# Memo

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| To: | Members of the City Council<br>Sharon Hanson, Lauren Deutz, Annette Storm, City of Marshall |
| From: | Mikaela Huot, Director |
| Date: | July 27, 2021 |
| Subject: | Financial Analysis and Tax Increment Revenue Projections for Proposed Suite Liv'n Housing Project |

**Background**
The City of Marshall received an application from L2A LLC, the developer, for financial assistance through the establishment of a Tax Increment Financing (TIF) Housing District to facilitate the construction of a new 48-unit mixed-income housing project that would comprise of 2 24-unit buildings. The application states there is a financial gap resulting from the development costs not being supported by projected rents of the housing units upon construction completion. The project budget for both buildings is approximately $6.277M.

This memorandum provides a summary of the preliminary tax increment revenue projections for the project and initial financial review of the development project costs and operating pro forma as provided by the developer to understand how tax increment financing may be necessary for the project to proceed. Prior to considering tax increment financing assistance for the project, the City will need to make a determination if the project as proposed would be unlikely to proceed "but-for" the requested Tax Increment Financing (TIF) assistance, and to determine the appropriate amount, if any, of public assistance. To establish a tax increment financing district, there are findings that need to be made by the City that include: 1) determination that the project qualifies as a TIF district and 2) determination that the project as proposed would not proceed without public assistance (meeting the "but-for" test).

**Developer Request for Assistance**
The developer's application includes a request for up to 26 years of tax increment assistance, of which the annual revenues would be used to provide additional cash flow to support operating expenses and debt repayment. Financial assistance through pay-as-you-go tax increment financing from the City of Marshall has been requested to provide additional revenues to support the required level of debt and project cash flow to repay annual debt service payments. Typical extraordinary redevelopment costs that cannot be supported solely by the project alone could justify the need for public financial assistance and allow the project to proceed as proposed to provide appropriate upfront funding and meet the minimum debt coverage requirements. The developer has indicated the receipt of City financial assistance is necessary for the project to proceed.

The sources and uses of funds without financial assistance through TIF is in the table below.

| Sources | Amount | Uses | Amount |
|---|---|---|---|
| First Mortgage | $3,306,566 | Acquisition | $502,315 |
| Equity | $2,507,089 | Site Development | $15,000 |
| Deferred Developer Fee | $463,521 | Construction | $4,785,492 |
| | | Soft Costs | $336,486 |
| | | Developer Fee | $313,858 |
| | | Contingency | $244,024 |

| | | | |
|---|---|---|---|
| | | Public Improvements | $80,000 |
| Total | $6,277,176 | Total | $6,277,176 |

The sources and uses of funds with financial assistance through TIF is in the table below.

| Sources | Amount | Uses | Amount |
|---|---|---|---|
| First Mortgage | $3,766,305 | Acquisition | $502,315 |
| Equity | $2,047,349 | Site Development | $15,000 |
| Deferred Developer Fee | $463,521 | Construction | $4,785,492 |
| | | Soft Costs | $336,486 |
| | | Developer Fee | $313,858 |
| | | Contingency | $244,024 |
| | | Public Improvements | $80,000 |
| Total | $6,277,176 | Total | $6,277,176 |

*With financial assistance, the developer is illustrating an increase in debt financing by approximately $459,739, with an equal amount of decreased equity, resulting in increased equity returns and additional cash flow with increased debt coverage returns.*

**Qualifications**

A housing TIF District is a type of tax increment district which consists of a project that is intended for occupancy by persons or families of low- and moderate- income. Tax increment revenues must be used solely to finance the cost of a housing project as defined, and not more than 20 percent of the square footage of the buildings that receive assistance from tax increments may consist of commercial, retail, or other non-residential uses. For the proposed project to qualify as a tax increment financing housing district, the property must satisfy the income requirements as follows:

- at least 20% of units are occupied by individuals whose income is 50% or less of area median income
- at least 40% of units are occupied by individuals whose income is 60% or less of area median income.

Revenues from a tax increment financing housing district can be used for all costs related to the qualifying project that may include acquisition, rehabilitation and construction, utilities, parking, streets and sidewalks. The cost of public improvements directly related to the housing projects and the allocated administrative expenses of the City may be included in the cost of a housing project.

