SUMMARY OF FINANCIAL FEASIBILITY ANALYSIS OF AND RECOMMENDATIONS ABOUT TID ASSISTANCE FOR THE PROPOSED WHEEL & SPROCKET REDEVELOPMENT IN BROOKFIELD, WISCONSIN

Letter Report to

CITY OF BROOKFIELD

From

GRUEN GRUEN + ASSOCIATES
Urban Economists, Market Strategists, and Land Use/Public Policy Analysts

September 2022

C1613

Gruen Gruen + Associates

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Applying Knowledge
Creating Results
Adding Value

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September 9, 2022

Brookfield Common Council
Via Mr. Daniel F. Ertl, A.I.C.P.
Director of Community Development
City of Brookfield
2000 North Calhoun Road
Brookfield, Wisconsin 53005

RE: **Summary of Financial Feasibility Analysis of and Recommendations About TID Assistance For The Proposed Wheel & Sprocket Redevelopment In Brookfield, Wisconsin**

Dear Mr. Ertl:

Gruen Gruen + Associates ("GG+A") conducted a financial feasibility analysis of the proposed redevelopment of the Wheel & Sprocket property and an adjoining Aamco Transmission shop in Brookfield, Wisconsin. The primary purpose of this analysis is to evaluate the financial feasibility of the proposed apartment, retail, and rental townhome development program with- and without- the Tax Incremental Financing District ("TID") assistance The Heimat Group (referred to as "developer") has requested.

The primary basis for the request for the TID incentive is the identified need to complete environmental remediation estimated to cost approximately $2,025,000 (before financing costs). The relocation of a public sewer line at an estimated cost of $294,000 is another reason for the request for TID assistance. The developer initially estimated total eligible TID costs of $5,142,000. Additional City staff review after completion of the initial letter report resulted in a reduction to TID eligible costs to $3,265,595 due to a change in the allowable property acquisition price.

APPROACH

To identify if the real estate economics of the proposed development, operation, and eventual sale of the mixed-use apartment, rental townhome, and retail development can support the estimated amount of environmental remediation costs and sewer relocation costs outlined above as well as total development costs, we completed a discounted cash flow analysis of the project. The developer provided spreadsheet models from which we obtained estimates of development costs, anticipated rents and operating expenses, and financial and investment terms.

GG+A simulated the investment results of the proposed redevelopment from the viewpoint of the developer-investor. GG+A completed the real estate economic analysis for one scenario assuming a five-story apartment building and for a second scenario assuming a four-story apartment building. The amount of retail space and townhome units are the same for each scenario.

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GG+A analyzed the feasibility and the returns from development based on a financial yardstick or measure referred to as the residual land value, assuming a required internal rate of return ("IRR") on the equity invested from the cash flow and resale value of the development. We used this methodology of estimating the land value that would be supported by the investment returns of the forecast revenues and costs, assuming a hurdle rate or return on investment requirement of a 15 percent Internal Rate of Return (IRR). In essence, we asked the following question:

> *"How much could a prospective developer-investor pay for the amount of land needed to site the postulated development and earn an IRR of 15 percent?"*

We also answered the related question:

> *Given the land acquisition cost and the estimated development costs including environmental remediation costs (and sewer relocation costs), would the cash flow from the development, lease-up, operation, and eventual sale of the project generates a return of 15 percent?*

The 15 percent return feasibility threshold reflected GG+A's recent findings from other similar projects that this level of return is typically required to compensate for risks and uncertainty and entrepreneurial effort and to attract equity investment.

To identify the effects of the costs of environmental remediation, we ran the analysis with- and without- environmental remediation costs for the five-story and four-story mixed use redevelopment scenarios.

RESULTS OF INITIAL REAL ESTATE ECONOMIC ANALYSIS

The results of the initial real estate economic analysis suggest **that TID assistance is needed to bridge the feasibility gap due to not only the costs of environmental remediation, the relocation of the sewer line and other public improvements, but also due to the cost of land purchase being more than the proposed redevelopment project can support.** It is not unusual that land costs of an existing occupied use that produces income has a higher "as is" value than a redevelopment project can support. This is especially often the case when the redevelopment is relatively small in scale.

