

Preserving Retail Affordability in Seattle's Little Saigon: The Impact of Policy on Financial Feasibility

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Abstract

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I present an exploratory analysis of the impacts of policy alternatives on the financial feasibility of a real estate development project in the Little Saigon neighborhood that includes affordable commercial space. Preserving affordable commercial real estate in this neighborhood can revitalize the local economy, retain uniqueness and cultural character, and mitigate the negative impacts of commercial gentrification.

This analysis provides a blueprint for understanding the challenges of affordable real estate and I outline and evaluate methods for making affordable commercial development more financially feasible. I conclude by recommending a broad-based, neighborhood-wide strategy to preserve affordable commercial space, thus stimulating the local economy and retaining the cultural character of the community.

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CHAPTER 1: INTRODUCTION

To its citizens, the City of Seattle is the gem of the West Coast, offering residents and visitors alike a thriving cultural and arts community, profound natural beauty, and a vibrant entertainment scene. One of the sources of this appeal is the strength of Seattle's neighborhoods. Residents take pride in the unique character and diversity of their communities, a fact that has been recognized by the City in its planning processes. The City utilizes an "urban village strategy" in its Comprehensive Plan, to capitalize on the strengths of its neighborhoods when allocating new growth across the city (DPD 2005). The balance of housing and employment, a tapestry of unique businesses, and strong connections to other neighborhoods make urban villages enjoyable places to live and work, as well as prominent features in Seattle's future growth plans.

Others are starting to recognize this appeal. In 2012, Seattle was ranked by Bloomberg BusinessWeek as the 2nd "most livable" city in the United States (Konrad 2012). Voting with their feet, many agree – Seattle is currently experiencing population growth at historic levels (DPD 2011). As a region, Metropolitan Puget Sound is also expanding, in both populace and size, as population in urban and suburban neighborhoods continues to rise and push against the urban growth boundary. The Puget Sound Regional Council predicts that the region will add nearly 2 million residents and 1.2 million jobs by 2040 (PSRC 2009). The population of Seattle's central business district alone is forecasted to double, from 31,500 to 62,000 by 2040 (PSRC 2009).

This growth provides a strong economic base for the region, driving the economies of surrounding cities and counties and solidifying Seattle's growing reputation as a major player in the global trade, aerospace, and technology industries. The City has sought to allocate this growth to its urban villages, capitalizing on and enhancing the density, walkability, and transportation options that already make these neighborhoods popular. To limit the negative financial and environmental impacts of sprawl, the City seeks to concentrate development within the urban core, often in neighborhoods where space is underutilized or inexpensive.

Growth also presents challenges. Traffic congestion and the strain on water, sewer, and energy systems create a burden on municipal budgets. The demand for increasingly-scarce space drives rents and property values higher. New real estate development to capture

higher demand raises rents further, forcing residents who cannot afford these rents to leave the neighborhood in search of cheaper housing. This process, commonly referred to as gentrification, displaces residents and changes the character of a community.

Rising housing costs force municipal governments to develop a series of policy and program alternatives, such as public housing projects, inclusionary zoning that requires “set-aside” affordable units, and financial incentives for developers that produce affordable housing. However, gentrification does not solely affect the residential market.

When a neighborhood experiences economic growth, demand for commercial space increases. Coupled with the ability of retailers to capture new demand in the neighborhood, heightened demand raises rents, which tightens retail profit margins and forces some businesses to close or relocate.

For neighborhoods with a retail sector that has a strong cultural meaning, the displacement of local businesses threatens the very fabric of a community. Termed “commercial gentrification,” this process is particularly harmful to a neighborhood’s character. Displacement of the residents and businesses that historically provided the foundation for a neighborhood’s diversity deprives the community of the uniqueness that first made it an attractive place to visit and live. The pace of change is the factor that makes commercial gentrification detrimental to local businesses that are unable to capture changing market demand before rents rise. How can Seattle’s neighborhoods accommodate future growth and development without fundamentally changing their unique character and cultural value? Essentially, this question provides the impetus for this body of research and informs the research question and design.

Commercial gentrification is a newly-recognized phenomenon and many policy makers, planners, businesses, and residents fear that its consequences will negatively impact a neighborhood as population and demand for space grow. As a result, many organizations have begun to emphasize the preservation of affordable commercial real estate as a tool to retain a diverse business fabric and unique neighborhood character.

Affordable commercial real estate has numerous benefits for a community. By retaining a diverse blend of businesses and a unique retail tapestry, neighborhoods appeal to residents and visitors in ways that districts with chain retailers do not. This draws new residents and shoppers from other neighborhoods, boosting the local economy. When these businesses are culturally significant, or serve as cultural institutions to residents, preserving affordable space creates cluster industries and attracts tourists. When local businesses remain in operation because they can afford the rents, the positive economic impacts reverberate

throughout the community, as profits, local wages, and local sourcing of goods and services recycle through the local economy.

Neighborhoods with vibrant and diverse retail districts can provide a city with a driver of economic growth and a blossoming tourism industry. They also enrich the quality of experience for citizens. Communities with a varied blend of local and niche businesses create a sense of authenticity and enrich the neighborhood experience for residents and visitors. Such culturally significant neighborhoods unravel when the retail fabric is homogenized by an increase in chain businesses. These businesses can often afford higher rent and more easily access emergent demand, and when they overtake a neighborhood the community loses its uniqueness and is infused with sameness – where a neighborhood in Seattle is no different than one in New Orleans, or Los Angeles.

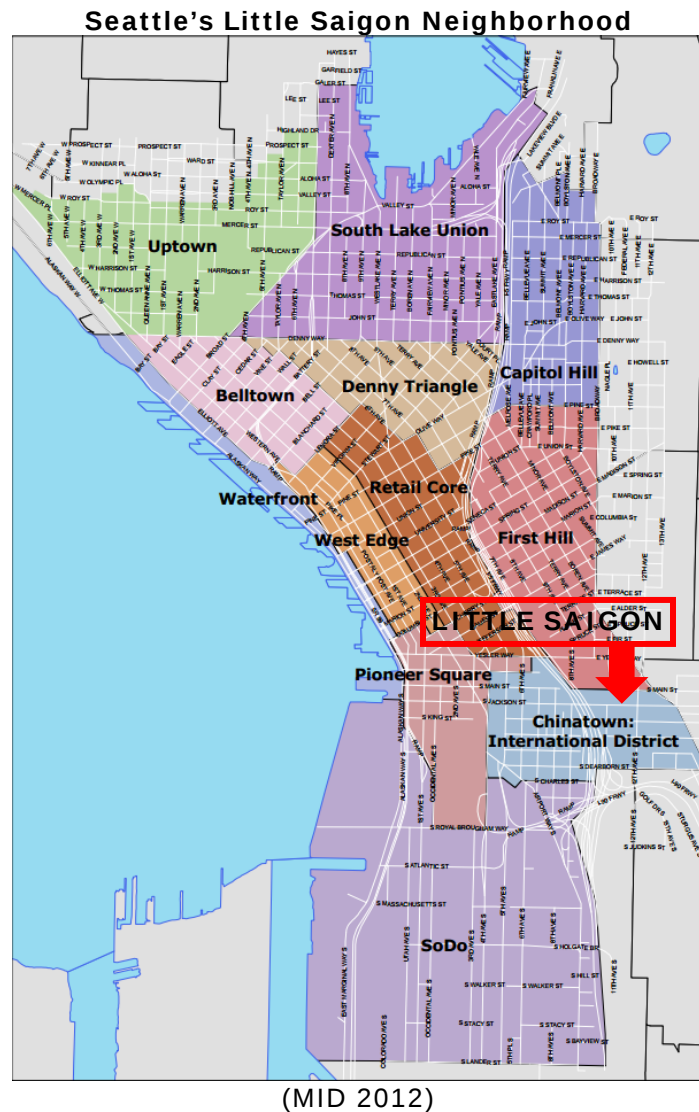
The distinct character that shapes the appeal of many of Seattle's neighborhoods is particularly vulnerable to these negative consequences of commercial gentrification. One of the neighborhoods that benefits from its cultural heritage and uniqueness is the International District, in the South Downtown area. For generations, this community has been the cultural epicenter for Asian-Pacific Americans in the area and has served a regional clientele drawn to the restaurants, shopping, and niche services offered in the neighborhood (DPD 2009, 26). The area is currently facing the most immediate challenges of commercial gentrification, particularly the portion of the neighborhood home to Seattle's largest Vietnamese-American population: Little Saigon.

Little Saigon is bounded by Interstate 5 to the west, S. Main Street to the north, Rainier Avenue to the east, and S. Dearborn Street to the south. Historically home to a vibrant jazz music scene and an important cultural resource for Seattle's African-American community, Little Saigon has represented the economic and social epicenter of the Vietnamese community since the early 1980s (Friends of Little Saigon 2012). The neighborhood is currently home to a diverse mix of commercial businesses, including a strong restaurant and retail shopping district and a cluster of other culturally significant commercial and industrial businesses (DPD 2009, 54).

Little Saigon relies on its strong retail sector to draw regional demand and maintain its vibrant local economy. This also makes the neighborhood susceptible to the challenges of commercial gentrification.

Growth in Seattle's central business district and south downtown area has created economic pressure in the International District, increasing the demand for space (Trang D. Tu Consulting 2007, 5). There is also significant population and employment growth allocated to the International District neighborhood: up to 10 percent of Seattle's total downtown growth forecasts, or 3,000 households and 2,000 jobs, are targeted for the International District by 2024 (BHC Consultants 2007). Because of Little Saigon's proximity and accessibility to Seattle's urban core and major transportation routes serving downtown, Rainier Valley, and the Central District, the City of Seattle forecasts significant growth in the neighborhood over the next 10-20 years (DPD 2009, 54).

Two factors increase Little Saigon's vulnerability to the impacts of commercial gentrification. First, in an effort to accommodate growth in the area, the City of Seattle passed rezoning legislation in 2008. This "Livable South Downtown Initiative" seeks to stimulate housing and employment growth in the International District/Pioneer Square area by implementing a variety of land-use actions that allow more dense development.



In Little Saigon, building height limits were raised and density bonuses provided for buildings containing affordable housing. This allows for more dense development, increasing the supply of housing and demand for consumer goods. However, raising development potential creates economic pressure in the area to develop existing buildings that capitalize

Little Saigon Neighborhood



(Google 2012)

on new market opportunities (DPD 2009).

Second, in 2012 the Seattle City Council approved plans for the Yesler Terrace Redevelopment Project (Young 2004). The project will add over 1,500 affordable housing units and 1,200 to 3,200 market-rate housing units to the 30 acres directly to the north of Little Saigon (Felton 2011). The City has planned over 800,000

additional square feet of office space and 90,000 square feet of retail (Felton 2011). The Project will infuse the neighborhood with significant capital investment, boost the housing market, and create new demand for goods and services (Felton 2011).

These two factors combine with increased development in the neighborhoods surrounding Little Saigon to put significant economic pressure on property owners and businesses in the area. Economic growth and expanded development potential captures the attention of property owners and developers looking for opportunities in an under-developed market. This growth increases a property's assessed value, and with it, the property taxes owed by the owner. Both dynamics impose significant economic pressure on the businesses currently operating there, many of which serve a lower-income clientele and operate close to the margin.

The City already recognizes the considerable challenges facing the neighborhood, noting that small businesses are "vulnerable to displacement as the area redevelops" (DPD 2009). While considered a regional hub for the Vietnamese-American community, the neighborhood

faces increased competition from other clusters of Vietnamese-American businesses and cultural institutions that capture cheaper rents outside of the downtown area and meet the demand for goods and services of customers reluctant to travel downtown (Trang D. Tu Consulting 2007).

Other challenges that the neighborhood faces actually serve to slow economic growth and gentrification. There are significant infrastructure deficiencies in the neighborhood, particularly with regards to sidewalks, public space, and pedestrian amenities (Trang D. Tu Consulting 2007, 9). Lastly, despite relatively low crime rates in the International District and an economically vibrant community, the neighborhood faces a stigma as a blighted area with public safety concerns.

Access to the Little Saigon Neighborhood



(Atelier Dreiseitl 2008)

At the same time, the Little Saigon neighborhood has significant assets to draw upon to maintain and enhance its economic vitality. Proximity to Seattle's Downtown and major tourist attractions such as the Stadium district, Capitol Hill neighborhood, and waterfront provides the neighborhood with a strong market for demand. The neighborhood is recognized as the regional hub for the Vietnamese-American community, offering culturally-significant goods and services to a broad base of demand and appealing to tourists (Trang D. Tu Consulting 2007, 8).

The revenues from local businesses in Little Saigon have grown in recent years, particularly in the service and retail sectors (Trang D. Tu Consulting 2007, 8).

This research focuses on the Little Saigon neighborhood for several reasons. First, the City of Seattle has made a commitment of preserving affordable retail space in this neighborhood. The Livable South Downtown Initiative specifically aims to “retain and enhance the successful small, primarily Southeast Asian, business community” in the Little Saigon commercial core (DPD 2009, 54). As a component of the Yesler Terrace Redevelopment Project, the City Council approved funding for a study of the feasibility of a

mixed-use development that includes affordable retail space in the Little Saigon neighborhood.

Second, the existing built environment in the neighborhood makes it a prime target for new development: the building stock is predominately low density and quickly becoming functionally obsolete and there are few historic preservation covenants limiting the redevelopment or demolition of existing buildings. Third, changes to the economic character of the neighborhood from Livable South Downtown and the Yesler Terrace Redevelopment Project give the preservation of affordable commercial real estate a sense of urgency.

Lastly, this thesis seeks to build off a body of research that evaluates affordable housing development in Historic Preservation Districts, particularly the International Special Review District in Seattle's Chinatown. While many of the incentives used in this analysis are similar in nature, ensuring affordable commercial development in the Little Saigon neighborhood requires a more innovative and creative strategy, as fewer policy options currently exist.

Recognition of the problem of commercial gentrification and the absence of policy solutions to slow rising retail rents has been growing among governments, non-profit community organizations, and private developers. However, no explicit policy tools currently exist that facilitate the development of commercial space that retains its affordability even during phases of heightened economic growth and real estate development.

These policies will allow business and communities to adapt to changes brought on by growth and prevent the negative impacts of commercial gentrification. In Little Saigon, policies that promote affordable commercial space can preserve the unique cultural character, local entrepreneurial spirit, and economic vitality.

Research Design

Preserving affordable commercial space can allow a community to capture the important economic benefits created by new development while retaining the cultural and economic foundation of the neighborhood. However, despite the numerous benefits that affordable commercial real estate offers to a community and local economy, there is little empirical research on the provision of affordable commercial real estate, the economic and neighborhood outcomes that it may produce, or the impacts that policy alternatives have on affordable commercial development projects.

This thesis seeks to add to existing research by examining the question:

How financially feasible are policy alternatives that promote or incentivize affordable commercial real estate development?

While many jurisdictions promote and regulate the development of affordable housing and other improvements to public space, such programs rarely target commercial developments. *This research presents an exploratory comparative analysis, evaluating the impacts of the programs and policies that seek to stimulate commercial real estate that retains affordability for target tenants.*

To evaluate the impacts of the policy alternatives, I develop and conduct an ex-post financial feasibility analysis of seven policy alternatives identified by theoretical and empirical research to have the most potential for producing affordable commercial space. An ex-post analysis considers a previous, successful development and thus can offer important insight into the actual impacts of policies as they are applied to an existing project. By providing the first comprehensive analysis to systematically evaluate the impacts of policy alternatives on the financial feasibility of affordable commercial development, this thesis adds to growing body of research on the impacts of commercial gentrification.

Financial feasibility analysis provides a methodology for evaluating the impacts that these policies have on a project, from the standpoint of a developer weighing value, costs, and income. This analysis seeks to demonstrate the feasibility gap produced by affordable commercial development and provide a blueprint for options to close this gap, improving financial feasibility. By examining the benefits of affordable commercial real estate and analyzing policy impacts on financial feasibility, this research will inform policy makers, developers, planners, non-profit organizations, and businesses when evaluating policy implementation, development feasibility, and business strategies.

The research is structured as follows:

Chapter 2: Literature Review begins with a review of the existing research and an exploration into the economic factors that influence the commercial real estate market and the ways in which rents affect project valuation. After examining the commercial gentrification process and its impacts on rent affordability I present an examination of the benefits of affordable commercial real estate, presenting a rationale for preventing commercial gentrification and creating local economic growth. This chapter concludes with an exploration of the policies that may be used to promote affordable commercial real estate.

Chapter 3: Methodology discusses the data sources and methods used to evaluate the impact of policies on a project's financial feasibility. I propose a definition of affordable commercial space that considers the current retail rental market and future growth and develop financial proformas from the subject project and present seven policy alternatives under three categories:

Capital Structure & Financing

- Tax Credit
- Low-cost Financing
- Special Financing Tools

Income and Cost

- Tax Increment Financing
- Commercial Land Trust
- Commercial Condominium

Hybrid

- Cultural Overlay District

Chapter 4: Results presents the findings of the financial feasibility analyses conducted for the base project and each policy alternative. A majority of policy alternatives do not achieve all of the feasibility metrics. These results indicate the challenges of using policies to promote affordable development as well as the need for a broad-based strategy that packages multiple regulations and incentives.

Chapter 5: Discussion explores the implications of the results. This research adds to a growing body of literature on commercial gentrification and sheds light on the need for a neighborhood-wide strategy to promote affordable commercial real estate. I consider ways to overcome the challenges of affordable development and recommend additional research to evaluate the impacts of affordable commercial space on businesses and the community.

Chapter 7 concludes with a summary of the important takeaways from this research, including the need for a holistic approach to overcome the negative impacts of commercial gentrification and to produce the economic and cultural goals of a vibrant and diverse local retail district. This approach uses a neighborhood-wide strategy to revitalize the local economy, boost local entrepreneurship and tourism, and preserve the cultural character of the community.

CHAPTER 2: LITERATURE REVIEW

This thesis evaluates the impact on financial feasibility of policies that promote affordable commercial real estate development. Understanding these impacts can help policy makers, developers, planners, non-profits, and businesses evaluate policy options, access appropriate intervention programs, and promote economic development in a neighborhood. A system of policies that effectively promote affordable commercial real estate will allow Seattle to maintain neighborhoods with strong cultural character and a vibrant local economy.

In this chapter, I introduce the research and empirical knowledge that is relevant to understanding the economic forces of the commercial real estate market. First, I examine the factors that influence the supply and demand of commercial real estate, the role that the development industry plays in the market, and how economic models of cities explain these forces. This discussion provides an economic foundation for exploring the challenges presented by commercial gentrification that many jurisdictions across the country currently face.

Next, I explore the economic and social impacts that affordable commercial space has on a community and outline a rationale for public intervention in the real estate market. The chapter concludes with an examination of the policies for promoting space that preserves affordability, seeking guidance other real estate sectors, such as affordable housing and arts districts. The seven policies discussed at the end of this chapter provide a framework for evaluating the impact of alternatives on the project's financial feasibility.

Urban Economics & Real Estate

When evaluating the impacts of policy programs on affordable commercial real estate development, it is important to understand the economic forces that drive supply and demand in real estate markets. This section presents a brief examination of the two interrelated real estate markets, the space and asset markets. These markets influence the demand and supply of real estate, which drive rent and vacancy rates.

Because this thesis evaluates policies aimed at keeping commercial space affordable, it is important to understand the fundamental economic dynamics that impact the market for commercial rents. This analysis considers financial impacts from the standpoint of a

developer. Thus, the components of the development industry – and methodologies for how real estate is valued – are also presented in this section.

After an examination of real estate markets, economic models for urban development – including *agglomeration* economies – are discussed, as they will help to provide a context for understanding the Little Saigon real estate submarket. I conclude with an exploration of the dynamics of commercial rents. The next section will build on this foundation to explore economic growth and the process of commercial gentrification.

Development: The Link between Two Real Estate Markets

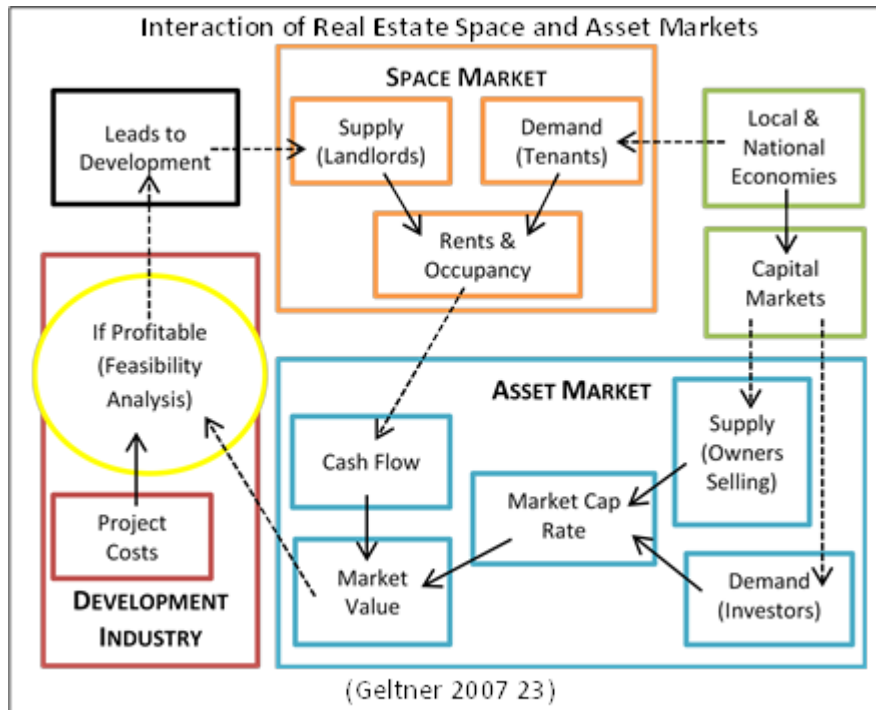
There are two fundamental markets for real estate, the space market and the asset market. The space market is the market for usage of, or the legal right to use, real property – the land and improvements built on that land (Geltner et al. 2007). In the space market, supply is the amount of property available for purchase or rent, and demand is the degree to which users desire that space. The space market is how most people experience real estate – the built environment that comprises their homes, the stores they shop at, their offices.

The asset market, also called the “capital market,” is the supply and demand for investment dollars used to develop the parcels and buildings that make up the space market (Miles et al. 2007, 149). The asset market considers real estate as an asset class in the broader capital market – ownership of the cash flow stream from income-producing property can be valued and traded to capture returns for investors. In the asset market, supply is the amount of real property ownership interests available in the market and demand is the extent to which investors desire the risk-adjusted income returns from real property (Geltner et al. 2007).

When evaluating the risks and financial returns of real estate assets, investors compare these projects to other asset classes like stocks and bonds when deciding where to invest capital. Thus, an investor’s demand for a real estate asset is influenced by opportunity costs in both the real estate market and other capital markets. When considering a proposed real estate project, if an investor can capture a greater return on a different project, or by investing in another asset market, say, in stocks, the proposed project will not be financially feasible for that particular investor (provided that the project does not fulfill other goals of an investor, such as portfolio diversification or a social benefit that can be marketed).

The two real estate markets function differently, but are intricately linked. The space market is the most fundamental type of market relevant to the real estate industry. Indeed, it is often referred to as “fundamentals:” the topographical, accessibility, legal, and market

characteristics of a property (DeLisle 2011). The asset market drives the built environment by supplying the capital needed in the space market (Geltner et al. 2007). Likewise, the space market determines tenant demand for space, which influences the financial return to investors in the asset market.



Thus, demand for investments in the asset market influences the supply of property in the space market. When investors seek to devote capital to real estate, supply of properties in the space market rises, provided there is adequate demand to produce income from that space. In periods of inflation, and when other asset classes

underperform, real estate becomes a more appealing investment, attracting capital and stimulating development in the space market. Conversely, in economic downturns, when retail revenues fall and consumer demand for property declines, the supply of economically attractive investment opportunities in real estate declines (Miles et al. 2007, 156).

The space and asset markets are linked together by the development industry – it is here that real estate value emerges. The development component of the real estate industry forms the connection between demand for buildings in the space market and investment capital available in the asset market (Geltner et al. 2007). The asset market has capital that must be allocated for a financial return, and development uses this capital to create supply in the built environment. Developers are ultimately responsible for ensuring that the created space will function over the life of the project and achieve the required returns to the developer as well as project investors and lenders (Miles et al. 2007, 39).

This research is positioned at the nexus of the space and asset markets, that is, at the development process. There are eight stages of development and the developer is responsible for managing this process. This analysis focuses on stage 3, the evaluation of project feasibility.

When we consider whether or not development of affordable space is feasible under various policy alternatives, the very definition of feasibility involves achieving a required return from the project under a set of specific constraints. The space and asset markets ultimately interact to form these constraints. First, the asset market provides the equity and financing for a project. The asset market is typically described as having “four quadrants” of capital streams for investment in development: private equity (investors like pensions); public equity (REITS); private debt (from banks and life insurance companies); and public debt (such as publicly traded mortgage backed securities) (Miles et al. 2007, 156). These four sources of capital make up the “investor bundle” available to developers.



When a developer accesses the asset market, new constraints are introduced to the project. Each lender or equity partner has unique objectives and these interests determine the metrics used to define feasibility.

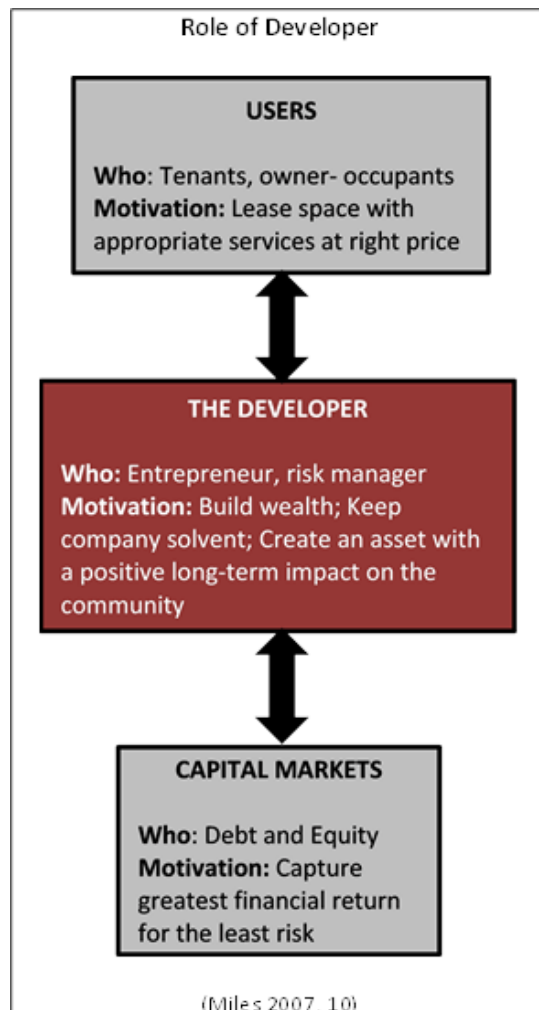
An equity investor will require a specified financial return to their investment, which changes the metric used to define financial feasibility. A developer with foresight will plan exit strategies for a project: one of these strategies is often to sell the project to long-term investors. Thus, a developer's calculations of financial feasibility must consider how an investor would value the project (Fisher and Martin 2008).

Lenders require that the loan be repaid, with interest and an administrative fee. The project must demonstrate a capability to repay the loan at the interest rate and terms required by the lender to account for project risk. For a lender, therefore, a project is feasible if it can

remain operational while continuing to pay debt service payments and avoid default (Miles et al. 2007).

A developer's consideration of feasibility will thus inherently consider the requirements and stipulations of the project's investors, lenders, and users. While this analysis focuses on the development stage of real estate by evaluating financial feasibility from a developer's viewpoint, this indirectly considers these interests.

When a project achieves a social benefit, government may intervene in the market to incentivize development. This essentially acts to close the gap between the returns expected from a project and the returns required by project investors and lenders. The public sector often intervenes by providing tax credits, low cost financing, and land use incentives which allow a developer to achieve feasibility metrics when they would not have otherwise, because the project accomplishes a social goal (Miles et al. 2007).



