

MEMORANDUM

Re: EHA Financial Feasibility Analysis: Updates 2022

Date: January 24, 2022

This memo supplements the EHA Financial Feasibility Report with additional analysis related to industry comments on the draft report. NAIOP Colorado submitted comments on the feasibility analysis which outlined a variety of potential proforma adjustments desired by the development industry across prototypes. Root and the City met with NAIOP on multiple occasions to discuss the inputs and policy perceptions among their members. The following discussion outlines at a very high level, Root’s analysis of NAIOP’s proposed feasibility model adjustments.

- **Industrial assumptions.** Key changes suggested by the industry were to lower construction costs (from \$215 psf to \$185 psf) and to lower rents from \$16.75 psf to \$9-11 psf. These assumptions were tested but result in negative returns (as measured by COC, IRR, and ROE) even under a base case scenario with the current linkage fee. NAIOP also provides an example in which the industrial return is 2.80% after applying a \$6.00 linkage; however, the same development assumptions¹ result in a 2.87% return even under current linkage fees—both yields are below industry standard but the difference “caused” by the linkage fee is just 7 bps. This differential mirrors the findings of the Financial Feasibility report.
- **Retail assumptions.** NAIOP also provided suggested changes to the retail assumptions and noted that re-running the proformas under their assumptions along with the proposed linkage fee results in a ROC of 4.20%. Root was able to replicate these results with the proposed assumptions. However, it should be noted that under current linkage fees, the same development yields a ROC of 4.25%—just a 5 basis point difference from the return under the max feasible linkage fees. As noted previously, the goal of the financial feasibility is to measure changes to returns based on linkage fee changes and this sensitivity analysis yields results very similar to the impacts identified in the original financial feasibility analysis.
- **Residential assumptions.** Many industry comments on the residential proformas simply required clarification and explanation from Root to reveal consistency between the Root feasibility model and NAIOP’s comments. For example, Root was able to clarify how marketing costs and replacement reserves were incorporated in the current model and the parking revenue and OpEx numbers were equivalent. Root also noted changes in the modeled density for 3-story developments that have already been incorporated to the feasibility model.

¹ Root was able to replicate this return using an \$18 psf land cost and setting rents at \$10.80psf.

- **Office assumptions.** Root agrees with NAIOP that office and retail have higher market uncertainty at present; however, the EHA policies are designed to gradually increase during this period of market uncertainty while ultimately expected to outlast such uncertainty. As such, the office and retail assumptions in the feasibility model reflect current conditions but also account for stabilized market potential. Root did conduct sensitivity testing with NAIOP's proposed inputs and the findings were similar to the industrial and retail analyses described above: NAIOP's inputs result in below-market returns prior to the application of increased linkage fees. Even so, the change in linkage fee results in manageable changes to outputs—in line with the differentials identified in the financial feasibility report.
- **Financing and output metric assumptions.** NAIOP requested itemized site costs and soft costs, which were modeled by Root at percentages of hard costs in the financial feasibility model. Root's approach is industry standard for feasibility analyses and was well-vetted with industry data and stakeholder input. Other key clarifications related to financing and outcomes include:
 - The first feasibility draft calculated an unlevered IRR, which was associated with a 20% expected return. Root has since edited to reflect levered IRR (which assumes payback of the loan balance on year 7) and lowered the threshold accordingly.
 - Development financing assumes 30% equity (70% loan). Construction financing assumes 35%/65%.

Broadly speaking, model adjustments that incorporate NAIOP's suggested changes yield below-market returns on all developments, even before modified linkage fees or affordability requirements are applied. Under these conditions, increased linkage fees also yield below-market returns; however, the difference between base case (current fees) and increased fees is similar to the differential identified in the Financial Feasibility analysis.

Figure 1 summarizes the change in return on cost as a result of increased linkage fees using the inputs suggested by NAIOP. Industrial and retail examples are based on 1-story prototypes, the multifamily residential example is based on a 5-story prototype, and the office example is based on a 12-story prototype. The multifamily example models the change from an inclusionary requirement of 8% of units at 60% AMI, as opposed to increased linkage fees.

Figure 1.
Changes in ROC
under NAIOP
Assumptions

Source:

Root Policy Research based on NAIOP Feasibility Comments (submitted to CPD on September 30, 2021).

Prototype	NAIOP ADJUSTED ASSUMPTIONS		
	Base Case ROC (current linkage)	ROC with Max Feasible Linkage/Inclusionary	Difference
Industrial Example	2.87%	2.80%	7bps
Retail Example	4.25%	4.20%	5bps
Multifamily Example	4.80%	4.58%	22bps
Office Example	2.59%	2.55%	4bps

Other industry comments were addressed on a case-by-case basis and tracked alongside all community feedback on the EHA Financial Feasibility report.