Memo

To:	Erik Thorvig and Joe Huss, City of Blaine
From:	Mikaela Huot, Director
Date:	August 29, 2022
Subject:	Financial Needs Analysis for proposed Tax Increment Financing Redevelopment (TIF) District and Request for Financial Assistance

Executive Summary

The City of Blaine received a preliminary request for financial assistance through Tax Increment Financing (TIF) to assist with financing redevelopment of the former Rainbow Village retail center through the offset of a portion of the costs necessary for redevelopment of the site and subsequent construction of 220 units of rental housing units. As part of the project the developer is proposing that all units will be market rate and the incomes as proposed in the project proforma are targeted towards occupants with incomes in the range of 70-80% area median income as applicable for the City of Blaine and Anoka County (Minneapolis-St. Paul-Bloomington, MN-WI HUD Metro FMR Area). The developer's updated financial information includes a revised tax increment level of assistance that is approximately $7.5 million over the maximum 26-year term of a redevelopment TIF district.

Prior to establishing 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). When reviewing requests for financial assistance it is important to understand how the level of financial assistance would impact the ability of the project to proceed as proposed and maximize new value created on the current project site.

The purpose of this memorandum is to provide a summary of Baker Tilly's review of the preliminary development project costs, operating pro forma and other financial information as provided by the developer to assist the City with making a determination 1) if the project as proposed would be unlikely to proceed "but-for" the requested Tax Increment Financing (TIF) assistance, and 2) if assistance was necessary, to determine an appropriate level of public assistance that could be considered.

The developer has identified approximately $8.38M of potential TIF-eligible expenditures related to redevelopment of the project site. The original total development project budget as presented in fall of 2021 was approximately $48 million and has increased to $53.6M to reflect an increase primarily in acquisition and construction costs. A breakdown of the total sources and uses (development costs) is included in Table 1a (original) and 1b (updated) and the list of potential TIF-eligible expenditures is included in Table 2 all on the following two pages.

Financial analysis of the project based on the developer's submitted information has resulted in the determination that public assistance through tax increment financing is necessary for the project to proceed as proposed. This determination is based on results of the projected financial performance of the project that includes estimated developer equity returns and debt coverage ratios that have calculated at below-market levels without any level of public assistance. With public assistance, the equity returns and debt coverage metrics are projected to increase. The level and amounts of public assistance will ultimately dictate the projected developer private financing and equity returns. However, the project is being proposed as all market rate with current rent levels estimated to be below market (closer to 70% AMI). Adjusting the rents closer to the 80% AMI levels for all unit types (studio, 1, 2 and 3-bedroom units) is projected to result in revenue increases that would offset the need for and level of public assistance. Additional discussion as to the viability of rent increases is recommended with the applicant, which may impact the level of public assistance that is required for the project.

Developer Request for Assistance

The developer has requested assistance that includes 90% of incremental revenues for up to 26 years related to redevelopment of the project site to support approximately $7.5M in TIF eligible costs. The preliminary request includes an approximate $53.6 million project funded through a combination of private debt and equity and public assistance through TIF. A summary of the sources and uses of funds is illustrated in Tables 1a (original) and 1b (updated) below.

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. Tax increment financing from the City provides an additional funding source to the project that allows the developer to obtain an appropriate level of upfront funding and meet minimum debt coverage and return metrics.

Table 1a: Original Sources and Uses of Funds (October 2021)

Sources	Amount	Uses	Amount
First Mortgage	$28,432,090	Acquisition	$2,500,000
Equity	$13,130,761	Construction	$36,300,000
		Construction Mgmt.	$143,000
TIF	$7,225,000	SAC/WAC	$1,000,000
		Carried Equity	$1,265,723
		Investor Pref Return	$530,064
		Developer Fee	$965,790
		Construction Loan Interest	$1,335,357
		Contingencies	$1,527,000
		Soft Costs	$3,220,917
Total	$48,787,851	Total	$48,787,851

Tax increment financing has been requested as pay-as-you-go and would not be an upfront funding source. Developer would obtain separate TIF Note supported by City Paygo TIF Note of $8.38M that would result in estimated available TIF proceeds amount of approximately $7,225,000

Table 1b: Updated Sources and Uses of Funds (July 2022)

Sources	Amount	Uses	Amount
First Mortgage	$36,208,300	Acquisition	$4,000,000
Equity	$,929,209	Construction	$38,170,000
		Construction Mgmt.	$143,000
TIF	$7,500,000	SAC/WAC	$1,000,000
		Carried Equity	$1,265,723
		Investor Pref Return	$332,748
		Developer Fee	$1,438,302
		Construction Loan Interest	$2,404,649
		Contingencies	$1,601,800
		Soft Costs	$3,281,974
Total	$53,637,509	Total	$53,637,509