To a developer, feasibility compares the value of a project plus a required return, with the costs of construction, services, and borrowing. Ceteris paribus, if the net cash flows from rent plus resale proceeds exceed the development costs of the project by the required profit margin, then the project will proceed. A developer's required return is influenced by a variety of factors, including the perceived project risks, opportunity cost of capital, and investor expectations (Geltner et al. 2007). The key evaluation in the development industry, and in this analysis, is how the development costs of a project, compare to the value of that project as an asset.

To understand how to evaluate the feasibility of affordable commercial real estate, the ways in which real estate is valued must be understood. Essentially, property value represents

two components: land value and improvement value. Land value is largely influenced by the market and location: the proximity of the site to amenities, activity centers, and services. Improvement value is the contribution that the buildings and other construction have on the property.

It is a common assumption that project value is a reflection of the costs to develop a building: the bricks and mortar that make up the physical improvement. This is referred to as the “cost approach,” where the project is valued at total cost of the building. However, the commercial real estate industry uses a definition of value that considers the *productive potential* of the project. This approach, termed the “income approach,” recognizes that a property is only as valuable as the income that it can capture for its owners. The productive potential is the ability of the project to produce income, primarily in the form of rent. A developer evaluating a project's feasibility will project the rents that the project is likely to produce (less vacancy and expenses) to develop an estimate of project income, or “Net Operating Income.” A capitalization rate is applied to this income to produce a measure of value, using the following equation (Geltner et al. 2007):

$$Value = \frac{Net\ Operating\ Income}{Capitalization\ Rate}$$

The capitalization (cap) rate is set by the growth potential in the neighborhood and the perceived risk of the property's cash flows, relative to other investment opportunities (Miles et al. 2007, 150). A low cap rate indicates less risk, alternative investments that are unattractive, and potential future growth of the project: and thus, results in higher value (Miles et al. 2007, 150). As the primary component of income, rent plays an extremely important role in determining value. A development is only as valuable as the rental income (plus other income, such as the tax consequences and refinancing) that can be captured from that development (Geltner et al. 2007, 324). When demand for space increases, the income potential rises as landlords can secure leases with higher rents (Miles et al. 2007, 150). A strong and growing market reduces risk of a project and investors are thus willing to pay a higher price for the income stream. This is reflected in lower cap rates and greater property values (Miles et al. 2007, 150).

The most basic measurement of feasibility is: if value exceeds project costs, then the project is feasible. However, comparing capitalized value to project costs is not the only measure of feasibility. Because net operating income is a static measure, calculated for only one year, capitalizing income to determine value does not take into account that the project will operate into the future, when rents and expenses will vary. This approach to feasibility

also does not consider the resale value of the project. Other feasibility metrics, including the internal rate of return (IRR), net present value of benefits (NPV), and cash-on-cash return evaluate a project's future performance and the financial return that this has for a developer.

How Commercial Rents are Set

Because of the importance of rental income to the valuation of a development project – and thus, feasibility – it is important to explore the factors that determine rents. Rent is predominantly a reflection of two forces: demand for buildings (in the space market), and cash flows projected from the project (in the asset market). This boils down to the demand/supply interaction in the space market and the revenue that businesses can achieve to produce cash flows to the asset market.

The Impact of Revenue on Rents

More so than other types of income-producing real estate, rents for retail space are linked to how much business can be generated at a particular location and in a specific space. While office space can accommodate employees whose clientele may be scattered among a city, nation, or even the globe, retail commercial entities, particularly small businesses, rely on local customer demand for their goods. Demand of customers for goods and services drives a business's sales revenue potential, which determines how much rent can be captured by the project.

The characteristics of the space also influence revenue potential. While changes to the physical characteristics of office space do not significantly impact revenues, even small changes to retail space, such as the physical layout and amenities, influence a buyer's experience and the likelihood that they become repeat customers. Thus, retail businesses must carefully consider the potential to generate sales revenues given the location, surrounding demand, competition, quality and characteristics of the space, and occupancy costs when deciding where to locate and how much to pay for that space (Criz 2012, 25).

Urban Economies and Real Estate

Urban economics provides a theoretical model for understanding how the space and asset markets interact to influence rental markets. In the early 20th century, cities were comprised of large central business districts, where firms and residents clustered to transportation hubs, services, and infrastructure systems. Transportation technology allowed residents to commute only short distances to employment and the firms clustered in

central business districts achieved economies of scale made possible by technological advances (O' Sullivan 2009, 168).

Another force driving the development of cities is the concept of *agglomeration economies*, or the efficiency achieved when businesses cluster to capture cost or productivity advantages produced by physical proximity (Geltner et al. 2007). There are two types of efficiency gains from agglomeration economics: "vertical linkages" which occur when stages of the production process are made less expensive or time consuming because of proximity; and "horizontal linkages" which arise when similar or competing businesses draw on a shared pool of skilled labor or production processes to stimulate growth (O' Sullivan 2009, 169). While it might appear counter-intuitive that increased competition would benefit businesses, clustering is advantageous because it allows businesses to take advantage of input sharing, labor pooling, skills matching, and knowledge spillovers (O' Sullivan 2009, 48). There is evidence that industries that cluster experience more rapid employment growth and are able to increase output per worker (O' Sullivan 2009, 57).

There are two types of agglomeration economies. When firms of the same industry cluster together, for instance the software industry in the Puget Sound Metropolitan area, this is a *localization economy* (O' Sullivan 2009, 43). When agglomeration economies cross industry boundaries, for instance when firms in one industry attract firms in another, this is termed an *urbanization economy* (O' Sullivan 2009, 48).

Both types of agglomeration economies can increase revenue potential for local businesses by increasing efficiency and drawing new demand to the market. Increased revenue potential raises the rents that these businesses can afford, thus increasing cash flows and improving project feasibility. This is particularly important when considering economic growth in Little Saigon, a neighborhood that has already experienced significant clustering of firms in the same industry (such as Asian restaurants), as well as cross-industry clusters (traditional Asian medicinal services, Asian grocery stores, restaurants, and services) that have created an agglomeration economy.

Despite the historic concentration of businesses and residents in central city areas, during the mid-20th century, advances in transportation technology, increased investment in highways and roads, cheaper manufacturing systems, and a variety of other factors, led to decentralization (O' Sullivan 2009, 170). Residents and firms moved out of central city areas, forming "activity centers" in suburban neighborhoods. Under this model, a city is comprised of a variety of activity centers along with a central business district (Geltner et al. 2007).

Land values increase with proximity to activity centers because of lower transportation costs to access goods and services in these neighborhoods. Where people and firms congregate in activity centers, land prices are higher, because the costs of transportation are lower and space is scarcer. Seattle's neighborhood structure serves as an example of the multi-nodal activity center model, where businesses cluster to increase efficiencies, improve accessibility from transportation infrastructure, and access demand of dense residential communities.

The Impact of Demand on Rent

A defining characteristic of the real estate space market is its inelasticity. Real estate supply is by definition a physical object and it cannot react quickly to changing demand for space. Indeed, most buildings are in operation for 20-30 years, while demand for space fluctuates widely in that same time period (Geltner et al. 2007). Additionally, buildings cannot move to follow demand in different geographic markets. This means that even with short-term changes in demand for space – or type of space – the space market cannot respond quickly. Indeed, there is often a disparity between the demand and supply of real estate, particularly in growing markets.

Another factor causing inefficiency in the real estate market is the long time frame required for developing buildings. The typical development takes one to several years to complete. The development time frame is increasing in most metropolitan areas because of the highly specialized nature of the industry and the layering of regulations that require permitting and impact evaluation (Miles et al. 2007, 40). When cities experience rapid economic growth in activity centers the demand for space increases more rapidly than supply. This is largely due to the inefficiencies in the space market. Per economic theory, when demand exceeds the supply, the price of rent increases.

When supply of space lags demand of that space, rent goes up. Over time, a market will achieve equilibrium and rents will come back down to the long-term price supported by the market. However, in neighborhoods that are under-developed, there is often un-captured development potential. The long-term equilibrium rent is thus higher than the current market support, even after supply “catches up” to demand: the consequences is a sustained increase in rents (Levy et al. 2006).

Another factor that influences demand for real estate is the segmented nature of real estate markets. Because real estate represents a physical asset, real estate markets are highly specialized, both geographically and by type of space. Demand varies widely even within a city, based on the characteristics of a neighborhood, access to and from that neighborhood, demographic composition and economic trends and these characteristics are reflected in

variant rental patterns. Because rents comprise an investor's cash flow and financial return, market potential is an extremely important component of development feasibility, and understanding the variations between markets is vital.

For instance, the average retail rent in the International District in 2009 was \$6-\$18 per square foot annually. In Pioneer Square, directly adjacent to this neighborhood, retail space averages \$10-\$25 per square foot annually. In the central business district, retail rents routinely exceed \$25 per square foot annually (BHC Consultants 2009, 8). For a developer evaluating potential cash flows and returns from a project, projecting rents from the wrong market can lead to miscalculating income potential from a project, significantly reducing financial returns.

Markets also vary widely by *type of use*. The four primary real estate uses are office and retail (commercial), residential, and industrial. There are also sub-uses, such as hotels, warehouse, multifamily residential, shopping centers, and a variety of others (Geltner et al. 2007). At any given time, demand for one type of space may be significantly different than demand for another. When considering affordable commercial development, it is vital to consider the target users and the demand for retail space in the submarket, because this will determine both market and “affordable” rents.

Because rental income forms the majority of an investor's projected cash flows, projects are designed to maximize rents potential. The higher the rents that a developer can capture, the greater the cash flow and proceeds from refinancing or selling the property. Thus, developers are incentivized to build projects that capture the highest rents possible, given market demand.

However, many developers do not solely have financial returns in mind when proposing projects – particularly in a market such as Seattle, where there is encouragement to consider social, environmental, and cultural impacts of developments. Socially responsible developers often pursue projects that do not meet typical profit margins, because of the other benefits that these developments offer. However, even for developers who find these types of developments appealing, there is little likelihood of obtaining financing from lenders or equity from investors if the project is not financially feasible.

The financing industry also creates an incentive to maximize cash flows. In real estate, lenders collateralize their loans with property. When a property owner defaults, the lender takes ownership of the property and seeks to capture cash flows. For homes, this cash flow is the resale value of the home. For income-producing properties, the cash flow used to collateralize the loan is derived from rental income. When considering a loan application, a

lender will look first to the rental income to evaluate risk and determine loan amount. Lenders using debt service coverage ratio, for instance, as their determinant for loans, will provide financing only to a predetermined percentage of net income from the property (typically 110% – 125% of net operating income) (Miles et al. 2007, 181). If rental income is held artificially low, the loan available to the project is reduced. Thus, if net income is lower than what it achievable in the market, because rents are kept “affordable,” the loan amount is significantly reduced. A project that does not maximize cash flows from rent may therefore have difficulty obtaining a loan that covers the development costs after equity contributions.

We now have a working model for how the two real estate markets interact and influence demand and supply of commercial real estate and how the development industry evaluates and captures financial return. The productive potential of a property drives the rental income, and thus the value of a project. Economies of agglomeration can boost the revenue potential for businesses, raising rents and increase project value. Scarcity and demand of space also raise rents in a neighborhood, as developers seek to maximize the income potential from a project. The next section examines the dynamics of economic growth in urban commercial markets, particularly the economic processes that lead to commercial gentrification.

Commercial Real Estate and Urban Growth

Heightened consumer demand for commercial goods and the lack of vacant space due to growth, raise the commercial rents in urban neighborhoods. Higher rents signify higher expected future productivity for property owners – and increased demand for development. This positive feedback cycle – increased earning potential due to higher consumer demand means higher retail demand for space, which means higher rents, which raises property values – accelerates during periods of high growth.

Even in periods of slow growth or recessions, when the values of income-producing properties fall due to reduced sales revenues, urban retailers are somewhat buffered by these losses. The concentrated buying power in cities, comprised of residents demanding household services and nondurable goods at relatively high rates, is less elastic to economic shocks (Boston Consulting Group 1996, 8).

As cities grow, demand for space increases, driving rents up and leading to development of under-utilized or vacant space. New development – and rehabilitation that captures under-utilized productivity – will thus inherently raise the rental potential of that property, in an

attempt to capture the newly created demand for space. Increased demand in downtown neighborhoods for intensive uses, particularly high-rise office, condominiums, and hotels, raises property values. More intense uses raise the productive potential of a property. Property taxes in these areas reflect these intensive uses, not land values supported by retail uses. This increases economic pressure for a landowner to convert the property to a more intensive use or sell the land to a developer to construct an alternative use, capturing the increase in income potential and capitalized value from this use.

Commercial Gentrification

For neighborhoods with properties that are under-utilized, these economic pressures incentivize new development and the rehabilitation of older buildings that have become functionally obsolete. When this development occurs in areas where residents and businesses cannot afford the sharp increases in rent, they are forced to look for cheaper space in other neighborhoods, move to lower-quality space, or go out of business.

This process, known as gentrification, generally occurs in historically low-wealth communities where rising real estate values cause a broad shift in the economic, social and cultural environment in the neighborhood (Hill 2005). Gentrification is traditionally recognized as a housing problem. Residents are forced to relocate to cheaper neighborhoods when the costs of housing rise due to increased demand by wealthier citizens, which increase potential return to property owners and developers.

Gentrification also affects the commercial market. Commercial gentrification occurs when economic growth in a neighborhood brings new consumer purchasing power and raises the demand for goods. Rising property values and economic growth create pressure for landlords to develop or sell their properties to capture the new economic opportunities to the neighborhood (Hill 2005). When commercial development occurs, developers will look for tenants who can capture, or who *think* they can capture, this demand. These tenants will pay more in rent due to higher potential revenues and local business that cannot afford these higher rents will be displaced.

Commercial economic growth can have positive effects, including higher local tax revenues, an influx of new businesses, public and private improvements to a neighborhood, and economic growth (Shiflet 2006). However, by displacing local businesses and unraveling the vibrant local economy, commercial gentrification can weaken the sense of community and cultural heritage in a neighborhood. Whether a neighborhood experiences positive economic growth, or the negative impacts of commercial gentrification largely has to do with the pace

of change. If local retailers are able to adjust their goods and services to capture the new demand in the neighborhood, economic growth can be positive for the local economy. On the other hand, when rent increases outpace the ability of these businesses to capture new customer demand and to benefit from the economic growth from revitalization, businesses that have operated successfully for generations are displaced and excluded from new economic opportunities in the neighborhood.

Change over time in any urban neighborhood is inevitable. Indeed, changes in the retail fabric of a community can be positive and retailers that do not attempt to adapt to neighborhood change will inevitably fail in the private market (Rose, 2001). However, rapid, exogenous increases to property value and rent will displace otherwise successful businesses, disrupting a neighborhood's local economy.

The two major factors that speed the pace of economic growth in Little Saigon are the Livable South Downtown Initiative and the Yesler Terrace Redevelopment Project, which will cause exogenous, immediate impacts in the neighborhood. The Livable South Downtown Initiative increases the level of development allowed in the neighborhood as way to increase density. Under the Initiative, building height limits are raised to 85 feet, building capacity per property is increased, and parking requirements are eliminated (DPD 2009). The Yesler Terrace Redevelopment Project will directly impact the neighborhood, as up to 5,000 housing units, 800,000 square feet of office space, and 90,000 square feet of retail space are planned for the 30 acres directly North of Little Saigon (Felton 2011). The rezone and Yesler Terrace Project will cause immediate impacts to the neighborhood that would not organically occur as quickly, increasing the risk that local businesses will be unable to adapt to the rapidly changing market.

Commercial gentrification also tends to increase the prevalence of chain businesses in a neighborhood, oftentimes at the expense of local entrepreneurs. Chain stores have several advantages compared to local businesses. They are able to offer lower prices and capture additional profit because of economies of scale in administrative and overhead departments and purchasing contracts (Ritter 2009). National chains are able to diversify risks over many markets and can thus take on the risk of locking in contracts, which lowers a developer's risk. Lastly, national chains are backed by large corporate structures and can lend their credit to a project, making it easier for a developer to obtain debt financing (Miles et al. 2007).

Local businesses that historically have relied on a niche customer base and regional demand have more difficulties quickly capturing emergent customer demand than chain or national

retailers. Neighborhoods that were once defined by their distinct character and small businesses retail districts offering unique products become characterized instead by chain businesses that cater to a wealthier clientele but compromise the diversity and entrepreneurial spirit of these neighborhoods (Hill 2005).

Commercial gentrification is particularly a problem in neighborhoods with strong cultural heritage, where local businesses have a large base of consumer demand in the neighborhood and offer niche goods and services to a clientele that depends on these businesses for culturally significant goods and services (Yip 1995). The demographic shift that occurs during gentrification can change the culture and character of a community, “particularly when this community has an ethnic identity that is anchored not only in its residents, but also in a variety of institutions, such as stores, religious institutions, and community organizations” (Trang D. Tu Consulting 2009, 9; Nyden et al. 2005, 5).

When local entrepreneurs are driven out due to increasing rents, the neighborhood's agglomeration of culturally meaningful businesses weakens and disperses to outside neighborhoods. A negative cycle, this dispersion further weakens remaining businesses' economic outlook, as the neighborhood loses its regional appeal, displacing other local businesses. Retailers that do not rely on this agglomeration economy, which are often chain businesses, can afford the rising rents and will cater to the emerging clientele of the neighborhood. Gentrification disrupts a neighborhood and reverberates through the local economy: reduced tourist appeal for culturally significant institutions; diminished tax revenues from local entrepreneurs; and a reduction of profits recycling throughout the local economy.

This process has already begun in Seattle, as smaller local businesses that operate close to the profit margin move to neighborhoods with cheaper rents, such as the Rainier Valley (Trang D. Tu Consulting 2009). In the International District, revenues from businesses that rely on agglomeration economies, such as Asian-owned restaurants and grocery stores, have been declining for years (Trang D. Tu Consulting 2009). However, other types of businesses, particularly business, professional, and legal services, have more than doubled from 1997 to 2006 (from \$87.9 million to \$242 million) (Trang D. Tu Consulting 2009, 13). These businesses provide services to the expanding downtown office sector. The shift from businesses relying on cultural demand, to those that cater to the growing office sector of the central business district, threatens to unravel the regional appeal of the neighborhood's retail and restaurant district.

Many new Asian-American owned restaurants and retailers are already choosing to locate outside the Little Saigon area, rather than face the potential loss of niche customer demand and confront increasing rents (Trang D. Tu Consulting 2009, 8). This reflects a growing trend for Vietnamese-American families, many of which are already relatively scattered around the region, to disperse even further (Trang D. Tu Consulting 2009, 9). Niche retailers lose their clientele to shopping areas in the suburbs, which often offer cheaper goods, more convenience access, greater parking availability, and more space (Buchanan 1993).

There is also evidence that businesses owned by immigrants are particularly vulnerable to the entrance of chain retailers in the market, even though these businesses offer culturally significant goods to a niche market and can capture regional demand (Trang D. Tu Consulting 2009, 9). Many of the businesses in the Little Saigon neighborhood are operated by immigrants (Trang D. Tu Consulting 2009, 9). Language and cultural barriers inhibit the ability of these businesses to access resources and mainstream financial products (Trang D. Tu Consulting 2009, 9).

Gentrification is particularly detrimental for neighborhoods with larger populations of low- and moderate-income households, who are more likely to seek out cheaper goods and who are impacted by increasing residential rents more quickly and severely (Levy et al. 2006, 4).

If this displacement continues, the International District's reputation as a unique and culturally significant neighborhood will diminish over time. When local entrepreneurs are forced to close due to economic pressure, this will threaten to unravel the cultural tapestry that generations of Asian-Americans have built in the neighborhood and ultimately dismantle the tourist economy, and regional customer demand along with it. By strengthening neighborhood cultural institutions and building an agglomeration of businesses that offer niche services, the neighborhood can regain its mantle of epicenter of Asian-American culture in Seattle, drawing significant revenues from regional demand and recycling profits throughout the local economy (Yip 1995).

One strategy to combat commercial gentrification is termed "equitable development" (Rose, 2001). An economic development strategy that effectively balances small, culturally diverse businesses and larger chain establishments should also aim to celebrate the unique heritage and character of a community (Kennedy and Leonard 2001). This will make the community more attractive to residents, developers, and investors, and foster a uniqueness that will serve the needs of the community while attracting residents from outside the neighborhood (Carr and Servon 2008). Equitable development also recognizes the historical and

geographic forces at work in gentrification in calling for a regional approach to preventing displacement and changes to community character (Rose 2002).

Ensuring that commercial space is retained at rents that are affordable to local businesses rents will slow commercial gentrification. However, there have been few efforts by municipalities to implement a strategy to preserve affordable commercial space. While government commonly intervenes in the residential real estate market to promote affordable housing, few municipalities recognize commercial affordability as an objective. Those that do, struggle with developing policies to incentivize affordable commercial space.

There are several challenges to defining affordability as applied to commercial real estate. While a definition of affordable housing is now standard in many cities, affordable commercial real estate has no commonly-accepted definition. There is no existing research that seeks to provide a working definition for affordable commercial space. Additionally, affordability must be dynamic – as a business's revenues grow, the rents that are affordable also rise. As new development occurs in the neighborhood, the productive potential for local businesses rises. It is the rapid pace of rent increases from new development, however, that produces commercial gentrification. If businesses are allowed time to capture the demand of emerging markets, by having access to affordable space, economic growth will benefit the community as a whole and ultimately rents will rise organically as businesses are able to additional sales revenue.

Lastly, keeping rents low for businesses may have unintended consequences, such as promoting deceitful accounting methods, incentivizing inefficient business decisions, and distorting the market by essentially picking winners and losers. Like affordable housing, any definition of commercial affordability will have certain unintended consequences.

The following section examines the economic and cultural benefits of preserving affordable commercial space and provides a rationale for public intervention in the commercial real estate market to promote this type of development.

Affordable Commercial Real Estate: A Means to an End

There are multiple reasons to pursue commercial real estate that maintains a level of affordability for local businesses. A detailed examination of the benefits to the economy, local entrepreneurs, and a neighborhood's cultural integrity will inform policy makers and planners when devising policies to promote affordable commercial real estate. These benefits are grouped into two categories: economic and cultural.

Economic Benefits of Affordable Commercial Development

There are many ways that affordable commercial space benefits the local economy and improves the financial position of both private and public entities. The economic rationale for preserving affordable commercial space forms the backbone for justifying a market intervention. While social objectives are undoubtedly important, in the current economic climate and with public budgets shrinking, policies that promote affordable commercial real estate are unlikely to be implemented without a strong economic benefit.

Attract tourists

“Tourism is not just an aggregate of merely commercial activities; it is also an ideological framing of history, nature and tradition; a framing that has the power to reshape culture and nature to its own need” (Wirth and Freestone 2009). Neighborhoods with cultural significance represent sources of identity and resources for communities. A strong cultural character also provides an important economic resource for a city, in the form of tourism. Tourism exists at the nexus of the conflict between culture as a resource for social meaning and a touchstone for economic growth (Wirth and Freestone 2009).

To attract regional demand, neighborhoods must offer a unique service or set of goods (Carr and Servon 2008). Tourists are attracted to niche goods and service, but also to the place itself. The visual and physical “consumption of place” shapes cultural meaning attached to that place (Wirth and Freestone 2009). Failure to capture and enhance the unique, more “authentic” character of a neighborhood will inhibit the ability to attract tourist dollars (Carr and Servon 2008).

The City of Seattle has recognized the importance of the International District as a “destination for regional entertainment” (DPD 2009). Indeed, the marketing of culturally significant experiences has emerged as an important tool for governments striving to capture economic growth (Wirth and Freestone 2009). Many neighborhoods have access to chain stores and their standardized inventories. It is the unique character and distinct goods offered by local businesses, particularly in neighborhoods that contain agglomeration economies, which drive demand and thus boost revenues and tax receipts from tourism.

There is also a market failure at work when considering efforts to build a tourist economy. When a neighborhood retains local businesses and preserves a strong agglomeration economy, it attracts tourism. All businesses and property owners benefit in the form of increased property values, sales revenues, and income from rent.

However, individual developers will undervalue these benefits because they do not accrue exclusively to the project. Rather, all business in the area will capture the benefits from a strong tourist economy, regardless of whether they participated in efforts to retain tourism by preserving retail space for local businesses. Such a “positive externality” arises when individuals are not compensated for actions that benefit others. Essentially, because the benefits of a strong tourist economy are undervalued by individual developers, there is little incentive to provide space for local businesses at affordable rates to strengthen an agglomeration economy that boosts tourism (O’ Sullivan 2009, 202).

The economic approach to correct this market failure is to “internalize” the effects of the externality (O’ Sullivan 2009, 268). Internalizing the benefits of a tourist economy may take the form of a financial incentive toward developments that contribute to this economy by offering affordable rents to local businesses. There is a precedent for reducing positive externalities of tourist economies by sharing the costs of enhancing and marketing tourist appeal through Business Improvement and Tourist Districts (Hack 2009).

The factors that ultimately make a city desirable as a place to live and work hinge on a city’s diversity, uniqueness, and character (Carr and Servon 2008). When neighborhoods grow organically in response to customer demand, rather than an influx of generic chain retailer franchises, a community attracts tourism and the benefits enhance the local economy (Carr and Servon 2008).

Boost Local Entrepreneurial Growth

Urban neighborhoods with strong cultural heritage and a unique character often have a strong undercurrent of local entrepreneurial spirit. Small businesses create economic opportunity and serve as an asset accumulation tool for moderate-income and immigrant entrepreneurs, many of which leverage their customer base and business connections into social and economic networks (Donjek 2012, 3).

This is undoubtedly true for the International District. Owing to provisions in the Chinese Immigration Exclusion Act of 1882, immigrants from China were primarily members of the merchant class – business owners who strove to capture new opportunities in their new countries (United States of America 2012). Additionally, property in the International District was predominately owned by family associations – many of which leased or sold retail space to local businesses at cheap rents or with low-cost financing, and many of which provided financial assistance and advice to these businesses (Kalthoff 2012). As a result, the International District was infused from the beginning with a strong entrepreneurial spirit.

There is evidence that local entrepreneurs better understand local communities, and can tailor their goods and services to local customers more efficiently (Civic Economics 2002). Local entrepreneurs “can run circles around larger chains” by residing in the marketplace and better understanding customer needs, thus tailoring goods and services to the specific needs of shoppers (Boston Consulting Group 1998). Individual small businesses can more immediately respond to changing tastes and preferences in the marketplace, capturing niche markets with tailored products (Boston Consulting Group 1998). There is also evidence that smaller, local businesses can better weather economic shocks, because of higher versatility than national chains (Kiviat 2009). These businesses can respond more immediately to both recessions and periods of economic growth, due to an ability to adjust product inventory and variable business costs (Moscarini and Postel-Vinay 2009). Boosting the entrepreneurial spirit in Little Saigon by ensuring that rents are affordable to local businesses will enhance the local economy and the City will benefit from an increase in tax revenues from these businesses.

Capture Indirect Economic Benefits

Heightened economic activity in a neighborhood with a vibrant local business district has other, less tangible benefits. Development that keeps rents affordable for local businesses will allow entrepreneurs to utilize their market knowledge to sell products that residents want for a price they can afford. Rising purchasing power, increasing employment and business opportunities for local residents can reduce blight and activate the economic undercurrent of a neighborhood (Sutton 2010, 354).

Local, ground-based economic development can lead to a virtuous cycle: reduced prices of goods due to affordable rents, coupled with the reduction of travel costs necessary to obtain goods in other neighborhoods, leads to greater disposable income in a neighborhood, much of which is recycled through the neighborhood, creating further economic growth (Civic Economics 2002; McDonald and McMillen 2007).

Economic activity and increased revenues from tourism, along with a public commitment to the neighborhood, may reduce crime rates and subsequently limit future expenditures on public services. These indirect benefits, while difficult to quantify accurately, can play a significant role in the economic revitalization in the neighborhood.

Create Business and Development Opportunities

There is evidence of significant unmet demand for retail goods in many urban markets (Boston Consulting Group 1998). One analysis found, for instance, that in most economically distressed urban neighborhoods,¹ more than 25 percent of retail demand was unmet within the community (Boston Consulting Group 1998). Retail demand per mile in these neighborhoods for nondurable goods such as groceries and apparel often exceeds retail demand “across all categories in surrounding locations” (Boston Consulting Group 1998, 8).

