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MEMORANDUM

Date: June 28, 2017

To: Britt Crum-Cano, Economic Development Coordinator, City of Lawrence

From: Tom Jackson, Senior Director, National Development Council

RE: Updated and Revised Gap Financing Analysis for Proposed Mixed-Use Development at 815 Vermont Street

The National Development Council (NDC), in a memorandum dated October 3, 2016, provided an analysis of the reasonableness of development incentives requested by the Schumm Property Company, LLC (hereinafter, the "Developer") for the development of a mixed-use project at 815 Vermont Street (the "Project"). This memorandum reviews an update to that analysis based on modifications to the Project's financials and the Developer's request, as follows:

- The project's hard constructions costs were adjusted upward by 5.05% over 2016 estimates given industry trends through the first quarter of 2017.
- Projected rents and operating expenses were raised by 3% consistent with the annual escalators projected in the initial analysis.
- Condominium sale prices, residential valuations and commercial valuations were increased by 2% over 2016 projections based on the trends identified by the Douglas County Assessor's office.
- Interest rate projections for initial financing and refinancing were adjusted upward given recent rate increases approved by the Federal Reserve and anticipated future adjustments.
- Projected bank underwriting for minimum debt coverage ratio was lowered to 1.20 to 1.00 given continued strengthening in the Lawrence real estate market.
- Property and sales tax burdens and rebate amounts were adjusted to reflect current levies and rates and adjusted project costs.
- Property taxes available for the NRA rebate were reduced given the State of Kansas's exemption (under Senate Bill 19) of school district capital levies from local government NRA, TIF and abatement incentives for incentives where public hearings weren't conducted before May 1, 2017.
- The Developer has not requested Neighborhood Revitalization Area (NRA) benefits associated with the condominium he intends to purchase for personal use.

NDC has analyzed a request by the Developer for a 75% Neighborhood Revitalization Area (NRA) property tax rebate and approval of Industrial Revenue Bond (IRB) financing during construction to provide a sales tax exemption for the development of the Project. The Project will redevelop two vacant parcels of land owned by the Developer into a five-story mixed-use building that will include:

- One level of underground parking with 22 spaces
- A first floor designed for retail, restaurant and commercial uses with 7,788 square feet of leasable space
- A second floor with 6,504 square feet of leasable space that will be divided into approximately 30 individual offices of 150-300 square feet each.
- Three floors (#3, #4 and #5) of for-sale residential condominiums totaling 12 units
    - The unit mix is currently configured as:
        - One Bedroom – 3 units
        - Two Bedroom – 8 units
        - Three Bedroom – 1 unit
    - A 600 square foot, one-bedroom unit on the 3rd floor will be fully finished and its sale will be restricted to income-qualified households.
    - The remaining 11 units will vary in size from 739 to 2,845 square feet and will be sold partially finished. Final finishes will be the responsibility of the condominium buyers and are estimated for the purposes of this analysis at $102 per square foot (adjusted from $100 per square foot in the initial review).

NDC has had extensive discussions regarding the Project with the Developer since the City received the original request for assistance in the fall of 2016. The Developer has supported its assumptions and projections on the Project's original and adjusted development costs, condominium sales proceeds and operating revenues and expenses with increasing detail as additional information has become available and in response to requests by the City and NDC. The Developer has provided the following documentation to support its request for NRA and IRB incentive financing and NDC's analysis of the request:

- A Development Budget based on:
    - Architectural designs by Hernly Associates of Lawrence. The designs are characterized by the Developer as having progressed through the schematic