The primary conclusion of the analysis is that the **proposed redevelopment is not likely to support a market rate return on equity investment without TID assistance**. **Without any TID assistance**, the five-story redevelopment alternative is estimated to generate an **IRR of 8.35 percent over 10 years. This would not be a high enough return to attract and reward equity investment and compensate for risk and uncertainty and entrepreneurial effort.** However, **with the originally requested upfront TID assistance of $4,848,243 plus $394,000 over 10 years of "Pay as Go"[1] TID assistance for the five-story alternative, the**

[1] Pay As Go TID financing refers to the disbursement of TID property tax increment proceeds by the City from a Special Fund to a developer on a pay-as-you-go basis, on an annual basis to reimburse

leveraged IRR on equity (assuming an equity investment of 25 percent of project costs and a holding period of 10 years) would be **16.8 percent (above the 15 percent feasibility threshold)**. The IRR would be higher if the property were held for a shorter time.

To **achieve a leveraged IRR of 15 percent assuming a 10-year holding period, the amount of upfront public assistance for the five-story alternative would need to be approximately $1,158,000 less than the initial requested amount of TID assistance or $3,690,000 (**plus the requested $394,000 Pay as Go TID incentive).

Without any TID assistance, the four-story redevelopment alternative is estimated to generate an **IRR of only 6.0 percent over 10 years. Again, a six percent return would be too low to attract or justify equity investment.** However, **with the originally requested upfront TID assistance of $4,848,243 plus $394,000 over 10 years of Pay as Go TID assistance, the leveraged IRR on equity** (assuming an equity investment of 25 percent of project costs and a holding period of 10 years**) increases to over the 15 percent feasibility threshold at 15.4 percent**. Note the IRR also reflects the $394,000 Pay-as-Go TID incentive.

Because the four-story development program was reported to be only 7.3 percent lower in development costs but 20.3 percent lower in operating income and capitalized value, **the need for TID assistance is higher for the four-story alternative than for the five-story redevelopment alternative**.

DUE DILIGENCE QUESTIONS SUGGESTED BY RESULTS OF ANALYSIS OF REAL ESTATE ECONOMICS

Due diligence questions were identified as the result of the initial real estate economics analysis. These questions related to:

- the basis for the land costs which serve to increase the amount of TID assistance needed (an affiliate of the main retail tenant Wheel & Sprocket is the land seller; an affiliate of Wheel & Sprocket, the tenant/land seller will also have an ownership interest in the development entity that builds/owns the redevelopment project along with The Heimat Group);

- development fees, property management fees, and asset management fees (if costs are higher than typical, the increased costs increase the amount of TID assistance needed);

- Rent assumptions (if obtainable rent is higher than estimated, this reduces the need for TID assistance);

- Holding period assumptions (all other factors the same, based on the developer's models, the longer the investment is held, the lower the IRR generated; this is not

Developer for Eligible TIF Expenses rather than by an upfront payment to the developer from the City via a bond or note issuance.

unusual as frequently the resale of a property generates a significant portion of the return on investment); and

- The basis for construction costs for the four-story redevelopment alternative being only 7.3 percent less than the costs of the five-story redevelopment alternative (If the difference in cost between a four-story alternative and five-story alternative are larger, the need for TID incentives for a four-story alternative would be reduced).

In addition, while the real estate economic analysis completed to solve for amount of TID assistance needed assumes a 25 percent equity investment, the original financial models provided indicated that initially the **developer-investor expected to only supply 10 to 11 percent of the equity while the requested TID assistance would comprise over 15 percent of the equity.** GG+A identified the risks and policy concerns with an investor-developer investing less equity in a redevelopment project than financial resources committed by the municipality.

VIDEO CONFERENCE CONDUCTED AND RESPONSES TO QUESTIONS FURNISHED ALONG WITH REVISED FINANCIAL MODELS

A video conference was held with representatives of the developer, the senior staff of Brookfield, and principals of GG+A, to review the results of the initial real estate economic analysis described above and covered in a comprehensive report provided to Brookfield staff. The purpose of the video conference also included confirming:

- the underlying development program for the five-story and four-story redevelopment alternatives;
- the development cost estimates;
- the rent, operating expense, reserve expense, and net operating income estimates; and
- investment and financial parameters.

Based on the analysis of the original proposal presented, **GG+A indicated that under an upfront TID payment structure the amount of assistance requested, especially for the five-story redevelopment alternative, was excessive (because it would provide a higher than 15 percent IRR to the developer) and not enough investor-developer equity was proposed. However, the four-story redevelopment alternative was identified to require greater TID assistance to bridge a feasibility gap because of the greater reduction in rental income and valuation than the reduction in total investment/development costs.**

This conclusion and questions and issues outlined above were raised and discussed. Following the meeting, the developer provided additional responses and updated and revised models.

