



But-For Determination Report

Parkville, Missouri

Six at Park Office Development

April 11, 2018 – Revised April 23, 2018

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Mission Statement

Springsted provides high quality, independent financial and management advisory services to public and non-profit organizations, and works with them in the long-term process of building their communities on a fiscally sound and well-managed basis.

1. Purpose

The City of Parkville has retained Springsted to review the proposed Six at Park Development Plan. The proposal is to develop a four-story commercial building on an approximately 2.64 acre lot. The lot is on the south side of east Six Street and east of Highway Nine/ East Street. The Developer is proposing the development of approximately 47,500 square feet of commercial facilities with an adjacent parking lot. Additionally, the Developer will be undertaking necessary onsite and public infrastructure improvements.

The City has requested this analysis to determine the need for the requested assistance, based on the cost and operating pro forma information provided by the Developer. The analysis that follows examines whether the proposed redevelopment scenario would reasonably be anticipated to be developed without adoption of the requested financial assistance.

We have approached this determination based on the proposed 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 development 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. This analysis is termed the Internal Rate of Return ("IRR"). The final determination is based on whether or not a potential IRR is reasonable without the requested subsidy, within the current marketplace and at the present time.

The Developer (Foutch Brothers) has requested assistance in the following forms:

-Chapter 353 Tax Abatement – Property tax abatement over a period of 15-years. The abatement request would be on a sliding scale as illustrated below:

Table A

Abatement Years:	1-3	4-6	7-9	10-12	13-15
Abatement %	100%	90%	80%	70%	50%

The Net Present Value (NPV) of the requested total abatement assistance is approximately \$1,308,463 based on a 5% interest rate.

-Parkville Old Towne Community Improvement District (CID)

Contribution – The Developer is seeking a contribution of \$350,000 from the CID for capital expenses related to the construction of the new parking lot.

-City Parking Lot Ground Lease Contribution – The Developer is seeking City participation via the City entering into a ground lease for the leasing of the parking lot site from Park University. The proposed ground lease would be 99-

years, with an annual payment of \$22,041 for the first 25-years of the lease, followed by an annual lease payment of \$1 for the remaining 75-year term of the lease. The total amount of payments proposed to be made over the lifetime of the lease is \$551,099. The estimated NPV of the ground lease payments is \$353,608 based on an interest rate of 3.75%.

-Chapter 100 Sales Tax Exemption – The City and the Developer have agreed that the Developer will seek a sales tax exemption on construction materials through the use of Chapter 100. This sales tax exemption is anticipated to result in an approximate project costs savings to the Developer of \$200,000, which they would in turn contribute to the City in the form of a capital contribution. It is anticipated that the City will use the proceeds from the capital contribution to reduce their out of pocket contribution to the Parking Lot Ground Lease payment described above.

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 B, below, details the significant findings of the sensitivity analysis:

Table B

Without Assistance Sensitivity Analysis	Change Necessary to be Feasible	Rate of Return without Assistance
Decreased Costs	21% Decrease	6.42%
Increased Revenue	27% Increase	6.47%
Combined Cost and Revenue Changes	12% Decreased Costs 12% Increase Rev	6.50%

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 *Korpacz/Price Waterhouse Cooper Real Estate Investor Survey* the current range of unleveraged market returns for a project of this nature is 6.00% to 12.00%, with an average of 8.34% which we used as our feasibility benchmark. Absent the changes outlined above, the projects would not attract a return sufficient to exceed the industry's threshold for investment and would not likely be completed through private enterprise alone.

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

Table C

Pro Forma	With Full Assistance Request	Without Assistance
Unleveraged	6.39%	3.91%

3. The Project

The Developer is proposing the development of an approximately 47,500 square foot office building with an adjacent parking lot. The lot is an approximately 2.64 acre property located on the south side of east Six Street and east of Highway Nine/ East Street. Construction of the development is projected to commence in the summer of 2018 and be completed early summer of 2019.

The total cost of the project is detailed in Table D, below.

