

U.S. Equities Realty

M E M O R A N D U M

TO Julia Carroll
City Manager

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FROM Martin Stern

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RE Fountain Square Preliminary Findings

CC John Lynch

PRELIMINARY FINDINGS

In reference to the most recent proposal for the redevelopment of the Fountain Square block by Focus Development, U.S. Equities performed a review of the financial models presented by the development team as well as a review of the public benefits the team has mentioned in defense of its appeal for TIF dollars in support of the project. Specifically, we conducted the following analyses:

1. A detailed review of hard and soft costs, interest and capitalization rate assumptions, and return requirements assumed by the development team in its financial pro formas;
2. Re-analysis of the financial models using alternative assumptions for figures deemed overly conservative;
3. Reconstruction of the financial pro formas to model a shorter (34-story) tower to gauge financial viability;
4. Qualitative assessment of the public benefits touted by the development team;
5. Coordination with Kane, McKenna and Associates regarding the quantitative effect on TIF increment forecasted by the proposed project.
6. Review of the Hahn Building rent roll to assess market value in relation to asking price.

We will summarize our findings in four sections: a review of project financial assumptions, an analysis of public benefits, comments on the Hahn Building acquisition cost, and our conclusions.

Project Financial Assumptions

With very few exceptions, we believe the development team's financial assumptions and pro formas are reasonable and appropriate. The budget for both hard and soft costs associated with both the 708 Church Street tower and the Hahn Building restoration are consistent with our current experience in the development arena. Projected sales prices and retail rents are appropriate and, if anything, are optimistic given the current real estate climate.

The acquisition and restoration of the Hahn Building as proposed does not stand on its own as a financially viable project. The development team has proposed a significant subsidy that would come from anticipated profits from the 708 Church development, but they (correctly, we believe) assert that a reasonable return rate on the 708 Church development does not provide enough subsidy to complete the Hahn restoration without some public assistance or other reduction in acquisition costs. The development team has asked for a \$3,000,000 TIF grant to make up the shortfall. This gap would grow significantly wider with any additional reduction in height of the proposed tower.

Our review uncovered four financial assumptions that we believe could be made slightly less conservative in order to budget additional dollars to subsidize the Hahn construction or aid a Fountain Square redevelopment. Note that we are not asserting the developers' assumptions to be "wrong", and we understand a developer's desire to be appropriately conservative in making forecasts, but the following changes are, we believe, reasonable and consistent with an overarching assumption that both the credit and housing markets would have to return to more normal states before this project could go forward:

1. The development team has assumed 7.5% capitalization rates on the sale of the retail components of the Hahn and 708 Church building. While we understand the 7.5% rate for the Hahn building owing to several less-than-ideal characteristics, it is reasonable to assume the 708 Church retail would sell at a better capitalization rate and we would be comfortable with 7 to 7.25%. At the forecasted rents, this would amount to an additional \$310,000 to \$640,000 in forecasted revenues.
2. The team has assumed an interest reserve of 6% with a 2% contingency (8% combined reserve plus contingency). Our current experience in the debt markets indicates that a combined 7% including contingency is appropriate, and is likely to become even more appropriate as markets become more stable. This budget change would result in a reduced reserve expense of about \$650,000.
3. The return requirement for the Hahn restoration project is a conservative 12%. We believe that, when performed in connection with the 708 Church building, a 10% return is appropriate. Since most of the funding sources are debt, however, the effect of this adjustment is small – about \$150,000.
4. The developers have forecast a tenant relocation budget of about \$1,350,000 for the combined 708 Church and Hahn Buildings. While this budget is extremely hard to estimate

owing to their dependence on tenant negotiations, we believe a 15% reduction may be possible because while some tenants may be difficult, some of the tenants in the Hahn Building may not need to be relocated at all. This change would result in a budget savings of \$200,000.

While all of these changes may not come to pass, the net effect of these suggested changes would be to reduce the required TIF by \$1,300,000 to \$1,600,000.

Height and Density

In order to evaluate the height and density of the proposed tower, we reconstructed financial models using assumptions for a building that would be shorter by a material amount while still retaining the general profile of the proposed project. Our analysis of a 34-story building indicates that a shorter building than the 38-story tower currently proposed at 708 Church Street would not be financially viable given market acquisition costs for the properties to be redeveloped. While a reduction of one floor may potentially be viable, we do not believe that this is a material difference and would not be advisable. Such a reduction may increase risks and reduce profits that could otherwise support the Hahn Building restoration or other public project.

