Corporate Partner Spotlight

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Reviewing a Deal: Finding the Right Size and Structure

By Lance Dorn and Geoffrey Dickinson, AICP

SB Friedman Development Advisors

The current real estate cycle has brought an influx of development activity to municipalities throughout Illinois, particularly in downtowns, walkable environments and around major anchors uses, such as universities and hospitals. While much of the new development has secured sufficient conventional financing, the public sector has seen an uptick in requests for financial assistance in support of more complex projects.

Municipalities are motivated to participate in these projects for various reasons – from fiscal and economic motivations to advancing community goals, such as placemaking or development of unproven property types. Regardless of the reason, it is important to enter into public-private partnerships prudently, keeping in mind the municipality's fiduciary responsibility to its taxpayers. This is especially important given that assistance programs frequently constitute a redirection of tax receipts generated by a project. These revenues need to be invested in a thoughtful manner, with assistance right-sized to an amount that achieves financial feasibility, without over-incentivizing the project.

Conceptually, a municipality should provide assistance when "but for" the assistance, the project would not occur. The municipality should first become comfortable that the developer has the capacity and experience to finance and execute the project. In-depth due diligence is then needed to understand the market and financial conditions that are impacting project feasibility. This can be done through a "gap analysis" that ties the assistance package to specific extraordinary costs and/or a project's demonstrated need for assistance. Key aspects of the project to evaluate include:

- Project Costs, Revenues, and Operating Expenses. Project pro forms should be reviewed, with key assumptions benchmarked against industry sources, third-party reports and/or comparable projects, to determine whether the developer is including unrealistic assumptions that may be impacting project feasibility. It is also important to evaluate whether a developer is paying a reasonable price for land and charging an appropriate developer fee.

- Financing. A project's capital stack should be reviewed to evaluate the presence of a reasonable amount of equity, adherence to current market conditions, and maximization of conventional debt financing- a less costly source of capital than investor equity. One should also understand how sources of capital interact with one another, including the terms by which construction financing converts to permanent financing.

- Developer and Equity Returns. Projected return on investment should be evaluated to determine whether return expectations are in-line with the market and appropriately account for development type, project location, and level of risk associated with the project. Return calculations should consider the long-term or residual value of the property, as well as near-term "stabilized" returns.

Based on this benchmark research, sensitivity analyses can evaluate alternative levels of assistance and their impact on returns. Using risk-adjusted, market-supportable rates of return, one can then calculate the financing gap.

Once the level of assistance has been right-sized, it is important to structure a redevelopment agreement that minimizes public sector risk. The largest risks facing municipalities are the uncertainty of future revenues and timing, particularly the execution date of the agreement and when revenues become payable to the developer. These risks can often be mitigated through a pay-as-you-go structure that distributes revenues as they are generated. The agreement can also incorporate upside-sharing mechanisms, should the project out-perform its projections, and assistance recapture provisions, should the project fail to provide the agreed-upon public benefits. These protections become challenging if a project seeks

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up-front funding through a debt issuance, leaving limited recourse for the municipality.

Regardless of the structure, one must analyze the dedicated revenue streams to determine their ability to satisfy the developer obligation without impacting the municipality's general funds. It is also preferable to withhold assistance until building occupancy, which ensures project completion and allows for "true-ups" to verify the actual incurred costs.

The goal of this process is to arrive at a level of assistance that balances project feasibility, development risk, and public benefit. This careful review and structuring of developer requests is critical to provide limited, yet effective levels of assistance that advance community goals.