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MEMORANDUM

TO: Laurie Sullivan, Finance Director
Donna Olson, Mayor
Rodney Scheel, Planning and Development Director
Matt Dregne, City Attorney

FROM: Mikaela Huot, Vice President/Consultant

DATE: December 4, 2016

SUBJECT: Financial Feasibility/But for Analysis of KPW's Phase 2 TIF Request

The City of Stoughton received an application for financial assistance through Tax Increment Financing (TIF) to assist with financing a portion of the extraordinary development costs related to Kettle Park West – Phase 2. The developer, Forward Development Group, LLC, has plans to develop the second phase of Kettle Park West as mostly residential of varying types along with park and open space and one potential office site. The purpose of this memorandum is to provide a summary of Springsted's review of the development project costs and pro forma as provided by the developer in order to assist the City with making a determination if the project as proposed would be unlikely to proceed "but-for" the requested Tax Increment Financing (TIF) assistance.

Background

The City's TIF policy has certain benchmarks that must be met prior to approval of a TIF Project and request for assistance. All TIF projects must be approved by the City Council, following review and report by the Finance Committee. The Finance Director shall provide a report to the Finance Committee and the City Council addressing the following issues, which shall be considered by the Finance Committee and City Council before approving any TIF project:

A. Is the project authorized by the Project Plan for the TIF District?
B. Does the project serve one or more of the City's general goals for the use of TIF?
C. Is Tax Incremental Financing feasible, in that the TIF District will support the level of TIF investment?
D. Is the amount of Tax Increment Financing requested reasonably necessary to make the project financially viable?
E. Should a development agreement be required, and what terms should be included in the agreement?
F. Is more process (such as additional public hearings or a referendum) appropriate?
G. Such other factors as either the Finance Committee or the City Council deem appropriate.

TIF is a tool communities use to facilitate the overall goals and objectives of the City. It is intended to finance extraordinary costs associated with development and redevelopment projects. TIF is commonly used to close financing gaps through reduced land purchase price, oversizing of infrastructure including streets, utilities and other public improvements, removal of blight or environmental conditions impeding redevelopment. It is not intended to ensure developer profit or reduce risk of development.

The developer submitted a request for TIF assistance with the purpose of using tax increment to finance extraordinary costs associated with construction of the project. The developer will purchase the site, prepare it for development including site grading and erosion control, installation of roads, utilities and other necessary public improvements and sell to other developers for physical construction. Following acquisition and site development, the developer has provided a site plan that includes the development of approximately 279 townhomes, 11 duplexes, 43 single family lots, 101 unit senior housing facility and office space.

Developer Request for Assistance

Assistance has been requested for financing a portion of the costs associated with the project. The developer has split the request for assistance related to the infrastructure costs between on-site and off-site improvements. The estimated on-site infrastructure costs have been estimated to be $5,440,774. The estimated off-site costs have been estimated to be $5,740,862. The developer has indicated the receipt of City financial assistance is necessary for the project to proceed to finance both the on-site and off-site improvements as identified in the following table. See complete sources and uses (current information as presented to Springsted by the developer) below:

Sources	Amount	Uses	Amount
Equity	1,250,000	Equity Repayment	1,250,000
Debt	3,250,000	Debt Repayment	3,250,000
Subtotal	4,500,000	Subtotal	4,500,000
Land Sale Proceeds	9,103,418	Acquisition	$4,107,708
		Private Improvements	$3,010,222
TIF Reimbursement	**5,440,774**	**On-site Public**	**$5,440,774**
		Taxes	$100,000
		Selling Expenses	$364,137
		Operating Expenses	$760,000
		Financing Expenses	$341,010
		Profit	$420,341
Subtotal	14,544,192	Subtotal	14,544,192
TIF Upfront	**$5,740,862**	**Off-site Public**	**$5,740,862**
Total	$20,285,054	Total	$20,285,054

The total estimated project costs are $20,285,054. The developer intends to finance the initial costs with a combination of equity and debt (combined for $4,500,000 as shown in the table). The on-site improvements would be financed through reimbursement from the City with available tax increment revenues. The remaining on-site improvements would be financed with land sale proceeds as the individual lots were sold to developers for construction. Development is expected to occur in phases and as annual land sale proceeds were received, the developer would repay the debt and equity and financing the annual operating expenses including taxes, selling, operating, and financing costs. The developer's proposal is that the off-site improvements would be financed by the City through bond issuance or available cash from the City's TIF District fund. Following receipt of all revenues and payment of project costs, the estimated profit from the project is estimated to be $420,341.

