

Redevelopment advising provided to the Town of Hillsborough, NC for the privately owned property located at 153 West King Street

Provided by the Development Finance Initiative (DFI), a program of the UNC School of Government
May 11, 2015

Executive Summary

The Town of Hillsborough engaged the Development Finance Initiative (DFI) at the UNC School of Government to advise on the redevelopment potential of the former Colonial Inn located at 153 W. King Street. Specifically, the Town asked DFI to:

- Assess the financial feasibility of redeveloping the property;
- Advise on the level of subsidy that will be necessary to support the financial feasibility of redevelopment; and
- Analyze options for Town of Hillsborough to redevelop or initiate the redevelopment of the property.

DFI partners with local governments to attract private investment to accomplish community economic development goals. Its team includes subject matter experts in community and economic development, real estate development and finance, as well as public private partnerships. DFI is housed at the UNC School of Government, which is a trusted resource for North Carolina's public officials for more than 80 years. The School of Government is non-partisan and policy-neutral.

DFI's analysis focused on the former Colonial Inn located at 153 W. King Street in Hillsborough. The Town of Hillsborough's Historic District Commission has identified the property as a contributing structure to the local historic district and the State of North Carolina provided the property the status of statewide significance in 2003. Below are other facts of this property:

- Year Built: 1838
- Total square feet: 11,621
- Land: 0.53 acres
- Tax Assessed Value: \$658, 658

ASSESS FINANCIAL FEASIBILITY

DFI's first step in assessing the financial feasibility of the property was to identify the program or potential uses. To do this, DFI analyzed four sectors as potential uses for the property.

- **Apartments:** One use DFI evaluated for the second floor is apartments. While multi-family housing demand is strong in Hillsborough, particularly in the historic district, it is DFI's opinion that the efficiency of constructing apartments on the second floor makes this option less desirable than other uses tested.
- **Hospitality:** DFI explored hospitality for the second floor of the property. Due to the small size of the second floor (approximately 3,679 square feet), DFI's research identified this use would be financially challenging due to the small number of rooms that could be constructed on the second floor. The resulting operational challenges make this option less desirable than other uses tested.
- **Office:** A third use DFI analyzed for the property is office. The strong demand for office space in Hillsborough's is projected to continue. It is DFI's opinion that the central location of this property as well as its historic character would help distinguish this potential office space and allow for higher than average market rent. This makes office use on the second floor the most financially viable option.
- **Restaurant:** A historic use of the first floor of the property is a restaurant. Market research identified a strong demand for additional restaurants in Hillsborough's Historic District. The nearly 8,000 square foot first floor is large for a restaurant, so it is likely that the first floor may be a combination restaurant/event space, or contain some retail or office space.

While all uses explored for the property showed strong demand and rents, DFI selected office space for the entire second floor and the new addition on the first floor as well as restaurant/banquet for the first floor. It is DFI's opinion that these uses are the most financially feasible for this property. DFI did not evaluate an exclusive residential use for the property.

After identifying a program for the property, DFI built a financial model for the redevelopment of the property. This model is dependent on key assumptions, including the following:

- Tenants would pay market-rate rents of \$18 per square foot (triple net leases);
- Developer/investor group would utilize the federal historic tax credit program as well as Governor McCrory's currently proposed state Historic Tax Credit program;
- Developer/investor group would sell building six years after it re-opens; and
- Town would rezone property to allow for the stated commercial uses and work with the developer/investor group to determine a viable parking solution.

Another important assumption in the financial model is the developer/investor group acquiring the property for \$142,000. DFI is not an appraiser, but did explore three potential methods for estimating the value of the property. These methods are similar to methods of professional appraisers.

- Sales price per square foot of comparable renovated properties less renovation costs;
- Capitalized value of net operating income less renovation costs; and
- Land value less demolition costs

The first two methods yielded negative total value due to the renovation costs exceeding the future value. The third method of land valuation identified the value of \$142,000. DFI's research identified an average land sales price of \$305,000 per acre in and very near Hillsborough's

historic district. The property is 0.53 acres, therefore the land is currently valued at \$162,000. Next, DFI subtracted the potential cost of demolishing the structure estimated at \$20,000 to arrive at the value of \$142,000.