Table D

Costs Category	Total Cost	% of Total Project Costs
Building Construction	\$4,899,010	51.4%
Parking Lot Construction	350,000	3.7%
Site Improvements	199,500	2.1%
Furnishing, Fixtures, & Equipment	1,360,000	14.3%
Permits, Fees & Overhead	700,851	7.4%
Contingency	325,426	3.4%
Soft Costs	1,692,948	17.8%
Total	\$9,527,735	100.0%

Acquisition

There is no cost of land acquisition for this project. The land will be leased from Park University for ninety-nine years through a ground lease at a rate of approximately \$22,041 per year.

Hard Costs

We have taken the project cost information submitted by the Developer and grouped the following line-items together under the hard cost heading, which are outlined in Table E below.

Table E

Total Hard Costs	Total Cost	% of Total Project Costs
Building Construction	\$4,899,010	51.42%
Parking lot construction	350,000	3.67%
Site Improvements	199,500	2.09%
Furnishing, Fixtures, & Equipment	1,360,000	14.27%
Permits & Fees	50,000	0.52%
Overhead	650,851	6.83%
Contingency	325,426	3.42%
Total	\$7,834,787	82.2%

The Developer incurred costs categorized together under the hard cost heading total \$7,834,787 which equates to approximately 82.2% of the total project cost.

The Developer is anticipating constructing a commercial office building of approximately 47,412 square feet. The Developer's projected cost of constructing this building is \$4,899,010 which equates to a per square foot cost of \$103.33.

To provide a comparison, we compared the cost estimates to the *Marshall & Swift* for estimated construction costs for a mixed retail with office units. The *Marshall & Swifts* data provides a range of cost estimates for the construction of vertical building improvements. The *Marshall & Swift* estimate range for this type of building ranges from \$101.52 to \$118.90 depending on construction type, with an average of \$108.92. The Developer's estimate of \$103.33 appears reasonable based on this comparison.

Tenant Finishes and Furnishings, Fixtures, and Equipment (FF&E) comprise \$1,360,000 and 14.3% of the total project cost. This cost equates to \$28.68 per square foot. To provide a cost comparison, we compared these estimates to the *2016/17 North America Fit-Out Cost Guide* from US Commercial Real Estate Services. According to their research, office FF&E costs an average of \$22.73 per square foot in the Kansas City market. While the Developer's costs are on the upper end of the estimate, they appear to be within reason when combined with below average costs for the vertical improvements.

The remaining Hard Costs include expenses related to improvement of the site, the extension of public utilities and street improvements adjacent to the site.

The total for all hard costs is \$7,834,787 which represents approximately 82.2% of the total project cost. 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 F below as Soft Costs:

Table F

Total Soft Costs	Total Cost	% of Total Project Costs
Architect/Design/Engineering	748,479	7.86%
Construction Interest	261,968	2.75%

Financing Fees	74,848	0.79%
Survey	8,000	0.08%
GP Legal	25,000	0.26%
Appraisal	8,000	0.08%
Construction Taxes & Accounting	30,000	0.31%
Environmental	10,000	0.10%
Title	25,000	0.26%
Lease Up Reserve	50,000	0.52%
Developer Fee	451,654	4.74%
Total	\$1,692,948	17.8%

The total amount of the costs categories grouped under the soft cost heading totals \$1,692,948, which equates to approximately 17.8% of the total development costs.

Reviewing the soft cost categories for largest percentage of the total project costs to smallest, the largest soft cost line-item is the Architect/ Design/ Engineering of \$784,749. The cost estimate equates to approximately 7.86% of the total project costs, which is a reasonable percentage for this project.

The next largest soft cost line-item is the Development Fee of \$451,654. This cost estimate equates to approximately 4.74%, which is a reasonable basis for the Development fee.

The third largest soft cost line-item is the Construction Interest at \$261,968. This cost includes permanent loan fees and construction loan fees. This cost equates to 2.75% of the Developer's total cost estimate.

The remaining soft cost line-items greater than 0.5% of the total project cost are the Financing Fee estimate of \$74,848 and Lease up Reserve of \$50,000. No basis for how these cost estimates were derived was provided. However, these estimates equate to approximately 0.79% and 0.52% of the anticipated project amount respectively, which is a reasonable amount.

The other remaining soft cost categories are all less than 1.0% of the total budget and, combined, equate to \$230,848 or 2.42% of the total project cost. Broadly, these categories include surveying, legal, appraisals, and testing of the site.

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.