Essential Differences Associated with Revised Financial Models from Developer

GG+A reviewed the responses and materials furnished by the developer including revised models for the five-story and four-story redevelopment alternatives.

The primary difference as the result of the review with the developer of the results of the real estate economic analysis and issues identified is the models indicate that **the developer now proposes to invest equity equal to 25 percent of the estimated development costs ($7,814,167 for four-story alternative, up from $2,933,292).** The developer would also invest equity equal to 25 percent of the five-story redevelopment costs.

The other primary difference is that instead of **asking Brookfield to provide upfront TID assistance, the developer proposes a Pay As Go structure, which shifts the risk from the municipality to the developer.**

The developer requested the first 15 years of the annual property taxes be allocated to the property owner for reimbursement of eligible TID expenses. Under the developer's models and original proposed TID eligible costs, this equates to $5,142,000 not discounted for the time value of money.

Minor changes include:

- using 1.25 percent for an asset management fee rather than one percent for the five-story alternative and 1.5 percent for the four-story alternative;

- for the four-story alternative, reducing the number of apartments by three units to 48 total units, removing six one-bedroom units and adding three two-bedroom units and for five-story alternative, reducing by four apartment units to 64 total units;

- reducing lower-level parking area to 30,000 square feet from 33,053 square feet, increasing upper-level circulation from 10,000 square feet to 12,100 square feet, and modestly increasing the amount of residential building area from 54,273 square feet to 54,902 square feet for the four-story alternative and to 68,120 square feet of residential building area for five-story alternative;

- Adding a geotechnical study for $17,500 and including in upfront development costs an allowance for off-site traffic improvements if any are found to be needed; and

- Small increases in property tax expenses and a slight increase in rent in year three.

Comments About Questions/Issues

<u>Land Costs</u>- The developer's models are not designed to "solve for" supportable land costs. The land cost of $2.6 million in the developer's model is reported to reflect the relatively recent cost of acquisition of the Aamco Transmission shop property ($775,000) and in effect the

price needed for the owners of the operating business and property to take the risks and invest additional capital related to both the operating business and by participating as an owner in the redevelopment. The rent is also reflective of the land purchase costs and may have been lower if the land costs were lower given the retail component is equivalent to a build-to-suit development as Wheel & Sprocket will occupy the preponderance of the retail space. The $2.6 million land cost is comparable to the current assessed value for both properties (the assessed value of the Aamco Transmission property is $582,200).

Fees-The developer indicated that the property management fees include leasing commission fees and that development fees include construction management fees and that as a whole the various fees are consistent with local market norms. We would simply note as described below that the change in the TID assistance structure benefits the municipality and reduces the value of the assistance to the developer more than the effects of any consideration of a reduction in fees.

Rents- GG+A used the rents specified by the developer. A market study provided by the developer indicated substantial advantages and anticipated fast absorption rates for the use of the property for apartments and rental townhomes exist including:

- a highly visible and accessible location;
- proximity to a wide array of services and amenities;
- well-served by transportation network;
- proximity to a large employment base that creates demand for rental units;
- favorable demographic and income characteristics; and
- a location in a highly desirable apartment market with extremely low vacancy rates and increasing rents.

Despite the positive findings, the market consultant to the developer recommended lower per square foot rental rates and lower monthly rates for smaller units for the proposed apartment than rents per square foot for Brookfield apartment developments with larger unit sizes built in 2017 and 2018. The rents estimated would appear based on information furnished to GG+A to be conservative. As noted below**, however rents will need to be higher than forecast for the four-story redevelopment in particular to obtain a 15 percent IRR, given the other assumptions and estimates**.

Holding Period- The developer's models assume holding the property indefinitely with periodic refinancings including in year 11 assuming a sales value capitalization rate of 5.5 percent. The developer suggested the use of a six percent capitalization rate for our modeling. We would note that **for every ½ percentage point change or, in the jargon of finance, 50 basis point change, the sales value of the property holding all other inputs the same**

assuming a sale in year 10 changes by about $3 million. A six percent capitalization rate, holding all factors the same would reduce the IRR for the four-story redevelopment alternative assuming a 10-year hold from 11 percent to nine percent assuming the original amount of TID eligible cost reimbursement assistance is provided.

