cost to complete the seven-story structure. Condominium build-out includes finished walls, carpet, granite countertops, standard fixtures and standard lighting. It is anticipated that individual condo owners will want additional work done prior to their condo being delivered, but those costs are not factored in above nor are there offsetting sale revenue assumptions above the basic unit.
- Pre-Development, Financing and Miscellaneous Costs include pre-opening operating expenses, interest expense for a construction loan of $21,000,000, fixtures, furnishings, room amenities, architectural costs, legal and overhead costs; and
- Contingency of 6.5% over all costs including the public infrastructure of $5,000,000.

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

| | |
|---|---|
| **Sources:** | |
| Condominium Sale Proceeds [1)] | $6,000,000 |
| Permanent Financing [2)] | $21,000,000 |
| Permanent Developer Equity | $10,000,000 |
| **Total Sources** | **$37,000,000** |
| | |
| **Uses:** | |
| Repay Construction Loan | $21,000,000 |
| Repay Developer Equity | $16,000,000 |

1) *The $6,000,000 for condominium sale proceeds anticipates 18,000 square feet of condominium space to be sold at $333.33 per square foot.*
2) *The permanent financing assumes 20 year debt with a 6.5% 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.*

# 4. Assistance Request

The Developer has requested TIF and TDD assistance of $11,000,000, plus interest. $11,000,000 is the amount estimated to cover the total cost of the public infrastructure and construction of a private parking garage, and the interest expenditures include financing costs related to debt issued to initially construct the improvements. The Transportation Development District (TDD) would be authorized by the City to levy a 1.0% sales tax on property within the area occupied by the Oread Inn hotel project.

The total property and sales tax increment projected during the 20-year term of the TIF Project is $5,001,787. The total TDD sales tax revenue projected during the 22-year term of the TDD is $917,095. The Developer will front 100% of the cost of the public infrastructure and parking garage, and requests reimbursement from ongoing TIF/TDD revenues of up to $11,000,000, plus interest.

The City proposes to cap the Developer's total reimbursement from TIF to $7,100,000 of hard construction costs plus interest expenditures (the interest reimbursed cannot exceed such amount based on prime plus 1.0%). If this cap is reached, only 50% of TIF revenue then generated would be paid to the Developer for total reimbursement of up to the $11M total cost, plus interest, for construction of the public improvements and parking garage (less any amounts paid for with TDD revenue). The other 50% of the TIF revenue would be returned to the taxing jurisdictions. Based on Springsted's total projected revenue, the projected property and sales tax increment generated from the Oread TIF Project combined with the TDD sales tax revenue is insufficient to support the requested level of assistance. We project a total reimbursement of $5,918,882.

The Developer has requested that the City authorize pay-as-you-go financing pledging 100% of the TIF revenue received during the authorized term generated from the Oread Project. This pledge only includes appreciation increases to other properties within the Project area not part of the Oread Inn hotel project, and not those resulting from renovation or redevelopment. Even though the current projections demonstrate that the total reimbursement would only be $5,918,882, the Developer has requested that the reimbursement be limited only by the revenue (both TIF and TDD). Thus, if revenues exceed projections, they could be reimbursed up to the full $11,000,000 estimated cost, plus interest. This occurrence is highly unlikely as the alternative revenue stream would need to exceed the projections by more than 100%.

## 5. Financial Feasibility/Developer Return – Proposed Seven-Story Project

Utilizing Developer projected Oread Inn hotel project operating cash flow (based on a market study completed by HVS) and the above construction costs and financing plan, a ten-year cash flow was prepared as a base case. The Developer provided 16-years of operating projections for the Oread Inn hotel project. The projections include all revenue assumptions (room rental, parking, food and beverage, banquet revenue, condominium services), expense assumptions based on the 92 room full-service hotel and private debt assumptions. Additionally, the Developer has assumed 1% inflation on both the revenue and expenditure side.

In order to calculate a projected internal rate of return (IRR) we have included a hypothetical sale of the asset (full-service hotel) in the tenth year. The fair market value of the asset is estimated based on the net income in the tenth year and an estimated 9.50% capitalization rate. The net proceeds from the sale assume fair market value paid, reduced by a 5% selling fee and the outstanding private debt. The return to the Developer is based on net cash flow after payment of debt service and reserve deposits, without depreciation expenses.

With this base case scenario we tested revenue and cost assumptions which impact the calculated IRR. We increased the inflationary increase (revenue/expenses) to 2% from 1% in the base case. We reduced the costs of the project by 5%, and the offsetting required debt and equity 5%. We combined the inflationary increase with the reduced costs. Lastly, we reduced the project revenue and expenses by 5% to create a less optimistic case for the Developer. With the base case and each of the alternative scenarios, we calculated the IRR for the Developer with the projected TIF/TDD reimbursements and without. Since we only prepared a ten-year cash flow, we removed the TIF/TDD revenue from the cash flow to calculate the value of the asset, and calculated the present value of the remaining revenue as a lump sum payment (only applies to the projections with TIF/TDD payments). The range of returns is included below.

