

**Evaluation of Risks Associated with the
Exchange Place Tax Increment
Financing Proposal**

**Prepared for the City of Wichita by
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Over the past weekend, I have assessed the model the City of Wichita uses to evaluate TIF proposals and analyzed the various input assumptions that are used to estimate the bonding capacity that the Exchange Place Tax Increment Financing (TIF) District can support. In what follows I review the City's TIF spreadsheet model, discuss the various assumptions that underlie that model, and consider how these assumptions affect the risks the city faces with this TIF district. For each part of the model, I review the various factors that may affect the City's risk should it decide to fund this TIF. At the end of the report, I outline several potential scenarios and indicate how much bonding capacity the Exchange Place TIF would have under each.

Because of time limitations, this report is necessarily brief. Nonetheless, I believe I have been able to gain a fairly solid understanding of the model and its underlying assumptions. All of the data used in this analysis were provided by City staff or the developer, unless otherwise indicated.

TIF Analysis Spreadsheet Model

The City of Wichita uses a spreadsheet model to help it evaluate the incremental cash flows associated with proposed TIF projects and determine the amount of funding that can safely be supported by the proposed TIF district. I have reviewed this spreadsheet and found its basic structure to be sound. While the workbooks might be reworked to simplify its use and make it easier for policy makers to follow the steps involved, the basic conclusions it delivers about the bonding capacity a TIF district can support are essentially correct.¹

Assumptions Underlying the TIF Analysis Model

Determining the bonding capacity associated with a given proposed TIF project depends on a number of assumptions, including:

- The market value (appraised value) of the project once it has been redeveloped;
- How long it will take before the project reaches its "full" project value;
- The mill rates that will apply to the incremental property values in the TIF district; and
- The terms at which the city can finance the notes and bonds it issues in support of the project.

In this report, I assess the first two sets of assumptions above with respect to the proposed Exchange Place TIF District. To facilitate the analysis, I divide the district into four groups:

¹ It should be noted that the spreadsheet must be modified to fit the particular conditions of any specific project. These modifications must be done correctly or the resulting calculations will be wrong. But the basic layout of the spreadsheet model achieves what is intended.

1. Exchange Place;
2. Wichita Executive Center;
3. Properties in the TIF district that are owned or managed by Real Development other than Exchange Place and the Wichita Executive Center; and
4. All properties in the TIF district that are unassociated with Real Development.

Exchange Place - Apartments

Two different scenarios have been considered for the Exchange Place building itself. The first assumes that the residential units will be maintained as apartments. The rent and vacancy assumptions used in this scenario exactly match the figures estimated in the market study conducted by Shaner Appraisals. Notable points related to the risk of this part of the TIF analysis include the following.

- The projected apartment rents (\$1.12 to \$1.48 psf) are at or higher than any rents currently being achieved in downtown Wichita, although two new projects (The Flats 234 and Finn Lofts) are reportedly successfully pre-leasing at rents comparable to those projected for Exchange Place.
- As representatives from Goody-Clancey have rightly noted, renters rarely price apartments on a per square foot basis. Instead, they focus on the total rent and the desirability of the space and amenities provided. On that basis, it is notable that the sizes of the apartments proposed for Exchange Place are generally smaller than those offered by other downtown apartments within any given rent range.
- Exchange place proposes to put 233 new apartment units into the market. The Shaner Appraisals market study used to support this project estimates total market demand for new downtown apartments at only 214 units. This study is not concerned with the need for this project to capture all new potential demand, as it assumes no additional inventory is being made available. In fact, however, at least two new high-end apartment properties are currently pre-leasing in the downtown area (The Flats 324 and Finn Lofts), bringing an additional 93 units into the market in the coming year.
- On the other hand, the Zimmerman/Volk study estimates total demand for downtown apartments to be 1,270 units. With only 676 units currently available in the market, their estimates would suggest the need for nearly 600 new downtown apartment units, leaving ample room for this project.
- Assuming that the downtown apartment market can support additional inventory of this magnitude, the five-year absorption period for the apartment units seems reasonably conservative.
- The \$15 per square foot rents assumed for the ground-level retail space is significantly higher than those reported for downtown in the latest J.P. Weigand Commercial Market Forecast.

Exchange Place – Condominiums

An alternative scenario assumes that the apartments will be converted into condominiums over 10 years, beginning in year 5 with complete conversion by year 14. Several points are worth noting in this analysis.

- Condominiums are expected to be valued at just over \$200 per square foot. This figure is well in line with the prices that the Zimmerman/Volk study suggests the market can support. The Zimmerman/Volk study's estimates are based on the income capacities of demographic groups that they deem likely to purchase downtown condominiums, suggesting that the units will be affordable to those who might be interested. This does not consider, however, the competitive environment and whether the potential buyers will be *willing* to pay these prices given the prices of other units in the market. Moreover, the value we must be concerned with is the *appraised* value of these units. By way of comparison, the \$200 per square foot figures proposed for this project are well above the average appraised values of other condominiums currently found in the downtown area:²

<u>Project</u>	<u>Units</u>	<u>Average Size</u>	<u>Value PSF</u>	
Grant Telegraph	13	2,677 sf	\$144.54	
Lofts at St. Francis	23	1,220 sf	\$181.15	
Rumley Lofts	28	2,155 sf	\$128.43	
WaterWalk	46	1,989 sf	\$164.83	
Exchange Place	233	838 sf	\$200.85	PROPOSED

Value per square foot does typically increase as the unit size gets smaller, but it has yet to be demonstrated that units in these price ranges will be adopted by home buyers in the Wichita market.

