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Economic Development Corporation Of Kansas City

But-For Determination Report
August 27, 2019

Contents

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1. Purpose

The report that follows is pursuant to a determination that the proposed Project would not reasonably be anticipated to be developed without adoption of the requested financial assistance. We have approached this determination based on the proposed Projects' plans regarding redevelopment 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 a potential return is reasonable without the requested subsidy, within the current marketplace and at the present time.

The Developer (Ice House Partners LLC) has requested assistance in the form of an LCRA property tax abatement on real property value at a rate of 75% for 10-years.

2. Executive summary

Shown in the tables below are the calculated internal rates of return with and without the subsidy request, based on the project costs and operating revenues of the proposed project. Determining if a project would occur without subsidy requires the testing of various assumptions which have a material effect on a project's feasibility. We have tested the sensitivity of the return without assistance by varying the cost and the revenue assumptions, each independently and then collectively. The reason for testing sensitivity is to illustrate the magnitude with which project assumptions would have to change in order for the project to be considered feasible without assistance. Table A, below, details the significant findings of the sensitivity analysis:

Table A

Without Assistance Sensitivity Analysis	Change Necessary to be Feasible	Rate of Return without Assistance
Decreased Costs	17% Decrease	7.17%
Increased Revenue	20% Increase	7.12%
Combined Cost and Revenue Changes	10% Decreased Costs 10% Increase Rev	7.35%

The table above indicates the magnitude at which project assumptions would have to change for the project to have a feasible rate of return without assistance. Based on the Price Waterhouse Cooper Real Estate Investor Survey the current range of unleveraged market returns for a project of this nature is 5.25% to 10.0%, with an average of 7.11% which we used as our feasibility benchmark. Absent the changes outlined above, the projects would not attract a return sufficient to exceed the Developer's threshold for investment and would not likely be completed through private enterprise alone.

Table B, below, illustrates the Developer's projected rates of return with and without assistance:

Table B

Pro Forma	With 10-Years @ 75% Request	Without Assistance
Unleveraged	8.67%	4.84%

3. The project

The Developer is proposing the redevelopment of the site into a new mixed-use residential apartment building. The project will be located at 226 W. 75th Street, and the site currently contains a severely blighted building. The overall area of the redevelopment site is 0.481 acres. The project is intended to be included in a newly created single project Urban Renewal Area.

The Developer is proposing the demolition of the existing building and the construction of a new four-story mixed-used building with commercial ground floor uses and approximately 33 market-rate apartments on floors two through four. The Developer will be setting aside three of the units as affordable for persons at or below 70% of the area median income, with the other thirty units at market rate. The ground floor of the building is proposed to contain office space totaling 4,800 sf. Additionally, the Developer will be construction necessary site improvements and the construction of a new parking lot.

The Developer of the project is Ice House Partners LLC. The Developer anticipates construction commencing on the project in February 2020 and occurring through March 2021. The Developer anticipates the building will achieve a stabilized occupancy by September 2021.

4. Redevelopment Costs

The total cost of the project is detailed in Table C below. The costs reflected below are after the savings provided by the requested sales tax exemption on construction materials.

Table C

Total Project Costs	Total Cost	% of Total Project Costs
Land/Building Acquisition	$550,000	7.31%
Hard Costs	5,724,000	76.07%
Soft Costs	1,251,000	16.62%
Total Project Costs	**$7,525,000**	**100%**

Acquisition

The Developer has the property under contract, for a purchase price of $550,000. The acquisition cost equates to 7.31% of the total project cost.

Hard Costs

The total cost grouped together as hard costs are detailed in Table D below.

Table D

Total Hard Costs	Total Cost	% of Total Project Costs
Construction Cost	$5,120,000	68.04%
Demolition	205,000	2.72%
Furniture, Fixtures, and Equipment	35,000	0.47%
Tenant Improvement Allowance	324,000	4.31%
Builders Risk Insurance	40,000	0.53%
Total Hard Costs	**$5,881,000**	**76.07%**

The Developer provided a preliminary estimate for the total cost of hard construction of $5,881,000, on which their pro forma was based. The total hard costs equate to 76.07% of the total project cost, which equates to $168.03 per square foot.