Public Benefits

The development team has presented a list of eight public benefits in support of its TIF request. Most of the identified items (though perhaps not all) are legitimate benefits to some degree, though several are difficult to quantify. Below is an evaluation of each identified public benefit grouped into three categories: Quantifiable Benefits; Unquantifiable Benefits; and Questionable Benefits.

a. Quantifiable Public Benefits

- i. **Creation of Significant TIF Increment:** Kane, McKenna and Associates revisited the property and sales tax revenue forecasts for the most recent project proposal. The KMA estimated total revenue (undiscounted) for 2010-2018 is now \$21,800,000, with the bulk of that figure (\$19,700,000) attributable to property tax revenue and the remainder (\$1,100,000) to sales tax revenue. This is tax increment that could be used by the City to fund other downtown improvement projects (such as the Fountain Square rehabilitation) while still providing financial assistance to the proposed Hahn Building restoration if desired by the City.
- ii. **Significant Contribution to the City's Affordable Housing Program:** The development team proposes a cash payment in lieu of providing affordable housing. As currently proposed with 218 residential units, that contribution would be approximately $10\% \times 218 \text{ units} \times \$40,000/\text{unit} = \$880,000$. Were the site to remain in its current commercial use, the Affordable Housing Program would be ineligible for any contribution. By converting the site to housing and tying the level of

contribution to the number of units in the building, the City's Affordable Housing Program clearly benefits from a residential high-rise project.

- iii. LEED Certification: Environmentally conscious design is a positive project attribute, though such certification does not provide unique justification for a tall tower as any project (large or small, new or rehab) is eligible for LEED certification. Still, we estimate that the certification may add 1-2% to total project costs, or about \$1,600,000 to \$3,200,000 for the project as proposed, and therefore should be recognized as a cost to the developer that benefits the public.

b. Unquantifiable Public Benefits

- i. Preservation of the Hahn Building and Retention of Class B Office Space: The Evanston community seems to be in support of the preservation and restoration of the Hahn Building, including retaining Class B office space. However, we have noted that such a project is unlikely to be financially viable as a stand-alone project and would require a subsidy or other reduction in acquisition costs.
- ii. Enhancement of Retail Core/Emerging Lifestyle Center: We agree that this is a public benefit of the project, and that the benefit is enhanced by the project's density. Quality retail space plus the addition of several hundred residents to the downtown area would have a positive effect on the enhancement of the downtown retail/lifestyle core.
- iii. Assurance of a Vision for the Block: We would agree that the proposed plan is a positive step toward creation of a singular vision for the block, though we would stop short of acknowledging "assurance" without control of the Fountain Square building. Because of that lack of control, the City would need to retain a significant role in protecting the vision for the block.

c. Questionable Public Benefits

- i. Outstanding Architectural Design: While outstanding design can unquestionably benefit the public by elevating perception of a neighborhood, this benefit is too qualitative and too easily debated in the public arena to justify public funding.
- ii. Variety of Housing Options: The variety of unit sizes provides more of a market benefit to the developers than a tangible public benefit to other City residents. While there is certainly a benefit to adding a mix of household types to the downtown core, that benefit has been addressed in the earlier reference to enhancing the retail core/lifestyle center.

Hahn Building Acquisition Cost

In a few instances in this letter, we have made reference to “other reduction in acquisition costs” to address the financial gap needed to rehabilitate the Hahn Building. Our examination of the existing rent roll in the existing Hahn Building indicates a market value of the current building that would not exceed \$6,500,000, a figure that is well below the figure currently being asked by the property owner. If the developer were able to narrow the gap between asking price and our estimate of market value, we would anticipate that the need for TIF assistance could be further reduced.

Furthermore, we note that the proposed tower proposal does not require acquisition of the Hahn Building. Removal of the Hahn Building restoration from the proposal would likely eliminate the need for TIF dollars in the project and would allow the amount of developer profit currently earmarked to subsidize the Hahn work to be redirected toward Fountain Square rehabilitation.

Conclusions

In summary, our conclusions are as follows:

- We do not see further height reduction of the proposed tower as financially viable.
- The Hahn Building restoration is not financially viable as a stand-alone project; while we believe the \$3,000,000 TIF request is higher than necessary to complete the project, a TIF of \$2,000,000 is probably necessary to fund the project without other reductions in acquisition costs.
- While the development team has somewhat overreached in its explanation of public benefits, the proposed project does offer meaningful benefits to the public in support of such a TIF.
- The asking price of the Hahn Building is high in relation to market value. The requested TIF funds for this project would likely be reduced by narrowing the gap in asking price versus market value.
- Because the development team is subsidizing a portion of the Hahn restoration from anticipated 708 Church Street profits, removing the Hahn Building from the project would allow for a direct developer contribution to the Fountain Square rehabilitation, lowering the City’s ultimate cost to fund such work.

Should you have any questions regarding this letter or the underlying analysis, please do not hesitate to contact me.