SHOW ME THE MONEY – Public Tools to Leverage Private Investment

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University of Arizona
Outline

- The Private Sector Calculus
- Goals of the Public Sector
- Public Tools to Leverage Private Investment
- Public Decision Making Criteria
Foundations of Real Estate Development Financing

A Guide to Public-Private Partnerships

ARTHUR C. NELSON
The Private Investor Calculus

- The Goal of real estate investment is to make money
- Not just $1 more than invested but more than alternative investments such as CDs, Index funds, the stock market
- Plus compensation for the sleepless nights, insane hoops, NIMBYs, etc.
- How much is needed?
Very Simplistic Return Targets

- 10%+ annual equity dividend rate aka *cash-on cash*
- $100,000 investment = $10,000+ annual cash
- 12% average annual return on total project cost aka *unleveraged return*
- 25% before-tax average annual return on equity aka *leveraged return*
Before-Tax Analysis

- Does not consider
  - Federal and state ordinary income and capital gains taxes
  - Depreciation
- The “public” in public private deals usually focus on unleveraged return and before tax leveraged return.
What is *Total* Return?

- Before Tax Cash Flow (BTCF) = Rent
  - Less vacancy and bad debts
  - Less operating expenses
  - Less real estate taxes
  - Less debt service

  **Annual**

- + Net sales price (NSP) = Sale price
  - Less outstanding debt
  - Less real estate commission & closing costs

  **At Sale**
How do we Know Return in Advance?

- Discounted Cash Flow (DCF) Analysis
- Annual BTCF discounted to the present using the target investment return →
  - Unleveraged @ 12%
  - Leveraged @ 25%
- Net sales price based on projected value discounted to present using same targets
How do we Know Value in Advance?

- Value = \textbf{Net Operating Income (NOI)} \\
  \textbf{Capitalization Rate (R)}

- NOI = Net rent less operating costs and real estate taxes (excludes debt service)

- R or “cap rate” = Estimate of value based on NOI, derived from sales prices

- A “cap rate” of 10% means project is worth less than when the cap rate is 5%

- Example …
Value with Different Cap Rates

- NOI = $1,000,000 @ 10% Cap Rate =
  $1,000,000 / 10% = $10,000,000

- NOI = $1,000,000 @ 5% Cap Rate =
  $1,000,000 / 5% = $20,000,000
## Downtown Retail Project Costs

<table>
<thead>
<tr>
<th>Development Costs</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard Costs</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Soft Costs</td>
<td></td>
</tr>
<tr>
<td>Design Fees</td>
<td>$500,000</td>
</tr>
<tr>
<td>Permit Fees</td>
<td>$500,000</td>
</tr>
<tr>
<td>Impact Fees</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Construction Fees</td>
<td>$500,000</td>
</tr>
<tr>
<td>Marketing Fees</td>
<td>$250,000</td>
</tr>
<tr>
<td>Total Soft Costs</td>
<td>$2,750,000</td>
</tr>
<tr>
<td>Land Cost</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Total Development Costs</td>
<td>$9,750,000</td>
</tr>
<tr>
<td>Total Development Offsets</td>
<td>$0</td>
</tr>
<tr>
<td>Total Project Cost</td>
<td><strong>$9,750,000</strong></td>
</tr>
</tbody>
</table>
# Downtown Retail NOI

<table>
<thead>
<tr>
<th>Step</th>
<th>Parameter</th>
<th>Figure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total project size, square feet</td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>Projected Sales</td>
<td></td>
<td>$14,000,000</td>
</tr>
<tr>
<td>Base Rental Income</td>
<td>$11.00/sq.ft.</td>
<td>$385,000</td>
</tr>
<tr>
<td>Rental Income from Sales Assessment</td>
<td>5.00%</td>
<td>$700,000</td>
</tr>
<tr>
<td>Gross Scheduled Income (GSI)</td>
<td></td>
<td>$1,085,000</td>
</tr>
<tr>
<td>Miscellaneous Income</td>
<td>5.00%</td>
<td>$54,250</td>
</tr>
<tr>
<td>Potential Gross Income (PGI)</td>
<td></td>
<td>$1,139,250</td>
</tr>
<tr>
<td>Less: Vacancy</td>
<td>7.50%</td>
<td>$85,444</td>
</tr>
<tr>
<td>Less: Concessions, Bad Debt</td>
<td>2.50%</td>
<td>$28,481</td>
</tr>
<tr>
<td>Effective Gross Income (EGI)</td>
<td></td>
<td>$1,025,325</td>
</tr>
<tr>
<td>Less: Operating Costs/unit</td>
<td>$7.00</td>
<td>$245,000</td>
</tr>
<tr>
<td><strong>Net Operating Income</strong></td>
<td></td>
<td><strong>$780,325</strong></td>
</tr>
<tr>
<td><strong>Going in Capitalization Rate</strong> = $780,325 / $9,750,000 =</td>
<td></td>
<td><strong>8.00%</strong></td>
</tr>
</tbody>
</table>
Investment Assumptions