The largest of this category is for building construction costs, which they estimated at $5,120,000 for purposes of creating their budget. In support of this cost estimate they provided a detailed budget estimate from their contractor, that provided induvial expense line-items for this category. This budget estimate totaled $5,222,686 after subtracting line-items budgeted separately within their pro forma budget. For purposes of this analysis we are using the lessor amount of $5,120,000 that is included within their application and pro forma. This cost estimate of $5,120,000 equates to $146.28 per square foot.

To provide a comparison, we compared the cost estimates to the Marshall and Swift Swiftestimator for estimated construction costs for a apartment building in the Kansas City metropolitan area. The Swiftestimator provided an average cost estimate of $141.50, with a range from $121.48 to $156.04 depending on construction material type. In comparison the Developer's per square foot cost assumption for vertical improvements, net of site costs, demolition, etc., was $146.28. Based on this the Developer's hard cost estimate appears reasonable.

In addition to vertical building costs, the Developer's hard costs also include an estimate for the cost of demolition for the existing building of $205,000. The Developer provided a detailed demolition cost estimate in support of this line-item that provided a cost estimate of $210,400.

Additionally, the Developer has included a tenant improvement allowance of $324,000 for the first-floor commercial space. This allowance equates to a per square foot cost of $67.50. This allowance equates to approximately 2.4 years of projected lease revenue for the commercial space, and as a result this estimate may be a touch on the higher side.

The construction cost category is the largest segment of the development costs, accounting for 77.87% of the total project costs. Consequently, this is a segment where project costs savings could have a positive effect on the rate of return realized by the Developer, while higher than estimated costs would have the converse effect. In the return analysis section of the report, we discuss the sensitivity of the rate of return to changes in the project costs, and the effect on the return without assistance of a decrease in project costs.

Soft Costs

For purposes of this review we have grouped the cost categories in Table E below as Soft Costs:

Table E

Total Soft Costs	Total Cost	% of Total Project Costs
Architecture and Engineering	$250,000	3.32%
Construction Loan Fees and Interest	157,000	2.09%
Permits and Fees	71,000	0.94%
Soils & Environmental Engineering	$7,500	0.10%
Legal/Accounting/Marketing/Etc.	94,000	1.25%
Taxes/Assessments (during construction)	15,000	0.20%
Miscellaneous	$6,500	0.09%
Development Contingency	250,000	3.32%
Developer Fee	400,000	5.32%
Total	**$1,251,000**	**16.62%**

The total amount of the cost categories grouped under the soft cost heading is $1,251,000, which equates to approximately 16.62% of the total development costs or approximately $35.74 per square foot.

Reviewing the soft cost categories for largest percentage of the total project costs to smallest, the largest portion of the soft costs is the Developer Fee of $400,000, which equates to approximately 5.32% of the total project cost. This is a reasonable percentage for a Developer Fee.

The next largest line-item is the Architecture & Engineering line-item of $250,000, which equates to 4.8% of the vertical construction cost, which is a reasonable percentage for this type of line-item. Additionally, the Developer has assumed a contingency amount of $250,000 which equates to 3.32% of the total project cost, which is a reasonable, if not conservative, contingency amount.

The remaining significant soft cost line item is the construction loan fee and interest estimate of $157,000, which equates to a 2.09% of construction cost. Given the level of

construction costs incurred by the Developer, at 2.09% of total project costs this amount appears reasonable.

The other remaining soft costs line-items, all of which represent 1% or less of total project costs, and in total are $100,000 which equates to approximately 1.33% of the total project costs.

In the “Return Analysis” section of the report we discuss the sensitivity of the rate of return to changes in the project costs, and the effect on the return of a decrease in project costs.

5. Assistance request

The Developer is requesting assistance in the form of an LCRA Tax Abatement provided at a rate of 75% of the incremental increase in property taxes that would occur without abatement, for a period of 10-years.

The Developer provided a post-development property tax estimate for the project without abatement of $66,538. This estimate was based on an appraised post-development market value of $4,120,000 for the completed project, which they have assumed will increase at 2% annually over the life of the abatement.

