Understanding Iowa City's Due Diligence Process for Gap Financing with TIF

CITY OF IOWA CITY

What To Expect

To be eligible for Tax Increment Financing (TIF) a developer must show public benefit(s) to the project and a financial gap to fill. The City may provide gap financing to projects in designated areas meeting public policy goals aligned with the City Council Strategic Plan and Iowa City TIF Policy. Projects must be structured so that private debt is maximized and developer equity yields a fair return while not providing undue enrichment to the developer. City policy for financial participation in development projects is to be "the last dollars in," if merited, and should not exceed developer equity.

1. After all other financing is secured, a developer may submit an application and the City will conduct its due diligence. This will involve a thorough analysis of all the project costs including design, land acquisition, construction loan and permanent financing and projected revenues and expenses in the operation of the building over 20 years. Through this analysis, we are able to confirm a stabilized net operating income, the fair market value of the project and most importantly, whether projected returns to the developer are reasonable. A third-party consultant may be used to conduct all or a portion of the financial analysis.

2. Once a project appears to show a reasonable financial gap which could be funded with City assistance, City staff must:

    a. Amend the appropriate urban renewal plan to include the project (if necessary); and
    b. Negotiate a development agreement that among other things, stipulates the type of funding-- rebate or cash up front, a minimum assessment of the property to ensure that the City is repaid in property taxes (if financing is cash up front and not rebated), and the details of the minimum improvements, etc.
    c. Complete all legislative approvals, which may include a recommendation by the City Economic Development Committee and ultimate approval by City Council.

Typical Timeline

Below is the typical process and timeline for the required steps. The process can move a bit faster, but the timeline below is a realistic scenario if everything falls into place.

If the developer:

a) Has a well-defined concept plan for design and financing of the project, <u>and</u>
b) Has provided all the financial information in the application for gap financing, then City can provide an initial analysis within two weeks.

If/when the financial analysis meets the City's TIF Policy standards (in that there is a public benefit to the project) and:

a) There is a financial gap, <u>and</u>

b) The City participation would be last dollars in, and
c) The developers would net a reasonable return (as determined by research conducted by a third-party consultant);

Then, negotiation of a development agreement can begin. The development agreement can be drafted within 10 working days once the developer and the City have agreed to the basic terms.

Once a draft development agreement to which all parties have agreed to has been developed:

1. The City may simultaneously send the draft agreement and a staff recommendation to the Economic Development Committee (a subcommittee of the City Council). This requires at least one week's time for scheduling the ED Committee meeting and developing the meeting packet.

2. The City will begin the process of amending the Urban Renewal Plan to include the project details. This is required by State Law and requires two City Council meetings, which can usually be accomplished in about six weeks, given the required time for meeting notices and packet assembly. The first of the two meetings is for a "Resolution of Necessity" and the second, approximately a month later, is to adopt the amendment to the Urban Renewal Plan.

3. If a Development Agreement has been signed by all parties prior to the 2nd City Council meeting adopting the updated Urban Renewal Plan, then a resolution to approve the Developers Agreement can also be on the same agenda (as long as it is after Urban Renewal Plan amendment).

Cash up front TIF vs TIF Rebates: Who Bears the Greatest Risk?

Cash Up Front TIF

Cash up front TIFs are both politically and financially more difficult. For cash up front, the City requires:

- Specific performance measures; and
- That the developer agree to a minimum assessment on the project property (and sometimes, in addition to the project property, a minimum assessment on other property the developer owns within the district) for a certain period of years.

This provides assurances the City will be able to pay itself back with the TIF increment generated from the project (and if required, the additional developer-owned property in the area). The duration and dollar amount determined for the minimum assessment includes the City (public's) cost of financing the project until it is recaptured by the TIF revenues the project generates. This option is more expensive and requires the City bear more risk than the other option – TIF rebates – which is why it is more difficult, politically.

TIF Rebates

TIF rebates are still political, but the developer assumes most of the risk. Rebates are simpler because they only require that the taxes paid on a successful development be rebated back to the developer – with no financing costs and no risk to the public (with the exception of the diversion of tax dollars to the TIF fund).

If the financial gap in a project could be covered by a TIF rebate as opposed to cash up front, it is highly preferable. Tax rebates begin about 18 months after taxes were paid, due to the lag time in property tax assessment year and revenue collections. It is important to note that while property taxes are paid at the Consolidated Property Tax Levy rate, the TIF levy and rebates are calculated at a lower rate (both rates change annually).

Definitions of key elements of the gap analysis process:

Gap / Gap Analysis

A financial gap is determined by the difference between all financing sources for a project and the project costs, with a focus on the developer's return, which is based in large part on developer equity and the maximization (attraction) of project debt. This allows consideration of public financing that fills a gap yet does not provide for undue enrichment to the developer. Market standards apply. Among other things, our gap analysis requires a firm project development budget and operating pro forma supported by an independent market study. In the end, a recommendation to Council will hinge on the reasonability of the developer's return, public benefit and availability of public financing.

The gap <u>is not</u> simply the difference between how much a desirable project costs and the financial resources to which a developer has access.

Equity

In the context of real estate development, equity is the difference between the current market value of the property and the amount the owner still owes on the remaining debt for it. It is the amount that the owner would receive after selling a property and paying off all debt on it.

Capitalization Rate

A "cap rate" determines value of a project. It is the number of cents of project income (net operating income, NOI, or annual cash flow) required by an investor for every dollar of purchase price paid. If a developer demanded a 7% cap rate, they would be willing to pay $1 for every 7¢ of NOI. If they demanded a 10% cap rate, they would be willing to pay $1 for every 10¢ of NOI. Higher cap rates mean there is higher risk indicated by the investor's requirement for more of the annual cash flow. It measures a return on all invested capital - debt and equity.

Market Cap Rate

Market Cap Rates are used to determine value by comparable transactions in the same market. The same equation is used as for cap rates, but considers an entire market's actual transactions, as compared to the investor's individual demands. Market cap rates in downtown Iowa City are in the 7% range; in an area that struggles economically, the market cap rate would be expected to be slightly higher.

For details about Iowa City's gap analysis, please see the companion document:
Key Elements to the Financial Analysis

Questions? Please contact the Economic Development division at 319-356-5248.