



SHOW ME THE MONEY – Public Tools to Leverage Private Investment

Arthur C. Nelson, Ph.D., M. ASCE, FAICP

**Professor of Planning and
Real Estate Development
University of Arizona**

Outline

- **The Private Sector Calculus**
- **Goals of the Public Sector**
- **Public Tools to Leverage Private Investment**
- **Public Decision Making Criteria**

FOREWORD BY CHRISTOPHER B. LEINBERGER

Foundations of Real Estate Development Financing



*A Guide to
Public-Private Partnerships*



ARTHUR C. NELSON

The Private Investor Calculus

- The Goal of real estate investment is to make money
- Not just \$1 more than invested but more than alternative investments such as →
 - CDs, Index funds, the stock market
- Plus compensation for the sleepless nights, insane hoops, NIMBYs, etc.
- How much is needed?

Very Simplistic Return Targets

- 10%+ annual equity dividend rate aka ***cash-on cash***
 - \$100,000 investment = \$10,000+ annual cash
- 12% average annual return on total project cost aka ***unleveraged return***
- 25% before-tax average annual return on equity aka ***leveraged return***

Before-Tax Analysis

- Does not consider
 - Federal and state ordinary income and capital gains taxes
 - Depreciation
- The “public” in public private deals usually focus on unleveraged return and before tax leveraged return.

What is Total Return?

- Before Tax Cash Flow (BTCF) = Rent

- Less vacancy and bad debts
- Less operating expenses
- Less real estate taxes
- Less debt service

Annual

- + Net sales price (NSP) = Sale price

- Less outstanding debt
- Less real estate commission & closing costs

At Sale

How do we Know Return in Advance?

- Discounted Cash Flow (DCF) Analysis
- Annual BTCF discounted to the present using the target investment return →
 - Unleveraged @ 12%
 - Leveraged @ 25%
- Net sales price based on projected value discounted to present using same targets

How do we Know Value in Advance?

- Value = $\frac{\text{Net Operating Income (NOI)}}{\text{Capitalization Rate (R)}}$
- NOI = Net rent less operating costs and real estate taxes (excludes debt service)
- R or “cap rate” = Estimate of value based on NOI, derived from sales prices
- A “cap rate” of 10% means project is worth less than when the cap rate is 5%
- Example ...

Value with Different Cap Rates

- NOI = \$1,000,000 @ 10% Cap Rate =
 $\$1,000,000 / 10\% = \$10,000,000$
- NOI = \$1,000,000 @ 5% Cap Rate =
 $\$1,000,000 / 5\% = \$20,000,000$

Downtown Retail Project Costs

Development Costs	Amount
Hard Costs	\$5,000,000
Soft Costs	
Design Fees	\$500,000
Permit Fees	\$500,000
Impact Fees	\$1,000,000
Construction Fees	\$500,000
Marketing Fees	\$250,000
Total Soft Costs	\$2,750,000
Land Cost	\$2,000,000
Total Development Costs	\$9,750,000
Total Development Offsets	\$0
Total Project Cost	\$9,750,000

Downtown Retail NOI

Step	Parameter	Figure
Total project size, square feet	35,000	
Projected Sales		\$14,000,000
Base Rental Income	\$11.00/sq.ft.	\$385,000
Rental Income from Sales Assessment	5.00%	\$700,000
Gross Scheduled Income (GSI)		\$1,085,000
Miscellaneous Income	5.00%	\$54,250
Potential Gross Income (PGI)		\$1,139,250
Less: Vacancy	7.50%	\$85,444
Less: Concessions, Bad Debt	2.50%	\$28,481
Effective Gross Income (EGI)		\$1,025,325
Less: Operating Costs/unit	\$7.00	\$245,000
Net Operating Income		\$780,325
Going in Capitalization Rate = \$780,325 / \$9,750,000 =		8.00%

Investment Assumptions

- 10 year investment period
- Rent and expense escalation @ 3%/year
- Terminal cap rate @ 8.00%
- Sales expense @ 5.00%
- Loan to value ratio @ 60%
- Loan rate @ 5.00%, 30-year amortization
- Loan due in 10 years

Base Case Return Analysis

Performance Indicator	Target	Actual
Cash-on-Cash After Year 3	10.00%	11.44%
Return on Project Cost (Unleveraged Return)	12.00%	10.35%
Return on Investor Equity (Leveraged Return)	25.00%	16.33%

Investor decision analysis

Cash-on-cash = yes

Unleveraged return = **no**

Leveraged return = **no**

Goals of the Public Sector

- Revitalize areas
 - Jump-start revitalization sooner than the market
- Attract targeted development
- Utilize excess public facility capacity
- Expand the tax base in the long term
- Generate new tax, fee, utility, related revenue
- Create synergistic outcomes
 - Incentivizing development in one place may stimulate collateral development elsewhere

Public Tools to Leverage Private Investment

- Administrative → Expedited review/permits
- Land use/regulatory → Fix zoning to meet current realities
- Low-cost → Fee waivers and abatement
- Allies → Grants for buildings, land, soft costs
- Tax authority → G.O. bonds; revenue bonds
 - Special case of tax increment financing (TIF)
- Partnership → low interest loans; equity positions

Building Write-Downs/Grants

- Sometimes publicly-owned buildings may be transferred to the private sector for rehab, redevelopment.
 - Abandoned schools common.
- Building construction may be facilitated with a development grant.
 - Common in exchange for public-use components of the land or building
- Grants often from CDBG, economic development funds, state/federal grants.

