Development Research Partners

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To: Kevin Tilson, Director, Castle Rock Downtown Alliance

Development Proforma Review for "The View" project at 610 Jerry Street, Castle Rock, CO

Development Research Partners, Inc. (DRP) has been engaged by the Castle Rock Downtown Alliance to review the development budgets and forecast operating proforma for The View development project.

This development review is intended to provide a third-party objective evaluation of market assumptions and development and operating proformas to inform public investment decision-making. This memorandum summarizes DRP's review and findings.

SCOPE OF REVIEW

To benchmark the proposed project to the market, DRP reviewed and provided independent research regarding the following assumptions:

- Market verification on project assumptions presented in the development proposal
- Construction costs estimates verification
- Financial gap analysis
- Market verification on commercial mortgage loan rates and terms
- Comparison with market rate investment criteria and yield indicators;
- Prepare briefings regarding research, analysis, and recommendations; and
- Impacts from the Covid-19 pandemic has not been explicitly considered in this analysis.

METHODOOGY

Developers provided drawings and renderings of the finished project along with several sets of development and operating proformas. The reviewer relied upon the most recent set of proformas dated June 17, 2020 for this analysis. The reviewer conducted independent research into market conditions and development costs to establish a market baseline for evaluating the projected project operations. The developers made themselves readily available to discuss project concepts, market positioning, costs, revenues, and other assumptions underlying their projections. Potential financial gaps are estimated by the reviewer through independent rate of return analysis targeting market-based investment expectations.

PROJECT BASIS

- The completed redevelopment project is proposed to include 218 rental apartment units (mix of studio, 1-, 2-, and 3-bedroom), 14,500 square feet of office space, 5,000 square feet of retail space.
- The developer, a partnership between TreanorHL, First Construction, and Sunflower Development Group, has purchased the Park Street Jerry Street Self-Storage facility, including a single-story, three-bay class C office-storefront building, for development of a mixed-use multi-family residential apartment project.
- The facility was purchased as an operating self-storage business along with the land and existing buildings. The storage facility is still operating as such and could continue this business during the interim period prior to redevelopment.
- The proposed development will replace the single-story mini-storage warehouse facility on a 2.1-acre, rectangular shaped site on the northeast quadrant of Sixth Street and Jerry Street in Castle Rock.
- The mini-storage warehouse, along with an associated office-storefront building will be razed for the new development.

PROJECT ASSUMPTIONS

The following chart compares the as-proposed development proforma assumptions with DRP's market-derived assumptions.

Assumptions:	**As-Proposed**	**Market-Estimate[1]**	**Comments**
Mix			
Residential Units	218	218	
Office	5,000 sf	5,000 sf	
Retail	14,500 sf	14,500 sf	
Rental Rates/mo	Weighted Average rent for each unit type per proforma	Estimates based on a survey of market reports and local rent comp analysis	Market rent range estimates are based prevailing market conditions during the first half of 2020. The developer's projected rents are generally at the higher end of this range and based on highly appointed units and amenities, projected upon opening 18 months hence. While estimated at the higher range they are not unreasonable expectations depending on future market conditions.
Studio	$1,359	$1,000 - $1,300	
1-Bed/1-Bath	$1,417	$1,350 - $1,450	
2-Bed/2-Bath	$2,005	$1,650 – $1,800	
3-Bed/2-Bath	$2,464	$2,000 – $2,100	
Absorption	18 month Absorption	18 – 24 month Absorption	

