City of Milwaukee

Office of the Comptroller

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October 23, 2009

Members of the Zoning, Neighborhoods
& Development Committee
200 East Wells Street, Room 205
Milwaukee, WI 53202

RE: Park East TID 48 Adjustment – Moderne Project

Dear Committee Members:

The File before your Committee authorizes additional funding for TID 48 in the amount of $12.1 million including $1.1 million in capitalized interest. The additional funding would support activities contemplated but not funded in the original Project Plan for the Park East (TID 48). Specifically, additional TID funding would include $9.3 million in loans for the Moderne condominium and apartment complex, $850,000 for the construction of a City owned public park within TID 48, and $850,000 for prior DCD administrative expenses. The File also approves the terms of a Development Agreement between the City and Milwaukee Moderne, LLC ("Developer") for the construction of the 30-story Moderne Project.

The Moderne Project is to be located in the Park East TID on the southwest corner of Old World Third Street and West Juneau Avenue. The complex would include 203 apartment units, street-level retail, 204 structured parking spaces and 14 luxury condominium units on the top three floors of this building. The average monthly rent of the 203 apartment units would be $2,037, or $1.90 per s.f. The average sale price of the 14 condominium units is $939,000, ranging from $243,000 to $2.5 million. The monthly condominium fee is $875.

Total public and private funding associated with this TID 48 adjustment is $58 million. Total costs for the Moderne Project are $55.2 million, supported by $41.4 million HUD 221(d) 4 guaranteed loan, $9.3 million in City TID funds and $4.5 million in past Developer project specific investment and new equity. In addition to direct financial assistance to the Moderne Project, the proposed TID spending provides $2.8 million of funding for a new downtown public park bounded by Broadway, Water and Ogden Streets, and for DCD administrative expenditures already incurred and capitalized interest. The sources and uses of funding by project component are as follows:

TID 48 ADJUSTMENT SOURCES AND USES OF FUNING
(Dollars In Millions)

	Total		Apartments		Condominiums		Other TID Exp	
SOURCES								
HUD 221(d) 4 Loan	41.4	71%	41.4	87%	-	0%	-	0%
City TID Loans	9.3	16%	1.5	3%	7.8	100%	-	0%
Other City TID Poject Costs	2.8	5%	-	0%	-	0%	2.8	100%
Developer Sunk Costs & Equity	3.6	6%	3.6	8%	-	0%	-	0%
Deferred Developer Fee	0.9	2%	0.9	2%	-	0%	-	0%
TOTAL	$ 58.0	100%	$ 47.4	100%	$ 7.8	100%	$ 2.8	100%
USES								
Land & Hard Cosrs	44.8	77%	37.3	79%	7.5	96%	-	0%
Soft Cost	8.5	15%	8.2	17%	0.3	4%	-	0%
Developer Fee & Overhead	1.9	3%	1.9	4%	-	0%	-	0%
Moderne Project Costs	55.2		47.4		7.8		-	
Capitalized Interest	1.1	2%	-	0%	-	0%	1.1	39%
Public Park	0.9	2%	-	0%	-	0%	0.9	32%
DCD Administration	0.8	1%	-	0%	-	0%	0.8	29%
Other TID Costs	2.8		-		-		2.8	
TOTAL	$ 58.0	100%	$ 47.4	100%	$ 7.8	100%	$ 2.8	100%

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Funding for the Modern apartments, parking and retail component ("Apartments") would be secured by the Department of Housing and Urban Development (HUD) 221(d) 4 program which provides FHA mortgage insurance to HUD approved lenders. The mortgage insurance protects the Lender, AFL-CIO Investment Trust, from risk of default. Capmark Financial Group would service this loan which is currently estimated at $41.4 million. Developer would provide its $4.5 million in prior Developer expenses, new equity and deferred developer fee investment, and as presented by the Developer, the City would provide $1.5 million in loan funds toward the Apartments for a total $47.4 million. **The Federal HUD loan guarantee is restricted to Apartment financing only and does not apply to the condominium component of the Project**. The term of the HUD loan is 40 years plus the construction period and is secured by a first mortgage on the rental income from the apartment, parking and retail component of the Project. **The City would have a second mortgage lien on the Apartments.** FHA has reviewed the preliminary financing proposal for the Project and has invited Developer to submit its application for formal underwriting, which is expected to be completed within 60 days of submission.