**Range of Internal Rate of Return (IRR)**

| With TIF/TDD Payments | Without TIF/TDD Payments |
|---|---|
| 8% – 13% | 5% - 10% |

*The Korpacz Real Estate Investor Survey, Third Quarter 2007*, reports discount rates (IRR) for the full-service lodging segment ranged from 9.0% to 14.0% with an average of 11.0%.

The calculated Range of IRR's with TIF/TDD payments correlates closely to the range seen in the current market, as described above. The calculated Range of IRR's without TIF/TDD approaches the low point of the range only, in the more optimistic view of project outcomes, both increased revenue and reduced capital costs.

If alternative revenues enable the Developer to be reimbursed to the maximum amount proposed ($7,100,000 of hard costs, interest expenses, initially paid with TIF, plus TDD reimbursement and additional TIF revenue up to the total $11,000,000 of hard costs, plus interest), the IRR range indicated above would increase only modestly to 9% - 14%. This range would not result in a return exceeding market expectations. The alternative revenue stream we prepared generates a total of $12,000,000 and as previously stated, greatly exceeds the projected revenue and in our opinion is an unlikely occurrence.

Based on a conversation with the President of the Convention and Visitors Bureau, the assumptions utilized by the Developer based on the HVS market study appear to be reasonable. The targeted audience for the proposed hotel project is currently un-serviced by the Lawrence hotel market. The meeting room space at the Spring Hill Suites is inadequate and the Eldridge Hotel does not offer enough rooms. Based on the ability of the Oread Inn hotel project to attract sufficient conference and meeting attendees currently not serviced within the Lawrence area, the projected revenue stream could be realized.

## 6. Alternative Six Story Project

The basis for our financial feasibility estimate, if the completed structure is limited to six-stories versus seven, is the Developer prepared height analysis. As previously stated, the Developer prepared a three-year operating analysis whereby the revenue expectations for a six-story facility would decline approximately 8% and the total expenditures would only decline 3.5%. The Developer’s analysis shows that this would result in significant ongoing annual losses. The Developer maintains that there are certain costs, specifically the public infrastructure, fixed operating levels, and minimum parking garage costs that are necessary even with one less story.

Using a straight 3.5% reduction in project costs (other than the public infrastructure) combined with an 8% reduction in operating revenue results in even lower IRR’s than those for the seven-story structure. Since the height analysis included adjustments to operating revenue and expenses only and did not reduce the condominium sales, we assumed the same level of condominiums and revenue from sales in the six-story alternative. We calculated a range of Developer IRR’s with TIF/TDD payments (also reduced as described above) of 4% - 7%. We prepared the same base and alternative calculations as for the seven-story structure.

As in the seven-story analysis, even if the Developer were to be reimbursed for the total costs of $11,000,000 plus interest, the IRR range indicated above would increase only modestly to 5% - 8%. This range would continue to fall below the range of market returns. Also as previously stated, this alternative revenue stream generates a total of $12,000,000 and greatly exceeds the projected revenue and in our opinion is an unlikely occurrence.

# 7. Conclusions

Alternative Six-Story Project: As detailed above, the projected IRR to the Developer if a six-story structure is completed, versus the requested seven-story, falls well below the current range expected within the marketplace. Therefore, Springsted concludes that the six-story alternative would not be financially feasible if a market return is expected.

Proposed Seven-Story Project: Also as detailed above, the projected IRR to the Developer if a seven-story structure is completed without any TIF or TDD assistance is at the low end or below the current range expected within the marketplace. Therefore, Springsted concludes that the proposed seven-story project would not be financially feasible without the projected TIF/TDD revenue if a market return is expected.

Proposed Cap on Total TIF Reimbursement: Alternative TIF revenue projections prepared in order to test the affects of the proposed cap result in a de minimus change to the Developer's projected return. Therefore, Springsted concludes that if the contract with the Developer enables reimbursements based on the costs of the project plus interest with a total cap, the potential return to the Developer would not exceed market expectations and would enable the return to the Developer to reach the upper-end of the range.

## 8. 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 hotel, the projected sale price of the condominiums and the projected offsetting tax revenue.

We did test the project cost and revenue assumptions, and note that if the project performs above expectations (reduced costs and increased project revenues) the projected IRR would be at the high-end of an expected market return.

The above conclusions are based on projected property tax and sales tax increment revenue generated by the Oread Project, as well as projected TDD sales tax revenue from hotel operations. The Developer is requesting 100% of this revenue as a reimbursement for up to $11,000,000 of costs, plus interest. However, the City is proposing to cap the total TIF payments to $7,100,000 plus interest paid from 100% of the TIF revenue and additional reimbursement at 50% of the TIF revenue, up to the maximum $11,000,000 of costs, plus interest (off-set by any TDD revenues). The projections indicate the revenue would only generate total payments of $5,918,882. The majority of the TIF revenues are generated by the property taxes with the majority of those generated by the hotel operations. Our alternative revenue projections would be off-set by increased hotel property taxes.