The developer has indicated this project would meet the income requirements outlined above with at least 40% of the units being affordable at a level of 60% of the area median income (AMI). The new units would include a mix of 1 and 2-bedroom units.

**Project Financing**

There are generally two ways in which assistance can be provided for most projects, either upfront or on a pay-as-you-go basis. With upfront financing, the City would finance a portion of the developer's initial project costs through the issuance of bonds or as an internal loan. Future tax increment would be collected by the City and used to pay debt service on the bonds or repayment of the internal loan. With pay-as-you-go financing, the developer would finance all project costs upfront and would be reimbursed over time for a portion of those costs as revenues are available.

Pay-as-you-go-financing is generally more acceptable than upfront financing for the City because it shifts the risk for repayment to the developer. If tax increment revenues are less than originally projected, the developer receives less and therefore bears the risk of not being reimbursed the full amount of their financing. However, in some cases pay as you go financing may not be financially feasible. With bonds, the City would still need to make debt service payments and would have to use other sources to fill any shortfall of tax increment revenues. With internal financing, the City reimburses the loan with future revenue collections and may risk not repaying itself in full if tax increment revenues are not sufficient. The project financing as requested includes pay-as-you-go for reimbursement of eligible costs.

**Tax Increment Revenue Estimates**

| | Scenario 1 | Scenario 2 |
|---|---|---|
| | Recommendation within Contract Terms | TIF Plan Authority: Maximum Budget Amount |
| Term of Collection for District | 12 years | 15 years |
| | | |
| Estimated Total Completed Value (includes existing apartment building value) | $3,320,900 | $3,320,900 |
| Total Tax Capacity | $54,014 | $54,014 |
| | | |
| **Incremental Value (new buildings only)** | **$2,457,400** | **$2,457,400** |
| **Estimated per Unit Value** | **$51,196/unit** | **$51,196/unit** |
| Captured Tax Capacity (Total less Original) | $30,718 | $30,718 |
| | | |
| x 2021 Local Capacity Rate | 129.013% | 129.013% |
| | | |
| Estimated Total Gross Tax Increment Revenue (less OSA deduction of 0.36%) | $39,487 | $39,487 |
| | | |
| Less: 10% for Administrative Expenses (Maximum Percentage is 10%) | $3,949 | $3,949 |
| | | |
| Estimated Net Annual Available Revenue | $35,538 | $35,538 |
| | | |
| **Total Estimated Gross Increment** | **$500,793** | **$635,617** |
| | | |
| ***Total Estimated Net Increment to Developer*** | ***$450,713*** | ***$572,054*** |

Additional assumptions utilized:

- Property classified as residential rental
  - 48 units:  1.25% classification rate (market rate)
- Maximum term of housing district (26 total years)
  - First year collection payable 2024
  - 12-15 years
    - *Based on financial 'gap'*
- Increment based on difference between existing value and new land/building value
- Construction commences and completes in 2022
  - 100% completed by December 31, 2022 for
  - Assess January 2023 for taxes payable in 2024
- Payable 2021 tax rates of 129.013%
- 1% annual market value inflator
- 10% retained by City for admin
  - *Maximum 10% for admin*
  - 90% pledged to project

**Developer Pro forma Analysis including But-For**

Upon approval of a TIF district and project, the City must make several findings, including the "but for" test: that the proposed development would not reasonably be expected to occur solely through private investment within the reasonably foreseeable future. The developer has stated that but for the provision of tax increment financing, the project as proposed would not occur. Based on the developer's stated position relative to the need for tax increment financing assistance, the City could make its "but for" finding and provide tax increment assistance. We recommend, however, that the City review the provided assumptions to consider if the project meets the but-for test and, if so, what an appropriate level and type of TIF assistance may be based on the information submitted by the developer.

