City of Milwaukee

Office of the Comptroller

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Members of the Zoning, Neighborhoods
& Development Committee
Milwaukee Common Council
City Hall, Room 205
Milwaukee, WI 53202

File 031565, 401 West Wisconsin Ave. Land Transfer Grant

Committee Members:

File 031565 would approve a Land Disposition Report, allowing the sale of a two acre parcel of City Redevelopment Authority (RACM) land located on North 4th and West Wisconsin Avenue to the Milwaukee Convention Center Hotel, LLC (MCC), a limited liability corporation, for the price of one dollar. The land is currently being leased as a parking lot. This land transfer would be subject to the terms of a Development Agreement between RACM and MCC whereby MCC would construct a six story, four star hotel including 253 room (5 suites), 6,600 sqft of meeting space, full service restaurant, coffee shop, swimming pool, full service business center and 86 valet parking spaces. MCC was established and is owned by principals of Hunzinger Construction Company who would build the hotel. The hotel licensor would be Sheraton, Starwood Hotels and Resorts World-Wide, Inc.

The most recent construction budget for the hotel totals $36,316,250 including $4,000,000 for the City land. Financing sources for the project are:

First Mortgage	$27,250,250 (75%)
City Land Contribution	$ 4,000,000 (11%)
Cash Equity	$ 3,816,250 (10.5%)
Developer Services Contribution	$ 1,250,000 (3.5%)
Total	**$36,316,250** (100%)

In light of the City's $1 transfer of the $4,000,000 parcel to the MCC, the proposed Development Agreement ("the Agreement") includes a provision allowing the City to share in the potential profits generated by the Project should these profits exceed current projections.

Is the Project Likely to Succeed?

The proposed MCC hotel Project (the Project) possesses a number of essential strengths. Its location on 4th and Wisconsin Avenue is adjacent to the Midwest Convention Center in the heart of downtown Milwaukee. The developer MCC, LLC, is owned by an experienced local construction company. This Company, Hunzinger Construction Company was builder/co-builder of a number of the City's finest public buildings including the Midwest Center, Bradley

Center, Miller Park and the recent Pabst Theatre renovation. Significant equity participation of \$3.8 million cash and an additional \$1.25 million in invested developer services provides a strong incentive for long term involvement by the developer and his equity owners. Also, MCC has apparently attracted one of the nation's finest brand names in the hotel industry, Sheraton, Starwood Hotels and Resorts World-Wide, Inc. Together with Allegiance Hospitality Services who would serve as hotel operator, this team is certainly capable of creating and operating a truly four star hotel in this vital location. In addition, while no independent engineering assessment has been made, based on available cost information on recently constructed hotels now in operation, the design, construction and initial marketing budget appear adequate to fund the Project to completion.

In spite of these many strengths, the Project is not without its risks. While there is apparently a shortage of area hotel rooms when competing for large national convention events, area room bookings have declined slightly over the past three years according to a recent Convention and Visitors Bureau Report[1]. Two other hotel project start-up efforts proposed for this location in 1998 and 1999 failed, apparently unable to attract sufficient financing.

Overall, based on the capable, experienced Project team assembled, the hotel's proximity to the new Convention Center, ample Project budget and strong private equity investment, **this Project can be expected to overcome market risks inherent in this type development. Our Office believes the Project provides adequate strengths to support its likely success.**

Is the Proposed Level of City Assistance Necessary to Make the Project Happen?

The City is providing substantial financial assistance to this Project through its proposed cost free transfer of the vacant two acre parcel currently appraised at \$4,000,000. This amount comprises 11 percent of total Project financing. In approaching this development, there were two basic avenues to minimize the public cost of this Project – 1) the City receives monetary compensation from the land sale, and/or 2) City profit sharing. The DCD and the developer are proposing profit sharing.

Our Office's independent analysis of the developer's construction budget and 10 year cashflows show an annual before-tax investor return of about 19%[2] which is within industry norms. We have further determined that requiring a land sale price of \$500,000 to \$1,000,000 to the City would lower investor returns to about 18% and 17% respectively. These somewhat lower investor returns would still remain within accepted industry norms. See Exhibit 1. An independent source familiar with the hotel industry indicates that hotel investors expect before-tax returns in the range of 17%- 22%, although they report that these expectations have been declining slightly as interest rates have declined. As shown in Exhibit 1, investor returns remain within these industry norms until the City land sale increases to \$1,500,000.

