

March 19, 2020

Mr. Stephen W. Williams
Borough Administrator
Borough of Chatham
54 Fairmount Avenue
Chatham, NJ 07928

Send Via Email Only

Re: Real Estate Financial Advisory Services – River Road Redevelopment Project Proposed for Property Presently located at 12, 16 and 22 River Road, Chatham, NJ, also designated as Block 135, Lots 9, 10, 11 and 12 on the tax map of the Borough of Chatham, NJ

Dear Mr. Williams:

At your request, our firm has reviewed the Application for Long-Term Tax Exemption submitted in connection with the redevelopment project captioned above (“Application”). The application was dated September 27, 2019 and was submitted to the Borough of Chatham (“Borough”) by Chatham River Road Urban Renewal, LLC. (“Developer”).

The Application sets forth a detailed description of a proposed redevelopment project to be undertaken on the site captioned above, including estimated costs for the development, sources and uses of funds, and a pro forma projection of income and expenses upon completion. The Application requests that the Borough enter into a Financial Agreement pursuant to the Long Term Tax Exemption Law of 1992, as amended and supplemented (N.J.S.A. 40A:20-1 et. seq.). Pursuant to such Financial Agreement, the project would be exempt from real estate taxes for 30 years, and instead, make payments in lieu of taxes.

Brief Description of the Project

The Developer proposes to clear the subject site of all existing improvements through demolition (and associated environmental remediation as needed), and then build a single 3 and 4 story building across the site on top of two levels of basement and 1st floor parking. The project will provide a total of 259 rental apartments, consisting of 220 units available at market rent, and another 39 apartments set aside and reserved for low and moderate income tenants. The market rate units will include 108 one-bedroom units and 122 two-bedroom units. The “affordable” units will include 8 one-bedroom units, 23 two-bedroom units and 8 three-bedroom units. There will be approximately 490 parking spaces provided within the project, a substantial portion of which will be structured parking beneath the first floor grade of the building. The project will include approximately 12,000 square feet of lobby and amenity space with a pool and 2 courtyards for outdoor recreation.

Purpose of this Analysis and Scope of Work

In the Application, the Developer provides its view of the need for the tax abatement, based on the statutory basis for the proposed exemption:

The tax exemption sought by this Application is necessary to achieve financial viability of the Project. The Project cannot be built at traditional tax levels. Applicant would suffer a loss on the Project if traditional real property taxes were levied. Applicant also believes the rents it will be able to offer if given a tax exemption will help to attract tenants. (Application, page 3.)

You have requested that our firm analyze the detailed financial elements of this project, and provide our professional opinion on two matters:

1. Is this project likely to be financially-feasible [as measured by the internal rate of return (IRR) on the developer's equity investment] if the project is subject to full real estate taxes?
2. In the event we conclude that the project is not likely to be financially feasible in the absence of a long-term tax-abatement agreement, what are the realistic options for structuring the payment rate for such an abatement within the constraints of financial feasibility?

Feasibility and Financial Analysis

We have prepared and attach here two financial model for the proposed River Road Redevelopment Project ("Project") in order to address these two matters in a detailed, analytical manner. The first model ("Financial Model #1) assumes the project pays full real estate taxes. The second model (Financial Model #2) assumes the project has the benefit of a PILOT agreement. With this model we can enter different payment rates for the PILOT and the model produces the IRR result for that assumption.

The models are built by assembling the relevant financial data on the project, and then integrating that data into a series of inter-connected worksheets in a manner that will calculate a fundamental metric of any capital investment: the internal rate of return on the investment, adjusted for a holding period and sale at fair market value.

Our model assumes the developer constructs the project, stabilizes the rental of the project to a 95% occupancy level, holds the project for 10 years, then sells the project at a capitalization rate of 6.0% of the then-net income of the project before debt service. The net gains on the sale in year 10, plus the net cash flows annually to the developer over the 10-year holding period, less the developer's initial equity investment, are then discounted back to the present to arrive at an internal rate of return on investment. This method of assessing the financial feasibility of a real estate investment is widely used in the capital markets by lenders and investors as the primary metric in allocating capital among competing investment alternatives.

The first step in preparing the model is to assemble (and validate the reasonableness of) the key financial data on the project provided in the Developer's Application for Long Term Tax Exemption. Among the key project data we reviewed were the following:

- Detailed project development costs;
- Projected rents for the market rate and affordable apartments;
- Estimated operating costs for the project;

- Sources and Uses of Funds proposed (i.e., a long-term mortgage loan plus developer's equity), including an assessment of the terms of the proposed mortgage loan;
- Projected increases in rental income and operating expenses over an assumed 10-year holding period.