Following thorough evaluation of the project as provided allows the City to be prepared to make an informed "but-for" decision based on the likelihood of the project needing assistance, as well as the appropriate level of assistance. To complete this analysis, we reviewed the developer's provided operating proforma and constructed similar ten-year project proformas, showing a result if the developer received the assistance as pay-as-you-go (reimbursement for TIF eligible costs) and showing a result if the developer did not receive assistance. Our analysis of the proformas included a review of the development budget, projected operating revenues and expenditures, and the project's capacity to support annual debt service on outstanding debt. The purpose of evaluating the operating proformas is to understand the potential cash flow performance through initial development of the project and the annual operations of the project over a 10-year period to assist with determining if the project is financially feasible and would need public participation.

Measuring project feasibility is typically accomplished by analyzing a combination of 1) projected rate of return – both annual and cumulative and 2) estimated debt coverage ratio (DCR). Rate of return analysis illustrates the projected return to the developer using the available cash flow after payment of operating expenses and debt as a measurement to the initial equity investment. Industry standards for development types indicate the level of investment a developer is willing to make based on projected returns from the project. Should the projected annual and cumulative returns fall below those standards, the project would require reduced level of equity participation and/or increased cash flow. Debt Coverage Ratio (DCR) is a calculation detailing the ratio by which operating income exceeds the debt payments for the project. If the DCR is greater than 1.0 it indicates the project has operating income that is greater than the debt-service payment by some margin; conversely if the DCR is less than 1.0 it indicates the project is incapable of meeting its debt-service payment and would need to seek additional revenue sources in order to pay its debt. Typical lending standards will require a DCR of greater than 1.0 as a measure of cushion in the event actual revenues and expenses are different than projected.

We reviewed the financial information as provided by the developer to assist with making the determination 1) that tax increment assistance is necessary and 2) what is an appropriate level of assistance. We analysed both the projected rate of return and debt coverage ratios using the available information. The level of debt financing the project can obtain and support is based on the net operating income (NOI). The annual lease and other (parking) revenues and operating expenses have been provided by the developer to project the NOI.

Review of the operating proformas based on with assistance as pay-as-you-go and with no assistance provides the range of financial feasibility for this project and what the estimated gap would be without assistance. It is important to note that certain assumptions were made based on the developer's provided information and market industry standards for annual lease rates, vacancy rates and annual revenue and operating expense inflators in order to understand the project performance. Adjustments made to those assumptions assist in understanding potential impact on project performance and what a required level of assistance may be.

To understand viability of the project and need for public assistance, we provided a sensitivity analysis to the proformas with adjustments made to the total project costs and funding sources, as well as annual lease rates. The developer currently owns the property, but the purchase had included both existing apartments, as well as undeveloped land available for future development (this proposed project). Including a purchase price for this project is reflective of the market and potential value of the property for new housing construction. The per unit purchase price for both buildings equals approximately $10,464. All other assumptions remaining the same, reducing the project costs (land purchase) and corresponding equity amount, subject to market, is expected to positively impact the projected rates of return. Upon review of the annual cash flow performance, adjusting the projected lease rates through an increase would result in additional cash flow that provides both higher debt coverage ratio and rate of return. Realizing these adjustments is subject to market conditions and what the project could command for rents and per unit land cost. The City's market study supports current assumptions as included in the applicant's financial analysis.

**Conclusion**

The applicant has requested tax increment financing from the City as a method of providing additional cash flow revenues required to achieve financial feasibility. The request was for 90% of the tax increments generated over the maximum 26-year term of the TIF District. Through submission of the tax increment financing application and supporting financial information, the applicant has indicated that the project would not occur as proposed without financial assistance from the City due to below market rates of return. The project will be privately financed through debt and equity and the increment would provide additional annual revenues to enhance cash flow and increase the developer's return. To assist with determining the need for and amount of tax increment assistance, we typically review both the annual (upon stabilization) and long-term (10-15-year period) investment returns to understand financial performance and verification of need for public assistance.

Based on the financial analysis and available financing assumptions, without financial assistance, the project does not appear to be feasible. Without assistance, the projected annual and cumulative rate of return is below industry standards for this type of project and with annual public assistance the project is projected to achieve more reasonable market returns. The rate of return analysis indicates that the provided financing structure would not be financially viable without one or more of the following: 1) reduction in project costs 2) additional annual cash flow, and/or 3) additional funding sources.