Tax increment financing has been requested as pay-as-you-go and would not be an upfront funding source. Developer would obtain separate TIF Note supported by City Paygo TIF Note that would result in estimated available TIF proceeds amount of approximately $7,500,000

Table 2: Estimated Total TIF Eligible Costs

	Eligible
City Streets	$150,000
Public Trails, Sidewalks, Pedestrian Improvements	$125,000
Site Improvements	
Acquisition	$4,000,000
Environmental Remediation	$950,000
Demolition	$500,000
Tenant Relocation	$475,000
Landscaping and Screening	$350,000
Trails and Pedestrian Improvements	$225,000
Grading and Import/Export Soil	$1,400,000
Retaining Wall and Fences	$75,000
Private Streets	$375,000
Park Improvements	$225,000
Storm Sewer and Stormwater Elements	$450,000
Interest on Eligible Costs	$480,000
Total	$9,780,000

Extraordinary Costs (range)	$5.8M - $7.5M

The range of public assistance is in part based on the financial parameters as further outlined below while considering what an appropriate level of public assistance may be for a redevelopment project while balancing the level of extraordinary costs and financial cash flow performance of the project and public policy guidelines. Considered parameters include the following:

- Return on Investment: *(City benefits)*
- Purchase price and other development costs: *(reasonable ranges and supported by project)*
- Public to private investment: *(public participation within 10% or less)*
- Public assistance (TIF) and private equity: *(public does not exceed private equity)*
- Extraordinary costs: *(as opposed to 'greenfield' or market)*
- Financial gap: *(limit on private debt and equity)*
- Term of collection (district): *(less than maximum term)*
- Other necessary public improvements: *(case by case basis to be determined)*

<u>Background Project Summary and Qualifications</u>
Tax increment financing is a tool the City may consider using to support financial assistance for the project, subject to meeting the but-for test and need for public financial participation as described throughout this memo. Providing financial assistance through tax increment financing would require the City to consider the establishment of a Tax Increment Financing District. A blight inspection confirming qualification of the building as substandard for inclusion in a Tax Increment Financing Redevelopment District would need to be completed to provide the basis for which a district could be established. The City retained the services of LHB to perform an analysis of the property proposed to be redeveloped and received confirmation that the project site does qualify for inclusion within a Redevelopment TIF District.

<u>Tax Increment Revenue Assumptions</u>
Tax increment revenues are generated by the incremental value created from redevelopment of the project site. A TIF District created by the City captures the incremental revenues to finance the extraordinary and TIF-eligible costs of the project. The City is also able to use a portion of the incremental taxes generated by the project to finance costs outside the TIF District and within the Project Area (referred to as 'pooling') on certain redevelopment-eligible activities. To illustrate the potential funds available for qualifying pooling activities, we are providing 2 alternate revenues scenarios in the charts on the following page.

To calculate the estimated tax increments, certain assumptions are used based on the value of the project, construction schedule, and anticipated financing terms as outlined below.

- Total existing value of $7,340,600
  - Parcel ID: 31-31-23.31-0016
  - Portion included within district (*estimated 33%*)
    - $2,444,420
  - Base value as of Jan. 1, 2022
  - Original net tax capacity (ONTC) of $30,555
  - Assuming re-classification as residential rental (from commercial-industrial)
    - Rental classification is 1.25%
- Estimated total market value upon completion
  - Range of $190,000 - $210,000 per unit – based on City and County comparable projects
  - Total taxable value range of $41,800,000 - $46,200,000
  - 220 new units
  - $46,200,000 assumed new taxable value of project upon completion
- Classification for all units as rental
  - Rental class rate (1.25% per unit)
- Incremental value based on difference between existing and new land/building value
- Construction commences in 2023 and is completed in 2024
  - Project values 100% complete for assess 2025 and taxes payable 2026
- First increment collected in 2025
  - Election to delay first increment by up to 4 years
- Net present value (discount) rate of 4%
- 2% annual market value inflation

Table 3a: Tax Increment Revenue Estimates – Reduced TIF District Term (15 and 20 years)

Tax Increment Revenue Estimates – General Assumptions	
Existing 'Base' Value	$2,444,420
Estimated Total Taxable Value	$46,200,000
Annual Market Value Inflator	*2%*
Estimated Annual Increment (full buildout 2024)	$571,933
Estimated Annual Property Taxes (Year 1 Full Buildout)	*$736,020*

Tax Increment Revenue Estimates – Reduced TIF District Term of 15 Years	
Estimated total available gross tax increment (15 years)	$9,462,184
City retainage (10%)	$946,218
Net amount available for development (90%)	$8,515,966
Estimated Net Proceeds to Developer over 15 Years (Present Value/Interest Rate of 4%)	*$5,823,005*