Developer Pro forma But-For Analysis

Pursuant to the City's Tax Increment Financing Policy, the City must make several findings, including the "but for" test: that the proposed development would not reasonably be expected to occur solely through private investment within the reasonably foreseeable future. The developer has provided financial information showing that the projected revenues of the project (primarily land sales) are not sufficient to support the total project costs that include acquisition, site development, installation of public utilities (both on-site and off-site) and some additional carrying costs. The developer has stated the assistance is necessary due to the high costs of developing the site, including site acquisition and installation of public improvements, and inability of the project to support those costs upon completion. 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 also consider an appropriate level and type of TIF assistance for the project based on the information submitted by the developer. Generally, a city's position relative to the use of tax increment has been to finance extraordinary costs of a project and the level of assistance is in part dictated by the 'extraordinary' costs of the project. In this case, due to the current conditions of the site (undeveloped land with significant on-site and off-site improvements), there are extraordinary costs required to be incurred for the project to proceed. The developer has also proposed that the on-site and off-site improvements be financed with a combination of upfront and reimbursement assistance.

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. The "but-for" test is used to determine whether a project is likely to proceed as proposed without the use of public dollars. To complete this analysis we reviewed the developer's financial information and proformas and also constructed similar proformas, one showing a result if the developer received the assistance (both City bond issuance and reimbursement for TIF eligible costs) and one showing a result if the developer did not receive assistance. Our analysis of the proformas included a review of the development budget, projected revenues and expenditures, and the project's capacity to support repayment of the developer's equity and debt injections necessary to finance the project.

In order to understand the potential return realized by the developer, with and without the tax increment assistance, we utilized the project cost and operating information provided by the developer to generate the proformas and calculate estimated performance of the project. The purpose of evaluating the proformas is to understand the potential returns to the developer through the initial development of the project and sale of the individual lots, as that is what the developer has indicated is driving the financial gap and requiring public assistance.

Generally, should the rates of return lie below a reasonable range without assistance; we could assume the project as proposed would not move forward without assistance. Should the returns lie within a reasonable range with the assistance, we could assume the amount of assistance tested is appropriate for the project. All such estimates should be viewed as general indicators of performance and not exact forecasts. The number of current and future variables affecting these estimates and actual results are great. There are no set rate of return benchmarks that dictates whether a project needs TIF assistance or not; however there are market/industry standards for certain types of projects, as well as more specific investor/developer thresholds that need to be achieved.

Our review of the proformas based on with assistance and, alternatively, with no assistance, indicates that without assistance, there is a significant gap in projected revenues and expenditures and the project would not be feasible. It is important to note that certain assumptions were made based on the developer's provided information in order to analyze the projected returns to the developer and overall project performance. Substantial changes to those assumptions may have an impact on the actual performance of the project. However, due to the size of the projected gap of available revenues to support total estimated project costs, including the identified on-site and off-site improvements, some level of public assistance will be required for the project to proceed as proposed.

Tax Increment Revenue Estimates

Assumptions were made relative to timing and phasing, annual absorption rates for individual lot sales and subsequent development and taxable values of the individual property types. Based on the information provided by the developer, total estimated incremental value of phase 2 would be $50.8M generating tax increment revenues of approximately $15.8M. Additional review and determinations regarding actual amount of provided assistance to the developer, assuming the project proceeded, as well as any retained increment by the City would dictate the projected term of assistance and district.

A Tax Incremental Financing District has already been created for Phase 1 of the development. Based on current assumptions for existing obligations and incremental values to be created, there may be additional available revenues to support the phase 2 anticipated obligations. However, for purposes of our analysis, we are focusing solely on phase 2 and the ability to support the phase 2 obligations related to financing of the on-site and off-site pubic improvements. We recommend further discussion commence regarding the tax increment revenue assumptions.

