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INDUSTRIAL DEVELOPMENT
IN THE PORTSIDE DISTRICT

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INDUSTRIAL DEVELOPMENT IN THE PORTSIDE DISTRICT

David Dowall, Noreen Ambrose, Ezra Rapport

Introduction

In 1976 Hartford Corporation closed its cement manufacturing operation in Marisol, demolished all facilities, and sold the 13.5 acre site to the Southern Pacific Transportation Company. The resulting loss of jobs worsened the already dismal economic conditions prevailing in the city's Portside District.

The Portside District is one of seven HUD-eligible Community Development districts in Marisol. Predominantly inhabited by low and moderate income families, the median household income in Portside is approximately \$2,000 below the figure for the City as a whole. Unemployment, crime, and juvenile delinquency are high, problems exacerbated by the fact that a large proportion of the District's population is under the age of 25. According to the 1970 census, 26% of District residents ages 16 through 24 either are not high school graduates or are not enrolled in school. A total of 83% of Portside residents are Black, with individual census tracts ranging from 32% to 94% Black.

In response to the District's problems community residents organized the Portside Local Development Corporation (PLDC), a non-profit

organization that was to take an active role in encouraging economic development. The president and primary contact person for the PLDC is Charles Johnson.

Phase I: Land Acquisition

Upon learning that Southern Pacific wanted to sell the Hartford site, Charles decided to request Community Development Block Grant funds to acquire the property. He was frustrated by the fact that the site had remained vacant for three years when so many District residents were unemployed. With the assistance of government programs he thought he could attract private capital to a project that would provide jobs for his people.

Charles felt strongly that because of its prime location, the site would be attractive to a private developer. The parcel was located in an existing industrial zone, and was surrounded by a few of the healthiest industrial concerns in the City. Transportation access to the site was excellent; it was located on a major traffic arterial only a few blocks from an interstate freeway. The site contained a rail spur which connected to the nearby Marisol Port facilities and to the transcontinental railway. The area was also well serviced by public transportation.

While Charles realized that it would require a major commitment of CDBG funds to acquire the site, he felt that this was a one time opportunity to create desperately needed jobs. He went to see Dolores Jones, at the Community Development Office to get her reaction to his plan. Her reaction was generally favorable, but she suggested that he "come up

with a concept for the project," before asking the City Council for approval.

Charles knew very little about industrial development, so he contacted Bob Walters, a local developer who had some experience with industrial projects, and arranged to meet him at the site. The first thing Bob noticed was the rail spur; he told Charles, "I know this isn't what you had in mind, but if I owned this land I'd build a multi-tenant warehouse that could handle Port traffic. There aren't many vacant sites in the City that have rail access, with that advantage a good agent could lease up the project before you even start to build."

Charles was well aware of the demand for warehouse space in the area. Another manufacturing concern had recently closed down, and the plant was snatched up for warehousing before the LDC could list the property with the City's industrial locator service. Charles replied, "I can't ask the city to invest in a project like that, I have to have something that will provide jobs for the people in this district." "Well," said Bob, "this site is large enough for a business park for small light industry." He told Charles about another developer who had just finished construction of such a project on the other side of town. That project consisted of individual industrial units ranging from 6,000-14,000 sq. ft. which were being sold as condominiums. Bob explained to Charles, "It's a new concept, but they've had some success with it in other parts of the state."

The industrial park concept appealed to Charles. He believed that if he set the project up as a condominium it might be easier to convince the city to go along. The City would be assured of getting its money

back quickly, and the LDC could avoid the management problems associated with leasing. Charles also believed that it would be possible to get Small Business Administration guarantees for small firms interested in buying their own unit, and that those businesses would be most likely to provide employment for people in his district.

Charles drove out to see the industrial condominium development, and he liked what he saw. He contacted the sales agent and learned that the project was about 80% sold out. He inquired about the types of business the purchasers were in to get an idea of the employment potential. The agent replied that all but one of the units were sold to investors who intended to lease to light manufacturers and wholesalers. The only owner-user manufactures cabinets for computer terminals and has about 10 employees.

Charles' next step was to contact the President of the local Chamber of Commerce, Andrew Burns. Upon explaining the plan, Burns said, "As you know, this is a city of small manufacturers and service industries. In fact, we've had many inquiries for that type of facility." Mr. Burns also promised Charles that he would send a letter to the Council in favor of the project.

With this information in hand, Charles went back to the Community Development Office. He met with Dolores Jones and other staff members to discuss his tentative project concept. Their response was very enthusiastic. They shared Charles' concern about the encroachment of warehousing uses in the industrial area, and felt that a successful project would encourage the development of similar manufacturing uses. Moreover, it appeared that this project did have a good chance of

success. The staff member in charge of the City's industrial facility locator service confirmed that there was a market for small unit industrial facilities. The service had received many inquiries from small firms engaged in import-export, light manufacturing, industrial/commercial supply, electronic industry subcontracting, plumbing and mechanical contracting, and other service industries. He noted that some of these firms would be willing to buy if the financing was available, and the price was right. Dolores mentioned that this was the right time to propose the project to the Council. In recent years the City had concentrated its economic development activities on commercial projects downtown; they were now under pressure to be more responsive to the needs of the blue collar residents.