Stabilized Vacancy	7% Stabilized Vacancy	5% vacancy + 2% credit Loss	
Operating Expenses*			Operating expense estimates for the residential units are considered reasonable
Per Unit	$5,800	$5,500 - $6,5,000	
Gross Rent %	29%	30% - 40%	
*Residential Component Only			
Debt			Financing terms are consistent with the market given lender relationships and project nuances
Loan:Value Ratio	70%	75% - 80%	
Interest Rate	4.75%	4.5% - 6.0%	
Amortization	30 years	20 – 30 years	
Capitalization Rates			In estimating financial gaps the reviewer use a 5.25% stabilized cap rate; and a 6.0% cap rate to estimate asset liquidation in investment year 10.
Stabilized (yr 3)	5.25%	4.5% to 5.5%	
Liquidation Value (yr 10)	5.25%	+ 50 to 100 Basis Points	
Target Yield			Market-based target yield rates are used to estimate the financial gap
Yield Rate (IRR)	na	7.5% - 8.5%	
Return on Cost (stabilized)	6.0%	6% - 7%	
Return on Equity (leveraged cash-on-cash)	na	5% - 12%	
Development Costs	$70,000,000	$70,000,000	The developer's cost estimate is at the high end of construction costs experienced in the market. After discussions with the developer it is the understanding of the reviewer that the product will be high quality construction, upgraded amenities, and unique features which will support the higher rental rate. The estimate of financial gap is based on the developer's estimate.

1. Source: RERC; Realtyrates.com; RS Means; Zillow; CBRE; DMCAR; NAR, Commercial Real Estate Finance Co. of America, CommercialLoanDirect.com, Integra Realty Resources, Hoyt Advisory Services; NMHC/NAA; U.S. Census Bureau; RealPage, fixr.com, Statista: Denver, Fannie Mae, EV Studio, ARGUS College, Development Research Partners

ESTIMATED FEASIBILITY GAP

Based on investor surveys and market data reviewed by DRP, the following target rates are used to proxy investment hurdle rates of return. In other words, it is assumed the cash flow projections must yield rates within the following ranges to be considered attractive to the market. Return On Investment (ROI) estimates are based upon stabilization, the first year of full occupancy and operations, in proforma year 3. The estimated NOI in proforma year 3 is about $3,750,000.

ROI Indicator	Description	Market Target
Return-on-Cost	Net Operating Income before debt service as % of equity	6% to 7%
Internal Rate of Return (IRR)	Annual revenue and asset sale over 10 years as return on development costs	7.5% to 8.5%
Return on Equity	Leveraged cash-on-cash after debt service	5% - 12%

The following sensitivity analysis illustrates the application of total GAP funding against construction cost during the first year of construction.

ROI Indicator	Market Target	GAP Funding (Up-front During Construction)		
Estimated Gap		**$6,500,000**	**$7,000,000**	**$7,500,000**
Return-on-Cost	6% to 7%	5.9%	5.9%	6.0%
Internal Rate of Return (IRR)	7.5% to 8.5%	7.6%	7.7%	7.8%
Return on Equity (70% loan-value ratio)	5% - 12%	4.3%	4.4%	4.6%

This developer uses return on cost as a key rate-of-return metric and is used herein to benchmark other market-rate of return indicators to the developer's decision to proceed. The developer is targeting a return on cost of about 6%, and as can be seen in the above table, all gap funding levels are estimated to be close to this target.

Return on equity is a useful metric in stable markets where short-term market conditions are more predictable. Return on equity evaluates annual stabilized income after financing costs and debt service. With the coronavirus pandemic's sudden onset, real estate financing markets has become somewhat volatile. Because estimated return on equity is highly dependent on financing terms, which is subject to daily revisions and now more highly dependent on underwriting the borrower, it has become less insightful as an indicator of project feasibility. In this evaluation the reviewer is relying primarily on internal rate of return (IRR) for feasibility determinations.

Given the development project as proposed by the developer indicates a **financial gap ranging from $6.5 million to $7.5 million.**

Gap Funding Analysis

Rental Rates

The indicated range of market rents by unit type is validated by comparing to competing properties within the town of Castle Rock. Rental rates for The View are not out of line with the local market, however they do define the current upper end. This can be attributable to rents being asked for the top floor units which is planned to have relatively large unit sizes, oversized windows and panoramic views, and loft-design.

The rental rates estimated for The View is primarily based on comparisons with its closest competitor, Riverwalk, and a market study completed in support of informing this project. The market study was reviewed and found reasonable. It is worth noting that the market study includes many comparables located in the regional market, and many of those projects are in transit-oriented (TOD) development locations near RTD light rail stations. Castle Rock does not have light rail service to Metro Denver and rent projections may be overstated; however, the proximity of southeast Denver business parks and transit stations somewhat offsets the lack of a TOD location. The risk of missing this forecast is that revenues maybe overstated.