In my opinion, with one material exception, the data provided by the Developer in its Application are reasonable, credible and consistent with data with which I am familiar on numerous other projects of a similar size and location. Specific areas of agreement may be summarized as follows:

- Land acquisition costs of \$12,100,000 (which is approximately \$47,000 per unit) compares favorably to land costs in similar Northern NJ inclusionary projects recently which have been as high as \$65,000 per unit.
- Projected hard construction costs for labor and materials to construct vertical improvements are estimated to be \$142.00 per square foot of building area. This is competitive with numerous similar projects with which we are familiar, where hard costs per square foot have ranged from \$135.00 per sq. ft. to \$160.00 per sq. ft.
- Soft costs for such items as design, engineering, legal and construction period interest are within a reasonable range of similar developments in recent years.
- Projected market rents proposed by the developer are consistent with comparable projects in this submarket. *Worksheet 9-A* in the attached model summarizes current market rents at three new comparable projects nearby. While not identical in location and product offerings, the three comparable projects confirm the credibility of the River Road Project projected rents.
- Projected affordable rents indicated by the developer were not exactly correct, and appear to be based on outdated income guidelines for low and moderate income housing in New Jersey. In our model, we utilized the income limits by family size for Region 2 published by the Affordable Housing Professionals of New Jersey for 2019. This is the source relied upon by affordable housing professionals for affordable income data since the Council on Affordable Housing ceased operations several years ago. These permitted rents are somewhat higher than shown in the Developer's model. These differences (while important to adjust for accuracy) are not material to the overall conclusions of our analysis. See *Worksheet 10 – Income Limits Rent Calcs* in our model.
- Both our model and the Developer's projections assume a total project cost of approximately \$100,000,000.
- There was one material difference I have with the developer's assumptions, which is the interest rate on the permanent loan. The Developer assumes the \$70,000,000 mortgage loan would have a fixed rate of interest of 5.5%, and an amortization schedule of 30 years.¹ My research confirms that in today's private debt market, such a loan would be priced at a fixed rate of approximately

¹ A \$70,000,000 loan amount is possible with a PILOT starting at 10% of AGR. However, if the project has no PILOT and pays full taxes, the result will be a reduction in net operating income before debt service. In turn, this will result in a reduction in the loan amount to \$65,000,000, based on the industry standard underwriting formulas. As a result, the project will require an increase in developer equity from approximately \$30,000,000 to \$34,600,000.

4.0% if closed in the next 3 – 6 months.² Obviously, this loan will not close for 3 – 4 years, while the approval process and construction proceed. However, the consensus among leading underwriters of such loans is that slowing economic conditions forecast over that near-term period (3-4 years) point to a continuation of today's low interest rate environment. For these reasons, I have adjusted the interest rate on the permanent loan in our model to 4.25%, a 125-basis point reduction over the Developer's assumption.

As a result of this adjustment, and assuming the PILOT arrangement requested by the developer, the annual debt service on a projected loan of approximately \$70,000,000 is reduced from \$4,822,346 (assuming a 5.5% loan) down to \$4,132,099 (assuming a 4.25% loan), a reduction of approximately \$690,000.³

Findings and Conclusions

1. Impact of Paying of Full Taxes: Attached to this report is a Financial Model #1 – Assuming Full Taxes. Our analysis indicates that, assuming the project pays full real estate taxes, the internal rate of return on the developer's equity investment in the project is 9.14%. In this event, the developer is projected to make a profit after the sale of the project in year 10, discounted back to the present, of approximately \$19,571,347, on an initial equity investment of approximately \$34,600,000.⁴ In my professional opinion, this internal rate of return of 9.14%, while certainly reflecting a "profit" to the developer, is not adequate in the real estate capital markets to attract approximately \$34,600,000 of capital, considering the risks associated with construction and lease up of the project. These risks include the following:
 - The project faces a number of challenging environmental remediation and site work tasks, and the project may require significant investments in infrastructure related to road improvements and utilities, the costs of which are not yet fully determined.
 - While Chatham is an attractive submarket for new rental apartments, the lease-up risks nevertheless are material.
 - The time frame for bringing this project to market and full stabilization will likely extend 3 – 4 years out, a period during which the economies of New Jersey and the U.S. can be expected to experience significant headwinds. These broader, near-term economic uncertainties only heighten the risks of an extended lease-up of the project, contrary to the assumption in our model of a rapid lease-up.

