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Public/Private Ventures

Institutions Harness Hot Market to Redevelop Facilities

BY MEREDITH J. KANE

One of the benefits of New York's red-hot real estate market is the unprecedented opportunity that it offers to New York's major civic institutions—schools, hospitals, churches, museums, universities, and libraries—to leverage their real estate holdings in prime areas into newly-constructed, state-of-the-art facilities in conjunction with developers. As building sites in prime, fully-developed neighborhoods become increasingly scarce, civic and cultural institutions find themselves in the enviable position of owning and occupying valuable and highly sought-after land parcels. For most institutions, real estate is an illiquid asset—as valuable as the institution's site may be if sold on the market, finding an alternate location may simply not be a viable option. For institutions, just as developers, a particular neighborhood location may be critical to the institution's mission. But where an institution seeks both to stay in its current location and unlock its real estate value, a creative transaction can be devised in which the institution essentially conveys the unused development potential of the site to a developer, in return for the developer constructing within the new building on the site a new, state-of-the-art facility to be owned and occupied by the institution.

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UNLOCKING VALUE

Numerous examples of this type of transaction have been recent news. The New York City Department of Education recently announced its first venture with a private developer on the Upper East Side to build a new residential building on a school site with new school facilities to be constructed in the base of the building, and has announced its intention to seek more such opportunities. Major hospitals, universities, museums and religious institutions have issued requests for proposals to the development community offering prime locations in return for a joint venture that would re-house the institution in new on-site facilities together with commercial uses. And developers have trolled neighborhoods looking for institutional property owners that are willing to partner with them in mixed-use buildings to house both the institution and residential or commercial development. Zoning policy in many districts encourages such combinations with density bonuses for on-site community facilities. Of course, not every institution can benefit from this type of redevelopment: opportunities are constrained in low-density zoning districts, and where landmark property is involved.

Even the most highly motivated partners in these transactions, however, must navigate the fundamentally divergent interests and risk tolerances of the institutional party and the developer party. The key to a successful transaction is to structure the financial, legal and project management relationships between the partners to take account of the different needs and objectives of the parties, and to ensure that each party is positioned to take advantage of the benefits that the other brings to the transaction. In general, the institutional partner will be concerned about getting fair market value for its site, controlling the financial risk of the transaction to the institution, including assuring the financial viability of the transaction and the developer partner, accessing development expertise to manage a large construction project, and managing the temporary relocation of its functions during construction. The developer partner will be concerned about maximizing development flexibility and market timing, certainty of accomplishing the project, minimizing carrying and pre-development costs, and ensuring the performance of the institutional partner, both financially

and in terms of project participation. Both partners are concerned to ensure the compatibility of uses and operating functionality of the resulting mixed-use building, including operational and marketing issues posed by the proximity of uses.

Developer Selection Process

If the development initiative is coming from the institution which controls the property, developer selection is usually done by a Request for Proposals (RFP) issued by the institution to seek a qualified development partner. Critical elements for a successful RFP include:

• The institution should give as much information as possible about the size, scope, use, and technical requirements of the facilities it is seeking to have built for its own use as part of the project, including specialty requirements. It should describe the development opportunity it is offering with as much detail as possible, including site information, zoning, floor area, and any use or operational constraints that the institution intends to place on the site. To achieve the best pricing, the institution should analyze and describe all other benefits that the institution is able to make available to the developer, including tax exemptions, zoning bonuses, or intangible benefits that add value to the developer, and make clear that it expects to be compensated for the value of such benefits.

• The developer's response should focus equally on pricing, and on its qualifications and ability to manage the development process for an institutional partner. Pricing should take into account the market value of the land and other benefits offered to the developer, and an order-of-magnitude estimate of the cost of the facility the institution seeks in return. Equally important as pricing is the developer's demonstrated ability to work with an institutional board of directors, and to manage a complex development project that will have multiple sets of design inputs and approvals, and potentially multiple funding sources. The developer's financial capability to complete the deal is critical, and its willingness to front certain pre-development costs on behalf of the institution—which are the funds most difficult for the institution to raise—will likely be viewed as a positive factor favoring its proposal.

The Financial Deal

The basic financial structure of a typical transaction is to have each of the institution and the developer pay for the allocated cost of its own facility within the new building. The source of funds for the institution's payment is a combination of its "project bank account"—that is, the agreed-upon value of what it is bringing to the developer in the transaction—and cash or financing to cover any excess costs. The first step is to negotiate an agreement between the institution and the developer identifying the sources of value that the institution is bringing to the developer, and establishing the fair market value of those items. Key elements of value that an institution can bring to the transaction are:

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• The project site and development rights to be made available to the developer, deducting the portion of the development rights that will be occupied by the institution.

• Possible exemptions from real estate taxes during construction, and sales taxes on construction materials used in the developer building, based on site ownership. These exemptions may be available if the site is owned by a government entity, and the developer can make a payment in lieu of those taxes for the benefit of the institutional partner.

