TO: Members of the Plan Commission
FROM: Hickory R. Hurie
SUBJECT: Preliminary Analysis of IZ Waiver Request for University Square
DATE: March 17, 2006

SUMMARY:

Executive Management Inc. developers propose a 350-unit apartment and mixed-use residential-office-retail development at the corner of University Avenue and Lake Street in central Madison. This is a 3.4-acre site that currently includes a shopping mall and surface parking lot. EMI seeks a change in the zoning from its current C-2 to a PUD. The company proposes to demolish the existing building and construct a 12-story building that would serve student, university, and nearby neighborhood needs, with 100,000 square feet of retail space, underground parking, University Office space, student activity offices, and 350 apartments for students.

EMI sought a full waiver of the inclusionary zoning requirements due to the tight site constraints, projected costs of the building, the multiple public purposes associated with the establishment of a new pedestrian mall along Murray Street and the larger scale of the development.

Staff recommend Plan Commission consideration of a waiver of all 53 of the onsite inclusionary units, and a payment in lieu of approximately $854,890, (contingent on future review of projected 'value' of units) based on the extraordinary costs associated with the complexity and added public benefits (and costs) of the project.

This analysis for an inclusionary zoning waiver is based upon data furnished by EMI and by the Planning Unit during January through March 17 2006.

METHOD OF ANALYSIS:

The Council adopted a waiver provision as part of the inclusionary dwelling unit ordinance that requires an analysis of project financial feasibility. The method consists of running three or more scenarios, using data provided by the developer. The first run is based upon a scenario whereby the project, using current zoning levels, is set at market rate sales. If this version is financially feasible according to the standards adopted by the Common Council, the project is then run with the full 15% inclusionary dwelling units included in the project. If this full IZ scenario does not meet the Council standards for financial feasibility, staff are to recommend a third 'waiver' scenario with attributes (a combination of a partial percentage of IZ units, with units off-site, or payment in lieu of units on-site or reduction of expected number of units) that will provide a sufficient return for financial feasibility.

MARKET RATE SCENARIO:

The IZ ordinance suggests that the market rate scenario should be run within the density of the current zoning classification for the parcel. According to Planning Unit staff, the current zoning for this site (C-2) permits up to 130 dwelling units on the site. Running the full-market rate scenario at the current zoning density yields a project with an approximate internal rate of return of 2.0%.

While this would normally preclude qualification for a waiver under the feasibility standards adopted by the Common Council, the Plan Commission in its review of the three most recent waiver requests has accepted the use of the gross profit margin at current zoning levels as a target gross profit margin for the analysis of waiver alternatives in three for-sale developments. The functionally equivalent measure for rental properties is the measure of the internal rate of return.

The overall complexity and scale of this project, with its accompanying parking, University Office space, construction standards, and public pedestrian mall appears to offer a limited base for feasible development of the residential units. Even with the requested density bonus of 169%, the large number of additional bonus units added at marginal costs within the context of the mixed use project provides some basis for a Plan Commission finding of extraordinary costs, due to the inherent construction standards and combination of retail, commercial, public, and residential uses.

IZ SCENARIO WITH ADDITIONAL DENSITY BONUS OF 169%:

Using the above conclusions, we ran a second scenario with the same cost assumptions but with the density requested by the developer, and the inclusion of the affordable units. According to the Planning Unit, the requested density of 350 dwelling units is 169% greater than the current zoning permits.

This second scenario, with the additional market rate units and the 53 inclusionary units (15% of 350 units 'rounded up') yields an internal rate of return of 1.7%. Hence it does not meet the feasibility standards adopted by the Council, nor does it meet the target internal rate of return margin suggested by the current zoning scenario.

MODIFIED IZ SCENARIOS WITH ADDITIONAL DENSITY BONUS OF 169%:

Staff discussed other options of providing the inclusionary units with the developer and concluded that the provision of new off-site units was not likely nor economically feasible, given the lack of available sites in the area. Even if the proposed revision ordinance were adopted by the Council to permit the use of rehabbed existing units within a mile of the development, research by EMI suggests that the total costs of acquisition and rehab to provide comparable off-site inclusionary units would not provide a more feasible way to meet the 15% requirement.

Using the above conclusions, we ran several additional scenarios with the same cost assumptions but different combinations of on-site inclusionary units and waiver payments. The waiver payments were calculated on a formula defined in the ordinance (10% of the average projected value of all units in the development). Each scenario with fewer than 15% iz units and a payment in lieu for the excluded iz units produced an internal rate of return less than the standard adopted by the Common Council for rental developments.

A scenario with no on-site iz units and a payment in lieu of the entire target level of 53 iz units of $854,890 produces an internal rate of return of 2.0%, approximately the target profit margin established by the 'current zoning' scenario and consideration of extraordinary costs based on the scale and nature of the development.

CONCLUSION:

According to the ordinance provisions, the project does not meet the initial standards of financial feasibility for a market rate project at the density levels permitted either under the current zoning. **However, if the Plan Commission were to find that the scale and complexity of the project produces a dynamic of extraordinary costs, then the project would meet that standard of financial feasibility with a waiver based on the provision of no on-site IZ units and a payment in lieu of $854,890 (53 units). This would then constitute a waiver and an alternative method to achieve the full 15% iz requirement contemplated in the ordinance for extraordinary circumstances.**

Since the budget for the entire project continues to change, and the developer has applied for TIF financing within the last week (for assistance on the non-residential portion of the project), this recommendation is contingent on the continuation of similar assumptions on the budget, revenue, and rent levels used in the current scenario. Any significant changes in these assumptions such as larger expenses or smaller rents should trigger another review of the waiver analysis.