Tax Increment Revenue Estimates – Reduced TIF District Term of 20 Years	
Estimated total available gross tax increment (20 years)	$13,447,833
City retainage (10%)	$1,344,784
Net amount available for development (90%)	$12,103,049
Estimated Net Proceeds to Developer over 20 Years (Present Value/Interest Rate of 4%)	*$7,497,862*

The scenarios illustrated in the above chart results in a limited term and potential level of assistance provided to the developer and amount retained by the City through the reduced term of the district (15 and 20 years, respectively, to result in estimated net proceeds of approximately $5.8M and $7.497M for the redevelopment project). An alternative option would be to maximize the use of ‘pooling’ dollars – whereby the City retains the maximum allowable amount (up to 25%) for eligible and qualifying redevelopment projects and expenses within the Project Area. The chart below illustrates the maximum amount of increment that could be available for both the development and City ‘pooling’ uses that include qualifying redevelopment projects and uses:

Table 3b: Tax Increment Revenue Estimates – Maximum TIF District Term (26 years)

Tax Increment Revenue Estimates – Maximum Pooling Option and Full 26 Year Term of TIF District	
Estimated total available gross tax increment (26 years)	$18,803,552
City retainage (25%)	$4,700,890
Net amount available for development (75%)	**$14,102,662**
Estimated Net Proceeds to Developer over 26 Years with Pooling (Present Value/Interest Rate of 4%)	*$7,759,762*

<u>Financial Needs (Pro forma Analysis) including But-For</u>

Upon approval of a TIF district and project, the City must make several findings, including the “but for” test: that the proposed redevelopment 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 project received financial assistance as pay-as-you-go (reimbursement for TIF eligible costs) and showing a result if the project did not receive assistance. Our analysis of the proformas include 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 in need of 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 investor 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 a reduced level of equity participation and/or increased cash flow to be feasible. 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.

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 impacts on performance and what a required level of assistance (number of years and total amounts) may be. Below is a summary of the financial assumptions related to the operating proforma:

1) 2.5% annual revenue inflator
2) 3% annual expense inflator
3) 5% vacancy rate
4) 37% operating expense ratio
5) 220 rental units average $1.96/SF rent (mix of studio, 1, 2- and 3-bedroom units)
6) Parking, storage units and other misc. income

To understand viability of the project and need for an appropriate level of public assistance, we provided a sensitivity analysis to the proformas with adjustments made to the total project costs (including land/building acquisition, construction costs, soft costs, developer and other related construction management fees and contingency) and corresponding funding sources, as well as projected annual lease rates and operating expenses. Realizing any adjustments are all subject to market conditions. The purpose of the sensitivity analysis is to test the level of assistance that may be needed using those assumptions to understand if the recommended level of assistance could be consistent with the City's objectives resulting in less assistance than what has been requested. The below table is a summary of the projected performance of the project based on current assumptions:

Table 4: Estimated Developer Returns

Projected Performance Metrics *	Calc without Assistance	Developer with Assistance	Calc Modified with Assistance (1)
Average Cash-on-Cash	>1%	7.3%	8%+
Debt Coverage Ratio	>1.0x	1.2x	1.2x+
10-Year IRR	2.36%	12.3%	15%+

** calculated using stabilized net operating income and net project costs financed by the developer*
(1) subject to assumptions relative to viability of increases to the level of potential rent increases

<u>Conclusion</u>
The developer has requested financial assistance related to redevelopment of the existing retail center and subsequent construction of 220 units of apartment units, of which all would be affordable below 80% median income. Through submission of the tax increment financing request and supporting financial information, the developer has indicated that the project would not occur as proposed without financial assistance from the City due to below market rates of return.

Based on the financial analysis and available financing assumptions, without financial assistance, the project would not appear to be feasible. Without assistance, the projected annual and cumulative rate of return is below industry standards for this type of project. 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. With annual public assistance the project is projected to achieve marketable returns. There are ranges of what would be considered market returns and are generally subject to the project type, market indicators, investor demands and financing structure. The level of public assistance is expected to have an impact on what the projected returns for the project could be.

Considered parameters for level of public assistance include the following:
- Return on Investment: *(City benefits)*
- Purchase price and other development costs: *(reasonable ranges and supported by project)*

- Public to private investment: *(public participation within 10% or less)*
- Public assistance (TIF) and private equity: *(public does not exceed private equity)*
- Extraordinary costs: *(as opposed to 'greenfield' or market)*
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- Other necessary public improvements: *(case by case basis to be determined)*

Extraordinary Costs (range)	$5.8M - $7.5M

The developer has requested tax increment financing from the City as a method of providing additional cash flow revenues required to achieve financial feasibility. The request is for 90% of the tax increments generated over the maximum 26-year term of the TIF District. The project will be privately financed through debt and equity and the increment would provide additional annual revenues to support a secondary TIF mortgage, enhance cash flow and increase the developer's return. 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, as well as identifying those costs considered TIF-eligible as extraordinary to the project.

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