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From: Jesse Silverstein, Senior Economist, Development Research Partners

To: Kevin Tilson, Director, Castle Rock Downtown Alliance

RE: Development Proforma Review for Project 1920

Development Research Partners, Inc. (DRP) has been engaged to review the development budgets provided by the project developer and to independently develop market data and proformas for the referenced project.

This memorandum summarizes DRP's review and findings.

PROJECT BASIS

- The proposed development is a multi-tenant, free-standing, 36,000 square foot mixed-use building to include 20 residential rental units and $21,600 square feet of retail and/or office space on an 11,310 square foot (0.26 acre) site.
- The site is currently used as a vacant parking lot.
- The developer is projects an average apartment rental rate of $1,350 per month and a blended rental rate for the commercial space averaging $22.92 net per square foot.

SCOPE OF REVIEW

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

- Land market values
- Market rental rates
- Construction costs
- Commercial mortgage loan rates and terms
- Commercial construction loan rates and terms
- Market survey investment criteria and yield indicators
- Feasibility gap estimates, if any

DRP's methodology entails evaluating construction costs, rental rates, and market performance compared to the developer's estimates.

PROJECT ASSUMPTIONS

The following chart compares as-proposed market assumptions with market-derived assumptions based on DRP's research.

MODEL ASSUMPTIONS	MARKET-BASED*	AS-PROPOSED	COMMENTS
Rent			
Residential	$1,400/mo gross	$1,350/mo gross	Basement restaurant, , first floor office and/or retail, second floor office
Office	$18.00/sf/yr gross	$26.03/sf/gross	
Retail	$14.00/sf/yr NNN	$19.83/sf/gross	
Avg Lease Term (yrs)			
Residential	1 year	Single stabilized Year	Developer provided single-year cash flow; DRP utilized 10-year proforma
Office	3 years		
Retail	3 years		
Expenses			
Residential	$5,000/unit/yr	$5,040/unit/yr	Retail expenses may be higher than shopping center retail due to the nature of the building and space; overall rent + expenses expected to be market competitive
Office	$8.00/sf/yr	$8.70/sf/yr	
Retail	$4.50/sf/yr	$9.17/sf/yr	
Stabilized Economic Loss	5.00% vacancy plus 2% credit loss	5.00% vacancy and credit loss	DRP assumes stabilization in operating year 2
Construction Loan			
Loan:Cost Ratio	70.00%	70.00%	For construction financing
Interest Rate	7.00%	5.5%	
Permanent Mortgage Loan			
L:V Ratio	5.5%	Not Stated	Developer provided proposed construction loan terms only
Interest Rate	75.00%		
Amortization	25 yrs	Not Stated	For perm financing
Cash-on-Cash Target	10% to 20%%	Not Stated	Investment goal
Overall Cap Rate	6.5%	Not Stated	Applied to stabilized income
Terminal Cap Rate	7.5%	Not Stated	Applied to future liquidation value
Growth Rate	3.0%	Not Stated	Applied to rent and expenses
Development Costs	$7,200,000	$7,139,482	As-proposed costs used to model returns

** Based on DRP market research*

METHODOLOGY

DRP researched real estate market indicators and estimated market-based feasibility gaps to evaluate general development interest by any developer in the market. Whether this particular developer would develop depends on their individual investment criteria and market projections, which is assumed to be in line with current market trends.

DRP used a 10-year cash flow analysis to evaluate the dynamics of the proposed investment. This dynamic analysis considers initial development costs, lease-up to stabilization, growth of market rent and expenses over time, and reversion (sale or liquidation) of the asset at the end of the 10-year holding period.

To evaluate feasibility, two approaches are used to evaluate hurdle rates of return on investment, and subsequently reconciled. Feasibility and gap financing is evaluated as: (1) an upfront cash infusion that offsets developer equity; and alternatively (2) annualized cash infusions allocated evenly over the 10-year investment period.

OBSERVATIONS

The following observations highlight the assumption differences between DRP's analysis and those provided by the developer:

- **Construction costs**: DRP estimated development costs utilizing RS Means construction costing guide and has estimated development costs as-proposed at $7.2 million, within 3% of the developer's estimate of $7,139,482, within a reasonable margin of error.For DRP's gap analysis, a $7.2 million development cost is assumed.
- **Market rent and occupancy**: DRP estimates apartment market rent to be $1,400 per month in today's market, comparing similarly to the developer's projection of $1,350 to $1,400 per month. DRP has used $1,400 per month in its analysis.

  The developer estimates rent for the office and retail space at $26.03 per year and $19.83 per year, respectively. The developer's proforma does not include expense reimbursements and therefore these rates are assumed to be quoted as gross rates. Based on rent comparables, DRP estimates market rent at $18 gross for office space and $14.00 triple-net (NNN) for retail space.