Based on financial review, the maximum term of 26 years from the housing district does not appear to be needed for the project to proceed. The recommended level of assistance is in the range of 12-15 years to allow for the early years of project stabilization and cash flow support, while still requiring the developer to maintain and certify that at least 40% of the newly constructed units would be affordable to occupants with incomes at 60% AMI.

Considerations for recommended level of public assistance parameters include:

- Return on Investment
- Purchase price and other development costs
- Public to private investment
- Public assistance (TIF) and private equity
- Extraordinary costs
- Financial gap
- Term of collection
- Public policy and need

Lastly, the City recently commissioned a comprehensive housing needs analysis update to understand current market demands and conditions in the City. The results of the study indicate a need for the housing that is being proposed for this project. It is estimated the City can accommodate 124 new market rate rental housing units, 75 shallow-subsidy units, and 128 deep-subsidy units through 2030. In addition, the projected rents as proposed for the project are within range of what has been identified in the study.

Thank you for the opportunity to be of assistance to the City of Marshall. Please contact me at 651.368.2533 or Mikaela.huot@bakertily.com with any questions or comments.

## Projected Tax Increment Report

**City of Marshall**
**Tax Increment Financing (Housing) District No. 6-1**
**Suite Liv'n Proposed 48-Unit Housing Project**
**TIF Revenues - 12 Years**

| Annual Period Ending (1) | Total Market Value [(1)] (2) | Total Net Tax Capacity [(2)] (3) | Less: Original Net Tax Capacity [(3)] (4) | Retained Captured Net Tax Capacity (5) | Times: Tax Capacity Rate [(4)] (6) | Annual Gross Tax Increment (7) | Less: State Aud. Deduction 0.360% (8) | Subtotal Net Tax Increment (9) | Less: Admin. Retainage 10.00% (10) | Annual Net Revenue (11) | | P.V. Annual Net Rev. To 02/01/22 4.00% |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 12/31/22 | 863,500 | 10,794 | 10,794 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/23 | 863,500 | 10,794 | 10,794 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/24 | 3,320,900 | 41,511 | 10,794 | 30,718 | 129.013% | 39,630 | 143 | 39,487 | 3,949 | 35,538 | | 31,697 |
| 12/31/25 | 3,345,474 | 41,818 | 10,794 | 31,025 | 129.013% | 40,026 | 144 | 39,882 | 3,988 | 35,894 | * | 30,783 |
| 12/31/26 | 3,370,294 | 42,129 | 10,794 | 31,335 | 129.013% | 40,426 | 146 | 40,280 | 4,028 | 36,252 | | 29,894 |
| 12/31/27 | 3,395,362 | 42,442 | 10,794 | 31,648 | 129.013% | 40,830 | 147 | 40,683 | 4,068 | 36,615 | | 29,032 |
| 12/31/28 | 3,420,680 | 42,759 | 10,794 | 31,965 | 129.013% | 41,239 | 148 | 41,091 | 4,109 | 36,982 | | 28,195 |
| 12/31/29 | 3,446,252 | 43,078 | 10,794 | 32,284 | 129.013% | 41,651 | 150 | 41,501 | 4,150 | 37,351 | | 27,381 |
| 12/31/30 | 3,472,080 | 43,401 | 10,794 | 32,607 | 129.013% | 42,068 | 151 | 41,917 | 4,192 | 37,725 | | 26,592 |
| 12/31/31 | 3,498,165 | 43,727 | 10,794 | 32,933 | 129.013% | 42,488 | 153 | 42,335 | 4,234 | 38,101 | | 25,824 |
| 12/31/32 | 3,524,512 | 44,056 | 10,794 | 33,263 | 129.013% | 42,913 | 154 | 42,759 | 4,276 | 38,483 | | 25,080 |
| 12/31/33 | 3,551,122 | 44,389 | 10,794 | 33,595 | 129.013% | 43,342 | 156 | 43,186 | 4,319 | 38,867 | | 24,356 |
| 12/31/34 | 3,577,998 | 44,725 | 10,794 | 33,931 | 129.013% | 43,776 | 158 | 43,618 | 4,362 | 39,256 | | 23,653 |
| 12/31/35 | 3,605,143 | 45,064 | 10,794 | 34,271 | 129.013% | 44,213 | 159 | 44,054 | 4,405 | 39,649 | | 22,971 |
| 12/31/36 | 3,632,560 | 45,407 | 45,407 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/37 | 3,660,250 | 45,753 | 45,753 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/38 | 3,688,218 | 46,103 | 46,103 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/39 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/40 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/41 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/42 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/43 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/44 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/45 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/46 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/47 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/48 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| 12/31/49 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | | 0 |
| | | | | | | $502,602 | $1,809 | $500,793 | $50,080 | $450,713 | | $325,458 |