While some retailers might shy away from perceived crime rates, lower purchasing power of urban residents, and the heterogeneous nature of urban markets, the dense environments offered by urban neighborhoods represents significant buying power and retail demand (Boston Consulting Group 1998, 8). Additionally, these neighborhoods are close to significant population bases and transportation hubs and many already have urban infrastructure systems in place, which reduce potential costs of development.

Many retailers use median income in their trade area as a metric for determining demand potential of a neighborhood (Boston Consulting Group 1998, 8). However, in urban neighborhoods, sales performance is a function of “income density” rather than household income – because the market is highly concentrated, there is high purchasing power per square mile despite lower household incomes (Boston Consulting Group 1998, 9). Lower discretionary spending of households also indicates a high level of nondurable spending, on items such as groceries, medical care, and other neighborhood services. This evidence indicates a significant business opportunity for retailers that can capture this niche market.

A developer who recognizes these opportunities, and works with local, niche businesses to create a synergistic and positive business environment, may achieve higher rental income over time as these businesses prosper.

Additionally, the fear of gentrification runs high in under-developed urban neighborhoods (Kalthoff 2012). Residents are concerned about changes to the character of their communities, because historically, these changes foreshadowed impending displacement. Community organizations often fight back against the development of space for national chain stores, such as Wal-Mart. For a developer that seeks to establish a positive reputation in a community, projects that include affordable space for local entrepreneurs and that fit

¹ A “distressed neighborhood” is defined in this analysis as zip codes where median household income is no more than 75 percent of median for MSA, unemployment rate is at least 30% above, and poverty rate is 50% above MSA mean.

the character of the neighborhood increase the potential to capture future development opportunities. Because there are relatively few developers completing projects in a given market in Seattle, building a reputation as having a positive impact in a community can provide significant economic returns to a developer (Rolfe 2012).

Build the Local Economy

An assumption underlying the argument for assisting local businesses during the gentrification process is that the money spent in these businesses will remain in the local economy (Civic Economics 2002; McDonald and McMillen 2007). This occurs through the direct effects of consumer expenditures, greater percentage of wages paid to neighborhood residents, profits to local business owners, and tax revenues from sales (Shiflet 2006). However, there are secondary economic impacts derived from this business. These include spending on support services and employee wages that are subsequently spent elsewhere in the local economy for goods and services.

When emergent consumer demand attracts chain retailers who can afford to pay higher rents, these benefits to the local economy dissipate. Local businesses provide an economic benefit when sales would otherwise go to chain retailers with headquarters and administrative functions outside the local jurisdiction.

There have been efforts to quantify the economic impacts of local rather than chain retailer sales revenues. There is evidence that a multiplier effect for local spending exists in the 1.5 to 5 range, indicating that for every dollar spent on local businesses, the local economy is boosted by \$1.5 to \$5 (Civic Economics 2004). A study of local spending in San Francisco found similar benefits. A city-wide 10% shift in retail spending toward locally-owned businesses would create 1,295 jobs, \$70 million in new income, \$15 million in additional retail activity, and a \$190 million increase in the city's economic output (Civic Economics 2007). Another study, conducted in Austin, TX and Chicago, IL found that locally owned businesses generated more revenue per square foot than chain stores and that 58 percent more revenues were spent in the local economy from locally-owned businesses than chain retailers (Civic Economics 2004).

Providing commercial space that local businesses can afford will likely increase the amount of revenues recycled through the community in the form of direct and indirect spending and further activate the economic undercurrent in the International District.

Cultural Benefits of Affordable Commercial Real Estate

Aside from the economic benefits of promoting affordable commercial real estate, there are important cultural reasons for preserving this space.

Strengthen Cultural Character

The International District is a historical institution in Seattle, serving as the cultural hub for Asian-Americans in the area and providing goods and services for a regional clientele drawn to the restaurants, shopping, and niche services offered in the neighborhood (DPD 2009).

The City of Seattle acknowledges the contribution of this neighborhood in providing a “unique blending of diverse culture and ingenuity” and the Chinatown/International District Strategic Plan recognizes the area as a “regional hub for Asian-Pacific American commerce and culture” (DPD 2009, 3; Department of Neighborhoods 1998).

The International District's development sparked a strong entrepreneurial community and prosperous local business district. There were two primary reasons for this.

First, the Chinese Immigration Exclusion Act of 1882 limited net immigration from China by establishing quotas for the number of immigrants allowed (Kalthoff 2012). However, merchants were largely exempt from quotas. Thus, a strong merchant class formed in the Chinatown area (Yip 1995). These businesses, once comprising the bottom of the merchant ladder in China, now formed the new business elite and the neighborhood was infused with a strong entrepreneurial spirit.

Second, Asian cultural organizations in the neighborhood have historically provided vital assistance to local businesses. Throughout the International District's development and expansion, the Asian community remained strongly organized. The traditional organization of the Chinese community was based upon family associations (Lai 2004, 40). These associations strengthened a unifying Chinese nationalist spirit that continued to grow during the 20th century and helped immigrants put down their roots in the neighborhood, particularly in helping merchants with business start-up and planning (Lai 2004, 40). This assistance solidified the business district and a strong merchant class.

The businesses in the neighborhood continue to comprise an important constituency for the city – a group that has already been challenged by the neighborhood's bifurcation by Interstate-5 and negative impacts from the stadium district, and that now feels economic pressure to relocate outside of the urban core. If the businesses that serve this niche cultural market are forced out by rising rents, they will lose much of the resources that they have relied on for generations: access to central city demand for goods, niche customer

markets, urban infrastructure systems, and social capital. The loss of this business class will deprive the city of an essential cultural heritage and a regional appeal. The result would be the city of Seattle losing a meaningful and important component of its cultural fabric.

Similarly to a tourism economy, there is an important economic market inefficiency at work. While collectively, developers and property owners may agree that a strong cultural character is an admirable goal, each individual developer is not motivated to develop projects that achieve this objective. If a strong community is created, in which a portion of commercial space is retained as affordable for local businesses, even property owners or developers who did not preserve affordable space will benefit from the positive economic impacts.

Developers, investors, and property owners will undervalue the impact of keeping rents affordable and creating a strong local economy, because these impacts will accrue to the entire neighborhood. When evaluating whether to produce affordable or market rate space, developers will choose market rate rents and capture the increased rental income derived from other property owners retaining affordable space and local businesses. These projects will reap higher profits due to higher rents. A public intervention that closes the gap between affordable rent and market-rate rents for developers opting to preserve this space will reduce these market inefficiencies and allow individual developers to capture the positive impacts of an enriched cultural character in the neighborhood.

Strengthen Equity Values

There are important values at stake when considering the cultural importance of a neighborhood. The forces of gentrification limit the ability of residents to freely choose where to live. While this is an inherent consequence of market forces, it raises concerns when the neighborhood in question is historically and culturally significant for a specific community. Many residents of the International District can trace their heritage back to the 19th century, to those immigrants who helped build the neighborhood and surrounding infrastructure of the city. Despite considerable obstacles, including negative economic impacts of industry, environmental injustice of infrastructure development, and outright racism, this community developed a strong cultural and economic foundation (Kalthoff 2012).

To allow this community to be swallowed by the rising tide of gentrification and development, only to wash up, displaced in neighborhoods outside of the downtown area, would signify a loss of a significant cultural foundation and send a message to other under-

developed neighborhoods in the City that they are on their own in the battle for space despite their contribution to the City's unique character and cultural authenticity.

Justifying a Market Intervention

The issues examined above form a compelling rationale for promoting affordable commercial development to achieve economic and cultural objectives. This justification is heightened by failures inherent in the marketplace, including the positive externalities produced by tourism, economic growth, and unique cultural character.

The economic benefits of affordable commercial space, including benefits to Little Saigon's economy from local businesses, increased tax revenues, new business opportunities in the market, and other indirect economic benefits to the neighborhood make it imperative to preserve affordable commercial real estate. The benefits that arise from maintaining the strong foundation of Asian-Pacific American culture, fostering a diverse blend of cultures in the city, and strengthening the city's commitment to principles of equity and social justice make preserving Little Saigon's cultural character an important goal.

The City of Seattle acknowledges the importance of preserving Little Saigon's affordable commercial space in its approval of the Yesler Terrace Housing Project. In recognition of the importance of the unique character of the neighborhood, the City Council prioritized and funded a study of a mixed-use project that will offer affordable commercial space in the Little Saigon neighborhood.

Little Saigon Resolution

"The City of Seattle, including the Office of Housing, the Office of Economic Development, and the Department of Planning and Development, and the Seattle Housing Authority, will work with the Friends of Little Saigon and other community members in Little Saigon to explore the feasibility of developing a mixed-use project that may include low-income housing, affordable commercial space, and a Vietnamese cultural center."

(City of Seattle 2012)

Promoting Affordable Development

To evaluate the feasibility of real estate projects that provide space that is affordable to target users, there are numerous policy tools to draw upon. This section explores the types of policies and programs that might be used to promote affordable commercial space. While no policies have been developed explicitly for promoting affordable commercial space, considering policies that encourage other types of affordable development can provide a blueprint for this analysis.

Seattle, like many metropolitan areas, imposes regulations and offers incentives to promote affordable housing (Office of Housing 2012; Office of Housing 2012b). These policies include the **Low Income Housing Tax Credit** that establishes an investment tax credit for the acquisition, construction or rehabilitation of low income housing; **Federal and State Housing subsidies** that are available for the development or rehabilitation of low income housing units; the **HOME Program** that allocates loans to rental housing developments for residents that earn no more than 80% area median income; and the **Multifamily Property Tax Exemption** that temporarily exempts the residential portion of a building from property taxes. There is also a demand-side incentive, the **Section 8 Housing Choice Voucher**, which enables renters to pay a higher rent than their incomes would otherwise allow, essentially making market-rate residential space affordable to them (Office of Housing 2012).

These policies “intervene” at various phases of the development process: construction and rehabilitation; operation; and demand. Common to all is that they lower rents while increasing a developer’s ability to capture a required return that otherwise would not be possible. Elementary to affordability, is that rents must be kept as low as possible per unit while still being able to finance, operate, and maintain the building, and capture the required return on investment.

Theoretically, there are a variety of methods for reducing the rents required for a development to be feasible (Geltner et al. 2007):

1. Reduce land acquisition costs through land grants or smaller sites.
2. Reduce construction costs by easing regulations that increase permitting or other construction costs.
3. Reduce the costs of financing through lower interest rates to developers providing affordable space.
4. Increase income potential by expanding leasable areas and easing zoning restrictions on heights or Floor-to-Area ratios.
5. Increase cash flows directly through tax credits or abatements.

Typically, these interventions reduce project costs or directly increase cash flows to the developer. This analysis draws on these methods for a framework for defining the policy alternatives to promote affordable commercial development.

There are numerous ways that a policy impacts an investor's financial calculations. This analysis evaluates a variety of tools, each of which influence a project in slightly different ways or at different phases of the development process. Some of the policies have been

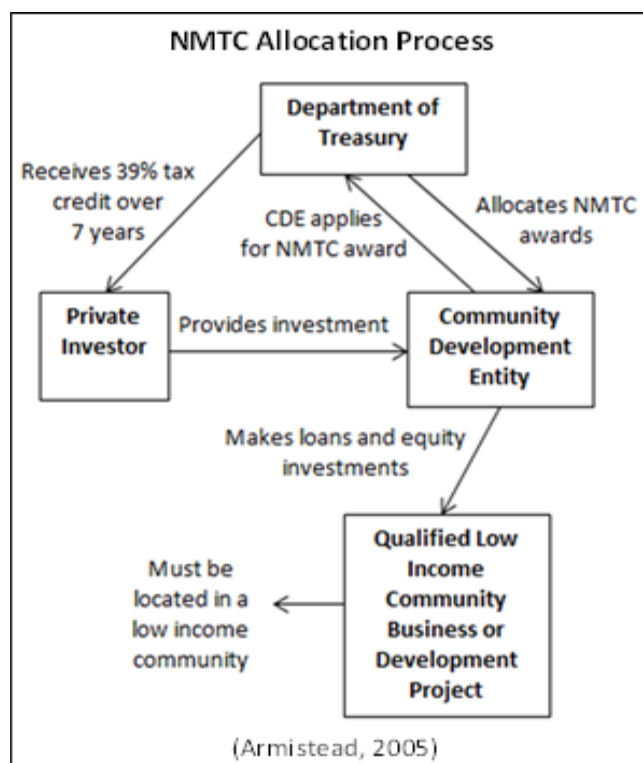
implemented and are currently utilized by developers, property owners, or non-profit organizations. Others do not exist in the form described, but rather are included in the analysis because they have received attention in the relevant literature as potential models for affordable commercial development. The specific characteristics of each policy, as I apply them to the financial feasibility analysis, will be discussed in more detail in the Analysis section.

Financial Incentives

The first type of policy considered is an incentive that directly impacts a developer's cash flows from a project. Governments promote desired behaviors using tax credits and inhibit unwanted behaviors using fees or fines. In this case, affordable commercial real estate is the desired outcome and an incentive is provided for developments that contain a set-aside for affordable space.

Tax Credits

Tax credits and deductions are popular tools for governments seeking to incentivize a behavior to accomplish certain outcomes. There are numerous such adjustments included in the tax code, ranging from the home mortgage interest deduction to promote growth in the housing market, to credits for low income working families, to special reduced rates for



capital gains to encourage investment in capital markets. Politically, tax credits and deductions are more appealing than fees, fines, or taxes levied on unwanted behavior.

Tax credits are also popular because they are a relatively high return on government investment, due to their capacity to leverage additional capital investment. For instance, a dollar in home mortgage interest deduction encourages significantly more spending in actual home purchases. Tax credits provide more of an incentive than deductions, as they represent a dollar for dollar reduction in tax payments, rather than a deduction on taxable

income.

Theoretically, a tax credit is purchased by an investor seeking to offset existing tax burden by providing capital to development projects that include affordable commercial space (Geltner et al. 2007). This model exists for residential development, in the form of the Low-income Housing Tax Credit, a federal program that rewards investors that provide equity for affordable housing projects by allocating tax credits to those who make equity contributions to the project (Kalthoff 2012).

The New Markets Tax Credit (NMTC) is the most widely used incentive program to spur commercial development in under-developed neighborhoods. Created in 2000, the aim of the NMTC is to create economic growth and revitalization by increasing investment in low income neighborhoods.

The NMTC uses the incentive of a federal tax credit, equaling 39 percent of the investment allocated over a seven-year period, to spur private equity contributions in these targeted communities (Rapoza Associated 2012).²

Private investors, typically banks seeking Community Reinvestment Act recognition, receive the credit when they provide capital in the form of a Qualified Equity Investment (QEI) to a Community Development Entity (CDE). In turn, the CDE provides the capital to local businesses or projects in one of two forms: 1) equity, through which the investors gain an ownership share and the credit increases their cash return to accommodate foregone productivity due to affordable rents; or 2) a loan, at below-market rates, often half the prevailing market rate. While mixed-use project do qualify for NMTC, for the project to receive a NMTC allocation, 20% of gross income must be received from non-residential units

Albers Mill NMTC Project

The Albers Mill project, in Tacoma, Washington, used a NMTC to convert a historic flour mill into a 60,000 square foot mixed-use development, with 36 market rate loft apartments on the top four floors, and approximately 10,000 square feet of ground floor commercial space including an art gallery, coffee shop, wine bar and deli.

When the project began in 2004, poverty rates in the neighborhood topped 24%. The \$15 million project received a \$10.8 million NMTC allocation, a majority of which was used to lower mortgage rates by 150-250 basis points for the project through U.S. Bancorp. The project created 107 construction jobs and six permanent jobs and aims to boost tourism and encourage other development project in the neighborhood.

(Armistead 2005)

² A target community is defined as a census tract with over 20% of residents at, or below, national poverty level and with median family income at, or below, 80% of area median income (Rapoza Associated 2012).

(Rapoza Associated 2012). Many projects “condominiumize” the commercial portion of the project in order to include larger amounts of residential space in the project while retaining NMTC eligibility.

Financing Tools

Most real estate development projects use a combination of equity and debt to pay for project costs, whether they include market-rate or affordable space. There are multiple advantages to borrowing capital, including sharing project risk with a lender, increasing purchasing power, obtaining tax benefits, and increasing cash returns through positive leverage (Geltner et al. 2007).

There is a cost to this financing – lenders must achieve their own financial return from the project. Lenders obtain this cash predominately from interest payments and loan fees. These costs are based on how much income the project is expected to receive (based on value or net income) and an adjustment for project risk. Commonly, up to 75% of a project's value is paid for through financing (Miles et al. 2007). The costs associated with financing thus significantly impact a project's financial feasibility and even minor changes to loan terms, particularly interest rate, improves a project's financial outcome.

Low Cost Financing for Affordable Projects

Incentives that reduce financing costs are particularly attractive for developments that include affordable space. Affordable projects are higher risk because they are often located in untested markets and target less financially stable tenants. These projects thus typically involve multiple financing sources, rather than one institutional lender. This increases the project's financing costs, as lenders require greater risk premiums and loan fees because they are less likely to be repaid loan principles if the project defaults.

There are several mechanisms to reduce the costs of financing for affordable projects. Community lenders often fill the financing gap for affordable housing projects and artist-space developments. These lenders, often community development intermediaries and community development financial institutions (CDFI's), make loans that other lenders deem too risky, when additional equity capital is unavailable, and when there is a strong community benefit (Walker 2007, 74). Intermediaries and CDFI's have both financial and social interests: while they expect to be repaid like a typical lender, they accept risk that others do not when the project advances their mission (Walker 2007, 91). These organizations also have access to tax-exempt financing tools, which reduce interest rate costs.

There are also programs that offer low-interest loans for organizations that pursue economic development opportunities in under-served neighborhoods. The most widely used loan is the U.S. Department of Housing and Urban Development's Section 108 program, which provides financing to community development organizations to pay for infrastructure improvements, affordable housing construction, and other neighborhood improvement projects (HUD 2012).

The program allows local governments to transform a portion of the Community Development Block Grants (CDBG) funds into federally guaranteed loans and infuse neighborhoods undergoing revitalization with significant capital investments. Section 108 loans are appealing because interest rates on both interim and permanent borrowing are extremely low.

The principle security for the loan guarantee is a pledge of current and future CDBG grants, which the public entity would subsequently lose if they default on their payments. This represents real risk for governments, and may limit the use of these loans to projects that are deemed less likely to default. Many cities allocate their Section 108 loans carefully, requiring detailed applications. There are many eligible uses for Section 108 loans. These loans can be used to acquire property, fund economic development activities, construct public facilities and infrastructure improvements, or in some cases even fund housing construction as part of a community economic development program.

The City of Seattle operates a Section 108 Loan Program from the Office of Economic Development (OED) that converts a portion of the City's CDBG into Section 108 loans to assist economic development projects. Since 2002, OED has lent over \$24 million to multiple projects – none of these loans have defaulted. To qualify for the City's program, a private project must create public benefits such as affordable housing or permanent job creation. In 2011, the City Council authorized the city to issue up to \$10 million of its CDBG grants for Section 108 loans (City of Seattle 2011).

Cadillac Hotel Section 108 Project

In 2004, the Office of Economic Development provided a \$2.04 million Section 108 Loan to Historic Seattle, for acquisition of the Cadillac Hotel. The historic Cadillac Hotel suffered serious damage during the 2001 Nisqually Earthquake and needed significant repair. Upon completion of the rehabilitation, the Cadillac Hotel became the new home of the Klondike Gold Rush National Historic Museum and also contains the regional headquarters of the National Park Service. The project received a National Trust for Historic Preservation Award in November, 2006.

Special Financing Tools

There are other financing tools available for projects that satisfy certain criteria, particularly when they include affordable housing, fulfill a non-profit's mission, or reduce energy consumption. For projects that advance a public purpose, financing from public bonds is commonly available. When a bond is issued for a specified public purpose, the bond purchasers do not have to pay federal income tax on the interest income received (Dernbach et al. 2011, 6). As a result, these bonds are referred to as "tax-exempt." Because bondholders do not have to pay income tax on the interest, they are willing to accept a lower rate.

Tax-exempt bonds offer a mechanism to obtain cheaper than market-rate financing. While the use of these bonds for private activity is limited, there are two potential avenues for using tax-exempt financing.

First, some private uses are eligible for tax-exempt bond financing. The Multifamily Housing bond program, operated by the Washington State Housing Commission, provides tax-exempt financing for projects that reserve a portion of their residential space for affordable units. The program requires developers to reserve 20% of the total units for households with incomes below 50% of median income or 40% of the total units for households with income below 60% of median income (HFC 2012).

Tax-exempt bonds are also available for non-profit developers when they pursue projects that are directly related to the organization mission. This includes construction and rehabilitation of buildings, land acquisition, and refinancing. The program commonly used for projects less than \$5 million is the Streamlined Tax-Exempt Placement program (STEP), which makes below-market rate loans to non-profit borrowers (HFC 2012b). STEP financing works similarly to conventional loans, except that interest payments to the lender are tax-exempt. The lender subsequently passes these savings on to the borrower in the form of a lower interest rate (HFC 2012b).

The second source of public financing for private activities is for improvements to infrastructure. Conservation bonds, such as the Qualified Energy Conservation Bond program (QECB), can be used by public entities for infrastructure improvements that reduce energy consumption (Department of Commerce 2009, 2). Infrastructure costs can comprise a not-insignificant portion of construction costs, from hook-up fees, improvements needed for water, sewer, and electricity systems to meet the utility demands of a project, and changes to existing infrastructure that interferes with project development, such as utility lines. Developers have begun to recognize these costs and potential sources of funding for

these improvements, partitioning out the costs of infrastructure from other construction costs.

The QECB program also allows for bonds to be used for private demonstration projects that promote the commercialization of green building technology (Department of Commerce 2009, 2). Up to 30% of Washington State's \$67.9 million in QECB issuing authority, or \$20.3 million may be used for eligible private activities (Department of Commerce 2009, 3). Other private projects that satisfy economic development objectives may also be eligible for certain city-issued tax-exempt bonds, but this depends on potential enabling legislation passed in upcoming State legislative sessions.

King County Green Community Initiative

Currently in the planning stages, the King County Green Community would provide QECB financing for projects that meet five criteria: Energy Conservation and Generation; Greenhouse Gas Emission Reduction; Green Building; Water Conservation; and District Energy.

(King County 2012)

Recently, the IRS, which administrates the QECB program, implemented its Green Community program to streamline the allocation process for QECBs. Privately-owned development projects do not currently qualify for tax-exempt financing under the Green Community Initiative. However, the program is in its pilot stages and there is growing support for allowing some economic development objectives, such as and infrastructure improvements to qualify for Green Community incentives when they promote energy conservation.

Tax Increment Financing

Another type of intervention that impacts the financial feasibility of development projects is Tax Increment Financing (TIF). Popular in the 1970's due to rising interest rates and constraints to public budgets, TIF is a method of funding investments in neighborhoods that need improvements to infrastructure and amenities or that are targeted for redevelopment (Casella et al. 1984). Initially, TIF was used primarily in neighborhoods identified as "blighted" as a form of urban renewal (Casella et al. 1984).

The objective of TIF is to provide public funding for capital improvements in a defined geographic area, identified as "the district." To pay for these improvements, the jurisdiction essentially borrows against future increases in property taxes that redevelopment in the district is expected to bring about (Roybal 1994, 32). While there are various forms of TIF currently used by local governments, the basic model is for governments to "freeze" taxes at the current levels and issue tax-exempt bonds in the amount of expected future

increases (Dye and Merriman 1999). This portion is termed the “increment” and the jurisdiction repays the bondholders, plus interest, with the increment when it is received from property owners via future property tax payments.

Some TIF legislation also allows local jurisdictions to capture taxes earmarked for other jurisdictions, such as state sales taxes and county property taxes. Including these tax revenues in the increment, which would otherwise be allocated to other jurisdictions, essentially allows cities to leverage their own tax revenues to capture a larger portion of bond funding for projects in the district.

TIF provides governments with a large capital reserve when bonds are issued – and governments repay the bonds over the life of the term. Thus, TIF is a method for spreading the large, up-front capital costs of improvements over the period that property owners receive the benefits from these improvements.

Enabling legislation for TIF commonly limits the use of this financing for “public purpose” projects, such as revitalization of blighted neighborhoods, low- and moderate-income housing, public transportation, and improvements to infrastructure and public space (Casella et al. 1984). To establish a TIF district, a municipality often must demonstrate that the development would not occur “but for” the use of the tax increment, as a way to ensure that public financing and a municipality’s debt capacity is not used to provide a windfall for developers (Dye and Merriman 1999).

In Washington State, a TIF district can only be used to fund infrastructure improvements. Nevertheless, because of the significant infrastructure deficiencies in the neighborhood, TIF is an appealing tool for Little Saigon (Trang D. Tu Consulting 2007, 14). TIF would provide additional resources for improvements to infrastructure and public amenities, which would spur demand for housing in the area, attract customers to retail businesses and restaurants, and enhance the character of the neighborhood. Indeed, the Final Environmental Impact Study conducted by the City for the Livable South Downtown Initiative rezone recommends that a feasibility study be completed for the implementation of a TIF district in the International District to help fund these types of improvements (BHC Consultants 2007). Paradoxically, using TIF for neighborhood improvements might increase the risk of commercial gentrification as it makes the neighborhood a more desirable place to live and boosts economic development. This risk makes linking the use of TIF to the provision of affordable real estate even more important (Dye and Merriman 1999).

Tax Increment Financing Mechanisms in Washington State

There are two forms of TIF currently allowable by law in Washington State: Local Revitalization Financing (LRF) and Landscape Conservation and Local Infrastructure Program. An LRF district functions as a traditional TIF, except that the source of the increment is the State sales tax on new construction in the district. When a jurisdiction forms a LRF, thus committing to invest in infrastructure improvements to spur economic development, Washington State pledges to match new local construction property tax revenues with an equal amount of new state sales tax, up to \$500,000 per year (Parham 2012). This is the primary benefit of a LRF. However, the program is currently unfunded due to State budget constraints. Because of on-going state budget shortfalls, this program is unlikely to receive funding in the 2013 biennium.

The Landscape Conservation and Local Infrastructure Program (LCLIP), however, does not rely on a state contribution. LCLIP allows cities to capture additional property taxes, contingent on accepting an allocated portion of transferable development rights (TDR). By allowing a city to capture county property taxes and to finance infrastructure costs with future tax revenues, LCLIP reduces the up-front construction costs for developers (Parham 2012). An additional benefit to LCLIP is that it is currently legal and does not require a contribution from the state. LCLIP requires that a participating city accept a minimum threshold of TDR. LCLIP allows a district to capture up to 75% of the city and county property taxes on incremental growth over 25 years.

Community Revitalization Financing Act

The use of TIF for private activities is extremely limited in Washington State, restraining its impact on development in an area. The Community Revitalization Act of 2011 (CRFA) is currently receiving attention as a potential solution for cities in Washington State desiring flexibility for incentivizing new development. Technically, the CRFA is a special assessment district, although it functions similarly to a TIF district. By levying an additional 1% tax on the projected increase in property value, CRFA provides a funding source for infrastructure improvements and certain developments that fall under criteria for eligible uses.³

Under the proposed CRFA, a small district would be created in which a 1% increase in future property taxes would be “captured” in the form of a municipal bond, which in turn would be used to fund affordable housing (25%) and infrastructure improvements (75%) (Parham 2012). The increased property tax would be used to pay the debt service on the bond. By

³ These uses would be defined by the State Legislature in enabling legislation.

using a municipal bond, CRFA essentially allows a developer to lower financing costs for the project. CRFA avoids a State contribution and may be a more politically feasible tool, although it is likely at least two years away from consideration by the State Legislature.

There are significant barriers to using TIF for neighborhood improvements. In Washington State, property tax revenues that jurisdictions receive are restricted to 101% of the previous year's rate, excepting new construction (Washington State RCW 84.55.010). Thus, even if property values grow significantly in the TIF district, the jurisdiction is limited by the 1% "lid" on tax revenue growth. Unless a constitutional amendment is passed that identifies TIF districts as an exception to this rule, TIF districts that significantly impact a neighborhood redevelopment are unlikely.