Based upon my experience in the development and financing of scores of similar projects over the past several years, and taking into account these risk factors noted above, *it my opinion that an internal rate of return of 9.14% on this projected \$34,600,000 investment is inadequate to compensate the developer for these risks.*

² "Multifamily Finance Update – Week of February 10, 2020," a publication of CBRE Capital Markets, a leading brokerage and real estate investment banking firm.

³ If no PILOT were provided, and the project paid full taxes, the permanent loan amount would be reduced by approximately \$5,000,000, requiring an additional equity investment of approximately \$4,600,000. This in turn, contributes to the significant reduction in the IRR from 11.7% with a PILOT down to 9.14% at full taxes.

⁴ Our conclusion here is contrary to the Developer's claim in the Application that "Applicant would suffer a loss on the Project if traditional real property taxes were levied."

For these reasons, I conclude that the project is not likely to generate an internal rate of return acceptable in today's capital markets if it is required to pay full real estate taxes.

2. Impact of PILOT Agreement as Proposed by Developer: Attached to this report is **Financial Model #2 – Assuming PILOT Agreement**. Our analysis indicates that the project, with a PILOT agreement structured per the developer's Application, will likely generate an internal rate of return on equity of 11.70%. This proposed PILOT arrangement would have the project pay 10% of annual gross revenues in year 1-10; then 11% in years 11-20; and then 12% in years 21-30. The developer is projected to make a profit after the sale of the project in year 10, discounted back to the present, of approximately \$29,152,900, on an initial equity investment of approximately \$30,000,000. *In my opinion, this return on equity is competitive and attractive in today's capital markets, taking into account the risks associated with construction and lease up of the project.*

Worksheet 4 (PILOT & Tax) in Model #2 illustrates the flow of PILOT revenues vs. hypothetical property taxes from the Project under these assumptions. By way of illustration, in Year 1 of Rent Up at left, the Borough's 95% share of the PILOT revenues is \$894,333. Across the page, hypothetical real estate taxes year 1 would be \$1,445,065, and the Borough's 23% share of such taxes would be \$334,966. Going down the page over the 30-year term, and assuming an annual increase in PILOT payments and taxes of 3%, one can see the cumulative impact of these alternative revenue streams. The Borough's 95% share of PILOT revenues over 30 years totals \$49,011,764. Alternatively, the Borough's share of full real estate taxes during that 30-year period is projected to be \$16,261,361. The PILOT revenues exceed the tax revenues to the Borough over that period by \$32,750,403.

3. Financial Feasibility of PILOT Agreement with Higher Payment Rates:

Finally, we analyzed the impact on financial feasibility of raising the payment rates in the PILOT agreement from the rates set forth in the Developer's Application (i.e., 10% for years 1-10, then 11% for years 11-20 and 12% for years 21-30).

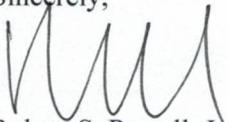
The table which follows summarizes the impact on the Internal Rate of Return (as well as the amount of PILOT revenues received by the Borough) *assuming several alternative and higher payment rates*, spread over the 30-year term.

<i>Chatham NJ - River Road Redevelopment Project Financial Models - Comparison of Results</i>				
<i>Assumption Re: Real Estate Taxes</i>	<i>Internal Rate Of Return</i>	<i>R.E. Tax Pymts to Borough Over 30 Yrs</i>	<i>Est. PILOT Pymts to Boro Over 30 Yrs.</i>	<i>Excess PILOT Pymts.</i>
Pay Full R.E. Taxes	9.14%	\$16,261,361	\$0	N/A
PILOT at rates of 10%/11%/12%	11.70%	\$16,261,361	\$49,011,764	\$32,750,403
PILOT at Rates of 11%/12%/13%	11.29%	\$16,261,361	\$53,285,971	\$37,024,610
PILOT at Rates of 12%/13%/14%	10.77%	\$16,261,361	\$57,619,209	\$41,357,848

In my opinion, the first and second PILOT payment options provide the developer with a competitive rate of return on investment. The second of these two (11%/12%/13%) with an IRR projected at 11.29% is as low a return as I believe the investment can achieve and still remain competitive by today's capital market standards.

I would be pleased to respond to questions you and your associates may have. As additional information becomes available with respect to details regarding the project, I reserve the right to revised my findings and conclusions accordingly.

Sincerely,



Robert S. Powell, Jr.
Managing Director

Attachments