The staff agreed to investigate going rates for industrial land for Charles. Because there were few vacant industrial parcels in the City, they contacted industrial realtors who operated in nearby communities. A consensus was arrived at on the estimate of \$100,000 per acre. Assuming that the parcel could be purchased at that price, they decided to give Charles a positive staff recommendation when he went before the Council. They felt that the money for the project could be found, especially since the City would be repaid when the industrial condominiums were sold.

Anticipating Council approval, Charles went back to see Bob Walters. He told Bob that if the project was approved the PLDC could probably use a portion of the acquisition price as their share of the equity. He needed to find a private developer to join in the venture, and it had to be someone who could put cash in up front to get the

project started. The PLDC had \$50,000 in "seed" money, but Charles knew that wouldn't be enough. Bob replied that he had recently been contacted by a friend who worked with a large housing development firm, Quality Homes, Inc. They were interested in diversifying, and he wanted to know if Bob had a project that they could become partners in. Bob had declined, explaining that his money was tied up and he didn't want to extend himself further at that time. He promised Charles that he would approach Quality Homes with the proposal.

Charles contacted Southern Pacific and arranged a meeting to discuss the property. His offer of \$100,000 per acre was very close to the asking price, and when he pointed out that it would be paid in cash, they accepted. The price was set at \$1,346,000. The agreement was made subject to Council approval.

The momentum was clearly in favor of approval by the time the matter came before the Council for a vote. The PLDC had been actively politicking for the project, bolstered by the positive staff recommendation. As expected, the resolution passed. The Council agreed to make a no interest loan to the PLDC in the amount of \$1,389,375 to cover land acquisition, liability insurance and title. The City was to receive a mortgage for \$989,375 to be secured by the land, although subordinate to the construction loan. The remaining \$400,000 was an unsecured loan to the PLDC, constituting their equity in the project. The full amount of the loan was to be repaid from the sale proceeds, with profits going to the PLDC to be used for other economic development projects.

Charles immediately contacted Bob Walters to inform him of the land acquisition, and learned that Quality Homes had expressed interest in

the project. In fact, they contracted with Bob to develop a preliminary site plan and financial analysis in conjunction with the PLDC. If the project was sound they would apply for City approval as co-developers.

Phase II: Industrial Condominiums for Small Businesses

Charles, Bob, Dolores, and an architect worked together on the project design and financial analysis. At Bob's urging they decided to develop only 10 acres of the 13.46-acre site as small unit condominiums. The remaining 3.46 acres near the rail spur would be reserved for a few larger manufacturing facilities that would be built (to suit) after the small unit project sold out. They would, of course, have to cover the full cost of the land from profits on the condominium project. Bob believed, however, that this offered the potential for a higher return. Although the market for large industrial units was not extensive, economies of scale in construction produced a larger profit margin for those units. This approach would also allow them to realize the full value of the rail spur on the property.

Charles, on the other hand, was motivated by the increased prospects for employment of District residents by larger manufacturing concerns. While he expected the small businesses to generate jobs for local residents, he realized that the larger shops would be more likely to provide opportunities for unskilled labor.

The small unit industrial facilities were to be built according to the attached site plan (see Exhibit 14). Unit sizes ranged from 3,600 square feet to 5,400 square feet as this size appeared to be most in demand. There was to be a total of 186,900 square feet of saleable

space in 47 individual units. Each unit was to contain approximately 10% office space, one restroom, and a sink area for beverage service. Office space would be completed and draped, heated, and air conditioned. The buildings would all be concrete, tilt-up, have 14 feet under roof, and have a 20-year bondable roof. Amenities included space for a child-care center, full landscaping of the common areas, and 24-hour guard service.

The cost analysis for the small unit industrial condominiums is set forth in Exhibit 1. The facility construction estimates of \$30 per square foot of office space and \$27 per square foot of industrial space were slightly higher than the going rates to account for the time lag. The prime lending rate was currently 11%, but moving upward. They assumed a prime rate of 12% at the time of construction, and therefore anticipated that they could get a construction loan at 14%.

Bob contacted a banker whom he had dealt with in the past to discuss possible financing terms. The banker reminded Bob of their policy of not committing to a construction loan until the take-out financing was assured. He also mentioned that the construction loan servicing fee was up to 1.5% of the loan. He advised Bob that the lender on the permanent loan would probably only commit to an amount based upon a break-even lease situation. "You know," he said, "the industrial condominium is a relatively new concept, the permanent lender is not likely to be willing to gamble on it."

Bob and Charles did the lease analysis shown in Exhibit 2. They assumed a lease rate of 36¢ per square foot; while that was higher than the current market rate of 32-33¢ per square foot, they felt it was

reasonable for new construction. Industrial mortgages are usually made at prime so Bob assumed a 30-year loan at 12%. Based upon these assumption they determined that \$6 million was the maximum amount available to them for take out financing, and even that would require additional equity to prevent a negative cash flow.

If the permanent loan was only \$6 million, then the maximum amount of construction financing would also be \$6 million, and that simply wasn't enough. They had estimated total costs to be \$9,171,745. After subtracting the City's loan for land acquisition, the PLDC's equity, and Quality Homes equity of \$600,000, they were about \$1.2 million short of financing the construction.

