Development Research Partners

Date: June 28, 2016

From: Jesse Silverstein, Senior Economist, Development Research Partners

To: Kevin Tilson, Kevin Tilson, Director, Castle Rock Downtown Alliance

RE: Development Proforma Review for the Riverwalk Redevelopment

Development Research Partners, Inc. (DRP) has been engaged by the Castle Rock Downtown Alliance to review the development budgets, develop independent operating proformas, and evaluate feasibility gaps for the referenced project.

This memorandum summarizes DRP's review and findings.

PROJECT BASIS

- The proposed redevelopment sites are two parcels located at 111-113 Wilcox Street and 215 Wilcox Street, straddling either side of Sellers Gulch. Confluence Partners, the developer, owns both parcels which are currently improved with commercial uses. Together, the assemblage totals almost 5.8 acres.
- The proposed redevelopment is planned to include 239 residential units, 24,188 square feet of office, 6,885 square feet of retail, and 137,252 square feet of structured parking.
- Because of the commercial building design and occupancy for existing buildings on the parcels, The developer reported paying a premium over and above vacant land price, which DRP confirms, leading to additional project costs associated with tenant relocation, demolition to clear the site, and relocation of utilities for the new use.

SCOPE OF REVIEW

In developing a market-based proforma and evaluating feasibility gaps, DRP has researched current real estate data to benchmark the developer's proposed project to broader market indicators in the development community at large. DRP reviewed and provided independent research regarding the following assumptions:

- Review of Apartment Appraisers and Consultant's market analysis commissioned by Confluence Partners
- Land market values
- Market rental rates
- Construction costs
- Commercial "permanent" mortgage loan rates and terms
- Commercial construction loan rates and terms
- Market surveys for investment criteria and yield indicators
- Feasibility gap estimates, if any

Methodology used by DRP entails evaluating construction costs, rental rates, and market performance based on the developer's proposed project specifications.

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PROJECT ASSUMPTIONS

The following chart compares the as-proposed development proforma assumptions with DRP's market-derived assumptions which illustrate generally prevailing market conditions. Every development project is unique and every developer has their own construction style and investment hurdle rates.

MODEL ASSUMPTIONS	Market-Based*	Developer-Proposed	Comments
Residential Rent			The development proforma assumes both office and retail are gross leases. DRP assumes retail rent is on a net basis and office rent is on a gross basis. It is assumed that office rates include tenant improvements amortized over the term of the lease.
Studio	$1,100/mo	$1,083/mo	
1-Bedroom	$1,200/mo	$1,183/mo	
2-Bedroom	$1,500/mo	$1,542/mo	
Commercial Rent			
Retail	$19.00/sf/yr	$20.00/sf/yr	
Office	$20.00/sf/yr	$20.00/sf/yr	
Lease Terms			Generally commercial leases are 3- to 5-years and often carry scheduled year 3 rent bumps
Residential	1	1	
Commercial (yrs)	3	3	
Expenses			The development proforma models all commercial space as gross (tenant pays all expenses) with $1.50 annual (re)leasing costs. DRP models office space on a traditional gross basis; retail on modified net basis.
Residential	$5,500/unit	$5,500/unit	
Office	$8.50/sf	$1.50/sf	
Retail	$2.00/sf	$1.50/sf	
Vacancy	5.0% + 2% economic loss & annual leasing costs	6.0% combined vacancy and economic loss	Both the development proforma and DRP assume stabilized vacancy by end of operating year 2
Perm Loan:			Loan terms are variable depending on specifics and location of the project, borrower credit, and other factors specific to each project.
Loan:Value Ratio	75%	70%	
Interest	5.5	6.0%	
Term	25	30 yrs	
Construction Loan:			Loan terms are variable depending on specifics and location of the project, borrower credit, and other factors specific to each project.
Loan:Cost Ratio	75%	65%	
Interest	5.5%	4.5%	
Term	Interest only	Interest only	
Growth Rate			DRP uses a long-term rate of growth; development proforma shows higher rates of rent growth in early years.
Market Rent	3.00%	6% yr1; 4% yr2; 3%-yr3+	
Op Expenses	3.00%	2.00%	
Development Costs	$64.5 million	$60.5 million	Market-derived cost source: RS Means Square Foot Costs.
Rates of Return Indicators			Return on Equity (leveraged cash-on-cash) is the primary indicator used herein for estimating the gap.
Cap Rate (going in)	6.5%	6.0%	
Terminal Cap Rate	7.5%	6.25%	
IRR (unleveraged)	5.2%	5.2%	
Return on Equity	14.1%	na	