- The unit sizes, on average, are quite small for the market. While the prices are affordable for a wide segment of the market, it remains to be seen whether potential buyers will be willing to purchase studio and one-bedroom condominiums in the *sizes* proposed for this project.
- The 233 units proposed for this project would more than triple the available inventory of condominiums in downtown Wichita. While the Zimmerman/Volk analysis suggests a much larger potential market for these units, Exchange Place would need to capture 100 percent of their projected annual condominium absorption for five years in order to sell out. If other units come on the market, a less than 100 percent capture rate will extend the absorption period for this project. As noted above, however, the model used assumes a 10-year absorption period once the units begin conversion into condominiums.

² Source: Sedgwick County Appraiser's Office 2009 valuations, as compiled by the City of Wichita Economic Development Office.

Wichita Executive Center

The second major component of this TIF district is the Wichita Executive Center (formerly the SC Telcom Building). Under the TIF analysis, the market value of this building is expected to rise from \$2,742,700 in the base year (2007) to \$28,810,702 once the project is completed. Risk factors to consider with this part of the proposal include the following.

- Valuation is calculated assuming the property will ultimately be worth \$90.72 per square foot. After considering the terms of the letter of intent to lease the former hotel space, this implies that office space in the rest of the building is expected to rent for more than \$16 per square foot on average (assuming a 20 percent vacancy rate, 40 percent operating expense ratio, and 8.5 percent capitalization rate). These would be Class A rents at the top range of what is currently being seen in downtown Wichita (Grubb & Ellis and J.P. Weigand Commercial Market Forecasts).
- If the Wichita Executive Center is able to raise its average rents to this high level, it would represent a very large addition of “new” Class A space in the downtown market (more than 220,000 square feet of office space). Would tenants in this building move from other properties in the downtown area (thereby cannibalizing other Class A buildings) or would the building be able to draw office users back downtown?

Real Development Properties other than Exchange Place and Wichita Executive Center

A number other properties controlled by Real Development are included in the Exchange Place TIF district, and their values are used to support the proposed TIF. As can be seen from the table below, these properties are also expected to show substantial appreciation:

Property	Base Market Value	Final Market Value	Valuation Assumptions	Other Comments
150 N. Main	\$884,430	\$11,313,316	Valued at \$77.45 psf	<ul style="list-style-type: none"> • The appraised value in 2009 was set at \$1,610,030. • The floors leased by the Wichita Workforce Alliance are valued at the same rate as the other floors (to be sold), rather than based on the lease currently in place
Broadway Plaza	\$985,400	\$4,180,000	Valued at \$380,000 per unit	<ul style="list-style-type: none"> • 2009 appraised value was \$2,225,900
Kaufman Building	\$275,000	\$3,004,528	Valued at \$80 psf	<ul style="list-style-type: none"> • 2009 appraised value was \$1,036,400
Kress Energy Center	\$2,097,940	\$2,565,000	Valued at \$50 psf; specific assumptions behind this value were not shown	<ul style="list-style-type: none"> • In 2009, the appraised value of this property was lowered to \$1,615,130

Property	Base Market Value	Final Market Value	Valuation Assumptions	Other Comments
Petroleum Building	\$1,609,000	\$3,309,500	Valued at \$352,000 per unit	<ul style="list-style-type: none"> • 2009 appraised value was \$1,745,600
Sutton Place	\$760,000	\$6,607,875	Valued assuming rents of \$12.95 psf with 80% occupancy using a 9% cap rate, along with a \$500,000 residential condominium	<ul style="list-style-type: none"> • 2008 appraised value was \$2,442,810 • 2009 appraised value fell to \$1,854,710
Totals	\$6,611,770	\$30,980,218		

Risk factors to consider in this aspect of the project include the following.

- These properties have already appreciated by 24.5 percent over their base values, and are expected to increase by an additional 276 percent over their 2009 values to support the TIF.
- Assuming a 20 percent vacancy rate, 40 percent operating expense ratio³, and an 8.5 percent capitalization rate, these properties would require the following rents to result in the projected property values:⁴

<u>Building</u>	<u>Implied Rent</u>
150 N. Main	\$14.50 psf
Broadway Plaza	\$14.20 psf
Kauffman Building	\$14.50 psf
Kress Energy Building	\$9.20 psf
Petroleum Building	\$10.65 psf
Sutton Place	\$12.50 psf

In comparison, the Grubb & Ellis and J.P. Weigand 2010 commercial market forecasts estimate Class A office rents in downtown Wichita at approximately \$15 per square foot (psf), and Class B office rents at approximately \$10.50 psf.