We note that in determining an appropriate amount of municipal assistance required to bridge a feasibility gap, if a developer could likely realize a higher return by not holding the property indefinitely or beyond 10 years, it is reasonable to assume an appropriate shorter holding period and a capitalization rate estimated closer to contemporary capital market conditions. For the analysis summarized in this letter report, we use a 5.5 percent capitalization rate of the estimated net operating income for the value of the building assumed to be sold in year 10.

<u>Construction Costs</u>-As indicated above, the developer has indicated that the construction cost for the four-story alterative being only 7.3 percent lower than the five-story alternative is based on cost estimate information provided by the contractor. The developer provided summary cost estimates from a contractor suggesting that the four-story redevelopment alternative would entail more of a cost difference from the five-story redevelopment alternative.

UPDATED SUMMARY RESULTS OF REAL ESTATE ECONOMICS ANALYSIS

We completed a real estate economics analysis of the revised Pay as Go structure under the assumption of TID eligible costs of $5,142,000. The results indicated that the five-story redevelopment alternative would be feasible (providing a nearly 15 percent return) if property tax increment was disbursed to the developer for 15 years. The results also indicated that if property tax increment were allocated to the developer for 15 years the four-story redevelopment alternative would produce a return (of 11 percent assuming a 10-year holding period) short of the 15 percent return threshold.

Reduced Eligible Costs

As identified in further detail in Appendix A, the TID eligible costs following further review by Brookfield staff and discussion with the developer have been reduced to an expected total of $3,265,595. Therefor, the amount of assistance requested and required for the five-story alternative to be feasible and for the four-story redevelopment alternative to be closer to attaining feasibility (approximately $5,140,000 over 15 years) will not be obtained unless the City agrees to provide accrued interest on the initial TID eligible costs upon their certification. The updated real estate economic analysis, below, reflects an assumption that unreimbursed eligible costs would accrue interest at a six percent (6%) annual rate until the $3,265,595 balance is fully paid.

Four Story Redevelopment Alternative

Under a Pay-As Go TID structure, and assuming for the four-story redevelopment alternative:

- a property value estimate for property taxes purposes of approximately $22,804,000 (reflecting estimated land costs and construction hard costs and excluding soft costs and financing costs). The redevelopment would result in a substantial increase in assessed value over the current assessed value of approximately $2.6 million;
- A Mill Rate of $16.25 per $1,000 of assessed value per the Finance Director of Brookfield; and
- No annual escalation in market value;

the **developer would receive annual property tax increment of $150,000 in year 2, $370,560 annually from year three though year 14, and a final payment of $338,880 in year 15, for a total of $4,935,595 to bridge the feasibility gap**. **Discounted at an annual rate of 15 percent, in present value the forecast property tax increment totals approximately $1,674,000. This compares to the amount of TID assistance estimated originally to be paid up front of approximately $4,848,000 plus $39,400 in Pay As Go TID assistance over 10 years for a total of $394,000**.

With the Pay as Go TID assistance specified above, **the IRR on equity investment for the four-story redevelopment alternative is estimated to be 8.6 percent assuming a 15-year period and 10.4 percent assuming a 10-year holding period. The IRR would be less than the 15 percent feasibility threshold under a Pay As Go structure, unless rents or property tax increment allocated to the developer are higher than estimated for the analysis.** Because the developer had provided the revised model, we assumed the developer may be willing to accept a lower rate of return than 15 percent given that one of the owners also operates the primary retail business that will occupy the retail space and expects to earn income from the retail business and because of the potential for higher rents or property taxes than estimated. A follow up discussion with the developer indicates that **the developer has determined that it may not be able to attract equity investment necessary to undertake the four-story redevelopment alternative given the below 15 percent threshold return, and the potential for capitalization rates to increase over time and therefore reduce the potential sales value of the redevelopment**.

Five-Story Redevelopment Alternative

The return improves with the same amount of TID assistance for the five-story redevelopment alternative. Under a "Pay-As Go" TID structure, and assuming for the five-story redevelopment alternative:

- a property value estimate for property taxes purposes of approximately $24,681,000. The redevelopment would result in a substantial increase in assessed value over the current assessed value of approximately $2.6 million;

- A Mill Rate of $16.25 per $1,000 of assessed value per the Finance Director of Brookfield; and

- No annual escalation in market value;

the **developer would receive annual property tax increment of $150,000 in year 2, $401,059 annually from year three though year 13, and a final payment of $206,234 in year 14, for a total of $4,767,884 to bridge the feasibility gap. Discounted at an annual rate of 15 percent, in present value the forecast property tax increment totals approximately $1,730,000. Again, this compares to the original request of upfront of approximately $4,848,000 plus $39,400 in Pay As Go TID assistance over 10 years for a total of $394,000.**