stage and ready to move into the design-development and construction documents stages.
    - Multiple preliminary construction estimates, based on the schematic designs and prepared and updated by:
        - First Construction LLC of Lawrence
        - RF Benchmark Construction of Eudora and Manhattan, Kansas
        - B. A. Green Construction of Lawrence
    - Bid comparisons compiled by the Developer
    - Soft cost estimates completed by the Developer and supported with average cost documentation from the Developer and Project design team.
- Proforma statements of annual operating revenues and expenses (the Proforma) that were supported by:
    - Rent and vacancy surveys of the Lawrence market prepared by Collier's International (2016 and 2017 Lawrence Market Snapshots)
    - Rent rolls and associated lease rates for the Developer's existing multiple tenant, small office space on Massachusetts Street.
    - Developer estimates of Common Area Maintenance (CAM) expenses by floor
    - Absorption and associated vacancy rates provided by the Developer as refined through requests from NDC.
    - Property tax estimates prepared by the Developer as advised by the County Appraiser's office.
- Projected gross and net condominium sales proceeds and a three-year sales schedule prepared by the Developer and refined during the course of the review given design changes and additional documentation on sales in the Lawrence market, comparisons of amenities and broker opinions.
- A letter of interest with preliminary terms for commercial financing from RCB Bank in Lawrence dated June 27, 2017. This updated analysis projects that the minimum Debt Coverage Ratio has improved (fallen) since the initial review while lending rates have risen.
- Project narratives from the Developer describing the development team and the Project's components and benefits.

Documentation that has not yet been available for review includes:

- A detailed appraisal report (FIRREA-compliant) that provides:
  - A third party opinion on the Fair Market Value of the proposed Project
  - Verification of estimates of revenues, expenses and vacancy rates for the retail and commercial space
  - Verification of residential condominium sale prices per square foot and likely absorption rates.
- A final commitment letter and term sheet from the Project's senior lender.

NDC's analysis of the Project's proposed financing sources and uses, projected net operating revenue, net condominium sales proceeds, property appreciation and associated returns on invested equity suggests that a NRA rebate of 75% of available property tax increment over 10 years, combined with an IRB sales tax exemption on eligible project costs is reasonable. As noted above, the Developer has modified its request to eliminate NRA rebate incentives associated with the residential condominium Mr. Schumm expects to purchase.

The reasonableness of the requests has been evaluated given the following:

1) The Project's financing sources and uses are summarized as follows:

	Amount	**% of Total**
Total Project Costs	**$9,675,629**	**100.00%**
Project Sources		
Projected Bank Loan	$3,404,489	35.19%
Net Condominium Sales Proceeds	$3,688,600	38.12%
Required from Developer	$2,582,540	26.69%
Total Sources	**$9,675,629**	**100.00%**

2) The estimated permanent bank debt projected by the Developer, $3,404,489, exceeds NDC's projection of debt capacity by $303,170 given the Developer's estimate of operating revenues and expenses and underwriting criteria (1.20 Debt Coverage Ratio (DCR), 80% Loan To Value (LTV) ratio) proposed by the prospective lender's preliminary term sheet and adjusted by NDC for a more favorable DCR.

a. The interest rates modeled in NDC's analysis start with an adjusted rate of 4.75% and increase to 6.25% given a projected refinance of the outstanding principal at the end of Year 5 of operations.
b. The maximum projected loan amount is also influenced by the capitalization rate. This rate has been identified by area appraisers for other observed sales and for proposed projects in the 7.0-7.77% range, depending on their location, proposed uses, and other factors. NDC's analysis projects a capitalization rate of 7.0%, at the lower end of this range given the Project's favorable location. The final capitalization rate will be determined by the appraisal report.
c. Pending completion of the appraisal report, the Developer has done a thorough job of documenting prevailing lease rates in the Lawrence market and associated Project revenues and expenses. The projected rents for the first and second floors of the project appear to be in the upper range for similar space in Downtown Lawrence.

3) The anticipated presales and sales of the 12 residential condominiums provide $3,688,600 in financing that reduce debt, equity and gap financing requirements.
   a. The unfinished market rate condominiums are projected to sell for $229.50 per square foot.
   b. The finished, affordable unit is projected to sell for approximately $161.50 per square foot for a total price of $96,900. The provision of the affordable unit reduces the Developer's sales proceeds, net of realtor/broker charges, by an estimated $38,352 and the estimated finishing costs of $102 per square foot brings the total additional cost of the unit to $99,552. The prorated value of the parking space assigned to the unit, $54,340, increases the total subsidy to $153,892.
   c. The appraisal report ordered by the Project's senior lender will verify or advise adjustments to net condominium sales proceeds.