[1] "Booking Pace Report Figures as of 2/29/04 – Room Nights Generated by Convention Sales Department, Convention Center and Self-contained Business"; March 11, 2004.
[2] This return is a before-income tax, after real estate tax 10 year internal rate of return including the proceeds from the sale of the development in year 10. Developer budget and cashflow estimates were applied without change.

Rather than establishing a sale price for the City land, the developer and the DCD have incorporated a profit sharing provision into the Development Agreement. The provision allows the City to gain one-fourth of "excess profits" exceeding 140% of forecast profits after debt service and reserve requirements are met and after the developer receives 20% preferred profits on its "in kind" services. This provision applies only to the first five years after project completion. The forecast of profits can be changed by the developer annually.

This formula is quite complex, however it is not meaningful because there is no likelihood of the City ever receiving profit sharing under this proposal. Based on our Office testing of this formula, **investor returns would have to increase from the expected 19 percent to the range of at least 40 percent per year before any City profit sharing would start**. Exhibit 2 shows the substantial increase in hotel occupancy before City profit sharing would "kick in". As shown, in 2008, even 100% occupancy would be insufficient to provide any City profit sharing. In addition, **should the Project generate a sufficiently high return in any of the first five years of operation for the City to share profits, the developer has the right to revise the profit projections, raising the financial threshold (the "bar") for any future year City profit sharing.**

The City is a substantial financial partner, contributing through its land grant nearly as much as the private investors ($4 million City vs $5 million investors). **Therefore, in a more typical project cycle, we would have suggested exploring revision of the current profit sharing provision to provide a meaningful opportunity for return to the City should the Project materially exceed current forecasts**. However, such discussions may not be feasible given the apparent urgency to finalize the Agreement now. Nevertheless, your committee should be aware that the value of the current profit sharing arrangement is negligible.

Overall, we agree with the DCD that this is an excellent project, and complement both the department and the developer for their work to date. While Project risks do exist, the risks to the City of leaving the land vacant are far greater in our opinion.

Sincerely,

W. Martin Morics
Comptroller
Cc Commissioner Patricia Algiers, Gregory Shelko, Michael Wisniewski

EXHIBIT 1
401 WEST WISCONSIN AVE. CITY LAND GRANT
DEVELOPER'S ANNUAL RATE OF RETURN
UNDER VARIOUS CITY LAND SALE PRICES

CITY SALE PRICE	DEVELOPER'S ANNUAL RETURN ON INVESTMENT*	
ZERO (current)	19%	Within industry norms of 17%-22%
$ 500,000	18%	
$ 1,000,000	17%	Within industry norms of 17%-22%
$ 1,500,000	15%	Outside industry norm of 17%-22%

* Pretax Internal rate of return over 10 year holding period.
Capitalization Rate = 10.5%
Credits developer's services-valued at $1,250,000-as cash investment.
Mjd/3-19-04

EXHIBIT 2
INCREASE IN HOTEL OCCUPANCY REQUIRED FOR CITY TO PARTICIPATE IN PROFIT SHARING

	2006 (First Year of Operation)	2008 (Third Year of Operation)
Current "Net Cashflow" Per Draft Agreement1)	$ (119,352)	$ 584,183
Net Cashflow Required for City Profit Sharing1)	$ 3,470,282	$ 4,700,581
Increase in Net Cashflow Required for City Profit Sharing	$ 3,589,634	$ 4,116,398
Estimated Occupancy2)	63%	69%
Occupancy Required for Profit Sharing3)	**93%**	**101% (Not Possible)**

1) See "Development Agreement - (Including Agreement for Sale)
Parcel ID 361-0726-110-3 (undated)
Also see "Sheraton Hotel Milwaukee Ten Year Projection 11-03-03
2) See "Sheraton Hotel Milwaukee Ten Year Projection 11-03-03
3) Assumes room revenues only are affected by increase in occupancy. Assumes no other expenses or revenues change.

Mjd/3-22-04