**DRP market research*

OBSERVATIONS

The following summarizes observations made during the analysis:

- DRP has estimated development costs almost 7% higher the developer; the Developer's estimated construction costs of $60.5 million are used.
- In consideration of the metro Denver apartment market's imminent plateauing, the projects pioneering location, and the number of units being added to the market, DRP smooths out an estimated long-term 3.0% growth rate across all years of the proforma and utilizes somewhat higher cap rates.
- Overall, the development proforma' s assumptions seem reasonable and generally within market parameters.

Notable Project Challenges

The Riverwalk project faces challenges unique to the location and transaction parameters leading to costs and coordination time over and above other similar projects including:

- A large mixed-use project in a pioneering location for that use creates lending risk for debt and equity financing.
- Land costs totaling over $55 per sf and still requires relocating tenants and demolition. In comparison, the vacant Mercantile Commons vacant site sold for about $23 per sf. While some of Riverwalk's premium is offset by revenue from existing tenants, a notable purchase premium was incurred.
- The project is spread across two separate building pads. Confluence Partners estimates that the two separate buildings, rather than a single building pad, adds about $18 per sf additional construction costs for duplicative architectural plans, foundation features, and related costs.
- Soil conditions require upgraded foundations and structural elements.
- There is a need to acquire surplus land for utilities relocation and easements, and to provide new utilities.

TARGET RATES OF RETURN

Based on investor surveys and market data reviewed by DRP, the following target rate is used to proxy investment hurdle rates of return. In other words, it is assumed the cash flow projections must provide rates of return within the following ranges to be considered attractive to the market:

MARKET-BENCHMARK SCENARIO

market-derived rent, expenses, and market performance; market financing terms; construction survey based development cost estimates

Gap Funding Level	Return on Equity
Rate of Return Target Range	*10% to 20%*
$12,000,000	9.5%
$13,000,000	11.3%
$14,000,000	**14.1%**
$15,000,000	18.5%

ESTIMATED FEASIBILITY GAP

DRP's financial analysis (see attachment) indicates at least a $13 million feasibility gap to just begin making the project financially feasible. DRP's investor survey reviews indicate that market developers generally find a return on equity of about 14% to 15% to be attractive.

In consideration of market status, location, development challenges, and market-derived assumptions **DRP estimates a market feasibility gap of about $14.0 million**.

Projected operating performance and required rates of return are very specific to each individual investor and developer. The market-rate assumptions are intended to evaluate the most typical acquisition terms in the market, which can and will differ with any specific individual developer.

ESTIMATED FEASIBILITY GAP WITH PROPOSED PUBLIC-PRIVATE PARTNERING

Castle Rock and Confluence Partners are both interested in the success of the Riverwalk project and have discussed an appropriate level of public investment that can be contributed to the project to yield public benefits and enable the project to be feasibly developed. To this end, DRP has evaluated the impact of these public-private partnering terms on feasibility.

In summary, DRP has evaluated the following annual public investments on project feasibility:

Public Investment Type	Annually
Sales Tax Increment	75% of estimated sales tax increment; sales estimated @ $220/sf
Property Tax Increment	75% of estimated property tax increment
Fee & Use Tax Waivers	$3,336,762 offsetting initial investment and construction costs; evaluated as a lump sum investment during the construction period
PIF	1% retail fee to the developer

Castle Rock and Confluence Partners have proposed the above public-private partnering terms totaling $12.2 million in public contribution over time. These terms were incorporated into a second feasibility model that also targeted a developers' cash-on-cash hurdle rate of 14%. Within this model the $12.2 million in public contributions over time is discounted to today's dollars along with all other future cash flows. After discounting these contributions to current value to account for the time value of money, the $12.2 million projected contributions over time equate to about $4.6 million in current dollars. While this present value may be lower than the lump sum contribution over time, annual payments do offer additional benefits to the developer such as supporting future cash flows and reducing risk to lenders.