Another challenge is the debt capacity restrictions for jurisdictions. The amount of debt that municipalities and other tax districts carry is limited by the state to 1% – 1.5% of total assessed value in the jurisdiction, less an emergency preserve (Noble et al. 2012). Debt issued for improvements in a TIF district adds to the outstanding obligations and thus counts toward the jurisdiction's debt capacity limits. For large cities, the debt capacity is extremely large – because of high assessed value – and there are ample opportunities to add TIF issued bonds. In early 2012, for instance, the City of Seattle had a debt capacity of \$1.7 billion, of which \$640 million remained available. However, smaller cities do not have this flexibility and debt capacity limits constrain the use of TIF (Noble et al. 2012).

Use of TIF in this manner would require three legislative changes: 1) allow the creation of districts that do not adhere to "uniform levy" property tax laws (jurisdictions are currently prohibited from taxing properties in one area at a different rate than others); 2) allow for cities to utilize revenue bonds without this debt counting toward the jurisdiction's debt limit; and 3) to increase the total allowable tax per \$1,000 in assessed value, so that a 1% increase does not limit ability of other districts, such as fire, school, and water, to capture revenues necessary to maintain services (Spitzer and Ost diek 2012).

If these barriers are overcome, TIF can be a valuable tool for jurisdictions seeking to spread the costs of improvements over the lifetime of their benefits and allocate costs to the recipients of those benefits.

Alternative Ownership and Program Models

Other than directly influencing cash flows with financial incentives, there are other types of policies that can change the cash returns flowing to a developer and equity investors. These models capitalize on the different strengths of private and non-profit organizations, adjust

the amount and type of space available for local businesses, and impact financial feasibility reducing specific project costs.

Commercial Land Trust & Trust Funds

One of the most significant capital requirements for any project is the cost of land. One model that reduces land acquisition costs is the Community Land Trust. While not widely used for commercial projects, the land trust model has the potential to reduce land costs for a project that retains affordable space.

Land trusts seek to conserve land with high development potential or remove the cost of land to make it affordable for a target community, often low-income. Typically, a land trust operates by a non-profit controlling property through the purchase or donation of land (Donjek 2012, 3). For housing land trusts, the non-profit then sells or rents residential units to families at an affordable rate. The non-profit organization is key to this model because, as a mission-driven organization, they can forgo the returns required by equity investors and can capitalize on their lower marginal tax rates (Donjek 2012, 4).

Champlain Housing Trust

The Champlain Housing Trust, headquartered in Burlington, VT is one of the largest community land trusts in the country. It is also one of the most experienced at managing commercial space, leasing 116,000 square feet of space to 42 tenants in 17 buildings.

The Champlain Trust is focused on providing space to tenants at lower-than-market rates by purchasing properties with nearly 100% equity contributions, thereby limiting debt service payments. The Trust strategically targets properties in identified "Neighborhood Revitalization Areas," and leases commercial space directly to tenants. Champlain emphasizes long-term leases and minimizes operating expenses by managing its properties in-house.

(Donjek 2012, 4)

Recently, land trusts dedicated to commercial space have gained attention as a way to preserve affordable retail space (Donjek 2012, 4). The concept of a commercial land trust (CLT) uses a similar structure to preserve the affordability of commercial space developed on the controlled properties. A corporate entity – often a non-profit organization – acquires property zoned for commercial uses and places the land in a trust (Donjek 2012, 5). The CLT ground-leases the land to a commercial developer that builds or redevelops commercial space and leases units to local businesses at affordable rates that are contractually stipulated (Broad Community Connections 2011). The CLT maintains ownership of the underlying land and is thus able to control future affordability. Thus, a CLT essentially removes the cost of land from the redevelopment equation, replacing it with a lease payment from the developer to the trust.

Few organizations have incorporated commercial property in land trusts. The difficulty capitalizing land acquisition costs remains the most significant barrier to scaling up commercial land trusts.

Commercial Condominiums

While financial incentives increase project cash flows and land trusts reduce the cost of land acquisition, the commercial condominium model reduces the cost of rent for businesses, captures design efficiencies, and transforms future rental income into up-front sale income for developers. Commercial condominiums operate similarly to residential condos and provide a business owner long-term protection from rent increases.

Condominiums provide an opportunity for tenants to own the unit or property that they operate. This ownership is particularly appealing for long-term tenants facing rising rent prices. Condo owners are able to leverage financing that would not be available for rent payments to buy the units. Commercial condominiums also allow tenants to reduce costs through shared common spaces and offer businesses the opportunity to tailor their own tenant improvements (Goldstein et al. 1973, 819). Condominiums serve a wealth creation function, as business owners capture financial returns from property appreciation. Lastly, condos allow synergistic businesses to cluster, creating a small economy of agglomeration and driving demand.

Indeed, many businesses in the Little Saigon neighborhood desire to own their units and many have attempted to purchase the property that they currently lease (Trang D. Tu Consulting 2007, 20). These businesses prefer to have “control over the property they operate on” so as to maintain “a stake in the future of the neighborhood” (Trang D. Tu Consulting 2007, 20). Condominiums are also attractive to developers who prefer to have income up-front rather than face the risk and costs of a tenant defaulting on the lease or high turnover rates.

Organizations across the United States have begun to recognize the potential for commercial condominiums to preserve commercial space for tenants at affordable levels (Trang D. Tu Consulting 2007, 20). In most projects where this model is used, a non-profit organization serves as the condominium board, purchases the land and ground-leases the property to a developer, who constructs the building. The non-profit organization is the master lessor for the units and acts as guarantor for the commercial condominium units, allowing the developer to reduce the risk of finding tenants. Non-profit organizations are likely more closely involved in the local business community and can thus more easily provide assistance for these businesses to access financing.

The condominium association establishes bylaws and contracts property management, and through this mechanism can create resale contracts and covenants that prevent the condo owner from speculating on property values and flipping the unit at market-rate.

There are significant barriers to commercial condominiums. The high cost of condo units prohibits many retailers from purchasing property (Trang D. Tu Consulting 2007, 20). The success of commercial condominiums is thus contingent on a business's ability to obtain financing. Because many local retailers are small and do not operate with high profit margins, obtaining low-cost financing is likely an obstacle. The Small Business Association (SBA) offers loans to businesses, particularly low-income or start-up retailers, to purchase property. These "504 Loan Funds" offer up to 90% leveraged financing for small businesses to fund capital expenditures, such as the purchase of property, building redevelopment, and furniture and equipment (SBA 2012). While this financing is a valuable opportunity for small businesses, accessing the loan comes with administrative costs and many businesses in the Little Saigon neighborhood face language and cultural barriers to mainstream financing and public incentive programs (Trang D. Tu Consulting 2007, 20). For developers evaluating a project, finding businesses eligible for SBA financing and ensuring that these businesses actually obtain financing to buy the condominium units, is a complex proposition and increases risk to the project.

Because of the various ownership interests, commercial condominiums are complicated in legal structure. Businesses pursuing this option generally form limited liability corporations (LLC) so that equity built-up in the property through mortgage repayment is not exposed to claims of business creditors (Tuchman and Pearlstein 2006). Additionally, lenders are often reluctant to provide financing for commercial condominium projects without a risk premium (Tuchman and Pearlstein 2006).

Nevertheless, this model offers a potential solution for rising commercial rents and as projects in cities around the United States more frequently utilize a condominium structure to retain affordability and capture financial benefits, additional solutions to these barriers are likely to be developed (Young 2007).

Regulatory Programs and Policies

Governments can also impose regulations that require or promote certain behaviors. These programs are implemented through zoning initiatives that define the development density allowed in a neighborhood and incentive systems that exempt developers from certain

requirements when projects achieve desired outcomes, such as affordable space or public improvements.

Zoning Initiatives & Cultural Overlay Districts

Municipalities utilize zoning and regulatory programs to provide criteria for the types of uses and density of development that is beneficial to the neighborhood. One of the most important roles that a jurisdiction plays is to define the types of uses and density of uses that are allowed in a particular area, to achieve a particular vision for that neighborhood. Municipalities use zoning and regulatory programs to limit building heights, increase density through reduced setback distances and greater lot coverage, incentivize affordable development, and provide design review criteria to achieve this vision. The City recognizes the benefits that Little Saigon's cultural character and diversity offers and has sought to promote these characteristics with the Livable South Downtown Initiative.

The Initiative bundles regulations, land use actions, and incentives into a package that seeks to improve the quality of the community by achieving the vision for a thriving economy, strong cultural foundation, improved public safety, and enhanced accessibility.

One type of zoning initiative that is commonly used by municipalities seeking to fulfill a specific vision for a neighborhood is a "special overlay district." The City of Seattle packages various regulatory and incentive tools in special overlay districts, which identify a set of desirable outcomes for specific neighborhoods and offers incentives and imposes regulations to accomplish these objectives (CODAC 2009). One such district is termed the "Cultural Overlay District." This model arose from recognition of the role that the City's cultural assets play in growing the local economy through "commerce, job creation, retail traffic, and neighborhood development" (CODAC 2009, iii). These districts explicitly seek to preserve affordable commercial space.

The Cultural Overlay District (COD) provides programs and incentives to lower the costs of development projects within the district that contain affordable space for artists and cultural

Livable South Downtown Initiative

1. Encourage incremental growth and development, allowing small businesses to adapt over time.
2. Retain the small- and medium-size character of businesses in the area.
3. Encourage the development of a residential community, including affordable housing.
7. Reflect Little Saigon's diversity in future development, including the prominence of Southeast Asian-American businesses.

(DPD 2009)

organizations. In the final recommendations of the Cultural Overlay District Advisory Committee, tasked by the City Council to study and recommend the components of a COD, cultural space is identified as an element of the city's infrastructure (CODAC 2009). This vision justifies a systematic approach to providing stable affordable space for cultural organizations and the COD was endorsed by both the City Council and the Office of the Mayor in 2009 (CODAC 2009, 3).

Capitol Hill Arts and Cultural District

In 2008, the Cultural Overlay District Advisory Committee proposed a model that incorporates various planning processes, addresses growing concerns for affordable space for arts and entertainment organizations, and creates an economic development strategy acknowledging the importance of affordable cultural space. The Advisory Committee proposed a package of incentives and regulatory tools that would achieve their vision for the neighborhood. These included:

Land use incentives such as density bonuses, and transfer of development rights programs for developers providing affordable space;

Regulations such as streamlining the permitting process for projects in the district and exemptions from certain regulations like parking requirements.

Financial Incentives for projects providing affordable arts and cultural space, including city property tax exemptions, reduced permit fees, and city financing for infrastructure and amenity improvements.

(CODAC 2009)

The COD presents a model for developing a regulatory and incentive system that promotes development of affordable commercial space within a specified neighborhood. As applied to commercial real estate, such a district would offer a similar menu of incentives, including density bonuses for projects with a percentage of affordable retail units “set-aside,” tax credits or abatements for developments with affordable commercial space, and financing and business assistance for local entrepreneurs. The COD would also impose regulations, including a review process for certifying developments that enhance the cultural character of a neighborhood (similar to International Special Review District for historic preservation).

The City of Seattle has argued that incentivizing affordable space for cultural organizations and artists achieves a public purpose because of the role that these assets play in growing the local economy (CODAC 2009). Using an overlay district to lower the rents for private, commercial entities is likely to be more controversial, even if these businesses are owned by local entrepreneurs and if providing this space achieves important economic development and cultural outcomes. However, the City recognizes

the important role that a strong and diverse cultural character plays in achieving a vibrant local economy (CODAC 2009, 3). Through the Race & Social Justice Initiative, the City

recognizes the value of promoting minority-owned businesses and ending institutionalized race-based disparities in Seattle (Nelson 2012). The Mayor's Office has directed resources for additional outreach to women- and minority-owned businesses in order to overcome the barriers that these businesses face in doing business by linking them with city contracts, low-cost financing products, and business assistance programs (McGinn 2010).

The criteria defining "eligible" uses is thus extremely important to the viability of a COD: whether this includes criteria limiting affordable space by the size of the business (revenues or employees), number of locations, local ownership, "culturally-significant use," or another metric will have a large impact both on the political feasibility, as well as the impact on the neighborhood, of a COD.

Given these approaches and the momentum toward implementing Cultural Overlay Districts for artists and cultural institutions, a similar approach to promote affordable commercial space for local entrepreneurs may receive increased attention as a viable option.

Conclusion

In this chapter, I examined the theoretical and empirical research on urban economic theory, commercial real estate development, and the commercial gentrification process.

The real estate development industry plays a vital role in determining the kinds of real estate developed in the space market and the investment opportunities offered in the asset market. This role has an impact in promoting affordable commercial space, the provision of which can allow a neighborhood to retain its vibrant economy, preserve a strong cultural community and unique character, enhance economic opportunity through tourism and locally captured profits, and uplift entrepreneurial spirit. These impacts can slow the negative effects of commercial gentrification while allowing a neighborhood to capture the benefits of development and economic growth.

While no policies explicitly promote affordable commercial space, there are numerous policies that can have an impact on this type of development, including tax credits and financing, ownership models, and overlay district regulations and incentives. The next chapter outlines the methodology and data sources that I use to evaluate the impact of these policies on the financial feasibility of affordable commercial development.

CHAPTER 3: METHODOLOGY

This goal of this research is to evaluate the financial impact of policy alternatives that seek to promote commercial real estate development that is affordable to local entrepreneurs. This includes a comparative analysis of the policies used to preserve and create affordable commercial real estate and a financial feasibility analysis, evaluating the value and costs of affordable commercial development from the standpoint of the developer. This research will inform policy makers, developers, planners, non-profit organizations, and businesses by providing a framework for evaluating the impacts of these policies on project development.

Data Sources

As discussed in the review of existing literature, there is little empirical research on affordable commercial real estate development or the impacts that policy alternatives have on financial feasibility. Thus, my research began with a review of the existing literature on commercial real estate markets and urban economic theory, in order to understand the dynamics of the commercial market, how rents are set, and how economic growth impacts the commercial sector in the form of commercial gentrification.

The data source for developing the base project proforma was three projects completed by the Seattle Chinatown International District Preservation & Development Authority. The policy alternatives were identified and quantified during the literature review and from stakeholder interviews. Data on tax increment financing models was obtained a study commission by the Puget Sound Regional Council on TIF in the Bellevue, WA area. Information on tax credit and loan terms was obtained from comparable projects that utilized these financing programs and stakeholder interviews.

Existing Research & Literature

To achieve my research objectives, I first conducted a thorough review of existing literature, to build a foundation of theoretical and empirical knowledge of urban economics, the real estate and economic development industry, processes of gentrification, and the various policy alternatives that currently exist or are being planned for future implementation. This research provides a basis for understanding the dynamics of affordable commercial real estate and forms the foundation for evaluating the impacts of policy alternatives on this sector.

Urban economic theory provides a valuable theoretical framework for the dynamics of the commercial real estate market, including models for city population and employment growth, how cities achieve economic equilibrium between sectors and geographic areas, and the location and cost decisions made by residents. Urban growth significantly impacts commercial real estate markets and urban economic theory provides a framework for understanding these impacts. Urban economics also presents a way to understand the impacts that reducing commercial rents may have on a neighborhood, including economies of agglomeration and local multiplier effects to evaluate how revenues are recycled through a neighborhood economy.

The *real estate industry* literature adds to this framework by providing models for the interaction of space and asset markets, the supply and demand of real estate sectors, and how land and buildings are valued. There is a large amount of literature on the gentrification process, particularly as it relates to residential real estate. This research provides a body of knowledge on the factors that influence commercial gentrification as well as potential mechanisms for overcoming the negative consequences of this process.

Research on *real estate and project development* informed this analysis by providing a framework for understanding how real estate is valued and methods for evaluating real estate development opportunities. The development industry also provides the metrics that I utilize to evaluate policy impacts on a project's financial feasibility.

Because there is little research on affordable commercial real estate, I drew heavily on other real estate sectors to gain an understanding of the characteristics and objectives for the policy alternatives that promote affordable space. There are numerous programs that seek to promote affordable housing and research on these programs provides a valuable foundation for understanding how policies to promote affordable commercial space may be structured and evaluated.

Stakeholder Interviews

The goal of this research is to evaluate the impact of a specific set of policy alternatives on a successful development project in a particular neighborhood. While existing research provides important frameworks for understanding the economic processes that influence real estate development, the general dynamics of providing affordable real estate, and a mechanism for understanding the consequences and mechanisms for fighting gentrification, this analysis also relies on a body of knowledge that lies outside existing literature.

First, I worked closely with the Seattle Chinatown and International District Preservation and Development Authority (SCIDpda) to develop an initial framework for my research questions and design. SCIDpda's mission is to "preserve, promote, and develop the Seattle Chinatown International District as a vibrant community and unique ethnic neighborhood," and the organization's real estate activities include developing affordable housing projects, managing properties, and conducting real estate feasibility studies (SCIDpda 2012). Because of their numerous activities in the community, involvement in neighborhood planning processes, and knowledge of the local real estate and commercial market, SCIDpda staff provided invaluable contextual insights into the economic and real estate dynamics occurring in the neighborhood.

I conducted interviews with a variety of other stakeholders, chosen for their expertise in various aspects of commercial real estate development. I used an informal interview protocol because of the diversity of information sought from the various interviewees. In order to promote truthfulness and accuracy of information obtained from interviews, I pledged to maintain the anonymity of interviewees. Below is a description of the industries from which I sampled interviewees and the type of information sought from each.

Developers: I interviewed two real estate developers to test the assumptions made in the financial feasibility analysis, to gain an understanding of current development opportunities in the neighborhood, and to devise financial feasibility metrics that developers typically use to evaluate projects. Both developers have completed projects in the International District within the past 5 years.

Financers: I consulted the director of a local Community Development Financial Institution (CDFI) that provides loans and assistance to non-profit organization and local entrepreneurs who lack access to mainstream financial products. This interviewee provided information on existing financing tools available for affordable housing projects and other economic development projects, and potential mechanisms for promoting affordable commercial space.

Planners: I interviewed three employees of the City of Seattle's Department of Planning and Development to gain insight into the objectives of the Livable South Downtown Initiative, the tools currently used to promote affordable development, and the political implications of policy alternatives that encourage affordable commercial space. These interviews helped to understand the initiatives that the City is currently working on to promote affordable space.

Housing Officials: To understand the affordable housing industry, I interviewed one employee at the Seattle Housing Authority and one at the City of Seattle's Office of Housing.

These interviews shed light on how the City evaluates the financial feasibility of affordable housing projects, the policy alternatives used to encourage private developers to produce affordable units, and the ways a project can provide both affordable housing and commercial spaces.

Economic Developers: I interviewed three members of the economic development community to gather information on policies to promote affordable commercial space that are utilized in other jurisdictions, to test the political and practical feasibility of the policy alternatives chosen, and to understand the potential consequences of affordable retail space in the local economy.

Land-use Attorneys: In order to ensure that the chosen policy alternatives are currently legal and to understand the legal barriers to those that are not, I consulted two land-use attorneys at a major law firm located in Seattle. These interviews provided insight into the municipal financing industry, the legal implications of using public funding for private activities, and alternative forms of project finance. Both attorneys work closely with municipal and energy conservation bond programs, as well as tax increment financing legislation in Washington State.

Professors: Last, I consulted numerous professors at the University of Washington to gain insight into the real estate development industry, the nonprofit development process, and community economic development initiatives and tools.

All stakeholder interviews were designed to provide context to the literature review and to test the assumptions and policy alternatives used in this analysis. These interviews helped ensure that the existing regulatory and incentive systems and market dynamics were fully understood and considered in the analysis. Interviews also helped to more fully understand the political constraints, transactions costs, and legal complexities of the policy alternatives evaluated in this analysis.

Similarly, because there is little empirical research on affordable commercial real estate, developing policy alternatives to promote this type of space requires a level of innovative thinking. The developers, non-profit organizations and planners who work in these industries are often the best resource for drawing upon a wide variety of ideas to devise creative solutions. All of the interviewees were asked about potential policy alternatives that could impact the financial feasibility of affordable commercial projects. Thus, the interviews helped develop a broader and more fully developed set of policy alternatives than would otherwise have been possible.

Stakeholder interviews also sought to reduce sample bias. The developers and non-profit organizations helped to define the feasibility metrics and project assumptions to use for the project. Vetting project assumptions was particularly important, as the financial proforma was constructed from three past projects, developed by a single non-profit organization. While using this data allowed for an ex-post financial feasibility analysis, the fact that the projects were developed by a single non-profit organization introduced the potential for sample bias. Project assumptions, including the projected income from rent, operating expenses, construction and services costs, and financing terms were thus carefully vetted with developers and other organizations familiar with the local market.

Financial Data

Ex-post feasibility analysis requires that data from a project that has already been successfully implemented is obtained and analyzed. To evaluate the impact of policy alternatives, this data is then adjusted for the impact that each policy has on the project. I received financial proforma data from SCIDpda for three projects that they developed from 2005-2010. All three projects are mixed-use buildings currently operating in the commercial core of the Chinatown neighborhood. The data received from SCIDpda allows for policy alternatives to be tested on actual projects, which makes this analysis more valuable. Rather than evaluate the impacts of policies on a hypothetical project, this analysis benefits from using actual costs and value considerations.

I adjust project data for several reasons. First, the central commercial Chinatown real estate market is slightly different than that of Little Saigon. For one, a majority of the buildings in Chinatown are protected by historic preservation covenants. Thus, most of the future development in Chinatown will be rehabilitation, rather than new buildings. Conversely, Little Saigon has few protected properties and more vacant parcels, indicating the potential for new development. Second, as a non-profit organization, SCIDpda has different responsibilities – and motivations – than a private developer, who would require a higher threshold of financial feasibility in order to achieve investor returns.

This thesis seeks to evaluate financial impacts from the standpoint of a typical developer. Using the standpoint for a private developer is beneficial for two reasons. First, it requires a higher feasibility standard. If an affordable commercial development is feasible for a private developer, it is likely that it would also be feasible for a non-profit, because of greater access to low-cost financing and grants, lower marginal tax rates, and familiarity in the neighborhood. Secondly, a goal of community revitalization is to spur private investment in the neighborhood. Evaluating the financial impacts of policy alternatives from the standpoint

of a private developer takes into consideration the different motivations of private development and thus evaluated the impact on potential private investment.

Financial Feasibility Analysis

This analysis seeks to evaluate the impacts of a series of policy alternatives on a project's financial viability. I evaluate these impacts using financial feasibility analysis.

Traditionally, feasibility is defined as the “formal demonstration of viability” (Miles et al. 2007). This research uses a developer's definition of viability, because developers ultimately provide the link between the space and asset markets. Even from a developer's viewpoint, feasibility considers the interests of the other actors involved in the project, because developers are ultimately responsible for investor and lender expectations, and must account for political and legal constraints.

Financial feasibility from the viewpoint of a developer considers a real estate project “feasible” when ***“it is determined that there is a reasonable likelihood of satisfying explicit objectives when a selected course of action is tested for fit to a context of specific constraints and limited resources”*** (Graaskamp 1975, 515).

Implicit in this definition are several assumptions important to this analysis. First the word “likelihood” indicates that feasibility analysis does not set forth a series of certainties (Geltner et al. 2007). Rather the analysis provides projections about the future, based on past performance, market trends, and growth projections. Rather than an exact blueprint for project performance, feasibility analysis provides a vision of what is probable, but not certain, to occur based on project constraints.

Second, “explicit objectives” must be defined. These include not only the goal of the developer to capture financial profit, but also all the objectives of the various parties who have play a role in the project. These objectives form the feasibility metrics used to evaluate the impact of the policy alternatives.

Third, a “selected course of action” requires that a specific development plan is proposed. This analysis seeks to compare the impacts of seven policy alternatives (ten scenarios) on the base development project. Because the evaluation must occur in a systematic way, all other components of the project are kept constant. This ensures that my evaluation considers only the impacts of the policy alternatives themselves, rather than exogenous factors affecting the project.

Lastly, a “test for fit to a context of specific constraints and limited resources” is defined within which the feasibility analysis is developed. This indicates a comparison of the proposed project to the rents achievable in the market, financing terms available, and other constraints.

A feasibility analysis can operate in a negative fashion: rather than defining the variables that contribute to profitability, the process can “neutralize incongruities, irritants, and the unpredictable forces that could cause unsatisfactory outcomes” (Miles et al. 2007). This is a particularly valuable framework for the current analysis, which evaluates the impact of policies seeking to promote affordable commercial space by overcoming barriers, such as high financing and land acquisition costs, which developing this space presents.

Ultimately, the feasibility study is a method that provides developers, investors, and lenders with the information they need to decide whether or not to move forward with a project and how to finance the project (UNIDO 1978). In other words, it is a “yardstick for the evaluation of the financial and economic success, or failure, of a project” that can be used to determine the impact that costs, income, financing, and other critical variable have on the performance of a project (UNIDO 1978).

The components of a traditional financial feasibility analysis that I utilize for this analysis are the Market Analysis and Financial Proforma Analysis (UNIDO 1978, 395). However, even a carefully developed feasibility study is not without its limitations. In the following section, I acknowledge these limitations and explore ways to reduce their impacts on this analysis, when possible.

Objectivity

A feasibility study should be objective and targeted on the goals and objectives of the client. However, it is common for feasibility analysts to lost focus and become personally or professionally invested in the project, introducing bias (Barrett and Blair 1988).

To maintain focus on objectivity, my research goal is not defined as *making affordable commercial real estate development feasible*. Rather, I frame this research to evaluate financial feasibility under various policy scenarios. This research does not seek to achieve feasibility per se, but rather aims to demonstrate the impact of various policies on feasibility.

Indirect Economic Impacts

The aim of the financial feasibility analysis is to compare and analyze a project's costs and income estimates into an overall measure of viability. However, there are secondary,

indirect economic impacts of development, including creating jobs through project construction and operation, enhancing the local economy, increasing tax revenues to a municipality, and increasing the strain and required public spending on local infrastructure. Secondary effects of a development are often difficult to quantify accurately and are commonly left out of financial feasibility analysis because of unreliable data measurement. These impacts often fall into a grey area and are commonly ignored (Barrett and Blair 1988).

These secondary impacts are particularly important when a development achieves public benefits. Affordable real estate is a means to achieve these benefits, and thus I examine the potential secondary benefits and costs of affordable commercial development on the local economy, community character, and city revenues. This will aid policy makers in weighing the indirect economic impacts of affordable commercial real estate, as well as provide developers with a rationale to use when advocating for the implementation of incentives to develop this space.

Unreliability of Data

Because most real estate deals are private, data is often difficult to come by. Information obtained from one project might be useful for highly similar projects, but not for others. However, due to a lack of data, information from projects that are not comparable might be used anyway (Barrett and Blair 1988). Market data such as demographic changes, user demand, and absorption rates will significantly impact a project's program and rental income. However, market data can be oversimplified to infer demand for a good that does not exist. Income estimates are only accurate if the market will uphold these assumptions – if the business can actually achieve the revenues to pay rent at projected levels. To mitigate data challenges, I develop project assumptions from previous projects and test these assumptions with multiple sources familiar with the local development market.

Market Analysis

To effectively evaluate feasibility, one must determine if a development pursued under a certain set of conditions will achieve the objective of the developer. It is the market that provides the “certain set of conditions” (Graaskamp 1970). The characteristics of the subject market will determine the rents that are obtainable for the project, and thus determine project value and developer profit. The market study includes factors such as rents (based on the productive potential of the retail units), the capitalization rates used to

value a property, the cost of land, and the growth in value and expenses that is expected in the neighborhood.

Fully understanding the market offers another benefit to this analysis: outlining the characteristics of the market in which the impacts of policy alternatives are evaluated allows the analysis to be applied to similar markets elsewhere, or adjusted for other markets that differ in systematic ways from Little Saigon. The market study thus enhances the generalizability of this analysis.

I present a summary of the Little Saigon real estate market below. This information is drawn from two real estate and neighborhood economy studies completed in preparation for the Livable South Downtown Initiative, a City-sponsored design study of the neighborhood, and from knowledge of the neighborhood provided by interviewees. Please see Appendix A for the complete market study used in this analysis.

Summary of Market Conditions

The overall picture of the Little Saigon commercial real estate market is one of both opportunities and challenges.

Opportunities

- The Little Saigon neighborhood is a prospering Vietnamese-American community, with strong retail and restaurant districts that serve as agglomeration economies that draw a regional clientele. Revenues from these businesses have increased in recent years.
- Retail rents in the neighborhood range from \$6 to \$20 per square foot, annually. Vacancy rates in the commercial core are relatively low. Retail space is small compared to other neighborhoods, averaging from 600 to 3,000 square feet.
- Additional demand for retail goods is expected as population and employment rates rise. Easy access to surrounding neighborhoods will likely boost business revenues.