4. Assistance Request

The Developer is requesting assistance from the following sources:

-Chapter 353 Tax Abatement – Property tax abatement over a period of 15-years. The abatement request would be on a sliding scale as illustrated below in Table G:

Table G

Abatement Years:	1-3	4-6	7-9	10-12	13-15
Abatement %:	100%	90%	80%	70%	50%
Average Debt Coverage Ratio:	1.20	1.20	1.21	1.21	1.18

The amount of tax abatement assistance, and the sliding scale outlined above, was based on the Developer's need to maintain a Debt Coverage Ratio (DCR) of approximately 1.20 in order to achieve project financing. When lenders review a project for financing one of the metrics analyzed is the rate at which project revenues are anticipated to exceed debt-service on the permanent financing; this is referred to as the Debt Coverage Ratio. A ratio of 1.20 is a typical standard necessary to achieve private financing and is an indication that for every dollar in debt-service the project has it is anticipated to generate 1.2 dollars in revenue to repay the debt-service. This coverage factor allows lenders to be confident in the project's ability to repay its financing.

Using the DCR metric of 1.20 as the level necessary for the Developer to achieve private financing we were able to structure the abatement on a sliding scale over a period of 15-years that allowed for the minimum amount of abatement necessary to achieve a 1.20 coverage ratio for the project. Table G above illustrates the sliding abatement scale and the corresponding impact on the DCR.

The Net Present Value (NPV) of the requested total abatement assistance is approximately \$1,308,464 based on a 5% interest rate.

The Developer has provided a post-development property tax estimate of \$154,121. This tax estimate equates to a post-development market value of approximately \$5,464,903, which they have assumed will increase at 1.5% biennially. The Developer has assumed a base level of taxes of approximately \$5,000 will be paid annually as a result of the property becoming taxable.

-Parkville Old Towne Community Improvement District (CID) Contribution – The Developer is seeking a contribution of \$350,000 from the CID for capital expenses related to the construction of the new parking lot.

-City Parking Lot Ground Lease Contribution – The Developer is seeking City participation via the City entering into a ground lease for the leasing of the parking lot site from Park University. The proposed ground lease would be 99-years, with an annual payment of \$22,041 for the first 25-years of the lease, followed by an annual lease payment of \$1 for the remaining 75-year term of the lease. The total amount of payments proposed to be made over the lifetime of the lease is \$551,099.

-Chapter 100 Sales Tax Exemption – The City and the Developer have agreed that the Developer will seek a sales tax exemption on construction materials through the use of Chapter 100. This sales tax exemption is anticipated to result in an approximate project costs savings to the Developer of \$200,000, which they would in turn contribute to the City in the form of a capital contribution. It is anticipated that the City will use the proceeds from the capital contribution to reduce their out of pocket contribution to the Parking Lot Ground Lease payment described above.

The Developer will be funding their portion of the Project costs through a mix of Developer equity and private debt, along with the contribution from the CID. The pro forma estimated an equity contribution of 20% of project costs, while the permanent debt portion is anticipated to equate to approximately 76% of total project costs. The remainder will be funded by the CID contribution. The Developer projected private financing terms of 5.6% interest over a term of 20 years. Table H provides the anticipated sources that will be utilized to fund the redevelopment project.

Table H

Sources:	
First Mortgage	\$7,272,188
CID Funds	\$350,000
Developer Private Debt	\$1,905,547
Total Sources	\$9,527,735

5. 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 a 15-year operating pro forma for the development based on a two-year build-out and lease up period, and operating revenue and expense assumptions. Utilizing the information provided in the Developer's operating pro forma we calculated an unleveraged internal rate of return (IRR) calculation based on 10-years of operation. We utilized their submitted pro forma as our baseline to estimate the potential return with and without the requested forms of 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.

Step One – Evaluate Project Costs:

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. In the following sensitivity analysis we examine the impact of cost savings on the projected rate of return without assistance.

Step Two – Evaluate Operating Pro Forma Assumptions:

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 projected average lease rates for the office components that will be constructed.

- The Developer has assumed a lease rate of \$23.00 per square foot for the office with the lease rate adjusting 1.0% for inflation each year.
- The Developer has assumed a 7.0% vacancy/unreimbursable expense allowance.