** election to delay receipt of first increment until up to 2024 (up to 4 years from approval date)*
*(1) Total estimated market value based on information provided by City Assessor ($51,196/unit incremental value)*
***preliminary and subject to further review. Includes 1% annual market value inflator***
*(2) Total net tax capacity based on residential rental class rate of 1.25%*
*(3) Original net tax capacity based on 2020/2021 existing property value*
*(4) Total local combined tax rate available for taxes payable 2021*

## Projected Tax Increment Report

**City of Marshall**
**Tax Increment Financing (Housing) District No. 6-1**
**Suite Liv'n Proposed 48-Unit Housing Project**
**TIF Revenues - 15 Years**

| Annual Period Ending (1) | Total Market Value [(1)] (2) | Total Net Tax Capacity [(2)] (3) | Less: Original Net Tax Capacity [(3)] (4) | Retained Captured Net Tax Capacity (5) | Times: Tax Capacity Rate [(4)] (6) | Annual Gross Tax Increment (7) | Less: State Aud. Deduction 0.360% (8) | Subtotal Net Tax Increment (9) | Less: Admin. Retainage 10.00% (10) | Annual Net Revenue (11) | P.V. Annual Net Rev. To 02/01/22 4.00% |
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| 12/31/23 | 863,500 | 10,794 | 10,794 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/24 | 3,320,900 | 41,511 | 10,794 | 30,718 | 129.013% | 39,630 | 143 | 39,487 | 3,949 | 35,538 | 31,697 |
| 12/31/25 | 3,345,474 | 41,818 | 10,794 | 31,025 | 129.013% | 40,026 | 144 | 39,882 | 3,988 | 35,894 * | 30,783 |
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| 12/31/31 | 3,498,165 | 43,727 | 10,794 | 32,933 | 129.013% | 42,488 | 153 | 42,335 | 4,234 | 38,101 | 25,824 |
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| 12/31/33 | 3,551,122 | 44,389 | 10,794 | 33,595 | 129.013% | 43,342 | 156 | 43,186 | 4,319 | 38,867 | 24,356 |
| 12/31/34 | 3,577,998 | 44,725 | 10,794 | 33,931 | 129.013% | 43,776 | 158 | 43,618 | 4,362 | 39,256 | 23,653 |
| 12/31/35 | 3,605,143 | 45,064 | 10,794 | 34,271 | 129.013% | 44,213 | 159 | 44,054 | 4,405 | 39,649 | 22,971 |
| 12/31/36 | 3,632,560 | 45,407 | 10,794 | 34,613 | 129.013% | 44,656 | 161 | 44,495 | 4,450 | 40,045 | 22,308 |
| 12/31/37 | 3,660,250 | 45,753 | 10,794 | 34,959 | 129.013% | 45,102 | 162 | 44,940 | 4,494 | 40,446 | 21,665 |
| 12/31/38 | 3,688,218 | 46,103 | 10,794 | 35,309 | 129.013% | 45,553 | 164 | 45,389 | 4,539 | 40,850 | 21,040 |
| 12/31/39 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/40 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/41 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/42 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/43 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/44 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/45 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/46 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/47 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/48 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| 12/31/49 | 863,500 | 0 | 0 | 0 | 129.013% | 0 | 0 | 0 | 0 | 0 | 0 |
| | | | | | | $637,913 | $2,296 | $635,617 | $63,563 | $572,054 | $390,471 |

** election to delay receipt of first increment until up to 2024 (up to 4 years from approval date)*
*(1) Total estimated market value based on information provided by City Assessor ($51,196/unit incremental value)*
***preliminary and subject to further review. Includes 1% annual market value inflator***
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