Challenges

- Perceptions of higher housing and retail prices have drawn Vietnamese-Americans to other neighborhoods outside of the core downtown, reducing the neighborhood's reputation as a regional attraction.
- There are concerns regarding rising rents in the future, as the Yesler Terrace redevelopment project progresses and the downtown commercial core continues to grow.
- A recent decline in retail revenues in Chinatown may reduce the potential for businesses in Little Saigon to capture spillover from customers traveling to Chinatown.

Defining Affordability

Before evaluating the impacts of policies on affordable commercial real estate projects, a working definition of “affordable commercial real estate” must be provided. I consider four methods for defining affordable commercial real estate.

Percentage of Area Retail Revenues

The residential real estate sector uses household income to define affordable housing, commonly defined as a percentage of Area Median Income (Kalthoff 2012). Using average revenues for an area to define retail rent is more problematic. First, there is a large disparity in revenues between retail sectors. Additionally, using income as a metric for affordable commercial space would allocate affordable space to those businesses with the lowest net revenues relative to aggregate neighborhood revenues. This might have the unintended consequence of funding space for businesses that are on the path to failure because they are unable to capture demand in the local marketplace.

Percentage of Tenant Sales Revenues

When leasing commercial space, a developer seeks tenants that are capable of paying rents at a level determined to be feasible for their business plan. It is in the interests of both the landlord and the tenant to negotiate a lease at rents that avoid creating hardship for the retailer while providing the required return to the developer.

Percent of sales is a common methodology for setting retail rents in other contexts, such as shopping centers, malls, and large mixed-use buildings. Using a percentage of sales revenue aligns the interests of both property owner and retailer: the more productive the unit allows a retailer to be, the more sales revenue that retailer can achieve and thus a greater return to the landlord.

Using a percentage of sales revenue to define affordability for commercial space would involve setting rent at a predetermined percentage of the sales revenues projected for a target tenant. For instance, setting affordable rent for restaurants at 14% of sales revenue would classify all units that did not exceed this threshold as affordable for restaurant tenants. Using a percentage of revenues to define affordability has the advantage of maintaining a base level of affordability, while allowing rents to grow as demand in the market grows. This allows rent levels to adjust based on a tenant's increased business potential as they respond to growing demand and development in the neighborhood.

This approach is not used in this analysis for several reasons. Using a percentage of sales to define rent is less common in predominately ethnic retail markets. Few retailers in Little

Saigon have leases that use a percentage of sales revenues to determine rent. Additionally, using percentage of sales to determine affordable rent is problematic for this model, because data on the actual sales revenues of local businesses was not available and because this financial feasibility analysis uses hypothetical retail tenants, whose projected revenues are undefined. In reality, this model might provide an effective way to determine affordability for local retailers.

Contributory Value of Target User

Another method for determining affordable space considered in this analysis is to develop criteria to identify target tenants for whom affordable space should be provided, and adjust the rents according to their ability to pay.

This methodology is similar to that used by the Pike Place Market Preservation and Development Authority, which classifies businesses eligible to lease space based on a metric aimed at calculating their value to the PDA mission. This metric includes criteria such as owner operation (to prevent chain retailers), local clientele, and size of business (Pike Place Market PDA 2010). This method is also used for the preservation of historically significant buildings, as contribution is classified based on how the building preserves the neighborhoods historic character.

Under this model, criteria would be developed to define local businesses that have high contributory value for preserving the neighborhood's cultural character and vibrant local economy. Businesses meeting these criteria would be eligible for affordable space.

This method is advantageous for district- or property-wide allocation of space because it allows a controlling entity to determine the criteria used to define a business's contribution. However, this model is more difficult to apply in private markets, where individual property owners retain control over which businesses lease their space. Additionally, developing criteria to identify the businesses targeted with affordable space requires an analysis of the types of businesses that would produce the desired benefits to the neighborhood. Such an analysis is outside the scope of this research.

Comparable Market Rent

The final method considered for this analysis assumes that the rents currently offered in the neighborhood to local businesses are affordable; otherwise those tenants would have relocated or closed their businesses. Under this assumption, affordability is defined as the current prevailing rents in the market for similar types of uses and space. The comparable rents must also be adjusted to account for future growth. Rent growth should occur at a

rate that allows businesses to capture new demand without being displaced while also promoting business efficiency.

The measure of growth has a significant impact on the sustainability of affordable rent. Affordable housing metrics commonly use a measure of inflation, such as the Consumer Price Index (CPI). Ideally, for retail space, the level of growth would represent increases in productivity – as a space becomes more productive, the rent should rise. In interviews with affordable housing developers, it was noted that inflation may not be an accurate measure of the productive capacity of a space. Using CPI as a growth factor is often avoided because of the large impact that energy prices have on the Index as well as the tendency for unpredictable fluctuations. Rather, a growth factor that considers increases to occupancy costs, or expenses, accounts for the actual projected costs faced by the landlord and tenant.

This model was suggested by several interviewees and provides a methodology for defining affordability that makes this analysis more feasible. Using a comparable rents model, it is still necessary to define criteria for businesses targeted with affordable commercial space. If affordable commercial space were provided using the definition above, retailers with high profit margins and national credit would be able to take advantage of low rents. Interviews with stakeholders indicated that the preferred criterion for businesses receiving subsidies was local ownership. This was cited as a more important characteristic than business size (number of employees or gross revenues), other ownership characteristics (such as minority-owned businesses), and whether or not the business had multiple locations, because of the benefits that local ownership brings to the local economy.

Thus, this analysis assumes that for a project to classify as “affordable commercial real estate,” a portion of the commercial space must retain the affordability of the current rental market, given a set growth factor, and the tenant must be local. For the base project, two rental rates are considered. The affordable rate is the prevailing rent for small retail spaces in the neighborhood. Another rental rate, termed “Market-rate Retail” represents the highest rent that could potentially be obtained for a new development. This rate is used so that the impacts of affordable rent can be compared to what a developer could achieve if rents are maximized.

Table 1. Market-rate and Affordable Retail Rents

Type of Use	Base Rent	NNN Rent
Market-rate Retail	\$21.00	\$17.10
Affordable Retail #1	\$15.00	\$9.00
Affordable Retail #2	\$15.00	\$8.25

These rents will be used in the proforma analysis, described below, to calculate the projected income to the project.

Financial Proforma Analysis

The primary tool of a financial feasibility analysis is the proforma. Taken from the Latin, “for form,” the proforma provides a static picture of the estimated costs and revenues of a project and quantifies a measure of the project’s economic viability (Miles et al. 2007). The components of a proforma, presented below, are: Program Elements and Specifications; Cost and Income Estimate and Financing; and Value Estimates and Feasibility Metrics.

One way to measure viability is to study a successful development that occurred under current conditions, and evaluate this development under the set of policies that would incentivize affordability. This is the methodology of ex-post analysis. If certain policies can maintain the success of a development at the required rate of return for the investor, while lowering the rent to affordable levels, then these policies are determined to be effective from a financial standpoint.

This analysis measures financial feasibility by constructing a sample development project from the specifications of three successful projects completed during 2005-2010, in the International District neighborhood. The costs, projected income from rent, and operating expenses for each project are compiled into a new base proforma that represents, as much as possible, a typical development in the neighborhood, given current market conditions. This base proforma is then adjusted for the seven policy alternatives (tern intervention scenarios), so that the impacts of each policy on the project’s feasibility can be evaluated. Feasibility will be evaluated along measures most commonly used by developers and investors (Geltner 2007).

Proforma Assumptions

There are four components of the financial proforma used in this analysis. Input assumptions, income proforma, cost proforma, and discounted cash flow. The income and cost proformas project the annual income and construction costs of the project to provide an indication of the equity required and profitability of the project. I partition the residential, market-rate retail, and affordable retail units in order to evaluate the impacts that each of these project components has on financial feasibility. In doing so, I allocate costs of the project to the various uses on a net square foot basis. This allocation plays a significant role in how the uses appear to impact the project. Alternative methods to partition the uses could use the percentage of income generated for each use. For instance, the cost of land

would be allocated based on how much each use contributes to net operating income. This would make the affordable retail units appear significantly more feasible and provides an alternative method for allocating contributory costs.

In the discounted cash flow, I project the operating income and expenses over the holding period of the project (assumed to be ten years), and perform discounted cash flow analysis to determine the internal rate of return, net present value of benefits, and return on cost to the developer.

The value of developing a proforma lies in its accuracy – and a proforma is only as accurate as the inputs. To test the accuracy of the assumptions, all parameters were vetted by both non-profit and private developers as well as professors in the University of Washington's Runstad Center for Real Estate Studies (Department of Urban Design and Planning).

Building the Base Proforma Model

As noted, ex-post analysis evaluates a project that has already been completed, by varying the constraints of the project. In this case, the project is evaluated for the impacts that alternative policies would have on financial feasibility. The research was initially designed to utilize the proforma completed for one project in the Little Saigon neighborhood that has been successfully developed. Using this methodology, an analyst can reduce the rents projected for the retail units designated as affordable and evaluate how this changes the financial feasibility. This scenario is the base proforma. Comparing the base proforma to the proformas impacted by the policy alternatives allows feasibility to be easily compared across alternatives.

The Seattle Chinatown International District Preservation and Development Authority (SCIDpda) provided proforma data for three projects that they developed from 2005-2010. All three projects are currently functioning, mixed-use buildings in the commercial core of the Chinatown neighborhood. The proforma developed for the three SCIDpda projects were compiled into project that captures the common characteristics and typical assumptions. These assumptions were then vetted with interviewees to develop a more accurate representation of a typical, successful development project.

Program elements and specifications

The project's space program – the uses and characteristics of the project's units – must be designed to meet the interests of the target user. Commercial real estate is designed so that tenants can meet their sales revenue projects, and thus, pay rent.

The program elements for the base project utilize the approximate size and uses incorporated in the three SCIDpda projects. Developing building uses and characteristics from these three projects means that the proforma is not entirely accurate for any one building. However, the project thus becomes an approximate estimation for typical successful developments in the area.

Cost and Income Estimates and Financing

As discussed above, it is the productive potential of a property that determines its value. In order to evaluate this potential, I estimate the income from rents and the costs of constructing and operating the project. These estimates form the foundation for the proforma analysis. Because few development projects are completed without leverage, the costs of financing are also included in the proforma.

Income

For a proforma to be a valuable tool for a developer evaluating a project, accurate forecasts for the project's productivity are essential. Rental income forms the foundation for a project's net operating income and thus its capitalized value. There are three types of rents forecasted for the base proforma: residential, market-rate retail, and affordable retail (See Table 2 and Table 3).

Rents for residential units were calculated by analyzing the SCIDpda projects, consulting market studies in the immediate neighborhood and interviewing developers. The average monthly rent for an apartment in the base proforma is \$848.00 or \$1.80 per square foot.

Market-rate retail rents represent the maximum rents that a new development would likely receive in the market. These were calculated by surveying recent market studies in the neighborhood and interviewing private and non-profit developers in the immediate market (Trang D. Tu Consulting 2009). This analysis uses annual per square foot rents of \$21.00 fully serviced.

Affordable retail rents are determined by evaluating rents for the three projects completed by SCIDpda, which included a portion of retail space set aside to retain affordability, and market studies of the prevailing rents in the immediate neighborhood. Retail rents in the neighborhood varied widely, from \$6 to \$24 per square foot per year. For the purposes of this analysis, "affordable" will be defined as annual per square foot rent of \$15.00 fully serviced.

Table 2. Project Rent Roll: Residential

Floor	Type of Use	Base Rent	Multiple Factor	Rent	Total Rentable SF	1 Bdrm (650 SF)	Number of Units	2 Bdrm (780 SF)	Number of Units
2	Apartment	\$19.20	100%	\$19.20	5,491	\$1,040	6	\$1,248	2
3	Apartment	\$19.20	100%	\$19.20	5,491	\$1,040	6	\$1,248	2
4	Apartment	\$19.20	100%	\$19.20	5,491	\$1,040	6	\$1,248	2
5	Apartment	\$19.20	105%	\$20.16	5,491	\$1,092	6	\$1,310	2
6	Apartment	\$19.20	110%	\$21.12	5,491	\$1,144	6	\$1,373	2
Total					27,455	\$5,356	30	\$6,427	10
Avg. Rent (month)						\$800	Avg. Rent (month)	\$960	

Table 3. Project Rent Roll: Retail

Floor	Type of Use	Base Rent	Multiple Factor	NNN Rent	Total Rentable SF	Annual Rent per Unit	Monthly Rent per Unit
1	Market Retail #1	\$21.00	110%	\$17.10	1340	\$30,964	\$2,580
1	Affordable Retail #1	\$15.00	100%	\$9.00	925	\$13,874	\$1,156
1	Affordable Retail #2	\$15.00	100%	\$9.00	844	\$12,667	\$1,056
1	Affordable Retail #3	\$15.00	100%	\$9.00	772	\$11,581	\$965
1	Affordable Retail #4	\$15.00	95%	\$8.25	772	\$11,002	\$917
1	Affordable Retail #5	\$15.00	95%	\$8.25	708	\$10,086	\$840
Total					5,362	\$90,175	\$7,515

Vacancy and Credit Loss

The vacancy and loss of credit expectations were determined using the assumptions developed by SCIDpda, adjusted for information provided by developers. This analysis assumes that 5%, 7%, and 10% of gross income from residential, retail, and parking will be lost due to vacancy, respectively. Vacancy in the neighborhood as a whole is slightly higher than these estimates. However, buildings in the commercial core of Little Saigon have less vacancy, and the reduced rents offered in the affordable units will also lower vacancy rates.

Expenses and Tenant Improvements

The costs of operating the building are also included in the income proforma. This analysis assumes a \$5.00 per square foot annual expense for residential, a \$6.00 per square foot annual expense for retail, and a \$500.00 per space annual expense for parking. A management fee of 6% of adjusted gross income is included. Tenant improvements for retail space are assumed to be \$30, calculated as the average of the less expensive improvements for conventional space and the more expensive improvements for restaurants and unique spaces.

Land & Construction

The primary expense of any development is the cost of land and construction. The land acquisition costs of \$95 per square foot were developed using SCIDpda's previous projects

in the neighborhood, proforma analysis completed by the City of Seattle for the Livable South Downtown Initiative, and interviews with developers (BHC Consultants 2009). Land costs will increase as the neighborhood is developed and property becomes scarcer.

The construction costs for residential and commercial units, tenant improvements, and parking, as well as for site preparation and the services and fees were likewise developed using SCIDpda's previous projects and adjusted based on input from developers with experience developing mixed-use projects in the International District.

Contingency

Because of the complex nature of developing mixed-use buildings, particularly those that rely on public incentives and credits, a contingency fund of 8% of construction costs was included. This cost represents changes to the project's design, financing, and construction.

Financing

Market rate projects are assumed to have access to financing through fully amortizing loans based upon a 25 year term, 5.5% interest rate, and a 1.5% fee. Underwriting criteria are based on a debt service coverage ratio of 1.2 or loan-to-value ratio of 70%, whichever is lower.

Capitalization Rates

There are two capitalization (cap) rates that are important in evaluating feasibility: the "going-in" rate which is used to represent value based on the first year's operating income and the "going-out" rate which forecast how that income stream will be valued when the project is sold in the future. The project is assumed to have an overall going-in market cap rate of 7.1%. This is calculated by blending the residential cap rate of 6.5% and the retail cap rate of 8.5%. The going-out market cap rates reflect the increased development activity projected for the area. The overall going-out cap rate used is 6.6%, representing a weighted average of the 6% for residential and 8% for commercial space.

These cap rates will be used to value the project as a whole as well as to partition the different uses (Residential, Market-rate Retail, and Affordable Retail) to determine their contributory value to the project's value estimation.

The cap rates will also be adjusted for the cost of capital. When a project uses financing, there is a cost to borrow this capital from a lender, in the form of interest. Reducing the cost of this financing, through a tax credit program or tax-exempt loan, thus also lowers the cost of capital, and this should be reflected in the cap rate. For the alternatives that use

lower-than-market rate financing (Alternatives 1,2,3 and 7), the cost of capital, weighted across the financing interest rates and equity costs, will be used to determine value.

Growth

To determine a project's on-going performance, a proforma must consider how productivity will change in the future. Traditionally, proformas include a measure of growth for income and expenses to reflect inflation. It is assumed that income and expenses will increase 2.5% annually.

Table 4. Summary of Proforma Assumptions

Parameter	Assumption
Rents	
Market-rate Retail	\$21.00 SF/yr.
Affordable Retail	\$15.00 SF/yr.
Residential	\$1.80 SF/yr.
Vacancy & Credit Loss	
Retail	7%
Residential	5%
Expenses	
Retail	\$6.00 SF/yr.
Residential	\$5.00 SF/yr.
Management Fee	6% of AGI
Costs	
Land	\$95 SF
Residential Construction	\$135 GSF
Retail Construction	\$140 GSF
Tenant Improvements	\$30 NSF
Parking Construction	\$87.50 GSF
Services & Fees	
WA State Sales Tax	9.5%
A/E and Consultants	5%
Permits	1%
Developer's Fee	4%
Interest Reserve	5%
Marketing & Leasing	2.5%
Other	3.5%
Market Financing	
Interest Rate	5.5%
Term	25 years
Debt Service Capacity Ratio	1.2
Loan-to-Value Ratio	65%
Loan fee	1.5%
Cap Rates: Going-in, Going-out	
Retail	8.5%, 8%
Residential	6.5%, 6%
Weighted	7.1%, 6.6%

Value Estimates and Feasibility Metrics

Feasibility metrics allow developers to demonstrate the overall financial return from a project. However, value is only one decision criteria: other strategic criteria are also used, including profit margin, cash-on-cash and cost returns, the tax benefits that project produces, and project liabilities. Depending on how the development partnership is structured, various players will emphasize different metrics, basing their decision-making on various outcomes.

Table 5. Definition of Feasibility Metrics and Hurdles

Feasibility Metrics	Definition	Hurdle
Profit	Difference between project value and project costs	Positive
Profitability Ratio	Ratio of project value to project costs	Greater than 1
Cash-on-cash return	Ratio of cash flow to equity contribution	5%
Unlevered IRR	Rate at which project income equals project costs	8%
Levered IRR	Rate at which developer cash flows equal equity contribution	14%
NPV	Net present value of before-tax cash flows, discounted at 5%	Positive
Return on Cost	Ratio of net operation income to cost	1.5% greater than capital costs
Return on Equity	Ratio of total return to equity contribution	200%
IRR (Cumulative Benefits)	Rate at which cumulative benefits equal equity contribution	13%
NPV (Cumulative Benefits)	Net present value of cumulative benefits, discounted at 5%	Positive

It is also important to note that while all projects must demonstrate some level of financial feasibility, for developments that are “socially responsible,” certain feasibility metrics are less influential on whether the project is completed. If a developer perceives other indirect benefits from a project, such as goodwill or marketing opportunities, the hurdle rates that the project is required to meet may be lowered or given less weight in feasibility discussion.

Policy Alternatives

To evaluate the impact that each policy alternative has on project feasibility, it is necessary to define the characteristics of the specific tools included in this analysis. I group the policy alternatives under three logical headings: policies that impact project *capital structure and financing*, policies that impact the *income and costs* of the project, and hybrid policy alternatives.

Table 6. Policy Alternatives and Interventions

Category	Policy Alternative	Intervention	Impact
Capital Structure & Financing	Tax Credit	New Markets Tax Credit: Loan and Grant	Reduces financing costs and equity requirement
	Low-Cost Financing	Section 108 Loan	Reduces financing costs
	Special Financing 1	Tax-exempt Bond and NMTC Loan and Grant	Reduces financing costs and equity requirement
	Special Financing 2	Tax-exempt Bond	Reduces financing costs
	Special Financing 3	Tax-exempt & QECCB Bonds	Reduces financing costs
Income and Costs	Tax Increment Financing 1	LCLIP	Rebate lowers costs
	Tax Increment Financing 1	CRFA	Rebate lowers costs
	Commercial Land Trust	Project developed as land trust	Reduces land costs
	Commercial Condominium	Units sold as condos	Increases up-front income
Hybrid	Overlay District	Packages tax-exempt bonds with other policies	Reduces financing costs and lowers project costs and risk

For some policies, I examine the existing alternatives available in the market and use the typical characteristics of these interventions. Ultimately, it is not the exact specifications of each policy that is important to this analysis, but rather how each type of intervention changes the feasibility of the project.

Once a policy alternative is quantified, the base proforma is analyzed for the impact of that policy. The policy alternatives evaluated in this analysis influence the project proforma at different points in the development process. For instance, a commercial land trust will eliminate the cost of acquiring land, reducing the initial project costs. Conversely, low cost financing will reduce the operating expenses in the form of lower debt service payments over the 25 year loan amortization.

This analysis considers a wide variety of policy alternatives, many of which are not mutually exclusive. Rather, several policies can be combined to create a greater impact on a project's financial feasibility. As one interviewee put it, "affordable development is like a lasagna – you have to keep layering the credits, the low-cost financing, the subsidies...until you can finally close that [financial] gap." Some of the policy alternatives are not legally permissible

to use on the same project. The NMTC, for instance, cannot be combined with certain types of other tax credits (such as a Low Income Housing Tax Credit) because this represents a “doubling up” of tax credits.

In the following section, I explore each policy alternative in detail and quantify the ways in which the policy characteristics will impact the project's proforma.

Policies that Impact Capital Structure and Financing

The first three policy alternatives impact the costs of financing and the level of equity contribution required for the project.

Policy Alternative #1: New Markets Tax Credit

Tax credits are a common way for a municipality to incentive certain behaviors. The policy evaluated in this analysis considers the New Markets Tax Credit program. To determine the impact of a NMTC, I examine the typical NMTC allocation to real estate businesses in general and to projects in Little Saigon specifically. Projects developed within the Little Saigon neighborhood qualify for NMTC based on impoverishment in the neighborhood (31% and 32% poverty rate in the two census tracts that the neighborhood lies within) (ACS 2010).

A NMTC contribution will impact the project in two ways: an equity contribution and low-cost financing.

In an analysis conducted by the Urban Institute in 2004 of all projects receiving NMTC allocations, nearly one quarter received equity (grant) contributions. The more common contribution was a loan with better terms than market-rate financing. Seventy-nine percent of projects received financing with below-market interest rates, 62% with lower-than-standard origination fees, 39% with longer than standard amortization period, and 29% with a higher loan-to-value ratio. Most NMTC contributions involved both an equity investment as well as multiple low-cost financing mechanisms (Abravanel et al. 2007).

In 2012, 501 businesses received a total of \$2.3 billion in financing from NMTC syndication. Of this, 71 (18%) went to Mixed-Use or Retail developments, for \$408 million total in contributions. The average contribution for these types of developments was \$5.75 million (Abravanel et al. 2007). This average contribution is comparable, but higher than the NMTC grant contribution for two of the projects analyzed for this research (\$2.6 million NMTC grant for total project costs of \$7.3 million and \$2.2 million NMTC grant for total project costs of \$9.8 million).

Given this research, I calculate the NMTC contribution to the project as:

Table 7. New Market Tax Credit Contribution

Parameter	Assumption
Grant	\$1,000,000
Interest Rate	3%
Origination Fee	1%
Loan-to-Value	40%
Term	25 years

Policy Alternative #2: Low Cost Financing

An examination of the City of Seattle's Section 108 loan program provides a blueprint for defining the contribution of low-cost financing to the project.

For interim borrowing, loans are available at the LIBOR plus 20 basis points. This translates to a current interest rate on interim financing of approximately .51% (.31% LIBOR plus .02%) (Bankrate 2012). The interest rate for permanent financing (take-out loan) is pegged to yields on U.S. Treasury bonds, plus a small basis point spread. Currently, this would translate to a permanent financing interest rate of approximately 3.39% (2.39% treasury yield plus 1% spread) (Treasury 2012).

The following rates are used in the proforma analysis for this policy alternative.

Table 8. Section 108 Financing Terms

Parameter	Assumption
Interim Interest Rate	.51%
Interim Term	30 months
Interim Fee	1%
Permanent Interest Rate	3.39%
Take-out Term	20 years
Take-out Fee	1%
Take-out Loan-to-value	80%

Policy Alternative #3: Special Financing Tools

To evaluate the impacts that tax-exempt financing has on a project's financial feasibility, this alternative applies the advantages of affordable housing program financing, in the form of the Multifamily Housing Bond (to represent tax-exempt financing), with several additional low-cost financing tools to retain commercial affordability.

For this alternative, several scenarios will be presented. In the first scenario, tax-exempt financing will be used for the residential component of the project and the New Markets Tax

Credit will be utilized for the commercial component. Use of both financing programs requires the residential and commercial components of the project to be owned separately, to prevent the use of affordable housing financing to cross-subsidize the commercial component.

The second scenario evaluates the impact of tax-exempt financing for both residential and commercial components of the project. While this alternative is not available for the project as it is designed, it is useful to evaluate the impacts of tax-exempt bonds on financial feasibility, because legislative changes, adjustments to the eligible uses, and development by a non-profit developer may allow the current project to utilize these bonds.

The third scenario considers the use of tax-exempt bonds to finance the residential portion of the project, and QECB financing for a portion of the construction costs attributed to infrastructure.

Program Coordinators at the Washington State Housing Financing Commission interviewed for this analysis identified existing rates and fees for multifamily bonds and an analysis of QECB contributions and rates was conducted to quantify the impact of the low-cost financing alternative.

Table 9. Scenario 1

Tax-Exempt Bond – Residential	
Loan Interest Rate	2.5%
Loan Fee	1%
Take-out Loan-to-value	80%
Term	25 years
NMTC – Commercial	
Equity	\$1,000,000
Interest Rate	3%
Origination Fee	1%
Loan-to-Value	40%
Debt Service Coverage	1.15
Term	25 years

Table 10. Scenario 2

Tax-Exempt Bond – Residential & Commercial	
Loan Interest Rate	2.5%
Loan Fee	1%
Take-out Loan-to-value	80%
Term	25 years

Table 11. Scenario 3

Tax-Exempt Bond – Residential	
Loan Interest Rate	2.5%
Loan Fee	1%
Take-out Loan-to-value	80%
Term	25 years
QECB – Commercial	
Loan Interest Rate	2.5%
Loan Fee	1%
Loan to Cost	10%
Term	25 years

Policies that Impact Income and Costs

The following three policy alternatives impact the costs and income projections of the project, by lowering the cost of land, reducing construction costs, and providing additional up-front income.

Policy Alternative #4: Tax Increment Financing

This analysis considers the impacts of both LCLIP and CRFA tax increment financing models on project feasibility. Under the LCLIP mode, funding will be contributed to the project in the form of a “rebate” for construction costs allocated for infrastructure improvements. Likewise, under the CRFA model, proceeds will be contributed in the form of a rebate for infrastructure improvement costs, but an allocation of the 25% of proceeds set aside for affordable housing will also be allocated to the project in the form of a “CRFA City Contribution.” Under both models, the project’s property taxes will be increased according to projections of assessed property value.

To evaluate the impact of the two TIF alternatives, I created a special assessment tax district in the Little Saigon neighborhood, comprising all property zoned DMR/C in the commercial core (See 0). I compile and analyze the appraised property values of each property from the King County Assessor’s Office database (King County Assessor 2012). The district contains 105 properties, with assessed values ranging from \$71,000 to \$7,654,900. There are 13 properties that are exempt from property taxes (faith-based or non-profit foundations). The total assessed property value in the district is \$91,971,300. The total property tax rate in the neighborhood is \$10.16567 per \$1,000 assessed value.

Figure 1. Little Saigon Tax Increment Finance District



(DPD 2012)

The increment is determined by assessing the increase in property values in the district over 25 years, on both existing buildings and new development. There are thus two factors that form the growth assumptions: growth in property values due to surrounding improvements in the neighborhood and growth directly related to properties in the district being developed to a higher value.

Growth assumptions are based on projected growth in the district, given the projected development trends influenced by infrastructure improvements, Livable South Downtown Initiative zoning changes, and increased development in the surrounding area, particularly the Yesler Terrace Redevelopment Project. Thus, growth is not assumed to be steady through the district's lifetime, but rather reflects the projected impacts on property values of events in the neighborhood. The increment is then discounted at 5% annually.