With these assumptions, DFI's calculations identified the total project costs (including acquisition) of \$2.9m to historically renovate the property. The potential sources of financing for project include:

- Investor equity: \$755,000
- Federal historic tax credit equity: \$765,000
- State historic tax credit equity: \$283,000
- Loan: \$1,089,000

DFI's financial analysis projects an internal rate of return (IRR) or average annual financial returns during project (hold period of six years) of 3%. Through its work renovating similarly distressed properties across North Carolina, DFI has identified a target IRR of 15-20% that is needed to attract the necessary investor equity. Therefore, it is DFI's opinion that this IRR of 3% is not a sufficient return to attract the private investor equity necessary to finance the project.

Additional challenges to the financial feasibility of the project are that the state historic tax credit program included in the financial model is not yet renewed by the General Assembly, and that the amount of tax credits that must be purchased by private individuals or corporations is likely to be too large for many individuals, while being too small for many corporations.

One positive of the program is that the strength of the Hillsborough commercial real estate market will mitigate potential operating risks.

LEVELS OF PUBLIC/PHILANTHROPIC SUBSIDY REQUIRED

After completing its financial analysis and concluding that the project could not attract private investment without subsidy, DFI explored options for public and/or philanthropic involvement. Specifically, DFI evaluated three potential options of public/philanthropic support that could increase the financial feasibility of the project:

- **Historic Landmark Status:** The Town of Hillsborough could designate the property as a Historic Landmark. This status would decrease the taxable value of the property by 50% in perpetuity, assuming owners maintain the historic nature of the property. This form of subsidy would be borne by the Town and County.
- **Grant:** DFI also explored the potential of the project receiving grant funds either at the beginning of the project in one payment or annually over five years. These grant funds could come from any number of sources, including the Town, State of North Carolina, private individuals or philanthropic groups. If the Town wishes to offer a cash grant, it must enact a municipal service district.
- **Mission-Driven Capital:** A third option is the project could obtain mission-driven capital, which is provided from investors that are willing to earn below market returns. The rate of return any individual would want is highly variable; DFI modeled investment at a return of 8-10% in the analysis.

DFI analyzed the impact of these three options in its financial model. Historic landmark status alone would not increase the IRR to the necessary range of 15-20% to be attractive to private capital. When combining landmark status with additional grant funds, the project could generate the necessary IRR with \$260,000 of grant funds in one payment at the beginning of the project, or an annual installment of \$90,000 per year over five years.

If the property is designated as a Landmark, and receives \$75,000 of grant funds up front or \$15,000 of grant funds per year for five years, it might attract mission-driven capital at the rate modeled.

OPTIONS FOR THE TOWN TO INITIATE REDEVELOPMENT

With significant public interest in the redevelopment of the building, the Town of Hillsborough is interested in knowing what options it has for hastening the redevelopment of the building. The following are the Town's options for actively participating in redevelopment.

The Town could acquire the property through purchase or exchange. There are statutory requirements for a public body to purchase property for the purposes of economic development, such as a requirement for a public hearing (see G.S. 158-7).

The Town can support a private individual or entity in their work to redevelop the property. This support can have many forms, from an upfront or ongoing grant or loan to the pre-leasing of office space. The goal here is to have a combination of support from the Town and other public and private sources that are sufficient to gain the project debt financing from a bank or credit union.

North Carolina statutes authorize the Town to enter into a public-private partnership in which the Town contracts with a private developer for the construction of public facilities. This is not a means of gaining site control, as the property would need to be acquired separately by the Town or by the developer, and the site is unlikely to become a public facility.

A property tax lien and a special assessment lien both allow the Town to foreclose on the property, resulting in an auction of the property. The Town may bid for the property at auction, but must win the auction to become its owner. The property is not currently delinquent on its taxes. For a special assessment lien, the Town would first need to go through the procedures for ordering repair of a commercial structure (if the structure qualifies for repairs, see G.S. 160A-439). Then the Town would need to complete the repairs if the owner does not. The cost of these repairs then becomes a lien.

The Town can create an Urban Redevelopment Area (URA) as provided in G.S. 160A-22, Urban Redevelopment Law. This process designates an Urban Redevelopment Commission, prescribes a URA and grants the local government the power of eminent domain for blighted parcels within the URA. Properties taken with eminent domain receive just compensation.

The Town can use existing eminent domain authority granted by G.S. 40A-3(b) to take property for public use (not for economic development), or to take Landmark designated property for which an application has been made for a certificate of appropriateness for demolition.