

Appendix C

Historic Property Reinvestment Program Reasonable and Appropriate Return on Investment

Introduction

As with its predecessor real estate development incentive, the Economic Redevelopment and Growth Program (ERG), a key statutory requirement within the Economic Recovery Act of 2020 (ERA) enacted real estate development incentives is that without the incentive award, the redevelopment project is not economically feasible. As such the applicant must demonstrate that a project financing gap exists, which requires that redevelopment project will generate a below market rate of return.

This appendix outlines the Authority's history with such analyses and present policy recommendations for administering related provisions such as determining the reasonable and appropriate rate of return on investment for the project.

Authority History with Gap Financing Programs and Hurdle Rate Determinations

As noted previously the Authority has experience administering gap financing real estate development incentives through the ERG program dating back to its establishment in 2012. In November of 2012 the Authority Board approved the use of a financial model developed by real estate services firm Jones Lang Lasalle (JLL) for the purpose of determining market returns that would be required for prospective real estate projects in the State to be considered economically viable, i.e., a hurdle rate. This model was subsequently modified in December of 2012 to add functionality and allow for its use more efficiently across the state. The model arrives at a project specific hurdle rate based upon three factors including the projects proposed zip code, industry class, and if it would be located in area of the state exhibiting economic distress.

The zip code factor methodology determines expected returns in a market by analyzing historical real estate investments in the same zip code as the proposed project. It does this either by looking at historical transactions in the zip code and adjusting them for current economic conditions or, when there are not sufficient historical transactions, by interpolation, whereby a set of "anchor cities" are relied upon for comparable recent transactions. Anchor cities currently include Newark, Paterson, Camden, Asbury Park, Trenton, Millville, Paramus, Morristown, Summit, Princeton, Wall, Cherry Hill, Galloway, and Cape May. These cities were selected in consultation with JLL because of the presence of readily available comparable transactions and because of their geographic and economic diversity.

Within each zip code the model has a set of hurdle rates that are dependent upon the second factor: the industry class represented by the prospective project, e.g., office, retail, industrial, hospitality, and residential. The hurdle rate will reflect the market realities for the prospective project, i.e., a reasonable

and appropriate return on investment is likely to vary within a specific market depending on the type of project that is being considered.

The third factor the model assesses is evidence of economic distress in the proposed project's location, which would be a further reason that a project would warrant a return above and beyond what would be anticipated in a market without such evidence of distress. These factors are median household income below the state median, median personal income below the state median, and median housing prices below the state median. Within the model these three factors are evenly weighted to in total represent the difference between investment grade and non-investment grade debt, and the hurdle rate is increased accordingly for each factor that is exhibited i.e. if at approval the difference between market indicators for investment grade and non-investment grade debt is 250 basis points each factor of distress that is present would result in the hurdle rate being increased by 83.3 basis points.

The model is updated is typically updated quarterly to reflect current market realities and was most recently updated in September of 2021 for continued Authority use within the ERG program.

Historically there have been instances where the model has not been relied upon to determine the hurdle rate for a project by the Authority, and Staff proposes to continue this process. These are instances where either the developer is utilizing Low Income Housing Tax Credits (LIHTC) administered by the New Jersey Housing and Mortgage Finance Agency (HMFA) and where the project lacked sufficient forms of traditional equity such as cash and land to allow for the logical calculation of an IRR; or where the project is so exceptionally large, unique, and/or complex that the data in the model are not relevant or a good fit. In the event of the project utilizing LIHTC the Authority has relied upon the HMFA rules and policy detailing what is an acceptable deferred developer fee, which is widely understood within the affordable housing industry and effectively represents the extent returns are associated with an affordable housing project as they generally do not generate a profit for many years. In the event of a large, unique, and/or complex project, which could include complex projects utilizing LIHTC but having a significant commercial component, the Authority has commissioned a proposed project-specific third-party analysis performed by a real estate services firm to determine a project specific hurdle rate. As provided in the Aspire rules, the cost of these services is charged to the applicant.

Policy within ERA enacted real estate development incentives for Determining Reasonable and Appropriate Return on Investment

Staff is proposing the continued use of the JLL hurdle rate model for purposes of determining the reasonable and appropriate return on investment that projects will be evaluated upon for program eligibility and award sizing. For the purposes of utilizing this model for product specific programs within the ERA such as Historic, Brownfields, and Food Desert, staff will work with the real estate advisory services consultant to amend the model as needed to reflect nuances related to capital financing strategies and market return expectations that may exist within the relevant sub-category. This effort has already begun for the Historic program and any modifications made to the model will be communicated to the board prior to the approval of the first award(s).

Staff will continue to rely upon the HMFA deferred developer fee model as the reasonable and appropriate return on investment when the project is utilizing LIHTC. For reference the HMFA deferred developer fee can be summarized as follows:

1. The amount of the developer fee is limited to 15 percent of project costs, except the developer fee shall only include 4 percent of building acquisition but excludes land acquisition
2. Of this 15 percent, at least 7 percent of the developer fee, i.e., deferred developer fee, cannot be realized in full prior to 5 years after stabilization of the project i.e. stabilization of rents. The developer must identify a reasonable point of stabilization the project's proforma based on the characteristics of the project. The Authority will review and determine whether the point of stabilization is reasonable and the project metrics (e.g., certain lease occupancy) that identifies stabilization. For purposes of assessing excess returns, the point of stabilization will be the earlier of the time period identified in the developer's proforma (plus a short, reasonable amount of time) or when the project metrics are achieved.

Staff proposed continuing to use a third-party consultant to perform project-specific analysis for large and highly specific projects. The Aspire Program includes provisions that envision larger projects than those previously supported through ERG, both in the form of larger relative subsidy and in the creation of the Transformative Project designation. Additionally, the program allows for phased projects which would be evaluated based upon of project level return analysis potentially relying upon complex financing structurers. In these circumstances, the Authority staff will continue to rely upon real estate advisory services providers on an as needed basis to determine project specific reasonable and appropriate return on investment for large, unique, and/or highly complex projects. As previously noted, it is likely that some of the product specific programs within the ERA may result in particularly unique projects as it relates to the product and the financing that may be utilized. In these events the authority may rely upon a third-party to complete certain aspects of the return analysis as needed.