The Developer has assumed a base PILOT level of taxes of $25,158 will be paid annually during the abatement period. They have not assumed any inflation assumption as it relates to the PILOT level of taxes with abatement. This PILOT payment reflects the current base level of taxes of $11,365 and the increase in taxes from the uncaptured 25% portion of the value of $13,793 annually, resulting in a total annual amount of $25,158.

In Table F below we show our estimate for the net present value of the requested tax abatement assistance based on a 6% interest rate.

Table F

Tax Abatement Scenario	Amount
10-Years @ 75% of increase over base amount - **NPV at 6%**	$346,007
10-Year @ 75% of increase – **Total Amount**	$476,992
Total PILOT Payments to Taxing Jurisdictions over 10-years	$137,930

The Net Present Value of the tax abatement savings is $346,007, which equates to approximately 4.6% of the total project cost. In the return analysis section, we will illustrate the impact on the projected rate of return with and without the requested tax abatement assistance.

Table G provides the anticipated sources that will be utilized to fund the redevelopment project.

Table G

Sources:	
Developer Equity (29%)	$2,175,000
Permanent Financing (71%)	$5,350,000
Total Sources	**$7,525,000**

6. Return analysis

Utilizing the operating pro forma prepared by the Developer we evaluated the need for assistance for the proposed development by comparing the potential return with and without assistance. The Developer provided an 11-year operating pro forma for the development based on a one-year build-out and first year stabilization, and operating revenue and expense assumptions. Utilizing the information provided by the Developer's pro forma we calculated an unleveraged internal rate of return (IRR) calculation after the 11-years of the pro forma. We utilized this IRR analysis to illustrate the potential return with and without the requested abatement assistance. The return realized by the Developer is a result of the assumptions used in the creation of the operating pro forma, therefore a number of steps must be performed to analyze the reasonableness of the assumptions used.

The first step in analyzing the return to the Developer is to determine if the costs presented are reasonable. We have discussed a portion of the costs above and have commented on the mechanics whereby cost savings on the private side could occur. If cost savings for the Developer's share occur absent any other changes, the Developer would realize a greater return than projected.

The second step in calculating the return to the Developer is to determine if the operating revenues and expenses of the proposed development are reasonable.

- The Developer has projected the following average lease rates:
  - $1,234/Month – Blended average for apartment units
  - $1.70/PSF – Apartment rent
  - $27.96/PSF – Commercial office space rent
- Additionally, the Developer has projected revenues generated by parking spaces, pet fees, and administrative expenses.
- The Developer has projected annual operating expenses (net of taxes) which are equivalent to approximately 26% of annual revenues upon stabilization.
- The Developer has assumed a 10% vacancy factor upon stabilization.
- The Developer has assumed a replacement reserve based on 3% of gross rent.
- Operating revenues and expenses are proposed to inflate at 2% annually upon stabilization.

We reviewed third-party market information to evaluate the projected lease rate, vacancy and inflations assumptions prepared by the Developer. The market information indicated average one-bedroom apartment asking rents of $1,161 for CBD/Plaza apartment rates, and $731 for inner Jackson County. Based on this information the Developer's operating assumptions outlined above appear reasonable.

The calculation of an internal rate of return requires the assumption of a hypothetical sale of the asset in the final year of the operating pro forma. The inclusion of this hypothetical sale is used purely for purposes of evaluating the return on the Developer's investment.

The determination of the potential market value of the project, through a hypothetical sale, is necessary as it allows for the inclusion of the value of the asset into the rate of return calculation. The calculation of an IRR without the hypothetical sale would result in an understated return, as the return would not be taking into account the value of the real estate asset. The use of a hypothetical sale assumption is not indicative of the Developer's intention to sell the development in the final year.

The third step in analyzing the return to the Developer is to determine if the assumptions for the hypothetical sale of the asset are reasonable. A critical assumption when valuing the asset at the time of the hypothetical sale is the capitalization rate. The available net operating income divided by the capitalization rate results in the assumed fair market value of the asset. The Developer provided value calculations based on a variety of capitalization rates. For purposes of our analysis, we utilized a capitalization rate of 7.0%, and a 3.0% cost of sale, to calculate the hypothetical sale value. In reviewing historical cap rate trends for multi-family developments, we feel 7.0% is consistent with historical trends.