4) The Developer, using construction estimates provided by the three firms identified above, originally estimated the incremental cost of the underground parking at $1,138,020. Given the 5.05% inflation factor used for this updated review, the estimated cost of this feature rises to $1,195,490. While the Developer has noted that few developments in the area provide underground parking, the appraisal report should address how this amenity may positively impact the Project's commercial lease rates and condominium sale prices.

5) The NRA incentive, according to an opinion issued by the Attorney General of Kansas, is only payable to the owner of the property that is responsible for the taxes. With the sale of each condominium, the ownership of the unit would pass from the Developer to the buyer. The

Developer has indicated that it will require the assignment of any NRA rebate for each condo unit back to the Developer as part of its sales agreements.

a. The market rate residential condos will be sold without final finishes, and the Developer estimates that finishing costs will average $100 to $200 per square foot. NDC's analysis added an additional $1.70 million, or $102 per square foot, in appraised residential value to the sales prices for the units that are not restricted for affordability to determine the valuation for property tax estimates.
b. Returns to the Developer associated with this 75% NRA rebate are outlined below. If the Developer is not able to take an assignment of the residential condominium property tax rebates, the estimated rebate in Year 1 would drop by over 50% from $96,674 to $44,806. Given this reduction, the returns on invested equity outlined in the following section, would drop dramatically.

6) The Developer's commitment of an equity contribution of $2,582,540 was based on the difference between projected project costs and the combination of projected bank financing and net sales proceeds.
    a. Given a 10-year rebate of 75% of the available increment in the completed Project's property taxes, excluding the Developer's unit; an IRB exemption of sales taxes on eligible construction costs; after-tax cash flows on the current projection of revenues and expenses; and, estimated net sales proceeds at the end of the 20th year of operations, the Developer's Internal Rate of Return (IRR) on invested equity is estimated at 7.43%.
        i. The general strength of the Lawrence market – as evidenced by observed capitalization rates, low vacancy rates and strong square foot rents – would suggest that an 8.0% to 10% IRR would be an appropriate range for investments in and near the Massachusetts Street business district. The projected return of 7.43% for this project falls below this range.
        ii. If the NRA incentives were reduced to 50% for ten years, the estimated IRR would decline to 6.98%. Without any level of NRA incentives, the estimated IRR would fall to 6.12%.
        iii. The discounted value of the 75% NRA incentive over 10 years, given a target IRR of 8%, is approximately $673,175. The undiscounted rebates are projected to total $1,019,888.
    b. The estimated IRB incentive totals $283,621 and reduces the need for an equal amount of additional Developer equity. Without the IRB incentive, but with a

75% NRA rebate for 10 years, the Developer's estimated IRR would decrease to 6.77%.

c. Absent both the NRA and IRB incentives, the estimated IRR would decrease to 5.58%.

7) Without the 75% NRA and IRB incentives, the Project's financing gap can be estimated by subtracting the projected net sales proceeds and its calculated debt and equity capacity from total project costs as follows:
   a. If maximum debt capacity is calculated given lender underwriting criteria (Debt Coverage Ratio and Loan to Value), prevailing interest rates, amortization terms and projected revenues and expenses; and,
   b. If the equity attracted to the project, given projected cash flows after tax and appreciation over twenty years, is calculated based on a target Internal Rate of Return of 9% (the middle of the target range); then,
   c. Without the NRA incentives outlined above, the project would face an estimated financing gap of $1,065,243.
   d. If the IRB incentive is also withdrawn, the estimated financing gap would increase to $1,323,372.

Conclusion: The documents, discussions and responses presented by the Developer in support of its request for incentives, as outlined above, demonstrate that a 75% NRA rebate and approval of IRBs to exempt eligible sales taxes are reasonable and help to avoid financing gaps that could make the project economically unfeasible and unlikely to proceed. If the appraisal report for financing, final terms for the senior debt, updated project costs and projected net sales proceeds are substantially different from what the Developer has projected, NDC will review this evaluation as requested by the City.