With this amount of TID assistance, **the IRR on equity investment is estimated to be 11.5 percent assuming a 15-year period and 14.0 percent assuming a 10-year holding period (prior to the revision of eligible costs, the return was estimated at 14.5 percent). The IRR would be one percentage point less than the 15 percent feasibility threshold under a Pay As Go structure, unless rents or property taxes are higher than estimated for the analysis. The follow-up discussion prior to the revision of the eligible costs with the developer indicates that the developer expects to be able to obtain the necessary equity investment for the five-story redevelopment alternative though it is deemed only "marginally feasible".**

RECOMMENDATION

TABLE 1: Summary of Incentive Requests and Recommended TID Structure		
	Original Developer Model **Not Recommended**	Revised Developer Model **Recommended**[1]
TID Request – 4-story	$4,848,243 present value + $394,000 Pay as Go over 10 years	$4,935,596 Pay as Go over 15 years (6% accrued interest on Eligible Costs); Present value of $1,674,000[2]
TID Request – 5-story	$4,848,243 present value + $394,000 Pay as Go over 10 years	$4,767,884 Pay as Go over 14 years (6% accrued interest on Eligible Costs); Present value of $1,730,000[2]
Return on Investment with TID Assistance[3]	15.4% - 4-story 16.8% - 5-story	10.4% - 4-story **Under Feasibility Threshold** 14.0% - 5-story **Marginally Feasible**

[1] GG+A property tax estimated for "Pay As Go" structure does not assume escalation in market value for purposes of estimating annual property taxes.
[2] The Pay as Go flow of property tax funds over 14 to 15 years is discounted at a rate of 15% to produce an estimate of present value. The present value of the Pay as Go structure to the developer is much less than the present value of the original structure of an upfront payment to the developer.
[3] The return on investment figures reflect an assumption of the sale of the property in year 10, even though property tax increment would be allocated to the developer/property owner for 14 years (5-story) to 15 years (4-story).

Source: Gruen Gruen + Associates

GG+A recommends a shift from the initially considered upfront TID assistance to a Pay as Go structure. Under the Pay as Go structure for the five-story redevelopment alternative, the developer would be allocated 100 percent of available property tax increment to reimburse TID eligible costs ($3,265,595) with six percent annual accrued interest for a period of up to 14 years.

For the four-story redevelopment alternative, the developer would be allocated 100 percent of available property tax increment for a 15 year period to allow for the reimbursement of $3,265,595 in TID eligible costs plus accrued interest on the unpaid balance of such costs.

For the four-story redevelopment alternative, even with extending the period of allocation of property tax increment to reimburse the developer for its investment in TID eligible costs, the return to the developer may be insufficient (without additional incentives) for the developer to undertake the project.

The five-story redevelopment alternative compared to the four-story alternative is more financially feasible based upon our financial analysis. For the municipality, the project will lead to the redevelopment of substandard commercial properties and more substantial real estate taxes being collected long-term. If either alternative is found to garner community support, the development team may wish to identify whether any potential project changes are available that would improve financial feasibility and therefore increase the potential for attracting equity investment for the redevelopment. Admittedly, finding such a solution for the four-story option will be challenging.

Very truly yours,

Gruen Gruen + Associates LLC

By ______________ ______________

Debra L. Jeans and Aaron N. Gruen
Principal Principal

APPENDIX A: TID Eligible Costs Updated September 7, 2022	
Property Acquisition	$775,000
Demolition	$108,995
Public Sewer Relocation	$294,000
Environmental - Phase 1	$2,600
Phase II Site Investigation Report	$60,000
Remedial Action Plan & Soil Management Plan	$16,000
Post Closure Modification Request	$11,200
Project Planning and ER TIF Project Development	$5,800
NR718 Exemption Request and Soil Sampling	$25,000
Monitoring Well Abandonment & Remedial Excavation Permitting	$12,000
Soil Management Coordination Oversight and Documentation	$45,000
Hazardous Lead Impacted Soil Remediation Disposal Coordination	$20,000
Impacted Soil Disposal & Dewatering	$1,600,000
Vapor remediation system	$120,000
Post Remedial Ground Water Monitoring	$50,000
WI DNR Case Closure Final Documentation	$20,000
Asbestos Abatement	$100,000
TOTAL	**$3,265,595**
Source: The Heimat Group	