The second largest source of funding for the Moderne Project would be $9.3 million in City TID loans consisting of a $3.3 million "mezzanine"[1] loan, a $6 million construction completion loan. In addition, TID funding includes $2.8 million for a public park, City administrative expenses and initial interest costs. The term of the City TID loans is four years including the construction period. **The City loans are secured by a first mortgage on the condominium portion of the Project.** The City mezzanine loan has a minimum interest rate of 14 percent and the City construction completion loan has an interest rate of around 6.5 percent Additional security for these loans is a second mortgage on the Apartments and any residual income from this component. The mezzanine loan is also secured by 50 percent of Developer's equity interest in the project ($2.3 million) and the construction completion loan carries the personal guarantees of two Developer equity partners. As presented by the Developer, **of the $9.3 million of City TID loans, $7.8 million provides the entire condominium financing, with the remaining $1.5 million financing about three percent of the Apartment component.**

The remaining $4.5 million of Project financing is from Developer-equity sources, including $2.7 million in Developer prior year ("sunk") costs and up to $1.8 million new equity including $700,000 in deferred Developer fees. The Developer fee consists of $1.4 million received during the course of construction and the above $700,000 upon construction completion. Most of the Developer's investment has already occurred including past land acquisition and other costs to continue with the Project.

The Developer initially proposed a hotel-condominium project for this site in early 2007 to be 100 percent privately financed. The current Project is mainly an apartment development, of which over 90 percent is City of Milwaukee TID financed or guaranteed by the Federal government. In addition, 14 condominium units have been proposed, to be financed 100 percent by the City of Milwaukee with City loan funds.

Is the Project Likely to be Successful?

To the extent that the project can acquire $41.4 million in FHA guaranteed loan funds, $9.3 million in City loans and $2.8 million in related City TID proceeds, completion is likely. These government sponsored financing sources comprise about 92% of the total TID adjustment project sources, and thus assume the vast majority of project risk. A review of the construction budget shows a budgeted contingency of $1.5 million, or 2.7 percent of the total Project budget. Typically a project of this nature would have a construction contingency closer to 5% of total project costs, so there is some potential construction completion risk should costs escalate beyond that amount, although the independent Concord Group has examined the construction budget and overall, concluded that the budget is sufficient to complete the project. Also, a guaranteed maximum price contract would provide protection on construction completion risk.

The fundamental risk to overall project success is lease up of the 203 apartments units and sale of the 14 condominium units. The current real estate market poses a significant risk for adequate lease up of the Apartments. However, a DCD sponsored market study concludes that the Apartments should achieve adequate lease up. Developer projections show

[1] "Mezzanine" loan for the Moderne project refers to a high interest rate projected six year City loan paid from available cash from all sources after operating expenses, reserves and apartment first mortgage loan payment satisfied.

stabilized apartment lease up by early 2013. The Federal HUD Office has reviewed this study, and should HUD provide financing, we are not in a position to challenge their conclusion that the proposed apartment rents could be achieved. Moreover, the entity assuming the bulk of Apartment lease up risk is Federal HUD, the guarantor of the $41.4 million first mortgage Apartments loan. The City risk related to the Apartment component is limited to $1.5 million.

The major project risk facing the City is the failure to sell the condominium units at the projected $939,000 average unit price, ranging from $243,000 to $2.4 million for a penthouse. These units are financed solely by $7.8 million in City loans. The condo component incorporated into the project to provide cash flow for a projected $5 million in Developer profits from condo sales. Therefore, both the success of the Moderne Project and the repayment of the City's $7.8 million in loan funds depend upon the successful sale of the condos.

DCD indicates that four of the fourteen condo units have been reserved with up to five percent reservation commitments, which at closing could result in as much $5 million in proceeds. Even so, private financing could not be obtained for the project. Given current credit constraints and the depressed state of the local condominium market, City financing of the condo component is clearly a speculative venture facing major financial risks. DCD believes it is "....unlikely that the project will be unable to sell two units per year to sell out the condo component.". Whatever the result, **unlike the Apartment component, should condo units remain unsold, the incidence of financial loss falls to the City.**

DCD has incorporated provisions in the Term Sheet to mitigate this risk. City loan repayment precedes Developer operating cash flows on both the apartment and condominium revenue. The City loan term sheet provides for personal guarantees by the equity investors and a 50 percent equity ownership in the even of default. Also, as previously mentioned, four of the 14 units have already attracted condo buyer deposits, each apparently totaling five percent of the purchase price. But as recent foreclosure actions on local condominium projects clearly demonstrate[2], personal developer guarantees and buyer deposits may prove insufficient when a project is in financial trouble.

Given the complexity of this financing, should the condo sales not proceed as planned and default on a City loan occurs, the City's financial exposure could extend the City's involvement far beyond the projected 2013-2014 final City loan repayment date. At our request on October 12th, a general default provision has been incorporated into the Loan Term Sheet. As of the date of this letter, the details behind this provision have yet to be negotiated with the Developer. The conditions under which the City would take title to the condominiums have not been negotiated. Given the number of parties involved in the project, the default provisions could be complex. Provisions such as the definition of events of default, cure periods (the time allowed to remedy the default), penalty and cross-default provisions, need to be agreed upon. These are not mere technical details, but can have a dramatic impact on the ultimate financial outcome for the City.