Although disappointed, Charles was not yet ready to abandon the project. He asked Bob to find out if Quality Homes would wait until they applied for Urban Development Action Grant (UDAG) funds. Charles felt this was the kind of project that the UDAG program was designed for, and he thought they had a good chance of success. They made the decision to request \$2 million from the U.S. Department of Housing and Urban Development (HUD). Although only \$1.2 million was needed under current conditions, they assumed that more would be needed by the time the grant was approved. They also wanted to provide leeway for the negotiations with HUD.

While the City's staff prepared the UDAG application, Charles and Bob approached various lenders about the construction and permanent financing. Charles knew that the City had a good reputation for processing Small Business Administration (SBA) 502 guarantees and 503 loans. He initiated discussions with the Regional Office in an effort

to obtain a forward commitment on the project. He realized that it would be nearly impossible to obtain permanent mortgage financing for small businesses without the guarantee. While he conceded that some of the units would have to be sold to investors, he wanted to maximize the number of owner-users in the project. He felt that this would contribute to the stability and quality of the industrial park, and it would give the PLDC greater leverage with respect to employment opportunities for District residents.

In the meantime, Bob used his contacts to arrange meetings with a number of local bankers to discuss construction financing. He found that their interest cooled substantially upon learning the location of the project. Most of them politely said they would consider the request when the SBA commitment was secured, but he did find one banker who levelled with him. That banker told him that there were too many good reasons not to lend on the project. First, he said, "The Federal Reserve appears to be serious about maintaining its tight money policy, and that means recession. Small businesses are particularly vulnerable in a recessionary economy. Even if SBA guarantees were available, you still need qualified buyers. If you can't sell the units you'll have to carry the construction loan at prime plus two, and at that rate it doesn't take long before default." Secondly, he explained, "The Portside District has one of the highest crime rates in the county. Ignoring the effect that that will have on absorption rates, it's just too damn risky an area for construction lending. Do you realize what kind of cost overruns you can have because of vandalism and theft?" Bob explained that they intended to have a first-class security system, and a 24-hour guard service once the project was completed. He added, "If it's

necessary we can put a security guard on at night during construction." "So, they shoot the guard," retorted the banker, "I'm sorry, I can't in good conscience recommend this loan to the committee."

Charles' appeal for financing was better received at the SBA. He obtained a forward commitment of \$6 million for permanent financing loan guarantees. The next step was to get a bank or institution to agree to originate the loans, but with a 90% guarantee that would not prove difficult. (See Exhibit 3.) Bob and Charles knew that this type of financing would help the project immensely. If they could qualify a substantial number of small businesses prior to project completion it would enhance their ability to attract tax shelter seeking investors who would bring permanent financing with them for the balance of the project.

Charles worked closely with City staff preparing the UDAG application. The decision was made to request the funds for use as a subordinate construction loan. The money would be repaid to the City upon project sell out, and then used to set up a revolving loan fund for small businesses in the Portside District. The City had employed this mechanism previously in a successful UDAG application, and found that HUD preferred that arrangement to direct grants.

A local commercial bank had agreed to provide permanent financing up to \$6 million under the SBA guaranteed loan program, at an interest rate of prime plus two points. Charles was very surprised to learn that this formula was standard for SBA loans considering the government guarantee. With the prime up to 14% by then, Charles worried that many small firms might not qualify, but he believed that interest rates wouldn't stay high for long.

Once the letter of agreement was received from the permanent lender, Bob approached a newly formed bank, capitalized by Japanese investors, for a construction loan. Fortunately, the bank managers were not familiar with area conditions in the Portside District of Marisol, but were well aware of the prospects for continued growth of the Marisol Port. Bob emphasized that their marketing strategy would be designed to appeal to Port-related businesses, and pointed out the advantages of the site. Based upon the security of the land, the subordinate UDAG construction loan, and the guaranteed loans for permanent financing, they gave a commitment for construction financing conditioned on obtaining the UDAG.

The letters of agreement were submitted to HUD along with the UDAG application. Due to the novelty of the project several clarifications were requested by the Washington Office, adding to the delay. The application was finally approved for \$1.6 million some six months after its submission. While Charles was pleased with their success on that front, he had become seriously concerned about the viability of the project as currently conceived.

Phase III: Rethinking the Project

The prime lending rate had increased to 16% while they were awaiting a determination on the UDAG application, and the consensus was that it would go higher. Charles realized that even well capitalized small businesses could not be expected to take on a 30-year mortgage at 18% interest. Moreover, he felt that merely delaying the project until interest rates receded would not guarantee success. The inevitable

recession would no doubt deplete the cash reserves of small businesses, placing even a small down payment beyond their reach.

Concern over escalating interest costs was shared by Quality Homes. They were already losing money at an extraordinary rate due to the carrying costs of construction financing for their slow absorption rate for the units. At their request a meeting was called to "rethink" the project.

Charles opened the meeting by suggesting the obvious alternative, that is, build the project as planned and lease the units for a few years until they had a "window" for permanent financing. During the course of discussion it was pointed out that Quality Homes had been attracted to the project because of the potential for a quick profit upon sell out and the opportunity to develop experience with industrial projects. As a seller of condominium units they would have been considered a dealer by the Internal Revenue Service and, therefore, gains upon sale would have been taxed at ordinary income rates. This fact was not a deterrent, however, since their cumulative business losses would have negated any tax liability.