In summary, **after considering the public investments described above, the feasibility gap is estimated at about $9,000,000**. The project as-built may perform better than market assumptions which would reduce this estimated gap accordingly.

PROJECT RIVERWALK'S ECONOMIC, FISCAL, AND MARKET IMPLICATIONS

Mixed-use development is a challenging real estate product type in any market. Most real estate development is of a single use, with straightforward construction, market analysis, proformas, and lenders/investors that are comfortable with the lending risks for a single-use property type. The inherent risk viewed by many different partners in a mixed-use project creates a challenge just to negotiate risk-reward parameters for all the parties. Additionally, construction is more challenging and requires tighter oversight and construction management. Due to these and other factors, only a small community of developers is willing to take on mixed-use development in general, particularly in a pioneering location. However, in today's community and economic development climate, this type of development can play a large role in shaping a community's functionality for businesses and residents, supporting economic health:

- Having diverse housing stock downtown attracts diverse households that can range from singles to young families to empty nesters. There is a symbiotic relationship between downtown residents and businesses wherein residents support downtown businesses and downtown businesses provide a lifestyle to residents.

- A well tenanted and active downtown is attractive to visitors who attend sporting events, fairs, or Castle Rock's recreational assets. This represents dollars imported to the community and a contribution to the economic health of the town.
- An active downtown lifestyle along with the availability of downtown housing will enable local businesses to attract a qualified work force to support growth, expansion, and attraction.
- Purchases by households financially support local businesses and the Town of Castle Rock. In a recent economic/fiscal impact analysis conducted for a similar project in Castle Rock it is estimated that each new mixed-use household will spend about $12,000 on taxable retail annually in town, supporting businesses.
- These businesses in turn purchase goods and services from other local vendors and suppliers, supporting overall revenues.

IN CONCLUSION

The developer has provided a realistic estimate of development costs and anticipated operating cash flows. The assumptions presented by Confluence Partners with regard to their specific projections are reasonable based on DRP's research of current market conditions.

DRP independently developed a proforma and financial analysis from a market perspective rather than the needs of any particular investor/developer. The conclusions reported herein are based on this market-derived analysis. As a fully private-sector funded project DRP's analysis identifies an upfront feasibility gap of about $14 million.

Castle Rock and Confluence Partners are both interested in the success of the Riverwalk project and have proposed public-private partnering terms totaling $12.2 million in public contribution over time. These terms were incorporated into the feasibility analysis to evaluate the impact on feasibility. After considering the time value of money and Castle Rock's contribution to the project, the feasibility is reduced to $9 million. This gap may be able to be addressed by greater than projected project performance, alternative financing, and/or other developer-based approaches.

Please let me know if you have further questions or desire clarification.

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Scenario:
Project River Walk As Proposed, analyzed with market assumptions

PROJECT SUMMARY

Property Summary	
No. Units	Various
Rentable SF	213,827
Total Construction Cost	$60,500,000
Construction per Square Foot	$283
Construction Equity	$18,150,000
ConstructionDebt	$42,350,000

Proforma	
Year Stabilized	3
Stabilized NOI	$2,589,850
Stabilized Cap Rate	6.50%
Stabilized Proforma Value	$39,843,845
Stabilized Value Per RSF	$186
Value upon Completion	$24,926,139
Reversion Cap Rate	7.50%
Growth Rate	3.00%

GAP FUNDING - applied to contruction equity	$14,000,000

Construction Loan Summary	
Loan : Cost Ratio	70%
Contruction Loan Term (mos)	24
Construction Interest Rate	5.00%
Construction Loan Amount	$42,350,000
Construct Loan Per RSF	$198.06

Perm Loan Summary	
Perm Loan : Value Ratio	70%
Perm Loan Amount	$27,890,691
Perm Loan Ammortization (yrs)	30
Perm Interest Rate	6.00%
Perm Loan Yearly Payment	$2,006,625
Perm Term	10
Perm Loan Balance	$23,340,527
Loan Fees/Closing Costs	2.0%