An unleveraged IRR calculation is used in order to compare the potential return to the Developer based on the Price Waterhouse Cooper (PWC) Real Estate Investor Survey, Second Quarter 2019, which provides a market comparison on which project feasibility can be judged.

Table H below, shows the Developer's base pro forma rate of return without assistance and the return with varying levels of assistance.

Table H

Developer Pro Forma	Unleveraged IRR
Without assistance	4.84%
With tax abatement 10-years @ 75% (Developer Request)	8.67%

To evaluate the rate of return a project of this nature would require to be considered "feasible" we consulted the Price Waterhouse Cooper Real Estate Investor Survey prepared for the second quarter of 2019. This survey provides a resource for comparing the Developer's rate of return to a market benchmark to help determine feasibility. According to the developers surveyed, the typical unleveraged market return necessary for them to pursue a project of this nature falls in a range from 5.25% to 10.00%; with an average return of 7.11%.

Sensitivity analysis

In order to answer the question "is the development likely to occur without public assistance" we analyzed the without incentive scenarios, using the Unleveraged Return

Analysis Pro Forma without assistance as the basis for the sensitivity analysis. The sensitivity analysis is performed in order to understand the magnitude at which project costs would have to decrease, or conversely project revenues would have to increase, for the project to be considered feasible. For this sensitivity analysis we used the PWC average return of 7.11% as the sensitivity benchmark.

To understand the impact of the project cost assumptions, we performed a cost sensitivity analysis to determine the rate at which project costs would have to be reduced for the projected rate of return to be in excess of our feasibility benchmark without assistance. Table I illustrates the development would need to realize a 17% reduction in project costs in order to be feasible without assistance. Given a 17% reduction in costs the project would have a rate of return of 7.17%.

Table I

Project Costs Sensitivity	Reduction in Project Costs	Rate of Return without assistance
	17%	7.17%

To understand the impact of increased revenues, we have performed a sensitivity analysis to determine the rate at which project net operating income, would have to increase for the projected rate of return to be in excess of our feasibility benchmark without assistance. Table J illustrates the development would need to realize a 20% increase in project revenues for the project to be feasible without assistance. Given a 20% increase in project revenues, the project would have a rate of return of 7.12% which falls into the reasonable range.

Table J

Project Revenue Sensitivity	Increase in Project Revenue	Rate of Return without assistance
	20%	7.12%

As a final step in the sensitivity analysis, and to understand the impact of a combined change in project costs and project revenues, we have performed a sensitivity analysis to determine the rate at which these areas would have to change for the projected rate of return to be in excess of our feasibility benchmark without assistance. Table K illustrates the development would need to realize a combined 10% decrease in project costs and a 10% increase in project revenues for the project to be feasible without assistance. Given these changes in assumptions the project would have a rate of return of 7.35%.

Table K

Combined Sensitivity	Reduction in Project Costs	Increased Project Revenues	Rate of Return without assistance
	10%	10%	7.35%

The three tables above (Tables I, J, and K) indicate the magnitude at which project assumptions would have to change for the project as a whole to have a rate of return in excess of the 7.11% feasibility benchmark used in the sensitivity analysis. Absent changes of the magnitude outlined above, the project would not have a sufficient return to draw market investment. Only by assuming either increases in project revenues, decreases in project costs, or a combination of the two does the return increase to a feasible level without public assistance. However, we project changes of the magnitude outlined above are unlikely to be realized, which indicates the proposed project, when viewed as a whole, would not likely be completed through private enterprise alone.

7. “But-For” conclusion

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 typically demands a positive return with a range between 5.25% and 10.00% based on the PWC Survey, with an average return of 7.11%. The unleveraged rate of return with assistance is 8.67% and without is 4.84%.

Based on their assumptions for project costs and operating revenues, the developments absent assistance are unlikely to be undertaken due to inadequate return. Therefore, we conclude the proposed project would not occur on this site at this time without a public subsidy.