- 10 year investment period
- Rent and expense escalation @ 3%/year
- Terminal cap rate @ 8.00%
- Sales expense @ 5.00%
- Loan to value ratio @ 60%
- Loan rate @ 5.00%, 30-year amortization
- Loan due in 10 years
## Base Case Return Analysis

<table>
<thead>
<tr>
<th>Performance Indicator</th>
<th>Target</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash-on-Cash After Year 3</td>
<td>10.00%</td>
<td>11.44%</td>
</tr>
<tr>
<td>Return on Project Cost (Unleveraged Return)</td>
<td>12.00%</td>
<td>10.35%</td>
</tr>
<tr>
<td>Return on Investor Equity (Leveraged Return)</td>
<td>25.00%</td>
<td>16.33%</td>
</tr>
</tbody>
</table>

### Investor decision analysis
- Cash-on-cash = yes
- Unleveraged return = no
- Leveraged return = no
Goals of the Public Sector

- Revitalize areas
  - Jump-start revitalization sooner than the market
- Attract targeted development
- Utilize excess public facility capacity
- Expand the tax base in the long term
- Generate new tax, fee, utility, related revenue
- Create synergistic outcomes
  - Incentivizing development in one place may stimulate collateral development elsewhere
Public Tools to Leverage Private Investment

- Administrative ➔ Expedited review/permits
- Land use/regulatory ➔ Fix zoning to meet current realities
- Low-cost ➔ Fee waivers and abatement
- Allies ➔ Grants for buildings, land, soft costs
- Tax authority ➔ G.O. bonds; revenue bonds
  - Special case of tax increment financing (TIF)
- Partnership ➔ low interest loans; equity positions
Building Write-Downs/Grants

- Sometimes publicly-owned buildings may be transferred to the private sector for rehab, redevelopment.
  - Abandoned schools common.

- Building construction may be facilitated with a development grant.
  - Common in exchange for public-use components of the land or building

- Grants often from CDBG, economic development funds, state/federal grants.
Land Write-Downs/Grants

- Publicly-owned, acquired land sold below value.
  - Post-Kelo concerns may result in long-term land leases.

- Tax foreclosed land may be assembled with gaps filled in through targeted acquisition creating developable sites at little public cost.

- Trades of land possible resulting in development where desired in exchange for land for other public uses.

- Suppose the City owns the land and is willing to “write down” $1 million of the $2 million value.
Soft-Cost Write-Downs/Grants

- Advance planning and feasibility analysis
- Engineering and design
- Entitlements
- Bridge construction loans
- Funding from nonprofits, foundations, CDBG, community redevelopment agencies, community reinvestment act funds, etc.
Fee Waivers

- Application and Inspection Fees
- Connection Fees
- Impact Fees
- Fees may be waived from other funds
  - CDBG
  - Economic development pools
  - Bond arbitrage revenues
  - Federal, state economic development grants
- Suppose impact fees are reduced by $500,000 because downtown traffic generation is lower.
Return Analysis with Land Write Down and Fee Reduction

<table>
<thead>
<tr>
<th>Performance Indicator</th>
<th>Target</th>
<th>Base</th>
<th>Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash-on-Cash After Year 3</td>
<td>10.00%</td>
<td>11.44%</td>
<td>15.27%</td>
</tr>
<tr>
<td>Return on Project Cost (Unleveraged Return)</td>
<td>12.00%</td>
<td>10.35%</td>
<td>12.96%</td>
</tr>
<tr>
<td>Return on Investor Equity (Leveraged Return)</td>
<td>25.00%</td>
<td>16.33%</td>
<td>21.26%</td>
</tr>
</tbody>
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**Investor decision analysis**
- Cash-on-cash = yes
- Unleveraged return = yes
- Leveraged return = no
Tax Abatement