Feasibility Indicators (10 yr hold)		Market Target Rate
Cost/Value*	151.8%	
Return on Equity (leveraged cash-on-cash)*	14.1%	10% to 20%
IRR on Project (unleveraged)	5.2%	9% to 12%

*Stabilized Year

OPERATING PROFORMA

Proforma Year	CONSTRUCT	1	2	3	4	5	6	7	8	9	10	11
Investment												
Construction Equity	(18,150,000)											
Construction Debt	(42,350,000)											
Construction Cost	**(60,500,000)**											
Operating Income												
Net Income from Property Operations	$0	$1,620,199	$2,531,711	$2,589,850	$2,690,718	$2,766,469	$2,829,999	$2,940,220	$3,022,996	$3,092,416	$3,212,858	$3,303,309
GAP Funding	*$14,000,000*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
NOI	**$14,000,000**	**$1,620,199**	**$2,531,711**	**$2,589,850**	**$2,690,718**	**$2,766,469**	**$2,829,999**	**$2,940,220**	**$3,022,996**	**$3,092,416**	**$3,212,858**	**$3,303,309**
(less) Construction Loan Interest Payment		($2,117,500)	($2,117,500)									
(less) Perm Loan Payments		($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)
Operating Cash Flow	**$14,000,000**	**($2,503,926)**	**($1,592,414)**	**$583,224**	**$684,093**	**$759,844**	**$823,373**	**$933,595**	**$1,016,370**	**$1,085,791**	**$1,206,233**	**$1,296,683**
Refinance/Gross Reversion Proceeds											$44,044,119	
(less) Closing Costs 2.00%											($880,882)	
(less) Loan Balance											($23,340,527)	
Net Refi/Reversion Proceeds											**$19,822,709**	
Unleveraged Cash Flow (NET OF CONST GAP FUNDING)	**($46,500,000)**	**$1,620,199**	**$2,531,711**	**$2,589,850**	**$2,690,718**	**$2,766,469**	**$2,829,999**	**$2,940,220**	**$3,022,996**	**$3,092,416**	**$46,376,094**	**$3,303,309**
Leveraged Cash Flow (NET OF CONST GAP FUNDING)	**($4,150,000)**	**($2,503,926)**	**($1,592,414)**	**$583,224**	**$684,093**	**$759,844**	**$823,373**	**$933,595**	**$1,016,370**	**$1,085,791**	**$21,028,942**	**$1,296,683**
Rates of Return Analysis												
Return on Equity (cash-on-cash)		-60.34%	-38.37%	14.05%	16.48%	18.31%	19.84%	22.50%	24.49%	26.16%	506.72%	31.25%
IRR on Project (unleveraged)	5.19%											
IRR on Equity (leveraged)	15.31%											
Return on Cost		2.68%	4.18%	4.28%	4.45%	4.57%	4.68%	4.86%	5.00%	5.11%	5.31%	5.46%

Scenario:

Project River Walk As Proposed, analyzed with market assumptions; includes planned public investment

PROJECT SUMMARY

Property Summary		Construction Loan Summary		
No. Units	Various	Loan : Cost Ratio	70%	
Rentable SF	213,827	Contruction Loan Term (mos)	24	
Total Construction Cost	$60,500,000	Construction Interest Rate	5.00%	
Construction per Square Foot	$283	Construction Loan Amount	$42,350,000	
Construction Equity	$18,150,000	Construct Loan Per RSF	$198.06	
ConstructionDebt	$42,350,000			
		Perm Loan Summary		
		Perm Loan : Value Ratio	70%	
Proforma		Perm Loan Amount	$27,890,691	
Year Stabilized	3	Perm Loan Ammortization (yrs)	30	
Stabilized NOI	$2,589,850	Perm Interest Rate	6.00%	
Stabilized Cap Rate	6.50%	Perm Loan Yearly Payment	$2,006,625	
Stabilized Proforma Value	$39,843,845	Perm Term	10	
Stabilized Value Per RSF	$186	Perm Loan Balance	$23,340,527	
Value upon Completion	$24,926,139	Loan Fees/Closing Costs	2.0%	
Reversion Cap Rate	7.50%			
Growth Rate	3.00%			
GAP FUNDING - applied to contruction equity	$9,200,000	**Feasibility Indicators (10 yr hold)**		Market Target Rate
		Cost/Value*	151.8%	
		Return on Equity (leveraged cash-on-cash)*	14.1%	10% to 20%
		IRR on Project (unleveraged)	0.6%	
		IRR on Equity (leveraged)	14.8%	