We reviewed *IRR Viewpoint Online* market information for Kansas City, which identified a projected lease rate for Class A suburban office lease rates of \$25.02 with an average vacancy of 13%. The net effective rate based on the 13% vacancy rate would equate to \$21.77. The Developer's assumption of \$23.00 psf and a 7.0% vacancy assumption equates to a net effective rate of \$21.39. Based on this review we feel the Developer's assumption is reasonable. The Developer's lease rate assumption as identified in their pro forma also ties out to their current online marketing of the potential new office space.

Step Three – Evaluate Hypothetical Sale Assumptions:

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. 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 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 take 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 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 has used a capitalization rate of 8.00% for the project to calculate the hypothetical sale value. The *IRR Viewpoint Online* market information identifies current cap rates for suburban Class A property of 8.00%, based on this we feel that the Developer's assumption is reasonable.

Springsted – Unleveraged Return Analysis:

Table I below, shows the Springsted calculation for the potential unleveraged Internal Rate of Return realized by the Developer based on varying levels of assistance.

Table I

Springsted 10-Year IRR Analysis	Unleveraged IRR
Without Assistance	3.91%
With City Land Lease Contribution	4.42%
With Land Lease & \$350,000 CID Contribution	4.93%
With Land Lease, CID Contribution, & Chpt 353 Abatement	6.39%

Market Return Benchmark:

The Developer's return was modified to be measured on an unleveraged IRR calculation in order to compare the potential return to the Developer to a third-party market source in the *Korpacz/Price Waterhouse Cooper Real Estate Investor Survey* prepared for the fourth quarter of 2017. The *Korpacz/Price Waterhouse Survey* provides a market comparison on which project feasibility can be judged.

To evaluate the rate of return a project of this nature would require to be considered “feasible” we consulted this survey as a resource to compare 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 to pursue a project of this nature falls in a range from 6.00% to 12.00%; with an average return of 8.34%.

Additionally, we consulted the *IRR Viewpoint Online* resource, which identified a target unleveraged rate of return of 8.5% for a suburban Class A office development.

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 Springsted Adjusted 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 use the Developer’s return with assistance of 6.39% as the benchmark for performing our sensitivity analysis. We utilized the Developer’s estimate as it provided a lower feasibility threshold than the average return of 8.34% from the *Korpacz/Price WaterHouse Cooper Real Estate Investor Survey, Fourth Quarter 2017*.

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 J illustrates the development would need to realize a 21% reduction in project costs in order to be feasible without assistance. Given a 21% reduction in costs the project would have a rate of return of 6.42%.

Table J

Project Costs Sensitivity	Reduction in Project Costs	Rate of Return without assistance
	21%	6.42%

To understand the impact of increased revenues, we have performed a sensitivity analysis to determine the rate at which project lease revenues would have to increase 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 27% increase in project revenues for the project to be feasible without assistance. Given a 27% increase in lease revenues, the project would have a rate of return of 6.47% which falls into the reasonable range.

Table K

Project Revenue Sensitivity	Increase in Project Revenue	Rate of Return without assistance
	27%	6.47%

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 L illustrates the development would need to realize a combined 12% decrease in project costs and a 12% 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 6.50%.

Table L

Combined Sensitivity	Reduction in Project Costs	Increased Project Revenues	Rate of Return without assistance
	12%	12%	6.50%

The three tables above (Tables J, K, and L) 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 6.39% 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.

6. "But For" Conclusion

The Developer is proposing the construction of an approximately 47,500 square foot commercial office building. In addition, the Developer will undertake onsite improvements necessary to develop the site.

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 demands a positive return with a comparable national market range of 6.00% to 12.00%, with an average of 8.34% as indicated in the *Korpacz/Price Waterhouse Cooper* study. As detailed above, the projected IRR to the Developer without assistance falls outside of the low-end of the range expected within the marketplace and significantly below the average return used as our feasibility benchmark. In comparison, the return with assistance is within the range, but slightly below the average return.

Additionally, a project's Debt Coverage Ratio can be utilized as a measure of project feasibility and the need for assistance. Absent any assistance the proposed project has an average DCR of 0.95 over the first 15-years of the development. This DCR indicates that the net operating income, after inclusion of the full property tax amount and land lease, would be insufficient to support payment on the private financing without assistance.

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