The lease alternative produced a radically different tax result. The project would probably just break even in the first few years and at best produce an insignificant cash flow, although generating substantial tax losses through depreciation. While these losses would be attractive to persons seeking to shelter income from other sources, they had no value to Quality Homes.

At this point, Bob Walters interjected the idea of "syndicating"

the project, meaning that they could sell interests in it to high tax bracket investors. As a small developer, he often made his profit by putting a project together and then selling it to limited partnerships, realizing a substantial return on his equity. He added that if the after-tax return was high enough he could put together a private syndication based on the assumption of sale to users within four years.

This idea was well received, but unfortunately syndication would not solve all of the difficulties created by high-interest rates. The alteration of the project concept meant that a new source of permanent financing had to be found. At this point Dolores Jones raised the possibility of issuing tax-exempt industrial development bonds. She noted that it was infeasible to provide permanent tax-exempt financing for small business owners because the risk was too great, but it would be possible to utilize that type of financing if Quality Homes was a co-issuer with the PLDC.

Dolores had done a quick calculation prior to the meeting, and felt that if the City agreed to allow both the land acquisition and UDAG construction loans to remain outstanding until the eventual sale to the users, then the revenue from the project would probably be sufficient to cover debt service on the bonds. She added that the municipal bond market was also suffering because of high interest rates, and therefore the best rate they could expect was around 14%. Noticing the look of surprise, she explained that general obligation bonds were "going out" at 12%, about 4 points below conventional rates. Revenue bonds for secure projects, such as sanitation districts, sold at a slightly higher rate of 12.75%, but an industrial development project which was built on

"spec" demanded a risk premium of about two points.

The meeting ended with the consensus that a financial feasibility analysis of the leasing option be undertaken. Quality Homes also demanded that a consultant be hired to do a market analysis to determine absorption rates for a leased project.

Phase IV: Small Industrial Units for Lease

A consultant was hired to determine the market potential for leasing the small industrial units under varying economic conditions. Based upon an analysis of roughly comparable industrial units which had been listed with realtors one year prior, the consultant projected the following absorption rates. (See Exhibit 4.)

Assuming a strong economy:

Prelease:	25%	(46,500 sq. ft.)
12 months:	30%	(55,800 sq. ft.)
24 months:	30%	(55,800 sq. ft.)
30 months:	15%	(27,900 sq. ft.)

Assuming a weak economy:

Prelease:	25%	(46,500 sq. ft.)
12 months:	17.5%	(32,550 sq. ft.)
24 months:	17.5%	(32,550 sq. ft.)
36 months:	17.5%	(32,550 sq. ft.)
48 months:	17.5%	(32,550 sq. ft.)
5%	vacant at end of 4th year	

The consultant had assumed that the units would be leased at 36¢ per square foot. An escalator clause attached to the lease would raise the base rent by 8% after every 12-month rental period. A continuous monthly absorption rate was assumed for each case. The consultant believed that there was sufficient lead time to obtain lease agreements on 25% of the total square footage prior to project completion, regardless of the economic outlook.

The projected absorption rates would result in the income streams shown on Exhibit 5. These revenue projections were used to generate the pro forma analysis, shown in Exhibits 6, 7, 8 and 9. The analysis was based upon the following assumptions:

- 1) A \$6 million construction loan at 18% interest for 14 months.
- 2) Issuance of tax exempt industrial development bonds in the amount of \$5,376,738 at 14%, amortized over 15 years with level debt service. The amount of the bonds was calculated as

follows:

Total Cost:	\$8,661,770
Land Loan	[1,389,375]
UDAG	[1,600,000]
Private Equity	[600,000]
Subtotal	\$5,072,395
Cost of Issuance (6% of Total)	+ 304,343
TOTAL	\$5,376,738

- 3) Total sell out at end of fourth year at \$60 per square foot.
- 4) Equity contributions of \$400,000 from the PLDC, and \$600,000 from the private developer.

When the analysis was completed the project showed a potential internal rate of return ranging from 26.3% to 30.6% assuming 60% and 85% absorption, respectively, by the end of the second year. Bob felt that even the rate of return assuming a weak economy was sufficiently high to attract limited partnership investment. A meeting was arranged with Quality Homes to present the findings.

At the meeting Charles noticed that although the pro forma demonstrated that the project was reasonably sound, the enthusiasm displayed by their Vice President had waned considerably since their last discussion. It soon came out that despite the results of the feasibility analysis, Quality Homes would have to withdraw from the project. They

were losing \$75,000 per day in carrying costs on their housing developments, and simply could not take on a new project in the near future.

Phase V: A New Project Concept?

Over the course of several months, Charles met with a number of potential developers. All of them expressed interest in the project, but none of them had the financial resources to take on the venture. Charles was finally forced to consider the proposal of Jim Belmonte of Industrial Properties, Inc., who had suggested an entirely new concept for the site. (See Exhibit 10.)

Belmonte had just completed a successful development of an industrial warehousing project on the outskirts of Marisol, and proposed developing the same type of project on the PLDC site. The rail spur to the Port would be the principal feature of the development. Multi-tenant units would be designed so that dock-high loading platforms could be used for cargo loading on and off flat and box railroad cars. Construction of the warehouse shells would make the size of the unit space easily adaptable to the needs of the tenants. The rest of the site would be developed as grade-high warehousing with a parking lot large enough to accommodate tractor trailers. The units would be finished with approximately 10% office space which would significantly raise the value of the lease.