LCLIP

To evaluate the impact of the LCLIP alternative, 75% of the city and county property portion of the tax increment will be utilized for infrastructure improvements to the neighborhood. LCLIP requires that a participating city accept a minimum threshold of TDR – this analysis assumes that Seattle has accepted this threshold and found a way to place the TDR credits. The total discounted increment from projected increases in property value is \$705,301,736. In the Little Saigon neighborhood, the City receives a .3% tax on property value and the

County receives a .1% tax on property value. Given the projected increase in property value, the resultant LCLIP tax increment to the City and County is \$3,068,702. LCLIP allows a district to capture 75% of these taxes, or a total \$2,301,527 of funding available in the district.

This financing is available for infrastructure improvements in the district and its direct impact on a project level is complicated to accurately predict. A 5% portion of the available financing is allocated to the project in the form of reduced infrastructure costs. Because these infrastructure and amenity improvements make the neighborhood more desirable, boosting demand, the growth in residential rents from the project is also increased under this alternative.

Table 12. LCLIP Allocation

Parameter	Assumption
District Assessed Value	\$91,971,300
Project Property Value	\$912,000
Proportion of Assessed Value of District	.99%
Total Discounted Increment	\$705,301,736
Total City/County Tax	\$3,068,702
Available to district	75%
LCLIP Financing Available	\$2,301,527
Infrastructure Allocation	\$115,076
Rent Growth (after three years)	3.5%
Property Tax Increase	5%

CRFA

This analysis assumes that CRFA is legal and available to cities and that the 25% funding for affordable housing would be applicable to affordable retail space, as is currently under consideration by the TIF Subcommittee. Given the economic and cultural benefits of affordable commercial space, using CRFA to invest these projects is justifiable.

To evaluate the impact of CRFA, I use the TIF district defined above. The tax rate on incremental growth in the district under CRFA is \$10 per \$1,000 of assessed value (assuming the full 1% excess levy is used). The difference between discounted incremental growth and discounted “frozen” assessed value of \$91,971,300 is calculated. The total discounted increment for the neighborhood is the same \$705,301,736 that the LCLIP district produces, because property values are forecasted to grow at similar rates. Assuming a \$10 per \$1,000 assessed value levy, the financing available to the CRFA district is \$7,053,017. Twenty-five percent of this fund is available for affordable development and 75% is available for infrastructure improvements.

This is applied to the base proforma in the following manner. While actual provision of CRFA financing for specific projects would likely be determined by specified allocation procedures, this analysis simplifies this process by assuming a proportional allocation would be provided for project infrastructure costs. For the affordable allocation, the project will receive an allocation of funds proportional to the amount of residential and commercial affordable space that is provided. A brief analysis of levels of affordable space in the neighborhood provides an approximate estimate that the project contributes up to 5% of this space. Assuming that this funding would be provided to development projects including affordable space, rather than existing projects, this analysis assumes that the funding allocation for the project would be 15% of CRFA funding allocated for affordable space. The project also receives an infrastructure contribution of 2%.

Table 13. CRFA Allocation

Parameter	Assumption
District Assessed Value	\$91,971,300
Project Property Value	\$912,000
Proportion of Assessed Value of District	.099%
Total Discounted Increment	\$705,301,736
Total Levy @ 1%	\$7,053,017
Infrastructure Allocation	75%
Infrastructure Funding Available to Project	\$115,076
Affordable Proportion	25%
Affordable Funding Available to Project	\$264,488
Total Funding Available	\$379,564
Rent Growth (after three years)	3.5%
Property Tax Increase	5%

Policy Alternative #5: Commercial Land Trust

There are a variety of ownership and lease structures for commercial land trusts. The impact of a commercial land trust on the subject project's feasibility will be evaluated using the following model (Broad Community Connections 2011):

1. Non-profit Land Trust purchases and maintains ownership of the land.
2. Land Trust ground-leases the development rights to a developer who constructs the building and leases the commercial property to tenants.

Table 14. Commercial Land Trust Contribution

Parameter	Assumption
Land Price	\$0
Lease Payment	\$1 SF/yr

Because the CLT is essentially subsidizing the acquisition costs of land for the developer, a contract requiring that all commercial space remains affordable would likely be included. This model assumes that the CLT will acquire the land and ground-lease the entire parcel to the developer, who in turn leases the space to commercial and residential tenants.

Policy Alternative #6: Commercial Condominium

To determine the prices that condominiums would draw in the market, I conducted an analysis of the commercial units currently for sale in the immediate area and surrounding neighborhood. According to the Commercial Brokers Association, there are only four commercial condominium units on the market in the neighborhoods surrounding Little Saigon, although none in the Little Saigon commercial district itself (CBA 2012). The price for these units is adjusted to account for differences from the subject property.

Table 15. Commercial Condominiums for Sale

Unit	Size	Rent per SF	Adjusted Rent
3333 Rainier Ave	1,148	\$184.44	\$147.55
3334 Rainier Ave	1376	\$253.63	\$202.90
1814 Summit Ave	2,300	\$329.76	\$197.85
1607 Summit Ave	1,658	\$358.87	\$215.32
Average	-	-	\$190.91

A project with commercial condominium units could technically offer a mix of rental and condo space. However, because a non-profit organization will act as master lessor and in order to achieve the design efficiencies of condominium units such as shared spaces, I assume that all retail units will be designed, built, and marketed as commercial condominiums. The retail rent roll will include affordable and market-rate condominiums.

Table 16. Commercial Condominium Rent Roll

Type of Use	Price per SF	Total Rentable SF	Total Price
Market Retail #1	\$190.91	1,340	\$255,905
Affordable Retail #1	\$175.00	900	\$157,500
Affordable Retail #2	\$175.00	872	\$152,600
Affordable Retail #3	\$183.75	775	\$142,406
Affordable Retail #4	\$183.75	775	\$142,406
Affordable Retail #5	\$192.50	700	\$134,750
Total: 5 Units		5,362	\$985,568

Hybrid Policies

The last policy evaluated here considers the impact of both low cost financing and policies that change the costs of a project.

Policy Alternative #7: Cultural Overlay District

To evaluate the impacts of this alternative, I create a cultural overlay district in Little Saigon. This “Little Saigon Cultural Overlay District” would seek to achieve objectives that are consistent with the recommendations of the Cultural Overlay District Advisory Committee. The incentives and regulations of the proposed Little Saigon COD are also consistent with the Livable South Downtown Initiative.

Drawing from the methodology and recommendations of the Cultural Overlay District Advisory Committee, a Little Saigon COD would seek to promote the neighborhood as a cultural institution, destination for heritage tourism, and economically vibrant community (CODAC 2009). The actions to achieve this vision fall under the headings recommended by the CODAC.

Table 17. Little Saigon Cultural Overlay District

Overlay District Parameter	Metric	Assumption
Land Use Incentives		
Density bonus	Floor to Area Ratio	Increase FAR to 5.25
Increase height limit	Building Height	Allow 85' height
Regulatory Relief		
Streamline permitting	Reduce permit delays/ costs	Reduce permit costs to .5%
Technical assistance	Reduce permit costs/ risk	Included above
Financial Incentives		
Tax-exempt financing	Financing costs	Use tax-exempt financing
Property Tax abatement	Operating Expenses	Reduce operating expenses by 20%
Tax credit	After-tax Cash flow	Include a 5% investment tax credit

Additional Policies Considered

Aside from the seven policy alternatives examined above, several additional policies were considered, but ultimately excluded from this analysis.

Partner Ownership & Operating Models

As this analysis has shown, the developer's responsibilities, motivations, and access to financing has a significant impact on the financial feasibility of a project. Non-profit

developers can access tax-exempt and other low-cost financing mechanisms while private developers face lower construction costs and often have access to larger sources of capital. These differences do not end with the development stage of a project. Rather, the property management, marketing, leasing, and tenant relations and assistance functions are also impacted by the partner performing them. The characteristics of tenants also impact the financing and equity available to a project. Buildings that lease to non-profit organizations are eligible for 501(c)3 credits, which are a form of financing available to developers to replace the cash flows given up by lowering rents for these organizations.

The impacts on financial feasibility of these various types of ownership and operating models are not considered in this analysis for several reasons. First, there are virtually unlimited partnerships that can be constructed under these various options and there is no definition of a “typical” alternative that can be generalized to other markets or projects.

Second, these alternatives use partnerships between private and non-profit organizations. While this is becoming more common, it is not yet standardized in the development industry and the impact of these alternatives would largely depend on finding partners willing to face higher transaction costs of the partnership. The various ownership structures become extremely complex with more than two partners. While such a structure may work for one project, its potential to be replicated in other projects is relatively low due to higher transaction costs and high expenses arising from the complexity. Lastly, developers using the 501(c)3 credit program to access additional low-cost financing have encountered difficulty finding non-profit tenants willing to sign leases. This has proved a significant challenge to the program.

Because one of the goals of this research is to provide a toolkit that is replicable and administratively feasible, devising an elaborate and complex ownership model is not explored.

Demand-side Subsidies & Business Assistance

Rather than incentivize developers to lower the rents offered to local businesses, another way to promote affordable commercial space is to help these businesses pay market-rate rents. This could be accomplished by providing subsidies directly to eligible businesses that allow them to pay the rents as they rise across the neighborhood. Business assistance programs can also help a business become more efficient and capture new market demand, boosting revenues. Increased revenue potential will increase the level of rents that a business can pay.

These alternatives are indirectly included in the currently analysis, in the form of Small Business Association loans for businesses seeking to purchase commercial condominiums and the Section 108 loan program which is also offered directly to local businesses for capital expenditures, like furniture and equipment. Business assistance programs could also be included in the Little Saigon Cultural Overlay District model. In fact, several non-profit organizations operate business assistance programs in the neighborhood. These assistance programs are not mutually exclusive to the alternatives examined above, and will likely be implemented independent of them. There are also numerous ways to provide this assistance and evaluating these programs and quantifying their impacts on a given business' ability to pay market-rate rent is outside the scope of this research.

Another commonly cited business assistance model in real estate is the business incubator. Typically operated by a non-profit organization, a business incubator provides small, flexible, and shared space for entrepreneurs to start and grow their businesses. The rents in business incubators are extremely low, or sometimes, completely subsidized. While this model is becoming more popular across the United States, I do not consider it here because the model is potentially difficult for private developers to pursue and it likely does not represent a viable option for providing large amounts of commercial space across a neighborhood.

CHAPTER 4: RESULTS

The primary aim of this research is to evaluate commercial real estate development that preserves affordability for local businesses in the Little Saigon neighborhood. Financial feasibility analysis is the primary method for determining if a project is viable. Following the methodology of traditional feasibility analysis, this research quantifies and evaluates the impacts of a variety of policy alternatives used to promote the development of commercial space that preserves a diverse blend of local businesses, enhances the community's cultural character, and grows the local economy.

I conduct financial feasibility analyses on a typical, successful development project in Little Saigon and evaluate the impacts of the policy alternatives defined above. For each policy alternative, income and cost proformas are developed that forecast the net operating income, value, and cost of the project. The sources of fund, including both loans and equity contributions are also included. Finally, measures of feasibility are presented so that the impacts of each alternative can be evaluated. For the base proforma, the operating model is also presented. This model is used to calculate the cumulative benefits and internal rate of return of the project. The operating models for proformas using policy alternatives are presented in Appendix B.

Base Project

The base proforma represents the scenario in which a private developer undertakes the project in the current market, with not policy alternatives applied. Using this as a base, the impact of the various policy alternatives can be understood more clearly. The base project uses the following financing and equity contribution (Table 18).

Table 18. Capital Structure for Base Project

Capital Contribution	Amount	Percentage of Value	Cost of Capital
Market-rate Loan	\$4,204,714	70%	7.4%
Equity	\$5,294,992	30%	6.8%
Total Project (Weighted)	\$9,499,707	100%	7.2%

The base proforma is not financially feasible by any metric. This demonstrates the need for incentives or subsidies for a project involving affordable commercial space to produce a financially feasible outcome. By revealing the gap between project value and costs, this

analysis provides an indication of the magnitude of policy intervention necessary to make affordable commercial real estate development feasible.

The total project cost is nearly \$9.5 million. Yet a bank loan, based on loan to value, provides only \$3.9 million, leaving over \$5.5 million as the required equity contribution.

The capitalized value of the project is \$5,694,244, which represents a \$3,797,806 proforma loss on the project. Partitioning the uses of the project indicates that the affordable commercial space results in a loss of nearly \$1.2 million. The capitalization rate has a large influence on this loss. Adjusting the overall cap rate just 1% results in a \$1 million change in profit. Regardless of profit, however, the equity contribution does not change significantly.

Note that all components of the project represent a proforma loss: residential (loss of \$2.5 million), market-rate commercial (loss of \$300,000), and affordable commercial (loss of \$1.2 million). Thus, while reducing rental income from the affordable retail space negatively impacts the project's feasibility, even if rents were high enough to close this gap, the project would still represent a loss.

Developer returns from the project fall well short of the hurdle rates. The cash-on-cash return is only 2.1%, the levered IRR is only 1.3%, and the NPV represents a loss of \$1,418,145. The IRR on cumulative benefits to the developer is 1.7% and the NPV of these benefits also represents a loss, of \$1.3 million. In short, the base project would not be feasible for a developer to pursue.

Figure 2. Base Project Operating Model

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,492,051)						
Equity Contribution	(\$5,506,080)						
Total Income		\$657,825	\$673,382		\$793,470	\$812,345	\$831,682
Less: Vacancy		(\$34,900)	(\$37,224)		(\$43,724)	(\$44,745)	(\$45,791)
Adjusted Gross Income		\$622,924	\$636,159		\$749,746	\$767,600	\$785,891
Less: Expenses		(\$212,464)	(\$217,636)		(\$258,313)	(\$264,718)	(\$271,282)
Net Operating Income (NOI)		\$410,460	\$418,523		\$491,432	\$502,882	\$514,609
Less: Debt Service		(\$293,728)	(\$293,728)		(\$293,728)	(\$293,728)	
Before Tax Cash Flow		\$116,732	\$124,795		\$197,704	\$209,154	
Leveraged Cash Flow	(\$5,506,080)	\$116,732	\$124,795		\$197,704	\$4,780,833	
After Tax Cash Flow		(\$118,863)	(\$106,490)		\$4,220	\$22,355	
Net Benefit	(\$5,506,080)	\$158,334	\$162,067		\$196,227	\$4,773,009	
Cumulative Benefit	(\$5,506,080)	(\$5,347,746)	(\$5,185,679)		(\$3,916,210)	\$856,799	

Figure 3. Financial Feasibility of Base Project

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,735	\$657,825
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,813)	(\$34,900)
Adjusted Gross Income	\$515,803	\$34,200	\$72,922	\$622,924
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,325)	(\$212,464)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,597	\$410,460
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	7.1%	7.7%	7.7%	7.2%
VALUE	\$4,889,745	\$276,109	\$539,642	\$5,694,244

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,519,022	\$120,619	\$358,616	\$1,998,256
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$111,203	\$7,887	\$20,419	\$139,509
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$7,197,042	\$574,562	\$1,720,446	\$9,492,051

FEASIBILITY METRICS	
Profit	(\$3,797,806)
Profitability Ratio	0.60
Cash-on-cash return	2.1%
Unlevered IRR	2.0%
Levered IRR	1.3%
NPV	(\$1,418,145)
Return on Cost	4.3%
Return on Equity	89%
IRR (Cumulative Benefits)	1.7%
NPV (Cumulative Benefits)	(\$1,267,883)

SOURCES OF FUNDS	
Project Cost	\$9,492,051
Bank Loan	\$3,985,971
NMTC:	\$0
NMTC Loan:	\$0
Section 108:	\$0
Tax-exempt:	\$0
TIF:	\$0
CASH IN	\$5,506,080

Policies that Impact Capital Structure and Financing

The following three sections (five scenarios) evaluate the impacts of policies that change the financing costs and equity contributions to the project.

Policy Alternative #1: New Markets Tax Credit

In this model, the financial feasibility of the base project is evaluated with an allocation from the New Markets Tax Credit program. The NMTC contributions, in the form of a direct equity contribution and a low-cost loan, change the capital structure of the project (Table 19).

Table 19. Capital Structure under NMTC

Capital Contribution	Amount	Percentage of Value	Cost of Capital ⁴
Market-rate Loan	\$2,936,651	42%	7.4%
NMTC Loan	\$2,796,810	40%	5.7%
Equity	\$2,721,864	7.3%	6.8%
NMTC Grant	\$1,000,000	10.7%	0%
Total Project (Weighted)	\$9,455,325	100%	5.9%

Using a grant contribution of \$1 million and a low interest rate loan of \$2.8 million from the NMTC program, the project also uses a market-rate loan of \$2.9 million. A \$2.7 million equity contribution is required. Under this alternative, the net operating income from the project is no different than the base model, and project costs vary only slightly, in the amount of financing costs from fees. Thus, the project projects a proforma loss of \$2,491,267 million.

The affordable retail space represents a loss of slightly over \$1,000,000. If the equity contribution is applied directly to this component, it would nearly completely close the profitability gap. The project's other components still represent a proforma loss.

While NMTC does not appear to make the project feasible, it does impact feasibility relative to the base proforma in several ways. Levered IRR is higher, at 4.7%, a result of the reduced equity contribution and the fact that cash flows are only impacted by the partial replacement of debt service from a market-rate loan with that of a low-cost loan.

Considering the cumulative benefits of cash flow, tax consequences, and resale proceeds, the NMTC program positively impacts a developer's position. The internal rate of return of

⁴ The weighted cost of capital is calculated by weighting the cost of capital for each financing or equity source by the percentage of value that each sources comprises, and adding these costs. The cost of financing is the mortgage coefficient for each loan; the cost of equity is the market cap rate; there is no cost of capital for the NMTC grant contribution.

cumulative benefits is 5.6% (rather than the 1.7% under the base model) and the NPV of cumulative benefits is a gain of \$142,196, or nearly \$1.3 million higher than the base project.

Figure 4. Financial Feasibility of NMTC

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Weighted Cost of Capital	5.8%	6.0%	6.0%	5.9%
VALUE	\$5,945,373	\$355,175	\$694,372	\$6,992,025

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,489,746	\$118,543	\$353,241	\$1,961,530
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$81,927	\$5,811	\$15,045	\$102,783
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$7,167,767	\$572,486	\$1,715,072	\$9,455,325

FEASIBILITY METRICS	
Profit	(\$2,491,267)
Profitability Ratio	0.74
Cash-on-cash return	1.3%
Unlevered IRR	3.6%
Levered IRR	4.7%
NPV	(\$61,417)
Return on Cost	4.3%
Return on Equity	125%
IRR (Cumulative Benefits)	5.6%
NPV (Cumulative Benefits)	\$142,196

SOURCES OF FUNDS	
Project Cost	\$9,455,325
Bank Loan	\$2,936,651
NMTC:	\$1,000,000
NMTC Loan:	\$2,796,810
Section 108	\$0
Tax-exempt:	\$0
TIF:	\$0
CASH IN	\$2,721,864

Policy Alternative #2: Low Cost Financing

In this model, the impact of Section 108 financing is evaluated. Section 108 financing contributes a \$4.7 million loan to the project, nearly completely replacing market-rate financing; a relatively small market-rate loan of \$826,236 is applied to the project. The equity contribution required is \$3.9 million.

Table 20. Capital Structure under Section 108

Capital Contribution	Amount	Percentage of Value	Cost of Capital
Market-rate Loan	\$826,236	14%	7.4%
Section 108 Loan	\$4,721,347	80%	6.9%
Equity	\$3,899,386	6%	6.8%
Total Project (Weighted)	\$9,456,969	100%	7%

Even though the Section 108 loan significantly reduces interest paid on the loan, the short maximum term for these loans (20 years), limits its impact on the project.

The project using a Section 108 loan represents a loss of \$3,545,284. Likewise, the feasibility metrics do not meet the hurdle rates required by a typical developer. The cash-on-cash return is actually lower than the base project, because of the greater debt service payment. Even though the Section 108 loan has a lower interest rate, the 20 year term and larger loan amount combine to require higher debt service payments. This diminishes the cash flow to the developer. The Section 108 loan would be more advantageous if the repayment period was extended, which would lower debt service obligations.

The 2.4% levered IRR under the Section 108 model is significantly lower than the 14% hurdle and both NPV of the project as well as NPV of the developer's cumulative benefits are negative.

Figure 5. Financial Feasibility of Low Cost Financing

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	6.9%	7.1%	7.1%	7.0%
VALUE	\$5,011,837	\$301,671	\$589,771	\$5,901,684

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,483,672	\$118,015	\$351,487	\$1,953,174
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$75,853	\$5,283	\$13,291	\$94,427
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$7,161,693	\$571,958	\$1,713,317	\$9,446,969

FEASIBILITY METRICS	
Profit	(\$3,545,284)
Profitability Ratio	0.62
Cash-on-cash return	0.6%
Unlevered IRR	2.3%
Levered IRR	2.4%
NPV	(\$793,426)
Return on Cost	4.3%
Return on Equity	97%
IRR (Cumulative Benefits)	2.6%
NPV (Cumulative Benefits)	(\$709,673)

SOURCES OF FUNDS	
Project Cost	\$9,446,969
Bank Loan	\$826,236
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$4,721,347
Tax-exempt:	\$0
TIF:	\$0
CASH IN	\$3,899,386

Policy Alternative #3: Special Financing Tools

In this model, three scenarios using special financing tools are applied to the base project: Tax-exempt bonds & NMTC, Tax-exempt bonds for the whole project, and Tax-exempt bonds and a QECB loan for infrastructure costs. Because of the large amount of financing available from these programs, all three scenarios avoid using market-rate debt. The three scenarios all use Multifamily Housing Bonds for the value of the residential component of the project and thus allow a comparison of the impacts of NMTC, Tax-exempt bonds for commercial, and QECB for infrastructure costs.

These financing sources are legally restricted to certain uses. Thus, the tax-exempt bonds for Multifamily are applied solely to residential portions of the project (residential value is used to determine loan amount) and the NMTC is allocated to the commercial portion (commercial value is used to determine loan amount). The QECB is allocated as a percentage of construction costs.

Table 21. Capital Structure under Special Financing Tools

Scenario	Capital Contribution	Amount	Percentage of Value	Cost of Capital
1: Tax-Exempt & NMTC	Tax-exempt Loan	\$5,562,405	68%	5.4%
	NMTC Loan	\$473,973	6%	5.7%
	Equity	\$2,427,412	15%	6.8%
	NMTC Grant	\$1,000,000	11%	0%
	Total Project (Weighted)	\$9,463,790	100%	4.9%
2: Tax-Exempt	Tax-exempt Loan	\$5,788,037	80%	5.4%
	Equity	\$3,680,266	20%	6.8%
	Total Project (Weighted)	\$9,468,303	100%	5.7%
3: Tax-Exempt & QECB	Tax-exempt Loan	\$4,961,967	80%	5.4%
	QECB Loan	\$609,425	2%	5.4%
	Equity	\$3,880,389	18%	6.8%
	Total Project (Weighted)	\$9,456,969	100%	4.9%

The first scenario has the largest impact on project feasibility, due to the NMTC equity contribution and low-cost financing from Multifamily (for residential value) and NMTC (for commercial value). Under this scenario, an equity contribution of \$2.4 million is required.

Similarly to the NMTC model, the affordable retail portion of the project represents a loss of slightly less than \$1,000,000. Applying the NMTC directly to this would close the gap between value and cost of the affordable commercial space.

This scenario achieves a positive NPV, of \$625,163 and the 8% IRR is the highest of any of the alternatives. Note that the return of cost, at 4.3% comes close to the weighted cost of capital of 4.9% (Table 21 above).

Figure 6. Scenario 1: Financial Feasibility of Multifamily Bond and NMTC

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	5.0%	5.3%	5.3%	5.1%
VALUE	\$6,953,006	\$400,990	\$783,942	\$8,127,461

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,497,185	\$118,956	\$353,855	\$1,969,996
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$89,366	\$6,224	\$15,658	\$111,248
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$7,175,205	\$572,900	\$1,715,685	\$9,463,790

FEASIBILITY METRICS	
Profit	(\$1,336,329)
Profitability Ratio	0.86
Cash-on-cash return	3.5%
Unlevered IRR	4.8%
Levered IRR	8.0%
NPV	\$625,163
Return on Cost	4.3%
Return on Equity	142%
IRR (Cumulative Benefits)	7.2%
NPV (Cumulative Benefits)	\$448,578

SOURCES OF FUNDS	
Project Cost	\$9,463,790
Bank Loan	\$0
NMTC:	\$1,000,000
NMTC Loan:	\$473,973
Section 108	\$0
Tax-exempt:	\$5,562,405
TIF:	\$0
CASH IN	\$2,427,412

The latter two scenarios are relatively similar, as they both provide low-cost financing for the project. Using a QECB for infrastructure costs slightly reduces the equity contribution required, but using tax-exempt bonds reduces debt service payments, which increases cash returns, IRR, and NPV. These scenarios produce return on cost projections that approach the hurdle rate, because of the low weighted cost of capital of low-interest loans.

Figure 7. Scenario 2: Financial Feasibility of Multifamily Bond applied to Project

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	5.6%	6.0%	6.0%	5.7%
VALUE	\$6,199,335	\$354,326	\$692,713	\$7,235,046

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,500,810	\$119,209	\$354,490	\$1,974,508
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$92,991	\$6,477	\$16,294	\$115,761
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$7,178,830	\$573,152	\$1,716,320	\$9,468,303

FEASIBILITY METRICS	
Profit	(\$2,233,257)
Profitability Ratio	0.76
Cash-on-cash return	2.7%
Unlevered IRR	3.8%
Levered IRR	3.8%
NPV	(\$339,832)
Return on Cost	4.3%
Return on Equity	100%
IRR (Cumulative Benefits)	3.0%
NPV (Cumulative Benefits)	(\$541,563)

SOURCES OF FUNDS	
Project Cost	\$9,468,303
Bank Loan	\$0
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$0
Tax-exempt:	\$5,788,037
TIF:	\$0
CASH IN	\$3,680,266

Figure 8. Scenario 3: Financial Feasibility of Multifamily and QECB Bonds

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	5.6%	5.9%	5.9%	5.6%
VALUE	\$6,224,127	\$358,042	\$699,977	\$7,272,217

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,487,816	\$118,304	\$352,213	\$1,958,333
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$79,997	\$5,572	\$14,017	\$99,586
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$7,165,837	\$572,247	\$1,714,043	\$9,452,128

FEASIBILITY METRICS	
Profit	(\$2,186,005)
Profitability Ratio	0.77
Cash-on-cash return	2.8%
Unlevered IRR	3.9%
Levered IRR	3.6%
NPV	(\$391,302)
Return on Cost	4.3%
Return on Equity	99%
IRR (Cumulative Benefits)	2.9%
NPV (Cumulative Benefits)	(\$599,354)

SOURCES OF FUNDS	
Project Cost	\$9,452,128
Bank Loan	\$0
NMTC:	\$0
QECB Loan:	\$609,425
Section 108	\$0
Tax-exempt:	\$4,979,301
TIF:	\$0
CASH IN	\$3,863,401

Policies that Impact Income and Cost

The following three policies alternatives impact the costs and income projections of the project, by lowering the cost of land, reducing construction costs, and providing additional up-front income.

Policy Alternative #4: Tax Increment Financing

Alternative 4 evaluates the impacts of the two Tax Increment Financing tools on project feasibility. By rebating a portion of project costs, TIF helps to close the gap between value and costs, which reduces the equity requirement. Of the two models, CRFA has the larger impact because a CRFA district collects a greater amount of property taxes than a LCLIP district.

LCLIP Financing Model

Applying an LCLIP district in the Little Saigon neighborhood captures future property tax revenues from the City of Seattle and King County. These are applied to the project as infrastructure cost savings, in the “hard costs” line item of the Cost Proforma.

These cost savings have relatively little impact to the project however, as they represent savings of only 2% of construction costs. While TIF

The required equity contribution remains over \$5 million and both project NPV and NPV of cumulative benefits are negative. None of the return metrics are better under LCLIP than other policy alternatives. For LCLIP to have a greater impact, the capture of additional taxes, to include in the increment is necessary.

