Memo

To: Richard Ball, Executive Director, Duluth HRA

From: Jason Aarsvold, Ehlers

Date: May 19, 2015

Subject: Point of Rocks Tax Increment Financing (TIF) District But For Determination

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The Duluth HRA has received a proposal from SDH&M LLC to construct a 114 unit rental development with 60% market rate units and 40% of the units affordable to those below 60% of area median income. The development is expected to commence construction in mid-2015 and be completed in 2016. As a result of the proposed affordability component, the development meets the qualification for a housing TIF district. The developers have requested $1.86 million in tax increment financing (TIF) assistance in the form of a "pay-as-you-go" note plus interest at a 4.5% rate. This memo is intended to review the need for TIF assistance based on our analysis of the developer's project budget and projections, generally known as a pro forma. This memo also includes a recommendation for an amount of assistance based on this review.

Ehlers conducted a thorough review of the developer's budget and operating pro forma to ensure all development costs, anticipated revenues, and expenditures were represented appropriately. The table below depicts the proposed sources and uses for the project.

SOURCES	Amount	Pct.
Developer Financing - First Mortgage	11,812,756	70.00%
Developer Financing - TIF Mortgage/Note	1,859,645	11.02%
Developer Equity	3,202,964	18.98%
TOTAL SOURCES	**16,875,365**	**100.00%**

USES	Amount	% of Cost	Per Unit
Acquisition Costs	100,000	0.59%	877
Construction Costs	15,395,365	91.23%	135,047
Professional Services	730,000.00	4.33%	6,404
Financing Costs	350,000	2.07%	3,070
Developer Fee	300,000	1.78%	2,632
TOTAL USES	**16,875,365**		**148,030**

Generally, this project meets the expectations of a mixed-income multifamily housing development with regards to the financing structure, projected revenues, on-going operational costs and developer fee. Following are our findings with regards to the analysis completed for the development:

- Our analysis confirms the maximum supportable first mortgage the developer can secure for this project based on current underwriting criteria is $11,812,756, assuming a 30 year loan at 4.5%. The developer is proposing to bring $3.2 million in equity, which is 18.98% of total project costs. This leaves a project gap of approximately $1.86 million, which is the amount of the developer's TIF request.

- The total development costs for this project are $16,875,365, or $148,030 per unit. Based on our experience with similar projects, we would expect total development costs to range between $170,000 and $190,000 per unit. This is slightly below what we would anticipate for a project of this nature, but land is already owned by the developer and not included in the total development costs. This could add between $8,000 and $12,000 per unit, bringing the project to within range.

- The development fee of $300,000 is under two (2) percent of total development costs. For a project of this nature, we would expect to see a developer fee of no more that 5%. The proposed fee is well within an acceptable range.

- Proposed rents range between $625 per month for an affordable efficiency unit, to $2,000 for a two bedroom unit with a view to the Lake. The average rent is projected at $1.62 per square foot. This blended rate includes the affordable units, which is an aggressive assumption. For this reason, we believe projected income is not underestimated.

- The operating costs are projected at $3,360/unit (The market range of operating costs is $3,500 to $4,500). The management costs are projected at 5.0% of effective gross income (EGI). We would expect to find management fees ranging between 3% and 5% of EGI. Based on our analysis and conversations with the developer, we conclude that the operating expenses and management fees are sufficient, but not excessive.

- Replacement reserves of $200/unit are slightly below the *minimum* industry standards of $300/unit. The developer is of the opinion this is sufficient to provide for future improvements and is an acceptable amount for their lender's underwriting criteria. Generally, we would prefer to see more reserves set aside for future viability.

- The projected cash on cash return on investment in year 5 (with assistance) is six (6) percent. This increases to 9.8 percent in year 15 assuming equal inflation of income and expenses. This return is below the 10% we would allow for a project requesting public assistance.

Format of Assistance and Recommendations

Based on our review of the developer's pro forma and under current market conditions, the proposed development may not reasonably be expected to occur solely through private investment within the reasonably near future. Due to the costs associated with constructing a mixed-income multifamily housing development, this project is feasible only through assistance, in part, from HRA contributions.

Our recommendation, however, is that the HRA provide **16 years of tax increment payments, rather than the full 26 years** allowed through the district. This is based on our analysis and the fact that the developer is projected to be meeting its debt coverage requirement by this point. For this reason, the annual payments should no longer be necessary for financial feasibility. This equates to a present value amount of assistance totaling $1.13 million assuming 4.5% interest.

The developers indicated that they are accepting of this proposal and are willing to move forward based on 16 years of TIF assistance. They have requested a pay-as-you-go note which provides no risk to the HRA because the developer is responsible for financing the project.

Please let us know if you have questions or comments.