City of Milwaukee

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November 19, 2009

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

RE: File 090805 Proposed Loan Guaranty for the Bookends Apartments

Dear Committee Members:

File 090805 would provide a loan guaranty related to the construction of a $60 million apartments-retail-parking Project to be located at 700 East Kilbourn Avenue. The City would guarantee repayment of a private loan in the amount of $3,450,000 to assist in financing the Project.

**Our Project evaluation cannot be completed due to several significant issues identified below which as of the date of this letter are not finalized or negotiated. Thus we are unable to reach any definitive conclusions about project financing, including the proposed City guaranty. We are unable to provide your Committee with a financial assessment of the benefits and risks of proceeding with this Project. We therefore recommend that your Committee require the issues below be addressed prior to your consideration of this Project.**

In contrast, when your Committee considered the Moderne project, the following items had been agreed upon. However, for the Bookends Project:

1. A lender/investor for a proposed $3.45 million subordinated loan to the Project has not yet been identified.
2. Due to 1) above, **the terms of the City's financial commitment to this project have yet to be negotiated.** This involves reaching agreement with a lender on the terms of both the City guarantee and the loan being guaranteed by the City.
3. The Bookends Apartment Project has not yet received an invitation from HUD to apply for a $51.75 million HUD/FHA guaranteed loan.
4. The Bookends Project requires a HUD waiver on the maximum per unit cost HUD will allow. The Developer has not yet received this waiver. Without the waiver, the HUD/FHA guaranteed loan would be reduced from the proposed $51.75 million to $45 million creating an immediate financing gap and related delay.
5. The design drawings for the Project have apparently recently been completed and are currently under review by DCD. Current budget estimates are based upon conceptual/schematic drawings without the benefit of a detailed design. Until detailed design is complete, no actual construction bidding can occur. With only a 3% budgeted design contingency, the construction budget could increase, creating an immediate financing gap and related delay.

Located on the northeast corner of Kilbourn and Van Buren Avenues, the Project would consist of nineteen floors and include 224 apartment units, 292 parking spaces on the first five floors and 3,000 square feet of retail space on the first floor. The average monthly rent of the 224 apartment units would be $2,220. Rents per parking space would be an additional $115 per month. Developer is Bookends North LLC, which is 50% owned by New Land Enterprises and 50% owned by Weichman Enterprises.

Total project costs for the Bookends apartments are $60.2 million, supported by $51.75 million HUD 221(d) 4 guaranteed loan, $5 million in past Developer investment and new equity (a portion of which is in the form of a deferred developer fee), and a $3.45 million unsecured subordinated bank loan. The City's loan guaranty would provide the security necessary for a private lender to provide the Developer with $3.45 million in loan proceeds.

The proposed sources and uses of funding are as follows:

| Sources | | Uses | |
|---|---|---|---|
| HUD 221 (d) 4 Loan | $ 51,750,000 | Land & Hard Costs | $ 46,669,000 |
| Developer Past & New Equity | 5,000,000 | Soft Costs | 11,123,000 |
| Unsecured Subordinated Loan | 3,450,000 | Developer Fee & Overhead | 2,408,000 |
| TOTAL | $ 60,200,000 | TOTAL | $ 60,200,000 |

**Our letter comments are below are based on the assumed acceptance of City proposed loan and guaranty terms by HUD and an unidentified subordinate lender.**

**Project Financing and City Guaranty**

The primary funding source of the Bookends Apartments Project is a proposed HUD 221(d) 4 program, which provides FHA mortgage insurance to HUD approved lenders. The mortgage insurance protects the lender, potentially the AFL-CIO Investment Trust, from risk of default. The term of this loan would be 40 years plus the construction period. The assumed interest rate would be approximately 6.25%. The Love Financial Group would service this loan.

Developer equity is the second largest source of funding. Developer equity consists of $2.6 million in land acquisition costs and $2.4 million of deferred developer fees. The $2.6 million identified as "land acquisition cost" is the amount required to retire principal and accrued interest on a prior Developer loan used to acquire the site. As a portion of the $2.6 million is apparently to be funded through the use of HUD 221 (d) 4 loan proceeds, it is not clear what actual cash equity amount is being provided. The remaining $2.4 million of developer equity is in the form of deferred developer fees, which Developer receives to the extent the Project generates net revenues during its operation and upon ultimate sale of the Project.

The third largest funding source is a proposed unsecured[1] subordinated loan ($3,450,000). Developer was unable to get a loan commitment from a private lender to provide this loan. However, Developer is working though a broker, seeking a lender to provide this loan backed by the City guaranty. The estimated term of the subordinate loan is seven years, including an assumed two year construction period. As the repayment of this loan is subordinate to the HUD 221 (d) 4 loan, it carries a higher interest rate, currently estimated at 9%. The loan would require interest only through its term, with a balloon payment in the final year. This loan would be supported only from available operating cashflows from the Project, having no claim on Project assets. Any annual cashflow shortfall would fall to the City guarantee described below.