Belmonte argued persuasively that the continuing expansion of the Port was the greatest economic asset in Marisol. Port traffic, which was already considerable, was expected to double by 1990. A new terminal had already been financed by Port revenues and construction had

begun. Conspicuously missing from the Port's terminal project was an area for storage of cargo, waiting to be loaded. Port directors, unable to buy land due to statutory restrictions, felt that Port property was too valuable to be used to warehouse goods waiting for shipment. Consequently, the demand for large scale warehousing would intensify in the future from its presently high level. Only one warehouse with a usable rail spur was operating in Marisol, and that site could only accommodate a modest amount of tractor-trailer traffic.

Due to the high demand for space and the unavailability of sites, Belmonte was convinced that he could prelease the entire warehouse at a lease level of 30¢ per square foot. An 8% escalator clause attached to the lease would increase the payments over successive years to 32¢, 35¢, and 38¢ per square foot. At the same time, construction of the large warehouse units would be considerably less expensive than Charles' small unit development. The warehouse shells, consisting of 225,000 square feet total, could be constructed at a cost of \$21 per square foot. The 25,000 square feet of office space would cost \$30 per square foot.

Belmonte argued that this project was almost risk-free, while the small unit concept was highly speculative. He pointed out that the PLDC, as equity contributors, would share the profits and could use the money to undertake other projects in the community. The warehousing project would also generate the type of jobs that Portside district residents could qualify for.

Although City staff was not enthusiastic about the prospect of using the site for warehousing, they could not disregard Belmonte's proposal. Anticipating major cuts in federal programs, they were anxious

to recover the cash payment made for the site in 1979. The warehouse project would recover those funds, and provide tax revenues in the near future, an important consideration for the "Prop. 13" fiscally strapped city. Building the warehouse also would achieve an important economic goal by supporting the operations of the Port.

One of the most serious drawbacks to this proposal was that the UDAG application would have to be resubmitted. The staff was not optimistic about HUD approval of the warehousing concept. An important UDAG criteria of creating 15 jobs per acre could not be met; the maximum employment a multi-tenant warehouse would generate is seven jobs per acre. The quality of employment would also diminish. Warehouse jobs are considered dead-end, while small businesses tend to create jobs that offer potential for skill development and wage increases.

On the other hand, HUD would not wait forever for the small unit concept to go forward. If it proved impossible to find a developer both sufficiently credit-worthy and willing to risk a speculative venture, HUD would eventually cancel the UDAG, and would be skeptical about approving a new grant for the same site in the future.

If the UDAG commitment was revoked, the biggest loser would be the PLDC. They had planned to use the funds as a financing source for future projects. Charles personally would suffer an important political defeat. The best industrial site in the Portside District, and perhaps, in all of Marisol, would be converted to warehouse use, providing only marginal, low-quality employment. He realized, however, that the rise in interest rates appeared to put the small unit concept on ice for the indefinite future. He could understand the City's decision to consider

the Belmonte proposal, even though he believed that they were only taking into account short-term interests.

The pro forma on the warehouse development assumed the loss of the UDAG funds. Dolores determined that tax-exempt bonds could not be used for the entire project. The \$10 million maximum small issue industrial development bond exemption incorporates "capital expenditure" limitations which would be applicable to all tenants occupying more than 10% in value of the facility. This Internal Revenue Service restriction places a \$10 million maximum on the aggregate amount of the bond issue and all capital expenditures made by project tenants within the City in the three years prior, and for three years following the issuance of the bonds. As it was not feasible to comply with that regulation, an alternative partial tax-exempt financing mechanism was employed. Using the industrial park bond exemption and a \$1 million small issue exemption, it was determined that \$3.5 million of the total project cost of \$9 million could be financed at tax-exempt rates. (See Exhibit 11.)

The balance of the financing required would come from a commercial bank in the form of a standing loan for four years. The idea of using a standing loan, which requires payments of interest only for the first four years, was suggested by Belmonte to avoid a negative after-tax cash flow in the first two years. The cost would be a slightly higher interest rate, and the prospect of refinancing after four years.

The pro forma also assumed that the project, built at a total cost of \$36 per square foot, could be sold at the end of four years for at least \$50 per square foot. This sales price was arrived at by applying a gross rent multiplier of 11 to the fourth year net income. (See

Exhibits 12 and 13.) Belmonte believed that the project could be sold at a higher price at that time, because of the demand that will be generated by growth of the Port. The pro forma shows an internal rate of return of 33.6% for the warehouse development.

You are the Director of the Office of Community Development in the City of Marisol. Your staff has just presented you with the preceding information. You must now decide what you will recommend to the City Council with respect to Belmonte's application to be co-developer. Your staff has outlined the following alternatives:

- 1) the small unit project.
- 2) Accept Belmonte as co-developer and build the warehouse.
- 3) Examine the feasibility of constructing a scaled-down version of the multi-tenant warehouse on the 3.46 acres reserved by the small unit project, building the small units later.
- 4) Require that the multi-tenant warehouse be capable of conversion to a manufacturing use, and request a revised proposal reflecting this option.