- When combined with the Wichita Executive Center, the Real Development office properties included in this TIF district account for more than 20 percent of all office space in downtown Wichita. For each of these buildings to be 80 percent occupied (implicitly assumed in the analysis) the Real Development properties in this TIF district would comprise nearly 25 percent of all *occupied* office space downtown (Grubb & Ellis 2010 Forecast). For this to happen, there would either need to be a substantial influx of new users in the downtown area, or these buildings would need to capture users from other downtown buildings.

³ Most of the pro forma analysis considered in the Exchange Place TIF Analysis assumes a 20 percent vacancy rate and a 40 percent operating expense ratio.

⁴ It should be noted that the Real Development office buildings do provide additional amenities that should allow them to command slightly higher rents than otherwise similar buildings.

Other Properties in the TIF District

The City's Exchange Place TIF Analysis assumes that properties that are not owned or managed by Real Development maintain their 2007 tax values (the base year for the TIF) throughout the project. Risk considerations associated with this aspect of the analysis include the following.

- Although this appears to be a conservative assumption (after all, property values typically rise), it does leave the project with an initial deficit, as the assessed value of these properties fell by 5.7 percent between 2007 (the base year) and 2009. Given the current economic environment and the pressures faced by commercial real estate, it may be several years before the values of other downtown properties rise above their 2007 base values.
- That being said, over the entire period of the TIF, it is likely that the values of these properties will rise, providing a cushion above that factored into the Exchange Place TIF Analysis.

Risk Scenarios to Consider

After reviewing the different aspects of this project, I believe that most of the assumptions used in the analysis are aggressive but defensible. With only a few exceptions noted above, variations in actual from expected outcomes will negatively impact the ability of the Exchange Place TIF District to support its bonds. For example, I believe it is more likely that actual office rents will be below those forecast than it is that they will be higher. Similarly, it is more likely that condominium prices will be lower than forecast and that absorption will be slower.

To this end, I have created several scenarios to show how various assumptions will affect the debt coverage ratio if the project were fully funded at \$11.6 million and the bonding capacity if the City's desired 1.20 debt coverage ratio (cumulative) is maintained. The first two rows in the table below show the results under the original Apartments and Condominiums assumptions, respectively. The rows that follow give the results of the following five scenarios.

1. The units are developed as apartments and absorbed as expected. Rents, however, are only able to average \$1.10 per square foot, consistent with the top rents currently observed in the downtown market.
2. The units are converted to condominiums and are sold at the prices expected in 5 years rather than the 10 years in the original analysis.
3. The units are converted to condominiums and sell in 5 years, but end up with a lower average value of \$180 per square foot.
4. The units are converted to condominiums and sell at the original assumed pace. Office rents for buildings *other* than the Wichita Executive Center average only \$12 per square foot.

5. The units are developed as apartments and sell at the original assumed pace. Office rents for buildings **other** than the Wichita Executive Center average only \$12 per square foot.
6. The units are converted to condominiums under the original assumptions, but property values appreciate at 3 percent annually rather than 2 percent.

Scenario	Key Assumptions	Debt Coverage at Full Funding of \$11.6 million	Bonding Capacity
Apartments	Original apartment assumptions	1.02	\$9,867,580
Condominiums	Original condominium assumptions	1.03	\$10,013,699
Apartments with Current Market Rents	Apartment rents average \$1.10 psf	0.98	\$9,538,813
Condominiums with fast absorption	Apartments convert to condos in five years	1.04	\$10,173,516
Condos values lower	Condos sell at fast pace, but at \$180 psf	1.03	\$10,082,192
Office rents lower (condos)	Office rents in buildings other than WEC average \$12 psf	1.01	\$9,876,712
Office rents lower (apartments)	Office rents in buildings other than WEC average \$12 psf	1.00	\$9,726,027
Property values appreciate faster (condos)	Original condominium assumptions with 3 percent property value growth	1.07	\$10,337,900

The purpose of these scenarios is NOT to suggest that these are likely outcomes. Rather, they are intended to help clarify the risks associated with this project in order to facilitate an informed decision about this project.

Glancing through the results in this table, two points become clear. First, the assumptions that have the biggest impact on the overall bonding capacity of the project are those that affect the commercial properties in the TIF district. This makes sense, as commercial properties are assessed at more than twice the rate of residential properties. Thus, the assumptions about the commercial property values are the most crucial in this analysis. Second, it is clear that even under the most optimistic scenario above, the project is unable to support \$11.6 million in funding.

Conclusions

The purpose of this analysis has been to help clarify the important assumptions that underlie the Exchange Place TIF Analysis and to assess the risks associated with these various assumptions. In my opinion, most of the assumptions built into this analysis are reasonable, but optimistic. Because of this, if the project's outcomes vary from those expected, it is more likely to happen in a way that will compromise the ability of the TIF district to meet its revenue requirements.