*Stabilized Year

OPERATING PROFORMA

Proforma Year		CONSTRUCT	1	2	3	4	5	6	7	8	9	10	11
Investment													
Construction Equity		(18,150,000)											
Construction Debt		(42,350,000)											
Construction Cost		**(60,500,000)**											
Operating Income													
Net Income from Property Operations		$0	$1,620,199	$2,531,711	$2,589,850	$2,690,718	$2,766,469	$2,829,999	$2,940,220	$3,022,996	$3,092,416	$3,212,858	$3,303,309
NOI		**$0**	**$1,620,199**	**$2,531,711**	**$2,589,850**	**$2,690,718**	**$2,766,469**	**$2,829,999**	**$2,940,220**	**$3,022,996**	**$3,092,416**	**$3,212,858**	**$3,303,309**
(less) Construction Loan Interest Payment			($2,117,500)	($2,117,500)									
(less) Perm Loan Payments			($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)	($2,006,625)
Operating Cash Flow		**$0**	**($2,503,926)**	**($1,592,414)**	**$583,224**	**$684,093**	**$759,844**	**$823,373**	**$933,595**	**$1,016,370**	**$1,085,791**	**$1,206,233**	**$1,296,683**
Annual Gap Financing Payments													
Construction Gap Funding		*$9,200,000*											
Sales Tax Increment			*$0*	*$29,240*	*$60,234*	*$62,041*	*$63,902*	*$65,819*	*$67,794*	*$69,828*	*$71,923*	*$74,081*	*$76,303*
Property Tax Increment			*$0*	*$0*	*$128,420*	*$256,839*	*$272,480*	*$272,480*	*$289,074*	*$289,074*	*$306,679*	*$306,679*	*$325,355*
Fee & Use Tax Waivers		*$3,336,762*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
1% PIF					*$21,659*	*$22,309*	*$22,978*	*$23,667*	*$24,377*	*$25,109*	*$25,862*	*$26,638*	*$27,437*
TOTAL ANNUAL GAP FINANCING		***$12,536,762***	***$0***	***$29,240***	***$210,313***	***$341,189***	***$359,360***	***$361,966***	***$381,245***	***$384,011***	***$404,464***	***$407,398***	***$429,095***
Refinance/Gross Reversion Proceeds												$44,044,119	
(less) Closing Costs	2.00%											($880,882)	
(less) Loan Balance												($23,340,527)	
Net Refi/Reversion Proceeds												**$19,822,709**	
Unleveraged Cash Flow		**($47,963,238)**	**$1,620,199**	**$2,560,951**	**$2,800,163**	**$3,031,907**	**$3,125,829**	**$3,191,965**	**$3,321,466**	**$3,407,006**	**$3,496,880**	**$23,442,965**	**$3,732,404**
Leveraged Cash Flow		**($5,613,238)**	**($2,503,926)**	**($1,563,174)**	**$793,537**	**$1,025,282**	**$1,119,204**	**$1,185,340**	**$1,314,840**	**$1,400,381**	**$1,490,255**	**$21,436,340**	**$1,725,778**
Rates of Return Analysis													
Return on Equity (cash-on-cash)			-44.61%	-27.85%	14.14%	18.27%	19.94%	21.12%	23.42%	24.95%	26.55%	381.89%	30.74%
IRR on Project (unleveraged)		0.55%											
IRR on Equity (leveraged)		14.80%											
Return on Cost			2.68%	4.18%	4.28%	4.45%	4.57%	4.68%	4.86%	5.00%	5.11%	5.31%	5.46%