- Reducing (usually) property taxes over a fixed period of time and amounts.
- Applicable only to the abating jurisdiction ➔
  - Cities cannot abate taxes to school districts
- Results in lower revenues than would be received over the abatement period
- But if abatement stimulates development then new taxes flow after the abatement period.
- Attractive when new development imposes little or no marginal cost.
Arizona Application

- Government Property Lease Excise Tax (GPLET) →
  - Government takes ownership for up to 8 years.
  - As government property it exempt from all property taxation jurisdictions.
- All property taxes abated over 8 years.
- However: In most of nation, only the city-share of property taxes abated: ~25%.
# Return Analysis with Property Tax Abatement

<table>
<thead>
<tr>
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<th>Leverage</th>
</tr>
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<tbody>
<tr>
<td>Cash-on-Cash After Year 3</td>
<td>10.00%</td>
<td>11.44%</td>
<td>13.56%</td>
</tr>
<tr>
<td>Return on Project Cost (Unleveraged Return)</td>
<td>12.00%</td>
<td>10.35%</td>
<td>11.06%</td>
</tr>
<tr>
<td>Return on Investor Equity (Leveraged Return)</td>
<td>25.00%</td>
<td>16.33%</td>
<td>17.93%</td>
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**Investor decision analysis**

- Cash-on-cash = yes
- Unleveraged return = no
- Leveraged return = no
Variations

- Sales taxes may be pledged instead of incremental property taxes.
- Utilities do variations of this already through reductions in utility connection charges in exchange for system improvements.
- Need not bond anything but merely pledge incremental revenue for improvements on a pay-as-you-go basis.
- Reduces costs and risks often with similar outcomes.
Downsides of Abatement

- Reduced revenue in face of increased needs created by new development.
- Favoritism concerns.
- Sometimes helps those who need it least.
- Long-term abatements can backfire if targeted investment becomes vacant eventually.
Upsides of Abatement

- New development is stimulated.
- Infrastructure often at excess capacity, especially schools; low to “zero” marginal cost to serve new development.
- Other revenues generated such as sales taxes, property taxes, state revenue-sharing transfers, CDBG revenues, etc.
- Collateral development may be induced outside abatement areas thereby increasing/offsetting abated taxes.
Low Interest “Mezzanine” Financing

- Typical L/V ratio is 70-75%. (In this case 60% LTV.)
- Equity investors need →
  - About 12%-15% “unleveraged” rate-of-return.
  - About 25%-30% “leveraged” before tax ROR.
  - The higher the equity the lower financial feasibility.
- Public sector may provide “bridge,” “gap”, “soft second”, or “mezzanine” financing.
  - 10-20% of cost; Commercial bank in “First” position.
  - Below market rate.
- Suppose 20% low-interest loan @ 3.00%, amortized @ 30 years w/10 year call. Equity cut 40% to 20%.
Return Analysis with Low-Interest Loan

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**Investor decision analysis**
- Cash-on-cash = yes
- Unleveraged return = no
- Leveraged return = yes
Advantages, Thoughts

- Return to local government is as low as public borrowing rate (3-4%) plus it stimulates new tax revenue from development and collateral development.

- Can take the place of abatements, write-downs so public merely finances costs.

- Can sometimes be used to create a “position” in the equity distribution when project sold or refinanced in later years.

- Local government seen as “business-like.”
Potential Solution

- $500,000 impact fee waiver based on analysis or other party paying the fee
- GPLET 8-year 100% property tax abatement
- 15% low-interest loan @ 3.00% amortized @ 30 years with 10-year call.
## Return Analysis with Fee Waiver, Tax Abatement, Low-Interest Loan

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<td>20.67%</td>
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<tr>
<td>Return on Project Cost (Unleveraged Return)</td>
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<td>10.35%</td>
<td>11.89%</td>
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### Investor decision analysis

- Cash-on-cash = yes
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- Leveraged return = yes
Nelson’s Guide to Choosing Tools

- Provide only what is needed to make a deal work based on reasonable ROR.
- Provide the mix of public financing tools that
  - *Minimizes* taxpayer exposure to losses
  - *Maximizes* private investment
- Take a long view.
- Attempt to covert public financial support into an equity position →
  - *Patient equity.*