Figure 9. Financial Feasibility of LCLIP Tax Increment Financing

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	7.1%	7.7%	7.7%	7.2%
VALUE	\$4,889,745	\$276,109	\$539,797	\$5,694,410

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,577,441	\$331,255	\$1,070,482	\$5,979,178
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,507,324	\$108,920	\$346,919	\$1,963,162
Sales Tax	\$434,857	\$31,469	\$101,696	\$568,022
A/E	\$228,872	\$16,563	\$53,524	\$298,959
Permits	\$45,774	\$3,313	\$10,705	\$59,792
Developer's Fee	\$183,098	\$13,250	\$42,819	\$239,167
Interest Reserve	\$228,872	\$16,563	\$53,524	\$298,959
Mktg & Lease	\$114,436	\$8,281	\$26,762	\$149,479
Other	\$160,210	\$11,594	\$37,467	\$209,271
Financing	\$111,204	\$7,887	\$20,422	\$139,513
Contingency	\$366,195	\$26,500	\$85,639	\$478,334
PROJECT COST	\$7,143,917	\$521,436	\$1,667,321	\$9,332,675

FEASIBILITY METRICS	
Profit	(\$3,638,264)
Profitability Ratio	0.61
Cash-on-cash return	2.2%
Unlevered IRR	3.3%
Levered IRR	3.5%
NPV	(\$624,245)
Return on Cost	4.4%
Return on Equity	106%
IRR (Cumulative Benefits)	3.7%
NPV (Cumulative Benefits)	(\$532,679)

SOURCES OF FUNDS	
Project Cost	\$9,332,675
Bank Loan	\$3,986,087
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$0
Tax-exempt:	\$0
TIF:	\$0
CASH IN	\$5,346,587

CRFA Financing Model

Assuming that the State Legislature has approved the use of CRFA, such a district in the Little Saigon neighborhood would lower project costs. Under this model, project costs are reduced to \$8.9 million, resulting in a proforma loss of \$3.3 million. However, nearly \$5 million in equity contribution is required, which prevent cash-on-cash and IRR from meeting hurdle rates. Both NPV calculations are negative, but relatively close to zero (NPV of Cumulative Benefits is -\$202,851, or 3.8% of project value).

Compared to an LCLIP district, CRFA has a greater impact on project finances. All feasibility metrics are improved under the CRFA model because of the greater cost savings. While the proforma profit on affordable commercial remains a loss of nearly \$1 million, this gap is less than in other alternatives because of the CRFA allocation targeting affordable development.

Similar to the LCLIP model, for the CRFA to significantly improve a project's feasibility, a larger cost savings is necessary, representing either greater tax revenue capture in the increment, or a larger percentage allocation to the project.

Figure 10. Financial Feasibility of CRFA Tax Increment Financing

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$212,465)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$410,472
Percent of NOI	84.7%	5.2%	10.1%	100.0%
Capitalization Rate	7.1%	7.7%	7.7%	7.2%
VALUE	\$4,889,745	\$276,109	\$539,797	\$5,694,410

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,445,197	\$331,255	\$938,238	\$5,714,690
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,466,989	\$108,920	\$306,584	\$1,882,493
Sales Tax	\$422,294	\$31,469	\$89,133	\$542,896
A/E	\$222,260	\$16,563	\$46,912	\$285,734
Permits	\$44,452	\$3,313	\$9,382	\$57,147
Developer's Fee	\$177,808	\$13,250	\$37,530	\$228,588
Interest Reserve	\$222,260	\$16,563	\$46,912	\$285,734
Mktg & Lease	\$111,130	\$8,281	\$23,456	\$142,867
Other	\$155,582	\$11,594	\$32,838	\$200,014
Financing	\$111,204	\$7,887	\$20,422	\$139,513
Contingency	\$355,616	\$26,500	\$75,059	\$457,175
PROJECT COST	\$6,960,759	\$521,436	\$1,484,163	\$8,966,358

FEASIBILITY METRICS	
Profit	(\$3,271,948)
Profitability Ratio	0.64
Cash-on-cash return	2.3%
Unlevered IRR	3.8%
Levered IRR	4.3%
NPV	(\$275,372)
Return on Cost	4.6%
Return on Equity	113%
IRR (Cumulative Benefits)	4.4%
NPV (Cumulative Benefits)	(\$218,093)

SOURCES OF FUNDS	
Project Cost	\$8,966,358
Bank Loan	\$3,986,087
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$0
Tax-exempt:	\$0
TIF:	\$0
CASH IN	\$4,980,271

Policy Alternative #5: Commercial Land Trust

This alternative considers the impact that a commercial land trust (CLT) model has on financial feasibility. The CLT essentially eliminates the cost of land from the development equation in exchange for a long-term ground lease payment.

Removing land from the cost proforma results in a savings of \$912,000. The lease payment is reflected as a \$32,000 expense in the Income proforma. Proforma profit is a loss of \$3.2 million and the equity contribution required is \$4.9 million. A CLT model produces very low return projects, including a cash-on-cash return of 2.2%, a levered IRR of 1.9% and a IRR of cumulative benefits of 2.4%.

Removing the cost of land has an impact on proforma profit, but doing so adds an expense in the Income Proforma and Operating model, which reduces cash flows from the project. Thus, this model might be appealing to a developer who seeks to limit capital expenditures and can forgo cash returns if the required equity contribution is reduced. This model might also be appealing to a non-profit developer, who can forgo higher return hurdle rates.

Figure 11. Financial Feasibility of Commercial Land Trust Model

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$37,139	\$77,749	\$657,838
LESS: Vacancy	(\$27,148)	(\$2,940)	(\$4,814)	(\$34,901)
Adjusted Gross Income	\$515,803	\$34,200	\$72,935	\$622,937
LESS: Expenses	(\$168,223)	(\$12,916)	(\$31,326)	(\$245,282)
Net Operating Income (NOI)	\$347,579	\$21,283	\$41,609	\$377,655
Percent of NOI	92.0%	5.6%	11.0%	100.0%
Capitalization Rate	7.1%	7.7%	7.7%	7.2%
VALUE	\$4,889,745	\$276,109	\$539,797	\$5,239,149

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$0	\$0	\$0	\$0
Construction	\$4,615,800	\$369,614	\$1,108,841	\$6,094,254
Hard Costs	\$4,615,800	\$329,400	\$988,200	\$5,933,400
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,514,180	\$120,237	\$357,470	\$1,991,887
Sales Tax	\$438,501	\$35,113	\$105,340	\$578,954
A/E	\$230,790	\$18,481	\$55,442	\$304,713
Permits	\$46,158	\$3,696	\$11,088	\$60,943
Developer's Fee	\$184,632	\$14,785	\$44,354	\$243,770
Interest Reserve	\$230,790	\$18,481	\$55,442	\$304,713
Mktg & Lease	\$115,395	\$9,240	\$27,721	\$152,356
Other	\$161,553	\$12,936	\$38,809	\$213,299
Financing	\$106,361	\$7,504	\$19,274	\$133,139
Contingency	\$369,264	\$29,569	\$88,707	\$487,540
PROJECT COST	\$6,499,244	\$519,419	\$1,555,018	\$8,573,681

FEASIBILITY METRICS	
Profit	(\$3,329,752)
Profitability Ratio	0.61
Cash-on-cash return	2.2%
Unlevered IRR	2.4%
Levered IRR	1.9%
NPV	(\$1,092,742)
Return on Cost	4.4%
Return on Equity	95%
IRR (Cumulative Benefits)	2.4%
NPV (Cumulative Benefits)	(\$896,032)

SOURCES OF FUNDS	
Project Cost	\$8,573,681
Bank Loan	\$3,667,404
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$0
Tax-exempt:	\$0
TIF:	\$0
CASH IN	\$4,906,277

Policy Alternative #6: Commercial Condominium

In the Commercial Condominium model, commercial rents are replaced by a contribution to the project from condo sales. Using the comparable properties in surrounding neighborhoods, a total contribution of \$985,568 is included in the proforma. The expenses for the commercial are eliminated. Additionally, commercial construction costs are reduced by 5% due to shared restrooms and common spaces.

Eliminating income from retail rents lowers the NOI and thus value of the project to \$5 million. Compared to the project costs of \$9.4 million, the loss to the project is \$4.4 million.

Considering the affordable commercial space, this gap is significant, indicating a proforma loss of \$1.5 million. The sale of condos partially closes this disparity, but nearly \$1 million gap remains. This is due to the significant reduction in value caused by reduced income to the commercial spaces.

The gap between value and cost lowers the loan amount available and requires a larger equity contribution. The maximum loan available to the project based on its value is \$3.5 million. After the contribution of condominium sales, the equity contribution required is over \$4.9 million.

This relatively high equity contribution and the reduced cash flows lower the return metrics of the project: the cash-on-cash return is 2.1%, the IRR is 1.6%, and the return on cost is 3.9%, or 300 basis points below the weighted cost of capital. The NPV metrics are both negative and the IRR on cumulative benefits is 2.2%.

Figure 12. Financial Feasibility of Commercial Condominium Project

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$542,950	\$6,175	\$18,525	\$567,650
LESS: Vacancy	(\$27,148)	(\$618)	(\$1,853)	(\$29,618)
Adjusted Gross Income	\$515,803	\$5,558	\$16,673	\$538,033
LESS: Expenses	(\$168,223)	(\$3,155)	(\$3,822)	(\$175,200)
Net Operating Income (NOI)	\$347,579	\$2,403	\$12,851	\$362,833
Percent of NOI	95.8%	0.7%	3.5%	100.0%
Capitalization Rate	7.1%	7.7%	7.7%	7.2%
VALUE	\$4,889,745	\$31,168	\$166,711	\$5,033,515

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$692,957	\$54,761	\$164,282	\$912,000
Construction	\$4,615,800	\$359,924	\$1,079,771	\$6,055,494
Hard Costs	\$4,615,800	\$319,710	\$959,130	\$5,894,640
T.I.		\$40,214	\$120,641	\$160,854
Services & Fees	\$1,511,993	\$114,358	\$343,896	\$1,970,247
Sales Tax	\$438,501	\$34,193	\$102,578	\$575,272
A/E	\$230,790	\$17,996	\$53,989	\$302,775
Permits	\$46,158	\$3,599	\$10,798	\$60,555
Developer's Fee	\$184,632	\$14,397	\$43,191	\$242,220
Interest Reserve	\$230,790	\$17,996	\$53,989	\$302,775
Mktg & Lease	\$115,395	\$8,998	\$26,994	\$151,387
Other	\$161,553	\$12,597	\$37,792	\$211,942
Financing	\$104,174	\$4,581	\$14,566	\$123,321
Contingency	\$369,264	\$28,794	\$86,382	\$484,440
PROJECT COST	\$7,190,014	\$557,836	\$1,674,330	\$9,422,180

FEASIBILITY METRICS	
Profit	(\$4,388,665)
Profitability Ratio	0.53
Cash-on-cash return	2.1%
Unlevered IRR	0.8%
Levered IRR	1.6%
NPV	(\$1,183,877)
Return on Cost	3.9%
Return on Equity	93%
IRR (Cumulative Benefits)	2.2%
NPV (Cumulative Benefits)	(\$975,403)

SOURCES OF FUNDS	
Project Cost	\$9,422,180
Bank Loan	\$3,523,461
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$0
Tax-exempt:	\$0
Condo Sales:	\$985,568
CASH IN	\$4,913,152

Hybrid Policies

The last policy evaluated here considers the impact of both low cost financing and policies that change the costs of a project. This policy packages several interventions that impact the project in varying ways.

Policy Alternative #7: Cultural Overlay District

This alternative considers various land use and regulatory actions to promote affordable commercial development within the overlay district. The building envelope is increased from 42,510 to 51,630, resulting in an addition of 1,000 net square feet of retail and 6,000 net square feet of residential. Building height is increased to 85 feet and an additional floor is included in the project plans. Permitting costs are reduced by 50% because of streamlined regulations and permitting assistance programs. A property tax abatement of 20% of retail property taxes appears as an expense savings.

Lastly, the project captures tax-exempt financing and the developer receives an investment tax credit of 5% of taxable income, which directly increases after tax cash flows.

Table 22. Capital Structure under Section 108

Capital Contribution	Amount	Percentage of Value	Cost of Capital
Tax-exempt Loan	\$7,211,187	80%	5.4%
Equity	\$3,941,576	20%	6.8%
Total Project (Weighted)	\$9,456,969	100%	5.7%

The increase in building envelope raises both the value and costs of the project and closes the profit gap signification compared to other alternatives. Under the COD, the project has a net operating income of \$511,398 and is valued at \$9 million. The costs of construction also increase, although financing and permitting costs decline. The total project costs are \$11.1 million, representing a \$2.1 million proforma loss.

The project uses tax-exempt financing to lower the borrowing costs and raise the loan amount available, but receives no other equity contribution. The required equity contribution is \$3.9 million.

Nearly all feasibility metrics improve under the COD model, demonstrating the potency of combining policy interventions. Cash-on-cash return remains low, due to the significant equity contribution, but levered IRR is relatively high, at 5.6%. Both project NPV and NPV of cumulative benefits are positive. By impacting the project at several leverage points

(reducing costs, lower financing costs, reducing weighted cost of capital, and allowing more dense development), the COD has a significant impact on project feasibility.

Figure 13. Financial Feasibility of Development in Cultural Overlay District

INCOME PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Gross Rental Income	\$670,703	\$44,425	\$91,667	\$806,795
LESS: Vacancy	(\$33,535)	(\$3,486)	(\$5,510)	(\$42,531)
Adjusted Gross Income	\$637,168	\$40,939	\$86,158	\$764,264
LESS: Expenses	(\$207,805)	(\$13,226)	(\$31,835)	(\$252,866)
Net Operating Income (NOI)	\$429,363	\$27,713	\$54,322	\$511,398
Percent of NOI	84.0%	5.4%	10.6%	100.0%
Capitalization Rate	5.6%	6.0%	6.0%	5.7%
VALUE	\$7,658,003	\$461,366	\$904,360	\$9,013,983

COST PROFORMA				
	Residential	Market-rate Commercial	Affordable Commercial	TOTAL
Land	\$704,800	\$51,800	\$155,400	\$912,000
Construction	\$5,646,163	\$431,185	\$1,293,554	\$7,370,902
Hard Costs	\$5,646,163	\$381,509	\$1,144,528	\$7,172,200
T.I.		\$49,676	\$149,027	\$198,702
Services & Fees	\$1,865,850	\$141,455	\$420,301	\$2,427,606
Sales Tax	\$536,385	\$40,963	\$122,888	\$700,236
A/E	\$282,308	\$21,559	\$64,678	\$368,545
Permits	\$28,231	\$2,156	\$6,468	\$36,855
Developer's Fee	\$225,847	\$17,247	\$51,742	\$294,836
Interest Reserve	\$282,308	\$21,559	\$64,678	\$368,545
Mktg & Lease	\$141,154	\$10,780	\$32,339	\$184,273
Other	\$197,616	\$15,091	\$45,274	\$257,982
Financing	\$172,001	\$12,099	\$32,235	\$216,336
Contingency	\$338,770	\$25,871	\$77,613	\$442,254
PROJECT COST	\$8,555,582	\$650,311	\$1,946,869	\$11,152,762

FEASIBILITY METRICS	
Profit	(\$2,138,779)
Profitability Ratio	0.81
Cash-on-cash return	3.1%
Unlevered IRR	4.6%
Levered IRR	5.6%
NPV	\$201,157
Return on Cost	4.6%
Return on Equity	121%
IRR (Cumulative Benefits)	5.3%
NPV (Cumulative Benefits)	\$107,351

SOURCES OF FUNDS	
Project Cost	\$11,152,762
Bank Loan	\$0
NMTC:	\$0
NMTC Loan:	\$0
Section 108	\$0
Tax-exempt:	\$7,211,187
TIF:	\$0
CASH IN	\$3,941,576

Summary of Findings

The feasibility metrics for the base project and each alternative are presented below. None of the policy alternatives had a large enough impact to overcome the gap between projected income from the project and the development costs. Likewise, no alternative on its own achieved the required return on cash, cost, or equity, nor did any policy achieve required IRR. Three policy alternatives produced positive net present cumulative benefits: the NTMC alternative (#1), the Tax-Exempt/NMTC (#3a), and the Cultural Overlay District (#7).

Figure 14. Comparison of Feasibility Metrics

Alternative	Profit	Profitability Ratio	Cash-on-cash return	Unlevered IRR	Levered IRR
Hurdle Rates	Positive	1.00	5.0%	8.0%	14.0%
Base	(\$3,797,806)	0.60	2.1%	2.0%	1.3%
1. NMTC	(\$2,491,267)	0.74	1.3%	3.6%	4.7%
2. Section 108	(\$3,545,284)	0.62	6.0%	2.3%	2.4%
3a. Tax-Exempt/NMTC	(\$1,336,329)	0.86	3.5%	4.8%	8.0%
3b. Tax-Exempt	(\$2,233,257)	0.76	2.7%	3.8%	3.8%
3c. Tax-Exempt/QECB	(\$2,186,005)	0.77	2.8%	3.9%	3.6%
4a. TIF - LCLIP	(\$3,638,264)	0.61	2.2%	3.3%	3.5%
4b. TIF - CRFA	(\$3,271,948)	0.64	2.3%	3.8%	4.3%
5. Comm. Land Trust	(\$3,329,752)	0.61	2.2%	2.4%	1.9%
6. Condominiums	(\$4,388,665)	0.53	2.1%	0.8%	1.6%
7. Cultural Overlay	(\$2,138,779)	0.81	3.1%	4.6%	5.6%

Alternative	NPV	Return on Cost	Return on Equity	IRR (Cumulative Benefits)	NPV (Cumulative Benefits)
Hurdle Rates	\$0	4.5% - 7%	200%	13.0%	Positive
Base	(\$1,418,145)	4.3%	89%	1.7%	(\$1,267,883)
1. NMTC	(\$61,417)	4.3%	125%	5.6%	\$142,196
2. Section 108	(\$793,426)	4.3%	97%	2.6%	(\$709,673)
3a. Tax-Exempt/NMTC	\$625,163	4.3%	142%	7.2%	\$448,578
3b. Tax-Exempt	(\$339,832)	4.3%	100%	3.0%	(\$541,563)
3c. Tax-Exempt/QECB	(\$391,302)	4.3%	99%	2.9%	(\$599,354)
4a. TIF - LCLIP	(\$624,245)	4.4%	106%	3.7%	(\$532,679)
4b. TIF - CRFA	(\$275,372)	4.6%	113%	4.4%	(\$218,093)
5. Comm. Land Trust	(\$1,092,742)	4.4%	95%	2.4%	(\$896,032)
6. Condominiums	(\$1,183,877)	3.9%	93%	2.2%	(\$975,403)
7. Cultural Overlay	\$201,157	4.6%	121%	5.3%	\$107,351

CHAPTER 5: DISCUSSION

Financial feasibility analysis provides a tool to evaluate the impacts that policy interventions have on real estate development projects. This ex post analysis of a sample project in the Little Saigon neighborhood can inform actions to preserve and develop commercial real estate that is affordable to local entrepreneurs. By adding to a growing body of research on the negative impacts of commercial gentrification, this analysis is valuable for neighborhoods, like Little Saigon, in which growing economic pressures threaten to create commercial gentrification and unravel the cultural character and local economy.

In this chapter, I draw on the findings of my analysis to explore the impacts that various policies have on financial feasibility, examine implementation concerns of these policies, discuss unintended consequences and limitations, and suggest next steps for research.

The policies evaluated in this analysis were chosen to provide a wide range of interventions: financial incentives, ownership models, and regulatory initiatives. Taken individually, none of the policy alternatives achieve all of the feasibility metrics of a typical private developer. Under each alternative, a substantial gap remains between project costs and the income necessary to justify development. In most cases, the feasibility metrics indicate a low return for developers, and in many cases, project an NPV loss. These findings highlight several issues.

The Contributory Value of Project Components

The project has a fundamental feasibility gap, between value and costs. A portion of this gap is caused by capping rents from the five retail units at an affordable rate. This leaves income on the table and subsequently reduces capitalized value. However, there is also a gap in the residential and market-rate retail components to the project. In other words, even if all retail rents rose to “market-rate,” the project would still not be financially feasible. The income shortage from capping retail rents at affordable rates is \$32,578 or a change to project value of \$554,940. Thus, if affordable rents rose to market-rate, the project gap between value and costs, averaging \$2,941,578 across all the alternatives, would only be reduced by 19%, leaving an additional \$2.4 million to bridge. Thus, the negative impact of affordable commercial space on a project’s financial feasibility is not as significant as it initially appears when evaluating project value as a whole.

This issue represents the difficulties in developing new buildings in the current market without significant subsidies. The residential and market-rate retail rents currently supported by demand in the market are not high enough to produce a feasible project, given the costs of new construction. There are three factors that might change this outcome: rising income potential, lower capitalization rates, or reduced costs. Income potential will grow as the neighborhood evolves and economic growth causes the productive potential of buildings in the neighborhood to rise, increasing income and capitalized value alongside it. The construction of new buildings might require mixed-income residential tenants, wherein wealthier residents can essentially subsidize the loss of income from affordable rents.

Lowering capitalization rates, by reducing the cost of capital will also improve the value of the project. Cheaper financing is a common method for achieving reduced cap rates and greater capitalized value (this discussed in more detail below). Lastly, reducing the costs of construction directly through direct subsidies and cost cutting on contingencies and cheaper construction will effectively close the gap between value and cost. As land values in the neighborhood rise, subsidizing the cost of land or using the commercial land trust model to eliminate land costs, will have also have a significant impact on project feasibility.

Overcoming the Value – Cost Gap

In order create and apply policies that promote affordable commercial development, policy makers must understand the gap that exists between project cost and its feasibility metrics. This analysis demonstrates that the magnitude of impact that a policy must sway a project's financial feasibility is significant. Even using the most advantageous financing terms currently available, the lack of cash flows from the project makes achieving the required return on investment challenging. Aside from substantial subsidies in the form of equity contributions, policies using only one intervention are unlikely to significantly impact a project's financial feasibility. It was the NMTC grant contribution that had the greatest impact on multiple feasibility metrics, including NPV of benefits, return on cash and costs, and IRR. By reducing the developer's equity contribution, the NMTC increases percentage returns and reduces the level of risk. It should be noted, that failing to meet a developer's required return does not necessarily condemn a project. A developer's fee of 4% is included in the project proforma and the developer will capture this profit even if the returns do not exceed hurdle rates.

Similarly, many developments are “socially responsible” and developers who recognize that economic profit is not the only benefit from a project can establish a track record for such

development, building up goodwill. This is an intangible benefit that can provide future economic benefits by creating a competitive advantage for certain projects and reducing perceived risk by investors and lenders.

The need for additional sources of capital to close the gap between project value and development costs is also readily apparent. None of the policies evaluated in this thesis were able to completely close the gap between value and cost, primarily because value was significantly reduced by low rents supported by the market and rents capped at affordable levels. There are two ways to close this gap: increase income or reduce the rate used to capitalize that income to project value.

All else equal, a lower cap rate will help to close the value – cost gap. Considering that cap rate represents the weighted cost of capital, lowering these capital costs will result in greater project value. Low cost financing is one way to reduce the costs of capital, and thus raise value. Alternative financial products, such as loans with long terms and interest-only loans also reduce the costs of capital, which will raise value relative to cost and reduce a developer's equity contribution. Assuming positive leverage, lowering equity is a way to increase financial returns.

Additionally, it is important to note that the gap between value and cost is somewhat hypothetical. Capitalized net operating income does not reflect actual value captured by a project, unless the project is *sold* at this price. Thus, a proforma loss does not represent an actual capital expenditure or out-of-pocket loss to the developer. Rather, value capture occurs at the time of project resale. If the neighborhood economy grows and the retail tenants are able to improve sales revenue from emerging markets, the value captured at resale may indicate the potential to capture significant profits. This will become more likely if a broad-based approach is used to prevent commercial gentrification and revitalize the local economy.

The Benefits of Up-front Interventions

Research and interviews indicate that given the choice between immediate and future benefits, developers prefer up-front subsidies, even accounting for the opportunity costs of capital, and time value of money. This research supports the idea that incentives applied early in the development process, such as equity contributions, are advantageous.

Up-front credits and interim financing help developers in the more risky site preparation and construction phases before a permanent, lower-cost loan can be secured with the income from the project. Up-front benefits may reduce the political risk that arises from the prospect of a profitable project receiving public tax benefits well into the future, such as the

Seattle Kingdome, for which bonds are still being repaid twelve years after the stadium was demolished. To be impactful, such a credit would need to affect construction costs, interim financing, or income flowing to the project. While significant over the lifetime of the project, the benefits of low cost financing do not provide an immediately captured benefit to the developer.

These findings indicate the significant financial barriers to producing affordable real estate. Without the application of policy alternatives, the base project operates at a proforma loss of nearly \$3.5 million. Achieving the levels of income from affordable space to justify the costs of development is a significant obstacle. The cost of land is also a barrier. Even at the \$95 per square foot used in this analysis, land represents a significant capital cost. With escalating development in the neighborhood, land value will rapidly increase. Spillover from the Yesler Terrace Redevelopment Project will also increase the cost of land, creating greater costs for developers and raising the barriers for developing affordable space.

For developers weighing the risks and rewards of numerous opportunities, and investors evaluating real estate investments against other capital assets, the added risk of developing affordable retail space, without a premium for this risk, is a substantial deterrent to a project.

Creating Neighborhood-wide Approach

This analysis supports the rationale that preserving affordable commercial real estate should be pursued at a neighborhood level, rather than on a per-project basis. There are numerous benefits of a local economy comprised of small, culturally significant businesses. Fostering cultural authenticity, a vibrant economy through which income is recycled, and an agglomeration economy that produces heritage tourism and draws regional demand can lead to neighborhood economic revitalization and equitable community development. Government can play a major role in promoting these principles – and in doing so foster economic development in neighborhoods that hold special cultural diversity. Rather than promote policies on a per project basis, such as city-sponsored financing, the level of magnitude required to promote affordable commercial real estate necessitates a broad-based approach.

Taking a holistic, neighborhood-wide approach to create opportunities for local entrepreneurs and enhance the cultural character of a community will unmask benefits that are hidden when feasibility is evaluated for individual projects. When a “critical mass” of affordable commercial space is provided in a neighborhood, the benefits to the local economy will emerge, and tenants who are able to access the affordable space in new

developments will capitalize on these advantages. For a developer who understands this vision for the community, whether a project projects a given return or profit may become a less important feasibility consideration. A neighborhood-wide approach to promote this vision, while also providing a package of sticks (regulations) and carrots (incentives) for individual project developers, will promote the benefits of the local agglomeration economy and cultural character of the community on both levels.

Packaging Policies: A Toolkit for Affordability

A broad, neighborhood approach would involve packaging a series of policy alternatives for developers, planners, and public officials to draw upon. This analysis demonstrates the impact of multiple policy interventions to leverage more financially feasible outcomes. The policy alternative that had the greatest impact on financial returns was the scenario combining the Tax-exempt Bond and the NMTC. As noted, there are costs to using multiple incentives, including administration costs and legal separation of residential and commercial ownership. However, the financial benefits of combining an equity contribution with low cost financing from two sources demonstrate the effectiveness of using multiple interventions.

This packaging of interventions is also what makes the Cultural Overlay District an attractive option. With appropriate public participation in the district planning process to define the neighborhood's vision and identify the types of businesses eligible for affordable commercial space, a COD would allow a developer to choose and apply a variety of incentives to a given project (CODAC 209, 37).

Lowering retail rent is only one component of this solution. Helping businesses develop better strategic planning, financial literacy, and real estate expertise will allow them to prosper even as development increases around them. Policies that subsidize affordable development can also subsidize businesses – in the form of low-interest loans, business assistance programs, and funding of start-up business incubators.

Innovation

Creative solutions should be welcomed. Thinking about affordable commercial development solely within the framework of affordable housing incentives might not produce effective policy solutions. Re-conceptualizing the problem for the commercial real estate market can drive better, more tailored solutions. Several such ideas deserve mention.

One policy concept replicates the façade easement program used for historic preservation. Under such a program, a building owner could essentially “sell” an easement of affordable retail units to a preservation authority. The sale price would close the gap between market-

rate and affordable rent levels and the easement would include a covenant that rents for particular units would remain affordable.