Development Costs

As previously noted, the developer's cost estimate is at the high end of construction costs experienced in the market. After discussions with the developer it is the understanding of the reviewer that the product will be high quality construction, upgraded amenities, and unique features which will support upper-end rates. An estimated $7,000,000 gap is 10% of the total $70,000,000 construction costs.

The residential units are planned to be constructed above a two-story podium. As proposed, the podium will house:

- 299 parking spaces
- 5,000 square feet of retail built out in the first story parking level, and
- 14,500 square feet of office space built out in the second parking level.

Construction for the podium component is estimated at about $9.1 million; adding an estimated $100 per square foot for commercial buildout (demising walls, utility fixtures, tenant improvements, other features) the overall cost is about $11 million. There may be an opportunity to value-engineer the podium with less commercial space and reduce the overall size of the parking structure, perhaps even reducing it to a single parking level.

The reviewer is not an expert in construction cost management but, for illustrative purposes has evaluated the cost estimates for the residential units to be constructed above the podium. Based on the developer's reported construction costs the residential units and amenities component are estimated to cost about $59 million to build, or about $270,000 per unit, notably greater than that generally experienced with other projects:

Development Costs	As Proposed	Market Experience Based
Residential Component *(above podium-parking-retail-office floors)*	$270,000/unit*	$100,000 - $220,000/unit
	$324/square foot*	$200 - $300/sf
	**reviewer estimate*	

A $7 million gap for 218 units equates to about $32,000 per unit. If possible, value engineering to reduce costs by this amount saves about $38 per square foot in cost savings. This would be a significant move to minimize the overall financial gap. Based on typical market costs, this construction cost level should allow for high quality construction, features, and amenities.

There is also an opportunity to value engineer other components of the living spaces, features, and amenities. This too however may change the price points for rental units depending upon how those changes are made and impacts on appeal, value perception, and market acceptance. Value engineered construction may alter the property's ability to achieve rent premiums as proposed.

It should be noted that value-engineering the podium and/or the residential components will likely impact the construction program and potentially the ability for the project to achieve the projected rental rates. Modifications may alter the project concept and reduce its market acceptance. Any value-engineering should be cautiously considered by a qualified engineer with full engagement by the developer.

Development Risk

Project proformas are projections and always carry market and other risks impacting costs, operations, and return on investment. In reviewing this project the following risks are summarized amongst other potential risks:

- Rental rate projections may be higher than can be realized;
- Potential Rent Concessions as a deduction to asking rents are becoming more common in the market;
- Public participation by the City of Castle Rock and its Downtown Development Authority may be limited due to funding availability; and
- The Covid-19 Pandemic may alter market conditions in unforeseen ways.

Gap Financing Options

There are various approaches to bridging the gap, some of which have been already tendered by the developer. These include, but are not limited to:

- Value-engineering costs
  - Focus on reducing costs to construct the residential component of the project while maintaining value for the tenants
  - Reduce or eliminate retail and/or office space to recover parking spots and possibly reducing the parking structure to a single level
- Improve annual cash flow
  - Utilize Tax Increment Financing to annualize gap funding
  - Public leases on office, retail, and parking spaces as revenue guarantees or for public use
  - Public Improvement Fees on location specific retail sales; the amount of PIF generated is likely to be very small
- Address up-front costs
  - Public funding for utility relocation costs
  - permit fee waivers
  - Allow developer's share of TIF revenue to be used as a loan guarantee for a second or mezzanine loan

IN SUMMARY

The View location offers an assembled site with dimensions to accommodate a new residential or mixed-use property in a location close to Castle Rock's central business corridor. With economic growth being experienced in metro Denver's southern region Castle Rock The View can take advantage of a small-town atmosphere with a relatively short commute time to employment centers. The project is designed to provide a unique property focusing on premium renters.

In today's market, feasibility and gap estimates are primarily based on pre-covid market conditions. It is recognized that a persisting pandemic may impact the residential markets in ways that could be positive, negative or simply chaotic.

In conclusion, it is the reviewer's opinion that a feasibility gap does exist for The View, as proposed, in the range of $6.5 million to $7.5 million.

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