Cc: Greg Rice and Susan Springman of Executive Management Inc.
Alder Austin King, Michael Verveer, Brenda Konkel, Jeanne Hoffman, Brad Murphy, Pete Olson, Barb Constans, and Mark Olinger

For your information, the project run at market rate and at the density requested by the developer, but without any IZ units, does make an internal rate of return of 3.50%, which is also outside the Council adopted standards.

Note: Part of the logic inherent in the discussions leading up to the adoption of the IZ ordinance suggested that the City should not be helping an infeasible project at market rate become feasible by waiving one of the primary City public goals (affordable units within larger projects leasing to economically integrated neighborhoods).)

Executive Management

University Square Proposed Zng, pymt in lieu, All market

Rental Parameters for Determining Financial Infeasibility of Inclusionary Zoning

For the periods from August 01, 2009 through December 31, 2019

Issue	Required range	Manual Calculation	Actual
Financing			
Interest rate	Maximum prime plus 2.5	Prime is 7%; This is within council-adopted standards	5.75%
Amortization period	Assume 30 years	Five years longer due to institutional investor	35
Project costs			
Land/Building acquisition - per square foot raw land	$5 per square foot - raw land	Cost less than Council standard range	$48.83
	$50 - $55 per square foot, downtown - vacant land		$48.83
	$90 - $125 per square foot, downtown - improved with building		$48.83
Hard cost contingency	5% new, 8% rehab of AIA contract	Close to Council standards (.1%)	5.1%
Soft cost contingency	5% new/rehab of soft costs	Within Council standards	4.6%
Reserves	Working capital - $750 per unit		$0.00
	Replacement reserve - $0 per unit		$0.00
Contractor profit	6% of AIA contract (net of profit, overhead and general requirements)		0.0%
Contractor overhead	2% of AIA contract (net of profit, overhead and general requirements)	If combined with standard above, then within Council standard	2.9%
Contractor general requirements	6% of AIA contract (net of profit, overhead and general requirements)	Within Council standards	6.0%
Parking	$1,000 per stall - surface $15,000 per stall - first level underground $20,000 per stall for second level underground $27,000 per stall for three levels or more of underground	No underground parking, but parking is enclosed, above ground on several floors	No Parking
Development fees	8% of total project costs, net of development fees and reserves	Under Council standard by over 5%	2.9%
Square foot cost of construction, includes buildings including profit overhead and general requirements, site improvements and personal property	4 stories and under - $62.50 per square foot and 5 to 8 stories - $110 to $120	Within Council standards, looking at net sq.ft	$173.99
Soft cost	10% of cost of construction	Includes larger contingency to handle longer period of construction and site costs assoicated with public right of way, current tenant relocation,	23.1%
Vacancy rate			
	MG&E vacancy rate by zip code multiplied by 120% floor of 5%. If the property is not in the MG&E service area, use citywide average vacancy rate 6 months to lease up.		9.0%
Replacement reserves			
	Up to $250 per unit per year		$0.00
Inflation factors			
Rent	2%		2.5%
Operating costs	3%	Within Council standards	3.0%
Real estate taxes	3%	Within Council standards	3.0%
Sales price assumptions			
Capitalization rate	Prime plus 4.5%	Based on Assessor's data.	5.7%
Cost of sale	6%		8.0%
Debt coverage ratios			
	First mortgage only - maximum of 1.15	Within range	1.07
	All mortgages - maximum of 1.15		1.07

Gross operating expenses, not including real estate taxes			
	$3,000 per unit or 25% of total operating income	Larger than ordinary expenses because it includes communication costs and turn-over due to student transiency	$10,874.37 45.0%
Internal rate of return			
Below prime plus 10.5 financial infeasibility not allowed until affordable units are below 95% of stated market IRR. If market IRR below 8% or IX IRR above prime plus 10.5 - no waiver recommended	Market run at current zoning yields a 'target IRR'; if 'market run' is below 8% or greater than prime plus 10.5%, then no waiver is permitted; if affordable run with incentives is below 95% of target IRR, then waiver is permited	Prime is 7% as of December 12, 2005 ; Market run at current zoning is about 2%; which is less than 8%: This scenario approximates that rate of return.	2.0%
Real estate taxes			
	Fair market value multiplied by City of Madison mill rate per thousand at time of application (NOI/capitalization rate = fair value)		$1,873,800.00
Market rate rent			
	Minimum HUD fair market rent based on bedroom size divided by 40%		See input pages on computer run

ASSUMPTIONS:
This scenario assumes density of 350 rental units as requested by the Developer, without any inclusionary dwelling units.
This is more than the density permitted by current zoning, which is 130 units.
This scenario is based on the figures submitted by the developer during the period Decemebr through March 17, 2006
This scenario uses an average value of $161,300 per residential unit to arrive at the 'payment in lieu' figure.

INTERPRETATIONS:
This scenario produces an internal rate of return of 2.0% , which is below the Council adopted standard of 8%, and matches the approximate 2% established for the project using current zoning densities.
A scenario with 53 inclusionary dwelling units (15% of the 350) wold produce an internal rate of return of 1.7%.

CONCLUSION AND RECOMMENDATION:
Several runs of this project included scenarios with combinations of on-site iz units and payment in lieu. Due to the extraordinary and uncertain costs (at this time) associated with the project, involving retail, mall, and University Office components, the length of time for internal construction of the project, and the low internal rate of return, this project appears to qualify for an IZ waiver.

The scenario that appears to best meet the waiver provision alternatives (the scenario that best yields an internal rate of return comparable to the current zoning density) is the 350 market rate apartment units with a payment in lieu of on-site units equal to 10 per cent of the value of the average apartment unit.

The payment in lieu would be 10% times 53 units times $161,300, or $854,890.