• Intangible benefits of involving a civic institution, including expediting the public approvals process, and giving marketing cachet and name identification to the developer's building.

It is important for the institution to establish that it is getting fair market value for its contributions and is able to demonstrate the fairness of the transaction to its overseers, including its board of directors and various governmental bodies with oversight responsibilities over not-for-profit organizations and government agencies. Fair market value can be established by an open and competitive developer selection process, but should generally be backstopped by an appraisal. If a project is going to be constructed at a point in the future such that the institution would be disadvantaged in fixing its land value today while confronting increased construction costs at the time of project start, a developer should consider offering some form of kicker or market adjuster in the land value given to the institution, since the developer will be able to capture future market changes in the sale or leasing of its project.

Pre-Development and Design

Once the amount of the institution's "project bank account" is established, the pre-development planning and design process for the joint facility will determine how the institution spends its funds to pay for its new facility. A threshold feasibility question is whether the institution will need additional funds beyond the value of its real estate in order to complete the transaction, and if so, what the institution anticipates will be the source and timing of those additional funds. From the RFP process, the institution should have an order-of-magnitude projection of the cost of its facility and the size of the funding gap, but a more developed schematic design will be necessary in order to narrow the range of the figure and enable the institution to determine project feasibility and plan its

funding strategy. A key issue at this stage in the project is to determine the conditions under which either party may terminate the transaction if it becomes financially infeasible, and what, if any, compensation should be paid to the other party if one side terminates.

The following practical issues should also be considered in the pre-development planning and design process:

• Retention and Coordination of the Architectural and Engineering Team: The design process for the new building may be conducted by a single project architect handling core and shell and fit-out for both parts of the building, or may be a joint design exercise in which each party has its own architect designing its own spaces. A typical division of responsibility is for the developer to engage an architect for the overall project core and shell, with review and input from the institution's architect as to design matters that affect the institution's space, design identity and budget.

• Sharing of Pre-Development Soft Costs: The parties must determine how fees and other pre-development soft costs will be shared if a single architect is retained, or if separate architects are retained but the developer's architect does overall building design. The cost of specialty consultants required for each party, as well as of any required public approvals process for the project must also be considered. Since pre-development funds are typically the most difficult for each party to raise, the parties should agree whether each will pay costs currently, or whether the developer is prepared to front pre-construction soft costs for the institution, with a credit against the institution's "project bank account" at closing.

• Design Development and Allocation of Project Costs Among Components: As the design progresses and construction cost estimates are prepared, a method of fairly allocating costs of shared construction items between the parties must be agreed on. These shared items typically include excavation and foundations, building structural elements, curtain wall, utility rooms and central building systems, common areas and the like. Allocation methods can include square footage, relative usage of item, or allocated structural or design load. Soft costs can be similarly allocated. The allocations are critical to determining the project cost and overall budget for each party.

Legal Structure

During the pre-development period, the institution will continue to hold title to the property and will enter into a series of legal agreements, typically including an omnibus development agreement, that will bind the parties to the transaction and define the circumstances under which either party may terminate. Once architectural planning and public approvals are completed, and the project is ready to close construction financing and begin construction, the closing between the institution and the developer must occur. The lawyer's job is to structure the ownership of the project both during and after construction to ensure that each party, among other concerns, can effectively finance its portion of the building, receives appropriate security for the performance obligations of the other party, has maximum flexibility to deal with equity requirements, and takes advantage of available tax incentives.

Ownership following completion of the project is typically in condominium form, in which each of the institution and the developer owns a condominium unit consisting of its premises, with shared common elements. This enables each party to have maximum flexibility for use, operation, financing and sale of its unit.

Ownership during the construction period can vary, depending on how the project is financed and whether tax benefits can be derived from keeping the project in the institution's ownership during construction. At one end of the spectrum is an outright sale of the parcel to the developer at construction closing with a conveyance back to the institution of the completed condominium unit at project completion. In this structure, the institution would likely receive a cash payment for the value of its "project bank account" at the closing, which may either be applied to the payment of development costs on a progress payment basis, or held till the conveyance of the completed unit and paid to the developer as a turn-key price upon completion. At the other end of the spectrum, the institution may retain title to the property during the development period and ground-lease the site to the developer until construction completion, at which time the parties will declare a condominium and exchange their interests for title to separate condominium units. Such a structure may be preferable where the institution will be financing a portion of the project on a progress-payment basis from sources other than its "project bank account," and where its site ownership may be critical to its ability to use a financing source, such as tax-exempt bond proceeds or other charitable funds.

In either case, the institution should enter into recognition agreements with the developer's construction lender to ensure that the lender undertakes, in the event of a foreclosure or deed in lieu of foreclosure, to perform the developer's obligations to the institution to construct and deliver the completed facility, and recognizes and credits the institution's "project bank account" and any progress payments made by the institution. Additional construction-period security, including a credit-worthy completion guaranty and a dedicated set-aside of funds constituting the institution's "project bank account," to the extent not paid at the construction closing, should also be provided by the developer to the institution.

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