Land Write-Downs/Grants

- Publicly-owned, acquired land sold below value.
 - Post-Kelo concerns may result in long-term land leases.
- Tax foreclosed land may be assembled with gaps filled in through targeted acquisition creating developable sites at little public cost.
- Trades of land possible resulting in development where desired in exchange for land for other public uses.
- Suppose the **City owns the land** and is willing to “write down” \$1 million of the \$2 million value.

Soft-Cost Write-Downs/Grants

- Advance planning and feasibility analysis
- Engineering and design
- Entitlements
- Bridge construction loans
- Funding from nonprofits, foundations, CDBG, community redevelopment agencies, community reinvestment act funds, etc.

Fee Waivers

- Application and Inspection Fees
- Connection Fees
- Impact Fees
- Fees may be waived from other funds
 - CDBG
 - Economic development pools
 - Bond arbitrage revenues
 - Federal, state economic development grants
- Suppose impact fees are reduced by \$500,000 because downtown traffic generation is lower.

Return Analysis with Land Write Down and Fee Reduction

Performance Indicator	Target	Base	Leverage
Cash-on-Cash After Year 3	10.00%	11.44%	15.27%
Return on Project Cost (Unleveraged Return)	12.00%	10.35%	12.96%
Return on Investor Equity (Leveraged Return)	25.00%	16.33%	21.26%

Investor decision analysis

Cash-on-cash = yes

Unleveraged return = yes

Leveraged return = **no**

Tax Abatement

- Reducing (usually) property taxes over a fixed period of time and amounts.
- Applicable only to the abating jurisdiction →
 - Cities cannot abate taxes to school districts
- Results in lower revenues than would be received over the abatement period
- But if abatement stimulates development then new taxes flow after the abatement period.
- Attractive when new development imposes little or no marginal cost.

Arizona Application

- Government Property Lease Excise Tax (GPLET) →
 - Government takes ownership for up to 8 years.
 - As government property it exempt from all property taxation jurisdictions.
- All property taxes abated over 8 years.
- However: In most of nation, only the city-share of property taxes abated: ~25%.

Return Analysis with Property Tax Abatement

Performance Indicator	Target	Base	Leverage
Cash-on-Cash After Year 3	10.00%	11.44%	13.56%
Return on Project Cost (Unleveraged Return)	12.00%	10.35%	11.06%
Return on Investor Equity (Leveraged Return)	25.00%	16.33%	17.93%

Investor decision analysis

Cash-on-cash = **yes**

Unleveraged return = **no**

Leveraged return = **no**

Variations

- Sales taxes may be pledged instead of incremental property taxes.
- Utilities do variations of this already through reductions in utility connection charges in exchange for system improvements.
- Need not bond anything but merely pledge incremental revenue for improvements on a pay-as-you-go basis.
 - Reduces costs and risks often with similar outcomes.

Downsides of Abatement

- Reduced revenue in face of increased needs created by new development.
- Favoritism concerns.
- Sometimes helps those who need it least.
- Long-term abatements can backfire if targeted investment becomes vacant eventually.

Upsides of Abatement

- New development is stimulated.
- Infrastructure often at excess capacity, especially schools; low to “zero” marginal cost to serve new development.
- Other revenues generated such as sales taxes, property taxes, state revenue-sharing transfers, CDBG revenues, etc.
- Collateral development may be induced outside abatement areas thereby increasing/offsetting abated taxes.

Low Interest “Mezzanine” Financing

- Typical L/V ratio is 70-75%. (In this case 60% LTV.)
- Equity investors need →
 - About 12%-15% “unleveraged” rate-of-return.
 - About 25%-30% “leveraged” before tax ROR.
 - The higher the equity the lower financial feasibility.
- Public sector may provide “bridge,” “gap”, “soft second”, or “mezzanine” financing.
 - 10-20% of cost; Commercial bank in “First” position.
 - Below market rate.
- Suppose 20% low-interest loan @ 3.00%, amortized @ 30 years w/10 year call. Equity cut 40% to 20%.

Return Analysis with Low-Interest Loan

Performance Indicator	Target	Base	Leverage
Cash-on-Cash After Year 3	10.00%	11.44%	17.81%
Return on Project Cost (Unleveraged Return)	12.00%	10.35%	10.35%
Return on Investor Equity (Leveraged Return)	25.00%	16.33%	24.91%

Investor decision analysis

Cash-on-cash = yes

Unleveraged return = **no**

Leveraged return = yes

Advantages, Thoughts

- Return to local government is as low as public borrowing rate (3-4%) plus it stimulates new tax revenue from development and collateral development.
- Can take the place of abatements, write-downs so public merely finances costs.
- Can sometimes be used to create a “position” in the equity distribution when project sold or refinanced in later years.
- Local government seen as “business-like.”

Potential Solution

- \$500,000 impact fee waiver based on analysis or other party paying the fee
- GPLET 8-year 100% property tax abatement
- 15% low-interest loan @ 3.00% amortized @ 30 years with 10-year call.

Return Analysis with Fee Waiver, Tax Abatement, Low-Interest Loan

Performance Indicator	Target	Base	Leverage
Cash-on-Cash After Year 3	10.00%	11.44%	20.67%
Return on Project Cost (Unleveraged Return)	12.00%	10.35%	11.89%
Return on Investor Equity (Leveraged Return)	25.00%	16.33%	26.39%

Investor decision analysis

Cash-on-cash = yes

Unleveraged return = yes

Leveraged return = yes

Nelson's Guide to Choosing Tools

- Provide only what is needed to make a deal work based on reasonable ROR.
- Provide the mix of public financing tools that
 - **Minimizes** taxpayer exposure to losses
 - **Maximizes** private investment
- Take a long view.
- Attempt to covert public financial support into an equity position →
 - **Patient equity.**