Exhibit 1

COST ANALYSIS

SMALL UNIT INDUSTRIAL CONDOMINIUM

Land Acquisition (including carrying costs)	\$1,389,375
Off-site Improvements (streets, utilities, etc.)	425,000
Facility Construction	
10% Office space at \$30/sq. ft.	560,700
Industrial space at \$27/sq. ft.	4,541,670
Construction Subtotal	<u>5,102,370</u>
Construction Loan Interest	
\$6 million @ 14% for 14 months @ 80% average draw	795,000
Servicing fee (1.5%)	90,000
Financing Subtotal	<u>885,000</u>
Architecture & Engineering Fees	155,000
Legal, Title, Impact Fees	80,000
General Administrative Expense	310,000
Sales Expense	625,000
Contingency	200,000
TOTAL	<u>\$9,171,745</u>

Exhibit 2

OFFICE/INDUSTRIAL CONDOMINIUM
MARISOL, CALIFORNIA

Location: Ocean & 30th Street

Gross Leasable Area: 186,900 sq. ft.

Income
Expense
Cash Flow

CONDOMINIUM LEASE ANALYSIS : Prior to UDAG
Application

GROSS ANNUAL INCOME (36¢/sq. ft./month) \$ 807,408

less VACANCY ALLOWANCE 40,370
(5% vacancy applied to small units)

EFFECTIVE GROSS INCOME (gross income less vacancy) \$ 767,038

less OPERATING EXPENSES OF OWNER

Real Estate Taxes \$ net

Janitorial/Gardening net

Utilities net

Property Damage & Public Liability net

Structural Reserve 10,000

Property Mgmt. Fees (3% of Gross) 24,225

Office Expense ---

TOTAL EXPENSE 34,225

NET INCOME \$ 732,813

less DEBT SERVICE
(Mortgage loan of \$6,000,000 @ 12% interest, 30) \$ 740,601

ANNUAL CASH FLOW < \$ 7,788 >

EXHIBIT 3

BANKS CAN EARN 40% ON SBA LOANS, even if they charge borrowers only 17%. High yields on loans guaranteed by the agency attract many banks and some nonbank lenders. Merrill Lynch and ITT, for example, plan to start making such loans later this year. The big yields are possible because as much as 90% of the loan can be sold to investors.

Here's how it works: The SBA can guarantee up to 90% of the loan amount against default. The agency's guarantee ceiling: \$500,000. Thus a lender can make a \$555,000 small-business loan and get the agency to guarantee \$500,000 of it.

Suppose the loan is for 10 years at 17% annual interest. The guarantee portion (\$500,000) can be sold to an investor who is willing to accept an annual return of 14½%. The lender still does the bookkeeping and collects the monthly payments from the borrower, passing on the investor's share and keeping the remaining 2½ percentage points of the interest amount as a "service fee." Thus the lender gets a return of 2½% on the \$500,000 plus the full 17% interest on the \$55,000 of its own money still tied up in the loan.

The arithmetic: The level monthly payment on the loan is \$9,645.77. So at the end of the first year, the lender has collected \$11,943 in service fees on the \$500,000 guaranteed portion, plus \$8,999 in interest on the \$55,000 portion. That's a total of \$20,942 in the first year -- a return of 40% on the lender's \$55,000.

Exhibit 4

CONDOMINIUM/LEASE COMPARABLES: SMALL UNIT INDUSTRIAL PROJECTS

<u>Property Description</u>	<u>Size</u>	<u>Rent</u>
1. New concrete tilt-up; 750 sq. ft. of air-conditioned office; two restrooms; wet bar; two drive-in truck doors; 14.6' clear height; 120/208 V-3 phase-400 amp. power; parking for 16 cars. City of San Miguel	7,760 sq. ft.	\$2,485 per month (32¢) gross
2. New concrete tilt-up; 750 sq. ft. of air-conditioned office; two restrooms; wet bar; two drive-in truck doors; 14.6' clear height; 120/208 V-3 phase-400 amp. power; parking for 18 cars. City of San Miguel	8,370 sq. ft.	\$2,660 per month (32¢) gross
3. New concrete tilt-up; 750 sq. ft. of air-conditioned office; two restrooms; wet bar; two drive-in truck doors; 14.6' clear height; 120/208 V-3 phase-400 amp. power; parking for 14 cars. City of San Miguel	7,663 sq. ft.	\$2,455 per month (32¢) gross
4. 3-building industrial office (warehouse complex ideal for small users; 17 units; 1,212-2,250 sq. ft.; abundant parking; completed offices; ready for immediate occupancy. City of San Miguel	2,250 sq. ft. 1,212 sq. ft. 1,363 sq. ft.	\$750 per month (33¢) gross 425 per month 475 per month
5. Office/warehouse space with 1,400 sq. ft. approx. of offices; one drive-in truck door. City of San Miguel	6,952 sq. ft.	\$1,750 per month (25¢) gross
6. Excellent air-conditioned office/R&D space; no carpeting. Includes shipping area with one drive-in truck door. Perfect for electronics	6,450 sq. ft.	\$2,900 per month (45¢) gross