  The developer provided a single-year, full occupancy cash flow estimate indicating a 5% vacancy rate across all uses. This rate is considered to be full occupancy (allowing for tenant churn) and is appropriate for a stabilized occupancy. DRP estimates first year vacancy to be 25% for commercial space and 20% for residential units, stabilizing at a 5% vacancy in year two and into the future. Additionally, DRP has imposed a 2% loss for tenant credit issues, releasing expenses, and other costs that may arise.
- **Revenues:** DRP estimates gross potential revenue during the first stabilized year of operations (year 2) at $460,124 versus $484,632 projected by the developer. DRP's projection is within a reasonable 5% margin of error of the developer's estimate; DRP's market rent assumptions are used in this analysis.
- **Expenses**: Based on market data DRP estimates total operating expenses to total $249,312, about 15% less than the developer's estimate of $293,760. This difference may be explained by the physical nature of the property wherein actual expenses for may be similar, and higher, for all uses due to physically integrated space. However, It is assumed leases will be signed at a market equivalent rate where pricing of the overall rent plus expenses package is competitive with other properties; DRP's estimated market rent and operating expenses combination are utilized in the analysis.
- **Net Operating Income:** DRP estimates annual net operating income upon occupancy stabilization to be $460,124, about 95% of the developer's estimate of $484,632, within a reasonable margin of error.

ANALYTICAL SUMMARY

To evaluate overall feasibility and potential feasibility gaps DRP developed a cash flow analysis assuming a 10-year hold with sale of the asset at the end of the hold period.

Target Rates of Return

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:

Cash-on-Cash	Income after debt service as % of equity	10% to 20% (minimum 10%)
Internal Rate of Return (IRR)	Annual revenue and asset sale over 10 years as return on development costs	9% to 12% (minimum 9%)

As illustrated in the table below, various levels of gap funding sensitivity were evaluated using two methodologies:

- Upfront gap funding to offset the developer's equity contribution
- Gap funding annualized and equally allocated over the 10-year hold to improve annual net operating income

	Upfront Gap Funding		**Annualized Gap Funding**	
Gap Funding Level	Cash-on-Cash	IRR	Cash-on-Cash	IRR
None	3.2%	7.4%	3.2%	7.4%
$1,400,000	9.1%	10.4%	9.7%	9.2%
$1,500,000	10.4%	10.7%	10.1%	9.3%
$1,600,000	12.3%	10.9%	10.6%	9.5%
$1,700,000	15.0%	11.2%	11.1%	9.6%
$1,800,000	19.1%	11.5%	11.5%	9.7%
$1,761,000 *As proposed*	17.3%	11.4%	11.3%	9.7%

Gap Analysis

To evaluate feasibility, two approaches are used to evaluate hurdle rates of return on investment, and subsequently reconciled. Feasibility and gap financing is evaluated as: (1) an upfront cash infusion that offsets developer equity; and alternatively (2) annualized cash infusions allocated evenly over the 10-year investment period.

Ideally, to attract developer interest both cash-on-cash and internal rate of returns (IRR) should fall into the acceptable range. The following summarizes the conclusions of the cash flow analysis:

- Based on upfront gap funding to offset equity requirements. The project is yielding insufficient annual income on its own during the 10-year investment period to meet minimum market hurdle rates on investment. Under this scenario the project is not considered feasible. Gap funding is estimated to improve feasibility as follows:
    - An upfront infusion of $1.4 million improves IRR and cash-on-cash returns to being marginally over the hurdle rate
    - An upfront investment of $1.8 million yields an IRR and cash-on-cash return at the upper end of the target range and may over compensate the market more than necessary to catalyze development.
    - This analysis suggests an appropriate level of gap funding between $1.5 million and $1.7 million.

- Based on annualized gap funding to improve annual income. The project is yielding insufficient annual income on its own during the 10-year investment period to meet minimum hurdle rates on investment. Gap funding is estimated to improve feasibility as follows:
    - An infusion of $150,000 annually moves both IRR and cash-on-cash returns into a range that should be marginally attractive to developers in the market.
    - An infusion greater than $170,000 annually adds 100 basis points to the cash-on-cash returns over the lower limit of targeted rate ranges and should be very attractive to market developers.
    - This analysis suggests an appropriate level of gap funding between $150,000 annually and $170,000 annually ($1,500,000 to $1,700,000 in aggregate).

IN CONCLUSION

Reconciling the two analytical approaches suggests appropriate gap financing in the range of $1.5 million to $1.7 million up front, or $150,000 to $170,000 annually. A target of $1.6 million in public investment to bridge feasibility gaps is indicated.

As with all investors, this particular developer has its own internal investment criteria, hurdle rates, and performance projections which may or may not match the generalized market parameters used herein. The suggested ranges of gap funding will necessitate negotiation to determine the specific level acceptable to the City and the developer.

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