Because municipal budgets are constrained, creating policy solutions that avoid the use of tax revenues to provide subsidies is also important. One method for doing so involves easing the regulations imposed on certain types of development. For local businesses seeking affordable retail space, restrictions on changing a building's use designations, regulations surrounding restaurant kitchens and sidewalk use, and other building codes make it difficult to retain affordability. Streamlining these regulations, when actions do not threaten public safety or create a nuisance, should be explored as a way to avoid subsidies. For example, a building with a shared commercial kitchen for several restaurant storefronts would allow a developer to save significant capital on ventilation and safety systems; these savings could be passed on to businesses in the form of cheaper rent.

Another consideration that policy makers and planners must balance when designing incentives is the prospect for deadweight loss and excessive market distortions. Any incentive system that seeks to produce affordable commercial space will create some dead weight loss. A tax credit for affordable space, for instance, will inevitably go to a developer who would produce this space with less of a credit or no credit at all.

This problem occurs on the demand side as well. Policies that preserve affordable rent will inevitably subsidize the rent of a tenant that would be able to afford higher rent. Similarly, a subsidy might help a business stay in operation in their current location despite rising rents, without making efficiency gains or capturing customer demand in emerging markets.

Setting the amount of intervention to limit deadweight loss is challenging. While this research seeks to evaluate the impact on feasibility of a variety of policies, it is the level of rent deemed affordable that will ultimately determine the influence of these policies on a project. By adjusting the definition of affordability, the level of impact needed would change accordingly. Thus, while dead weight loss is important to consider, it will likely occur at some rate no matter what intervention is used. Policy makers should make attempts to limit dead weight loss when possible.

This analysis can be applied to a variety of contexts. Affordable commercial space can allow neighborhoods that rely on a diverse blend of retail businesses for their economic livelihood to preserve their unique character. Neighborhoods with a strong local entrepreneurial spirit can use these policy alternatives to preserve a vibrant local economy, reaping the benefits of profits recycled through the community. Any neighborhood that is on the precipice of significant changes, such as major rezones, development projects, or economic

development initiatives can encourage affordable commercial space as a way to allow local businesses to capture new demand before they face rapidly increasing rents. These efforts will allow a community to retain its unique fabric of local business and character.

Future Research

The negative impacts of commercial gentrification and the benefits of affordable commercial real estate in preventing these effects, has recently gained attention. This field will benefit from additional research. Empirical research evaluating the few projects across the nation that seek to develop affordable commercial properties will help shed light on the real impacts of these policies on businesses and communities.

Given the rate of new construction forecasted for Little Saigon, this analysis considers policies that impact new development projects. Equally as important, however, is the potential for existing buildings to preserve affordable commercial space. Some of the policies evaluated here can also be applied toward existing properties, including the Section 108 Loan for operating expenses and property tax credits under a cultural overlay district. The easement concept discussed briefly above is another example of a policy to encourage property owners to limit the pace of rent increases. Preserving existing affordable commercial space by targeting existing property owners can have a significant impact on retaining local entrepreneurial spirit and the cultural character of the neighborhood.

CHAPTER 6: CONCLUSION

This research presents an exploratory evaluation of the impacts on financial feasibility of policy alternatives that promote affordable commercial real estate development. The policies evaluated have a diverse array of impacts on project feasibility and provide lessons for policy makers, developers, planners, and businesses to consider.

Threat of Commercial Gentrification

This research provides a blueprint for understanding the potential negative impacts of commercial gentrification on a community. While policy-makers and planners promote neighborhood economic development, it is important to recognize the negative consequences of this development on local businesses, particularly in culturally diverse neighborhoods. When the new development and rent spikes outpace the ability of these businesses to capture the benefits of demand from emerging markets, commercial gentrification can unravel the diverse blend of retailers and unique character of a neighborhood. These effects are particularly harmful for neighborhoods with strong cultural institutions, as they can disperse the business clusters that provide culturally-meaningful goods and services and that draw regional demand to the neighborhood.

Benefits of Promoting Affordable Commercial Real Estate

Affordable commercial real estate provides one solution to combat the negative effects of commercial gentrification, while allowing neighborhoods to capture the benefits of economic development. Attracting tourists to culturally significant business clusters, boosting local entrepreneurship, revitalizing the local neighborhood economy, and creating additional development and business opportunities provide the economic rationale for preserving affordable retail space. Enhancing the cultural character of a community, retaining a culturally-meaningful retail district, and promoting equitable development in the neighborhood provide social and community benefits.

Overcoming the Challenges of Affordable Development

This analysis demonstrates the difficulty developing new projects in under-developed markets, particularly when rents are kept at affordable rates. The need for additional sources of capital to close the gap between project value and development costs is also readily apparent. Policies that contribute equity to a project have the greatest impact on a developer's return. Rather than low-cost financing or relatively small reductions in

construction costs, policy alternatives with an equity contribution have a greater impact on financial feasibility.

Affordable commercial development can provide a significant economic benefit to the neighborhood, and developers that acknowledge socially responsible development may be able to replace traditional financial returns by capturing intangible benefits. Lastly, the challenges of promoting affordable space require a broad approach that incorporates more innovative thinking. Applying a series of policies, packaged together to impact a project at multiple stages, can significantly improve financial feasibility.

Need for a Broad-based Solution

To achieve local economic and cultural benefits, a broad, neighborhood-wide approach is needed to preserve and promote affordable commercial real estate. Rather than provide policies on a per project basis, the level of magnitude required to promote affordable commercial real estate necessitates a holistic approach that creates opportunities for local entrepreneurs and enhances the cultural character of a community.

Using this vision as a blueprint for a broad strategy to promote affordable commercial development will allow these benefits to emerge on a neighborhood level, improving the feasibility of individual projects. For a developer who understands this vision for the community, whether a project produces a given return or profit may become a less important consideration.

Taking a neighborhood-wide approach to promote this vision, while also providing a package of sticks (regulations) and carrots (incentives) for individual projects, will promote the benefits of a local agglomeration economy and the cultural character of the community on both levels. Solutions like Tax Increment Financing and Cultural Overlay Districts may offer the best hope for scaling up these efforts, from a per project to neighborhood level.

The Importance Private – Non-profit Partnerships

This research indicates the important role of both non-profit organizations and private developers. A private partner has access to capital and often faces lower construction costs, and a non-profit has access to cheaper financing and can use existing relationships in the community to offer business assistance. The non-profit can also act as guarantor, reducing risk to the project and providing credit to capture additional financing. Drawing on the strengths of non-profit and private sectors will make affordable commercial projects more financially feasible. This analysis should serve as a call to arms for non-profits to engage the

development community to devise creative partnerships, such as commercial land trusts, that preserve affordable commercial space in the neighborhood.

Strong Public Sector Leadership

This analysis makes clear that more involvement is required by governments to support and regulate certain commercial real estate markets. Strategic government intervention can enhance economic growth, boost local entrepreneurship, and promote the unique culture and diversity of the neighborhood. The City of Seattle has acknowledged the need for affordable commercial space and the opportunity is ripe for broad-based efforts to package regulations and incentives that enhance the financial feasibility of developments with affordable commercial space. Not all interventions require significant subsidies from tax revenues to be effective and the public sector should evaluate a wide variety of innovative solutions.

Conclusion

As commercial gentrification processes take hold in urban neighborhoods across the country, community businesses face displacement and the unique character that drives the local economy is threatened. Policies promoting affordable commercial space will continue to attract more attention as tools for preserving culturally significant communities, promoting local entrepreneurship, and revitalizing the economic livelihood in these neighborhoods. Only through a holistic, well-balanced approach that balances the interests and motivations of developers, businesses, and residents can the unique and diverse mix of neighborhoods continue to drive economic growth and municipal pride already solidifying across the City of Seattle.

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APPENDIX A: MARKET ANALYSIS

Geographic Area

The International District neighborhood is located southeast of Pioneer Square in downtown Seattle. One of the city's oldest neighborhoods, Seattle's International District is rich with history and culture. Located in the easternmost area of the neighborhood, Little Saigon is a strong Vietnamese-American shopping district with restaurant, retail, and personal service businesses, as well as clusters of small office spaces. There are also a variety of manufacturing and light industrial uses in the neighborhood.

Business Distribution

Of the occupied businesses located in the neighborhood, 27 percent are restaurants, all but one of which offer Asian cuisine (Trang D. Tu Consulting 2007, 26-32). These restaurants are clustered on S. Jackson St and form the backbone of the shopping district. Retail businesses comprise 33 percent of the neighborhood businesses – this sector is comprised primarily of jewelry stores (23% of retail) and specialty and non-specialty grocery stores (20% of retail) (Trang D. Tu Consulting 2007, 26-32). The services industry is made up primarily of salons (50% of services) and travel agencies (18% of services) (Trang D. Tu Consulting 2007, 26-32). The retail and services distribution forms an urbanization economy and demonstrates the neighborhood's appeal as a “daily and weekend shopping destination for Vietnamese-American and other Asian-American families” (Trang D. Tu Consulting 2007, 26-32).

Nineteen percent, or 46 of the business storefronts were vacant in 2007 (Trang D. Tu Consulting 2007, 26-32). Vacancies detract from the character of a neighborhood and diminish the potential to draw regional demand. Additional analysis discovered that much of this vacancy is located outside the commercial core and consists of light manufacturing buildings. However, these vacancies may also signify an opportunity for expansion of retail and services businesses when emerging markets arrive in the neighborhood due to the Yesler Terrace project and growth in south downtown.

Little Saigon can also benefit from its proximity to Chinatown and the significant city-wide and regional demand that this neighborhood attracts. However, the business tapestry in Chinatown has shifted in recent years. The neighborhood enjoys a strong retail and professional services economy, buffered by large tenants such as Uwajimaya that draw a regional clientele. As a whole, revenues have increased in recent decades, growing 8%

annually, from 1997 to 2006 (\$203 million to \$358 million) (Trang D. Tu Consulting 2007, 26-32).

However, this growth is fueled by expansion of the service industry, particularly business and professional services catering to the downtown office sector. Retail revenues, once comprising a majority of business income in the Chinatown neighborhood, have declined significantly during this time (\$65 million to \$41 million) (Trang D. Tu Consulting 2007, 26-32). Eating and drinking establishments, which comprise a majority of retail businesses, declined from \$30 million in 1997 to \$21 million in 2006 (Trang D. Tu Consulting 2007, 26-32). This decline in revenues, coupled with the expansion of other Asian-American districts, threatens the on-going health of Chinatown's traditional businesses as a regional attraction and reduces the ability for Little Saigon businesses to draw on this demand.

Economic Growth

In contrast to Chinatown, the retail sector in Little Saigon has grown modestly, but consistently in the last decade, from \$22 million to \$33 million in sales revenues. This growth was driven by grocery and specialty stores. Restaurants also make up a significant portion of the retail market in Little Saigon: as a whole, the restaurant industry's revenues doubled from 1996 to 2007 (from \$3 million to \$6 million). Average annual growth rate in the neighborhood from 1996 to 2007 was 2.8 percent.

Real Estate Market Conditions

The following characteristics of the Little Saigon real estate landscape provide a foundation on which to base the projections for target users of affordable commercial space, as well as the potential rent, vacancy, and expense projections.

Unit Size

The mix of commercial space in the Little Saigon area is smaller than typical commercial spaces, owing to the needs of the businesses historically and currently operating there. The average size of commercial space in the neighborhood was below 3,000 square feet, and ranged from 600 square feet for a small restaurant to 15,000 for a large supermarket.

Vacancy Rates

As noted above, there were 46 vacant spaces, representing 19 percent of the total commercial properties in the area. Most of these vacancies were located in predominantly industrial blocks outside of the central shopping district, however, and the vacancy rate for properties along the commercial core is lower.

Rents & Lease Terms

An economic study of the restaurant and miscellaneous retail properties in the Little Saigon area found rents to range from \$6 to \$18 per square foot per year, although newer developments captured rents at the high end of the range (BHC Consultants 2009, 11). Nearly all businesses have triple net leases.

An additional study composed of interviews with local retailers, determined rents to be slightly higher, ranging from \$1.5 to \$2 per monthly square foot (\$18 to \$24 annually). These rents are slightly higher than in the Chinatown commercial area, likely due to the more recent development of space in Little Saigon as well as greater access to Rainier Avenue (Trang D. Tu Consulting 2007, 36).

Interviews conducted with local business owners as a component of the City's Environmental Impact Statement for the Livable South Downtown Initiative, indicated a mixed response from retailers regarding whether rents were too high. Many retailers found rents to be "affordable" although there were concerns about potential for future increases in rents and the poor property maintenance by landlords (Trang D. Tu Consulting 2007, 36). Lease tenure appeared correlated with affordability – the businesses that have been in the neighborhood for a longer period reported paying lower rent. Whether this is due to a lack of tenant improvements, lower vacancy risk, or other reasons was not clear.

Proprietor Characteristics

Many businesses in the area are self-financed and were not aware of public financing programs (Trang D. Tu Consulting 2007, 39). Those that attempted to utilize public programs cited difficulties accessing financing. There was also a consistent lack of knowledge of strategic business analysis and planning among proprietors in the neighborhood.

Development Trends

There have been several property transactions in the Little Saigon neighborhood in recent years, although the small size of the neighborhood and limited number of transactions makes it difficult to define market trends reliably. There were two development projects completed since 2002: a two-story office building and a one-story retail building with four retail spaces.

There were eight commercial property transactions recorded in the neighborhood. While it is difficult to forecast expected appreciation from the limited amount of transactions, and the

widely varied uses and characteristics of these buildings, the price for commercial retail buildings ranged from \$147 (2002), \$229 (2003) and \$245 (2002) per square foot.

While current rents in the neighborhood are not high enough to support new office development, recent economic development in the surrounding neighborhoods will likely make office development viable within five to ten years (BHC Consultants 2009). The expansion of the office sector from downtown presents a challenge for International District businesses already struggling to remain a city-wide and regional economic driver. Increased development is expected as population growth and increasing rents make such development more feasible.

APPENDIX B: OPERATING MODELS

Operating models for the base proforma and each policy alternative are presented here. These models allow for internal rate of return and discounted cash flow analysis to inform the feasibility metrics and the evaluation.

Base Proforma

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,492,051)						
Equity Contribution	(\$5,506,080)						
Total Income		\$657,825	\$673,382		\$793,470	\$812,345	\$831,682
Less: Vacancy		(\$34,900)	(\$37,224)		(\$43,724)	(\$44,745)	(\$45,791)
Adjusted Gross Income		\$622,924	\$636,159		\$749,746	\$767,600	\$785,891
Less: Expenses		(\$212,464)	(\$217,636)		(\$258,313)	(\$264,718)	(\$271,282)
Net Operating Income (NOI)		\$410,460	\$418,523		\$491,432	\$502,882	\$514,609
Less: Debt Service		(\$293,728)	(\$293,728)		(\$293,728)	(\$293,728)	
Before Tax Cash Flow		\$116,732	\$124,795		\$197,704	\$209,154	
Leveraged Cash Flow	(\$5,506,080)	\$116,732	\$124,795		\$197,704	\$4,780,833	
After Tax Cash Flow		(\$118,863)	(\$106,490)		\$4,220	\$22,355	
Net Benefit	(\$5,506,080)	\$158,334	\$162,067		\$196,227	\$4,773,009	
Cumulative Benefit	(\$5,506,080)	(\$5,347,746)	(\$5,185,679)		(\$3,916,210)	\$856,799	

Alternative 1. New Markets Tax Credit

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,483,293)						
Equity Contribution	(\$2,749,832)						
Total Income		\$657,838	\$673,396		\$793,484	\$812,360	\$831,697
Less: Vacancy		(\$34,901)	(\$37,225)		(\$43,725)	(\$44,746)	(\$45,792)
Adjusted Gross Income		\$622,937	\$636,171		\$749,759	\$767,613	\$785,905
Less: Expenses		(\$212,465)	(\$217,777)		(\$258,868)	(\$265,340)	(\$271,973)
Net Operating Income (NOI)		\$410,472	\$418,395		\$490,891	\$502,273	\$513,932
Less: Debt Service		(\$375,557)	(\$375,557)		(\$375,557)	(\$375,557)	
Before Tax Cash Flow		\$34,915	\$42,838		\$115,334	\$126,717	
Leveraged Cash Flow	(\$2,749,832)	\$34,915	\$42,838		\$115,334	\$3,562,182	
After Tax Cash Flow		(\$144,183)	(\$130,765)		(\$12,073)	\$7,183	
Net Benefit	(\$2,749,832)	\$85,379	\$88,606		\$119,560	\$3,559,667	
Cumulative Benefit	(\$2,749,832)	(\$2,664,452)	(\$2,575,847)		(\$1,833,386)	\$1,726,281	

Alternative 2. Section 108 Financing

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,446,969)						
Equity Contribution	(\$3,899,386)						
Total Income		\$657,838	\$673,396		\$793,484	\$812,360	\$831,697
Less: Vacancy		(\$34,901)	(\$37,225)		(\$43,725)	(\$44,746)	(\$45,792)
Adjusted Gross Income		\$622,937	\$636,171		\$749,759	\$767,613	\$785,905
Less: Expenses		(\$212,465)	(\$217,777)		(\$258,868)	(\$265,340)	(\$271,973)
Net Operating Income (NOI)		\$410,472	\$418,395		\$490,891	\$502,273	\$513,932
Less: Debt Service		(\$386,275)	(\$386,275)		(\$386,275)	(\$386,275)	
Before Tax Cash Flow		\$24,197	\$32,119		\$104,616	\$115,998	
Leveraged Cash Flow	(\$3,899,386)	\$24,197	\$32,119		\$104,616	\$4,306,798	
After Tax Cash Flow		(\$102,398)	(\$87,800)		\$38,982	\$59,330	
Net Benefit	(\$3,899,386)	\$60,036	\$62,850		\$90,972	\$4,286,032	
Cumulative Benefit	(\$3,899,386)	(\$3,839,349)	(\$3,776,500)		(\$3,225,761)	\$1,060,271	

Alternative 3. Special Financing Tools

Scenario 1: Tax-exempt Financing and NMTC

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,463,790)						
Equity Contribution	(\$2,427,412)						
Total Income		\$657,838	\$673,396		\$793,484	\$812,360	\$831,697
Less: Vacancy		(\$34,901)	(\$37,225)		(\$43,725)	(\$44,746)	(\$45,792)
Adjusted Gross Income		\$622,937	\$636,171		\$749,759	\$767,613	\$785,905
Less: Expenses		(\$212,465)	(\$217,777)		(\$258,868)	(\$265,340)	(\$271,973)
Net Operating Income (NOI)		\$410,472	\$418,395		\$490,891	\$502,273	\$513,932
Less: Debt Service		(\$326,418)	(\$326,418)		(\$326,418)	(\$326,418)	
Before Tax Cash Flow		\$84,054	\$91,977		\$164,473	\$175,855	
Leveraged Cash Flow	(\$2,427,412)	\$84,054	\$91,977		\$164,473	\$3,642,358	
After Tax Cash Flow		\$3,130	\$16,936		\$135,067	\$153,654	
Net Benefit	(\$2,427,412)	\$82,959	\$86,049		\$117,200	\$3,588,579	
Cumulative Benefit	(\$2,427,412)	(\$2,344,454)	(\$2,258,405)		(\$1,534,343)	\$2,054,236	

Scenario 2: Tax-exempt Financing

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,468,303)						
Equity Contribution	(\$3,680,266)						
Total Income		\$657,838	\$673,396		\$793,484	\$812,360	\$831,697
Less: Vacancy		(\$34,901)	(\$37,225)		(\$43,725)	(\$44,746)	(\$45,792)
Adjusted Gross Income		\$622,937	\$636,171		\$749,759	\$767,613	\$785,905
Less: Expenses		(\$212,465)	(\$217,777)		(\$258,868)	(\$265,340)	(\$271,973)
Net Operating Income (NOI)		\$410,472	\$418,395		\$490,891	\$502,273	\$513,932
Less: Debt Service		(\$311,593)	(\$311,593)		(\$311,593)	(\$311,593)	
Before Tax Cash Flow		\$98,879	\$106,801		\$179,298	\$190,680	
Leveraged Cash Flow	(\$3,680,266)	\$98,879	\$106,801		\$179,298	\$3,861,014	
After Tax Cash Flow		\$13,669	\$27,304		\$144,051	\$162,410	
Net Benefit	(\$3,680,266)	\$94,095	\$97,245		\$128,880	\$3,804,171	
Cumulative Benefit	(\$3,680,266)	(\$3,586,171)	(\$3,488,926)		(\$2,684,624)	\$1,119,546	

Scenario 3: Tax-exempt Financing and QECB

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,458,222)						
Equity Contribution	(\$3,869,495)						
Total Income		\$657,838	\$673,396		\$793,484	\$812,360	\$831,697
Less: Vacancy		(\$34,901)	(\$37,225)		(\$43,725)	(\$44,746)	(\$45,792)
Adjusted Gross Income		\$622,937	\$636,171		\$749,759	\$767,613	\$785,905
Less: Expenses		(\$212,465)	(\$217,777)		(\$258,868)	(\$265,340)	(\$271,973)
Net Operating Income (NOI)		\$410,472	\$418,395		\$490,891	\$502,273	\$513,932
Less: Debt Service		(\$300,864)	(\$300,864)		(\$300,864)	(\$300,864)	
Before Tax Cash Flow		\$109,609	\$117,531		\$190,027	\$201,410	
Leveraged Cash Flow	(\$3,869,495)	\$109,609	\$117,531		\$190,027	\$3,956,991	
After Tax Cash Flow		\$16,985	\$30,424		\$145,647	\$163,766	
Net Benefit	(\$3,869,495)	\$103,664	\$106,883		\$139,051	\$3,899,673	
Cumulative Benefit	(\$3,869,495)	(\$3,765,831)	(\$3,658,949)		(\$2,785,103)	\$1,114,570	

Alternative 4. Tax Increment Financing

LCLIP Model

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,332,675)						
Equity Contribution	(\$5,346,587)						
Total Income		\$657,838	\$673,396		\$849,906	\$879,653	\$910,441
Less: Vacancy		(\$34,901)	(\$37,225)		(\$47,018)	(\$48,664)	(\$50,367)
Adjusted Gross Income		\$622,937	\$636,171		\$802,889	\$830,990	\$860,074
Less: Expenses		(\$212,465)	(\$218,384)		(\$268,718)	(\$276,859)	(\$285,249)
Net Operating Income (NOI)		\$410,472	\$417,787		\$534,171	\$554,130	\$574,826
Less: Debt Service		(\$293,737)	(\$293,737)		(\$293,737)	(\$293,737)	
Before Tax Cash Flow		\$116,735	\$124,050		\$240,434	\$260,394	
Leveraged Cash Flow	(\$5,346,587)	\$116,735	\$124,050		\$240,434	\$5,716,216	
After Tax Cash Flow		(\$113,062)	(\$101,437)		\$52,749	\$79,395	
Net Benefit	(\$5,346,587)	\$156,307	\$159,553		\$221,972	\$5,688,428	
Cumulative Benefit	(\$5,346,587)	(\$5,190,280)	(\$5,030,727)		(\$3,682,055)	\$2,006,373	

CRFA Model

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$8,966,358)						
Equity Contribution	(\$4,980,271)						
Total Income		\$657,838	\$673,396		\$849,906	\$879,653	\$910,441
Less: Vacancy		(\$34,901)	(\$37,225)		(\$47,018)	(\$48,664)	(\$50,367)
Adjusted Gross Income		\$622,937	\$636,171		\$802,889	\$830,990	\$860,074
Less: Expenses		(\$212,465)	(\$218,384)		(\$268,718)	(\$276,859)	(\$285,249)
Net Operating Income (NOI)		\$410,472	\$417,787		\$534,171	\$554,130	\$574,826
Less: Debt Service		(\$293,737)	(\$293,737)		(\$293,737)	(\$293,737)	
Before Tax Cash Flow		\$116,735	\$124,050		\$240,434	\$260,394	
Leveraged Cash Flow	(\$4,980,271)	\$116,735	\$124,050		\$240,434	\$5,716,216	
After Tax Cash Flow		(\$99,741)	(\$88,116)		\$66,070	\$92,715	
Net Benefit	(\$4,980,271)	\$151,645	\$154,891		\$217,310	\$5,683,766	
Cumulative Benefit	(\$4,980,271)	(\$4,828,626)	(\$4,673,735)		(\$3,357,699)	\$2,326,067	

Alternative 5. Commercial Land Trust

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$8,568,901)						
Equity Contribution	(\$4,901,497)						
Total Income		\$657,838	\$673,396		\$793,484	\$812,360	\$831,697
Less: Vacancy		(\$34,901)	(\$37,225)		(\$43,725)	(\$44,746)	(\$45,792)
Adjusted Gross Income		\$622,937	\$636,171		\$749,759	\$767,613	\$785,905
Less: Expenses		(\$212,465)	(\$217,636)		(\$258,314)	(\$264,719)	(\$271,283)
Net Operating Income (NOI)		\$377,655	\$385,390		\$455,909	\$467,003	\$478,372
Less: Debt Service		(\$270,253)	(\$270,253)		(\$270,253)	(\$270,253)	
Before Tax Cash Flow		\$107,403	\$115,137		\$185,656	\$196,750	
Leveraged Cash Flow	(\$4,901,497)	\$107,403	\$115,137		\$185,656	\$4,474,877	
After Tax Cash Flow		(\$133,894)	(\$122,194)		(\$16,894)	\$351	
Net Benefit	(\$4,901,497)	\$154,265	\$157,905		\$191,569	\$4,474,754	
Cumulative Benefit	(\$4,901,497)	(\$4,747,232)	(\$4,589,327)		(\$3,351,143)	\$1,123,611	

Alternative 6. Commercial Condominium

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$9,422,180)						
Equity Contribution	(\$4,913,152)						
Total Income		\$567,650	\$581,841		\$691,627	\$708,917	\$726,640
Less: Vacancy		(\$29,618)	(\$30,358)		(\$36,086)	(\$36,988)	(\$37,913)
Adjusted Gross Income		\$538,033	\$551,483		\$655,540	\$671,929	\$688,727
Less: Expenses		(\$175,200)	(\$179,580)		(\$213,464)	(\$218,801)	(\$224,271)
Net Operating Income (NOI)		\$362,833	\$371,903		\$442,076	\$453,128	\$464,456
Less: Debt Service		(\$259,646)	(\$259,646)		(\$259,646)	(\$259,646)	
Before Tax Cash Flow		\$103,187	\$112,258		\$182,431	\$193,483	
Leveraged Cash Flow	(\$4,913,152)	\$103,187	\$112,258		\$182,431	\$4,375,066	
After Tax Cash Flow		(\$138,733)	(\$125,852)		(\$22,264)	(\$5,303)	
Net Benefit	(\$4,913,152)	\$151,744	\$156,306		\$190,223	\$4,376,922	
Cumulative Benefit	(\$4,913,152)	(\$4,761,408)	(\$4,605,102)		(\$3,377,233)	\$999,689	

Alternative 7. Cultural Overlay District

OPERATING MODEL							
Project Year	0	1	2	3 - 8 hidden	9	10	11
Project Cost	(\$11,152,762)						
Equity Contribution	(\$3,941,576)						
Total Income		\$806,795	\$825,868		\$973,088	\$996,227	\$1,019,933
Less: Vacancy		(\$42,531)	(\$45,386)		(\$53,304)	(\$54,548)	(\$55,821)
Adjusted Gross Income		\$764,264	\$780,482		\$919,783	\$941,679	\$964,111
Less: Expenses		(\$252,866)	(\$259,014)		(\$307,409)	(\$315,028)	(\$322,837)
Net Operating Income (NOI)		\$511,398	\$521,467		\$612,374	\$626,651	\$641,274
Less: Debt Service		(\$388,207)	(\$388,207)		(\$388,207)	(\$388,207)	
Before Tax Cash Flow		\$123,191	\$133,260		\$224,167	\$238,444	
Leveraged Cash Flow	(\$3,941,576)	\$123,191	\$133,260		\$224,167	\$4,825,588	
After Tax Cash Flow		(\$38,874)	(\$23,486)		\$108,616	\$129,387	
Net Benefit	(\$3,941,576)	\$138,741	\$142,655		\$186,152	\$4,780,303	
Cumulative Benefit	(\$3,941,576)	(\$3,802,835)	(\$3,660,181)		(\$2,507,478)	\$2,272,825	