Project Financing

There are generally two ways in which assistance can be provided for most projects, either upfront or on a reimbursement (pay-as-you-go) basis. With upfront financing, the City would finance a portion of the developer's initial project costs through the issuance of bonds or as an internal loan. Future tax increment would be collected by the City and used to pay debt service on the bonds or repayment of the internal loan. With pay-as-you-go financing, the developer would finance all project costs upfront and would be reimbursed over time for a portion of those costs as revenues are available.

Pay-as-you-go-financing is generally more favorable than upfront financing for the City because it shifts the risk for repayment to the developer. If tax increment revenues are less than originally projected, the developer receives less and therefore bears the risk of not being reimbursed the full amount of their financing. However, in some cases pay as you go financing may not be financially feasible. With bonds, the City would still need to make debt service payments and would have to use other sources to fill any shortfall of tax increment revenues. With internal financing, the City reimburses the loan with future revenue collections and may risk not repaying itself in full if tax increment revenues are not sufficient. The developer's financial information includes a combination of both upfront and pay-as-you-go financing.

Conclusion

The developer has requested financial assistance as related to the significant development costs necessary to allow new development to occur. Any assistance provided would be supported by tax incremental revenues and subject to availability. Through the submission of the tax increment financing application and supporting financial information, the developer has indicated that the project would not occur on the current site without financial assistance from the City due to the significant development costs deemed necessary for the project to proceed and the inability of the projected available revenues to support those development costs. Following our review of the provided information, we reconcile with the developer's financials and it appears the use of tax increment financing is necessary to fill a financing gap and support a portion of the on-site and off-site public improvement costs.

To support this conclusion and as illustrated in our analysis outlined above, based on the projected rates of return and negative cash flow without assistance, it has been determined that the project is infeasible without some level of assistance absent significant changes to either the project cost or revenue amounts. Further discussions with the developer can determine if a reduction in project costs and/or increase in income is feasible to close a portion of the projected financing gap. The projected return without assistance is negative and would require a significant amount of equity to close the financing gap and would generate negative and below market returns. The projected return with assistance as requested is within market standards and developer/investor thresholds as required for the project to proceed.

Based on the provided details regarding anticipated lot sales (revenue) and on-site and off-site improvements (expenditures) both with and without assistance, it may be reasonable to assume the amount of assistance from that initially requested could possibly be reduced, although further discussions with the developer are recommended to determine how much, if any, without impacting overall project feasibility. Any reduction in the requested amount of assistance may need to be analyzed to determine how it impacts investor return thresholds and overall cash flow performance of the project. Any tax increment financing provided to the developer would have to be deemed necessary (through the but-for analysis) and is recommended to be consistent with past tax increment financing policy and practices of the city.

<u>Next Steps/Considerations</u>:

The purpose of this memorandum is to provide a summary of our initial review of the submitted application and supporting materials provided by Forward Development Group for development of phase 2 of KPW. The review is intended to address the policy points of the City's TIF policy and to understand if tax increment financing assistance will be necessary to allow the project to proceed. Review of the financial information has allowed us to determine that based on the provided assumptions, tax increment will be necessary to finance a portion of the project costs. Should the Committee and Council choose to move forward with the project, next steps will include review in greater detail of the developer's financials and identified on-site and off-site project costs to understand and recommend the appropriate amount of tax increment assistance.

Any actual amounts of tax increment assistance that would be included within a TIF Development Agreement between the City and developer will be based on the following:

1. Reasonableness of developer assumptions
2. Projected rates of return
3. Priority projects (and corresponding costs) City would like include
4. Feasibility of revenues to support project costs

A project of this magnitude is based on a variety of assumptions including projected revenues, estimated project costs, and timing (phasing) of development. Adjustments to the assumptions may impact the amount of assistance and type that should/could be provided to the developer.

Thank you for the opportunity to be of assistance to the City of Stoughton. Please contact me at 651.223.3036 or 651.368.2533 or mhuot@springsted.com with any questions or comments.