Exhibit 4 Continued

<u>Property Description</u>	<u>Size</u>	<u>Rent</u>
firm, assembly or general offices. Parking available. City of Marisol		
7. Premier industrial warehouse; 800 sq. ft. of offices consisting of one general, one private and bathrooms. Dock-high truck spots; one rail door; 24 feet vertical clearance. City of Marisol	11,220 sq. ft.	\$2,805 per month (25¢) gross
8. Office and warehouse. Modern concrete, tilt-up building. 1,100 sq. ft. of panelled office and showroom space. Two restrooms. Ample off-street parking. One drive-in truck door. Three year lease. City of Marisol	3,500 sq. ft.	\$1,260 per month (36¢) gross
9. Warehouse including 900 sq. ft. office plus two restrooms. Features: sprinklered; mechanical exhaust system; electric roll-up door; 240 volt/225 amp/3 phase power. City of Marisol	7,500 sq. ft.	\$2,100 per month (28¢) gross
10. New tilt-up concrete office and warehouse building; subdivided units. Features: drive-in truck doors; fluorescent lighting; off-street parking; fully sprinkled; individual restrooms. City of Marisol	1,200 sq. ft.	\$ 425 per month With small office \$460 per month. (35½¢) gross
11. Modern one-story concrete office and warehouse building with A/C offices; 400 amp power, high clearance and other "special" features. City of Marisol	22,222 sq. ft.	FOR SALE \$935,000.00 under market financing available
12. Office/warehouse with special features: Offices to suit; HEAVY POWER; skylights; drive-in loading; off-street parking. City of Kenton	4,400 sq. ft.	\$1,320 per month (30¢) gross

Exhibit 5

SMALL INDUSTRIAL UNITS FOR LEASE

REVENUE PROJECTIONS: "WEAK ECONOMY"

Absorption Rate: 25% pre-lease; 32,550 sq.ft./yr.

<u>Time Leased</u>	<u>Base Rent</u>	<u>Revenue</u>
12 months	36¢	\$ 277,047
24 months	39¢	447,097
36 months	42¢	639,607
48 months	45¢	854,784

REVENUE PROJECTIONS: "STRONG ECONOMY"

Absorption Rate: 25% pre-lease; 55,800 sq.ft./yr.

<u>Time Leased</u>	<u>Base Rent</u>	<u>Revenue</u>
12 months	36¢	\$ 330,519
24 months	39¢	603,834
36 months	42¢	871,317
48 months	45¢	1,004,400

Exhibit 6

COST ANALYSIS
SMALL UNIT INDUSTRIAL LEASED PROJECT

Land Acquisition (including carrying costs)	\$1,389,375
Off-side Improvements (streets, utilities, etc.)	425,000
Facility Construction	
10% Office Space @ \$30/sq. ft.	560,700
Industrial Space @ \$27/sq. ft.	4,541,670
Construction Subtotal	\$5,102,370
Construction Loan Interest	
\$6 million @ 18% for 14 months @ 80% average draw	835,800
Construction Loan Fee	90,000
Architecture and Engineering Fees	155,000
Legal, Title, Impact Fees	80,000
General Administrative Expense	360,000
Property Management Fee (3% of Gross Income)	34,225
Contingency	200,000
TOTAL	\$8,661,770

Exhibit 7

SMALL INDUSTRIAL UNITS: LEASED PROJECT ¹

Cash Flow: Weak Economy

	Year 1	Year 2	Year 3	Year 4
GROSS INCOME	\$277,047	\$447,097	\$639,607	\$854,784
- Operating Expenses	8,311	13,413	19,188	25,643
NET INCOME	268,736	433,684	620,419	829,141
Loan Payment	859,248	859,248	859,248	859,248
Interest	745,636	728,668	709,168	686,754
Principal Payment	113,612	130,579	150,079	172,493
Loan Balance (end of year)	5,263,126	5,132,547	4,982,468	4,809,975
Straight Line Depreciation	484,826	484,826	484,826	484,826
Taxable Net Income	- 961,726	- 779,810	- 573,575	- 342,439
Tax	- 489,863	- 389,905	- 286,787	- 171,219
After Tax Cash Flow	- 100,649	- 35,659	47,958	141,112
				2,605,304
Equity Reversion on \$1 million equity ²				\$2,746,416

I.R.R. = 26.3

¹ Includes following Public Subsidies:
a) \$989,375 interest-free loan from Marisol CDBG fund
b) \$1.6 million interest-free UDAG loan
c) Take-out financed from \$5,376,738 in industrial development bonds

² Equity invested:
a) \$600 K from private developer
b) \$400 K from PLDC (donated to PLDC from Marisol CDBG fund)

Exhibit 8

SMALL INDUSTRIAL UNITS: LEASED PROJECT¹
Cash Flow: Strong Economy

	Year 1	Year 2	Year 3	Year 4
GROSS INCOME	\$330,519	\$603,834	\$871,317	\$1,004,400
- Operating Expenses	9,916	18,115	26,139	30,132
NET INCOME	320,603	585,719	845,178	974,268
Loan Payment	859,248	859,248	859,248	859,248
Interest	745,636	728,668	709,168	686,754
Principal Payment	113,612	130,579	150,079	172,493
Loan Balance (end of year)	5,263,126	5,132,547	4,982,468	4,809,975
Straight Line Depreciation on \$7,272,395	484,826	484,826	484,826	484,286
Taxable Net Income	- 909,859	- 627,775	- 348,816	- 196,772
Tax	- 454,929	- 313,887	- 174,408	- 98,386
After Tax Cash Flow	- 83,716	40,358	160,338	213,406
Equity Reversion ²				2,605,304
				<u>\$2,818,710</u>