Is the Proposed Level of City Assistance Necessary?

Analyzing the necessity of TID assistance to a project involves examining the Developer's return on investment. The objective is to determine what minimum level of City of Milwaukee financial assistance is needed to produce the necessary return to induce the Developer to move the project forward to completion. Of the Developer's projected $4.5 million investment, $1.8 million is estimated being spent in 2010 and 2011, with the other $2.7 million already spent in 2006-2009. Therefore, in order for the development to move forward, the City should provide only that financial assistance necessary to enable the HUD loan to close and induce an additional $1.8 million in private equity investment.

Using the DCD consultant projections[3], we calculate a 23% annual rate of return of investment to Developer over the project's projected 10 year life. This return is largely generated from a more than $5 million profit from sales of all the condos and in addition, the sale value of the Apartments component at the end of year 10. Given the limited *future* Developer's investment (up to $1.8 million) and the extensive risk borne by the City for sale of 14 condominiums, we find this rate of return well above what would be expected *relative to the level of private investor risk incurred*.

[2] Wisconsin Tower (74 residential and four commercial condominium units); Park Lafayette Condominium Towers (281 units) : Milwaukee Journal Sentinel; Tom Daykin; October 10, 2009 and October 16, 2009.
[3] The projections were provided by S. B Friedman & Company, October 9, 2009. We calculated Internal Rate of Return assuming the actual dollar value of equity investment to date.

Entering into this agreement at the proposed levels of City financial sets a significant precedent. Providing $9.3 million in loan funds directly to aid the construction of high end condos ($7.8 million) and apartments ($1.5 million), the City would open a new level of taxpayer assistance to private development. In the past the City has assisted many successful downtown apartment and condominium developments through street and streetscape improvements, riverwalk and dockwall financing, small parks and open space, pedestrian bridges, etc. These were all public improvements. The only material direct City financial assistance to residential development has occurred for middle and low income projects (City Homes on West Walnut Street is an example.)

DCD indicates that given current market conditions, without the proposed $9.3 million in City loans, the apartment –retail-parking-condo project would not proceed. But should the Moderne project be approved as proposed, the City of Milwaukee would now be in the condominium financing business and could reasonably expect other downtown developers to propose similar levels of assistance for future projects. This means that City officials will need to develop a set of condo/apartment program requirements and benchmarks to manage the risk the City is willing to bear and to provide a basis for approval or rejection of subsequent requests for City financial assistance. Such requirements should address minimum private cash equity investment, maximum City assistance as a percent of total project cost, percent pre-sale commitments, targeted City development area, job creation, etc. However such a program is established, ultimately City officials will have to decide what priority the financing of high end condominiums/apartments holds versus other more conventional City purposes such as streets, sewers, low income housing, etc.

Recommendations

1. Should your Committee wish to proceed with this File as proposed, recognize that the City of Milwaukee is assuming a significant risk of non payment given the current state of the downtown condominium market. No one knows what this market will look like two years from now, but we do know that commercial lenders are not willing to assume the risk. You should also realize that with this project the City would for the first time extend significant, direct taxpayer financial assistance to the high end housing market.

As of the date of this letter, default provisions regarding the City loans have not been negotiated. Thus, the conditions under which the City could take title to the condo units are not yet laid out. Given the size of the City's investment and the complexity of the default provisions when multiple, competing interests are involved as in this project, prompt resolution of this issue is essential to the City. Therefore, should your Committee wish to proceed with this proposal, once the default terms have been negotiated, we recommend that these provisions be reviewed and approved by your Committee.

2. Should your Committee find the project as proposed too risky but wish to attempt to capture the significant funds supporting the Apartments component, we would recommend that DCD re-examine the current Moderne project approach, focusing only on accomplishing the Apartments (apartments/retail/parking) component. Financed principally with City of Milwaukee loan funds, the condominium component of the Moderne Project provides added profit to the Developer – a portion of which may be beyond the amount necessary to get the Apartments component accomplished. The objective would be to identify a minimum City guarantee and/or other financial assistance needed to accomplish the construction of the Apartments component while still retaining a HUD loan guarantee for first mortgage financing of this component. The current proposed City loan commitment for the Apartments component is only $1.5 million. If proved feasible, this modified approach could reduce the City's financial exposure well below the proposed $9.3 million in City loans.

3. An amount of $850,000 is being requested as part of this proposal to reimburse the DCD for administrative expenditures including significant past TID 48 project costs. As we understand it, the DCD has implemented new controls which will help minimize these cost overruns in the future. As new TIDs are considered, we recommend that the DCD report to your Committee on the impact of these new procedures in controlling future TID project administrative costs.

Should you have any questions about this letter, please contact me at your convenience.

Sincerely,

W. Martin Morics
Comptroller

Cc Richard Marcoux, Lori Lutzka, Allison Rozek Cdk/Mjd/Wmm/10-23-09