The term of the proposed City guaranty is seven years to match the loan being guaranteed. For providing the guaranty, the City will assess an origination fee of 2% of the amount to be guaranteed to be paid at closing. In addition, the City will assess an annual maintenance fee of 2% during construction and the first year of operation and 4% thereafter. The annual maintenance fees would only be paid to the extent that there are net revenues, that is, only to the extent the Project generates sufficient net cash flow. The Term Sheet requires first lien personal guarantees of the Developer partners of $1.65 million to be applied should the City's guaranty be called upon.

[1] The sole security for loan repayment is the proposed City of Milwaukee guaranty.

At this time, neither the HUD loan guaranty nor unit price waiver has been granted. Because a subordinate lender has not yet been identified, the terms of this loan have not been negotiated and are simply the Department's proposed loan terms. The actual terms of the HUD loan and the subordinate loan could be substantially different from those proposed by the City, so our comments above may or may not apply.

**Is the Project Likely to be Successful?**

Once the design is complete and the general contractor's not-to exceed bid acquired, construction risks would be manageable given the controls to be implemented by the City. Should the Bookends Apartments Project secure $51.8 million in FHA guaranteed loan funds, the City of Milwaukee benefits from the underwriting standards established by HUD in making the HUD guaranty decision. Also, with completion of the design, the general contractor (KBS) for the project will be providing a guaranteed maximum price contract for the construction costs. While its pre-design estimate was about 5.5% higher than the construction budget, the DCD consultant[2] concluded that the KBS construction costs were reasonable.

As a $60+ million high rise downtown construction project working against a 19 month construction deadline, the Project is subject to material Project completion risks. Also, without the benefit of completed design drawings reviewed by the City, the construction budget could increase, creating an immediate financing shortfall and related delay. The DCD indicated today that it is currently in the process of reviewing the design drawings.

Operational risks to both the Project and the City depend on the continued performance of the Project. Project performance in turn depends upon the lease up of the 224 apartment units at projected rent levels. Average monthly apartment rents are projected to total $2,220, or $2.09 per square foot, with $115 per month per parking space. Developer has conducted two market analyses – both of which support his estimates of projected rent. However, the DCD financial consultant, S.B. Friedman & Co. observed that these rent levels "…are projected to be above the current high end… in Downtown Milwaukee"[3]. Currently the highest local market rents range from $1.80 to $1.90 per square foot. Achieving these higher lease rates is clearly at issue. Should the project not lease up or if pro forma rents are substantially below projected levels, the project is not likely to generate sufficient cash flow to service the debt of the subordinated $3.45 million loan, thereby triggering a call on the City guarantee.

As mentioned above, the terms of both the City loan guaranty and the subordinate loan have yet to be negotiated, so it is impossible for our Office to reach any definitive conclusions regarding this financing.

**Is the Proposed Level of City Assistance Necessary?**

As the HUD 221 (d) 4 loan is secured by a first mortgage lien against the Project, the remaining $3.45 million of the Project that is to be supported by debt is unsecured (except for the City guaranty) and subordinate in terms of repayment to the HUD loan. It is unlikely that a private letter of credit guaranty could be obtained under current credit market conditions. Therefore, the City's loan guaranty or additional Developer equity is required to complete the Project financing.

**S.B. Friedman characterizes the projected 23% return as "…at the higher end of the range observed… for speculative real estate development projects."[4].** Even given the inherent Project risks noted above, we concur with the DCD consultant analysis that the projected Developer returns seem very high. **A 23% annual rate of return (IRR) on the Developer investment over the project's projected 10 year life is beyond what we would expect.** Given our earlier noted question about the actual Developer's cash equity contribution to be made at closing, the ultimate annual return to Developer could exceed 23%. The above conclusions are based on projected cashflows provided by the DCD financial consultant, S. B. Friedman & Company and the assumed financing structure and terms.

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[2] The Concord Group, a engineering consulting firm

[3] Proposed Bookends Project and TID: Economic Feasibility Study, S.B. Friedman & Co. 10/2010; page 5.

[4] Ibid, page 7.

**Initial Conclusions & Recommendations**

1. **We recommend that your Committee require the Project readiness issues be addressed prior to your consideration of this Project.** See page one of this letter.

2. Given the 23% projected annual average return to the Developer and related project completion and occupancy risks placed upon the City guaranty, **the City should negotiate either a full collateralization of the City's $3.45 million guarantee through personal guarantees by the Developer, or meaningful "upside" profit participation by the City.**

3. This Project continues the precedent established with the Moderne Project of the City providing direct financial assistance to high end residential housing projects. As was the case with the Moderne, if successful, the Bookends Project would create an additional estimated $35 million tax base downtown as well as valuable construction jobs during a severe recession. However, ultimately City officials will need to decide on what priority the financing of high end residential projects hold versus other more conventional City purposes such as streets, sewers, low income housing, etc.

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

Sincerely,

W Martin Morics
Comptroller

Cc Mayor Tom Barrett, Commissioner Marcoux, Lori Lutzka
WMM/CK/MD/11-19-09