I R R = 30.62

¹Includes following Public Subsidies:
a) \$989,375 interest-free loan from Marisol CDBG fund
b) \$1.6 million interest-free UDAG loan
c) Take-out financed from \$5,376,738 in industrial development bonds

²Equity invested:
a) \$600 K from private developer
b) \$400 K from PLDC (donated to PLDC from Marisol CDBG fund)

Exhibit 9

EQUITY REVERSION:

Sale of Small Industrial Unit Leased Project

Selling Price at end of 4th Year ¹ (\$60/sq. ft.)	\$ 11,160,000
Selling Expenses (3%)	334,800
Loan Balance	4,809,975
Land Acquisition Repayment	989,375
UDAG Loan	1,600,000
Capital Gains Tax*	820,546
	<u>\$2,605,304</u>

* Capital Gains Tax Calculation:

Basis	\$ 8,661,770
Adjusted Basis	6,722,466
Net Selling Price	10,825,200
Capital Gain	4,102,734
Capital Gain Tax	820,546

¹ Gross Rent Multiplier of 11

Exhibit 10

COST ANALYSIS: WAREHOUSE PROJECT

Land	\$1,389,375
Architecture and Engineering	213,000
Off-Site Improvements	425,000
General Administration	360,000
Legal	80,000
Contingencies	200,000
Leasing Agent Fee (3% of 1st year Gross Income)	27,000
Construction Costs	
a) 225,000 sq. ft. warehouse shell @ \$21/sq. ft.	4,725,000
b) 25,000 sq. ft. offices @ \$30/sq. ft.	750,000
Construction Loan Fee (1.5%)	92,295
Construction Loan Interest (18% for one year)	1,107,540
Cost of Bond Issuance	214,925
TOTAL	<u><u>\$9,584,135</u></u>

Exhibit 11

WAREHOUSE PROJECTION:

ELIGIBLE COSTS FOR TAX-EXEMPT FINANCING

Industrial Park Bond

Land	\$ 1,389,375
Off-Site Improvement	425,000
Engineering Fees	113,000
Administration	180,000
Legal	25,075
Cost of Issuance (6%)	214,925
Building Construction (10%)	234,737

\$ 2,582,112

\$1 million Small Issue

1,000,000

TOTAL TAX-EXEMPT FINANCING

\$ 3,582,112

Conventional Financing

4,012,648

Interest-Free Land Loan

1,000,000

Equity

1,000,000

\$ 9,594,760

Exhibit 12

CASH FLOW ANALYSIS FOR WAREHOUSE PROJECT

	Year 1	Year 2	Year 3	Year 4
GROSS INCOME ^a	\$900,000	\$960,000	\$1,050,000	\$1,140,000
- Operating Expenses (3% of Gross) (Property Mgmt. Fee)	27,000	28,800	31,500	34,200
NET INCOME	\$873,000	\$931,200	\$1,018,500	\$1,105,800
Loan Payment ^b	1,279,653	1,279,653	1,279,653	1,279,653
Interest (aggregate tax-exempt and conventional)	1,138,783	1,127,478	1,114,487	1,099,555
Principal (tax exempt only)	75,688	86,992	99,984	114,916
Loan Balance (end of year)	7,519,072	7,432,080	7,332,096	7,217,180
Depreciation ^c	546,317	546,317	546,317	546,317
Taxable Net Income	- 812,100	- 742,595	- 642,304	- 540,072
Tax (50% bracket)	- 406,050	- 371,297	- 321,152	- 270,036
After-Tax Cash Flow	- 603	22,844	59,999	96,183
Equity Reversion (\$1 million in equity)				\$2,973,219
				<u>\$3,069,402</u>
Internal Rate of Return:	33.63			

^a100% pre-lease, triple net to lease; 8% escalator clause (\$.30, .32, .35, .38)

^bConventional Mortgage; 4-year standing loan; @ 16% for 15 years \$4,012,648
 Tax-exempt bond; net interest @ 14% for 15 years =
3,582,112
\$7,594,760

^cTotal Project Cost \$9,584,135 Interest free loan from city \$1,000,000
 Depreciable Basis 8,194,760 Equity 1,000,000
 15 yr. straight line \$9,594,760

Exhibit 13

WAREHOUSE PROJECT EQUITY REVERSION

Selling Price ¹ (end of 4th year @ \$50/sq. ft.)	\$ 12,500,000
Selling Expenses (3%)	- 375,000
Loan Balance	- 7,217,180
Land Loan Repayment	- 989,375
Capital Gain Tax*	- 945,226
	<u>\$ 2,973,219</u>

* Computation of Capital Gains Tax:

Basis	\$ 9,584,135
Adjusted Basis	7,398,867
Net Selling Price	12,125,000
Capital Gain	4,726,133
Capital Gain Tax (20%)	945,226

¹ Gross Rent of Multiplier of 11

Exhibit 14

