

Sustainability concepts

Enhancing Communities Through TOD



A supplement to:

MassTransit
BETTER TRANSIT THROUGH BETTER MANAGEMENT



A 10-Part TOD Finance Plan

By John Stainback and William Reed

How public partners can use TODs as a major source of funding for transit facilities.

Transit-oriented development combines residential, retail and commercial uses with public open space near transit. A TOD allows people direct access to transit and to live, work, play and shop in a pedestrian-friendly environment. Development around transit also promotes compact development, mixed-uses and enhanced auto, pedestrian and bicycle connections.

Most TODs are located within 1,500 to 2,500 feet from a transit station or stop.

From the perspective of transit agencies and government, TODs are clearly a proven way to:

- Increase ridership
- Reduce traffic congestion
- Reduce environmental pollution
- Enhance tax revenue from increased land value and expanded development

From the perspective of private developers, TODs are an excellent investment because they:

- Capture premium rental rates and price points
- Increase density of development
- Increase net proceeds from the refinance, and/or sale of the TOD
- Increase retail sales from access to transit riders
- Increase productivity

TOD tenants and residents are willing to pay a premium to walk to the transit station, walk to shop and use transit to get to their office. In other words, people are willing to pay a premium to live, work, shop and play in a pedestrian-scaled mixed-use development.

TODS ARE GENERATING PREMIUM RENTAL RATES AND PRICE POINTS

The Center for Transit-Oriented Development recently completed a study which revealed that the demand for housing within walking distance of transit will more than double by 2025. The Center went on to state that currently, properties within a five- to 10-minute walk to a transit station are selling for 20 to 25 percent more than comparable properties further away — a price premium that is likely to increase as traffic jams worsen. According to a study by the nonprofit Congress for New Urbanism, while less than 25 percent of middle-aged Americans are interested in living in dense areas, 53 percent of 24- to 34-year-olds would choose to live in transit-rich, walkable neighborhoods, if they had the choice.

According to the Urban Land Institute (ULI), residential properties for sale near commuter rail stops in California consistently enjoy price premiums, including a 17-percent

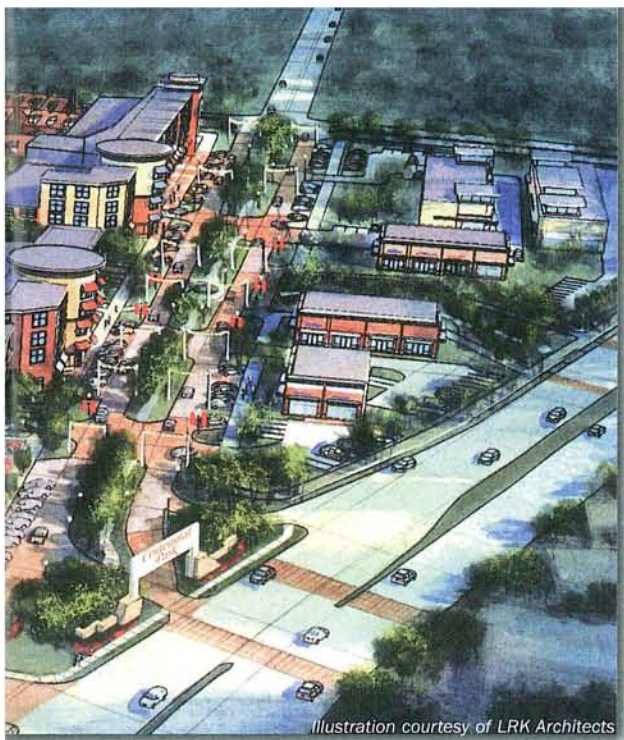


Illustration courtesy of LRK Architects

Centennial Park mixed-use TOD at the Spring Valley Station in Richardson, Texas.

investment goals, the source of funds and the level of risk in the project. Equity investors are also the owners of the development. The primary reason the returns on an equity investment are high when compared to the interest rate on a construction loan is that equity investors are the last to be paid. They share in the funds available after expenses and after debt service payments. The amount of equity required for a project is most often determined by the construction lender or the provider of the permanent loan. The equity portion of development financing typically ranges from 10 to 25 percent or more. The balance is financed with debt.

Debt

The loan to the developer is limited to a percentage of the project cost, commonly referred to as loan-to-cost (LTC). Currently, the LTC for most developments ranges from 75 to 90 percent. In other words, the construction lender will provide on the average 80 percent of the project financing, in the form of debt, and requires that the balance of the project cost (20 percent) be in the form of equity, or at-risk cash.

PART 2: PUBLIC PARTNER(S) CAPITAL INVESTMENT

If the financial analysis reveals a basis for a public partner to invest in a TOD, there are a multitude of funding sources to tap. Investment could be in the form of cash, bonds, grants and/or tax credits. Many public facilities also generate operating income, which can be used to support bond financings. Public partners should think creatively when trying to optimize operating income. For example, for public facilities such as libraries, new sources of income can be introduced to help cover a portion of the debt service and/or operating expenses. The public/private finance plan could include community funding programs, income from an on-site retail shop and/or café, income from operating the library garage after hours and on the weekends, renting out major spaces and/or classroom space after hours, and lease payments for naming rights for the library, selected rooms and/or public spaces.

Government-Owned Land

For most traditional commercial developments, land cost equals 10 to 15 percent of the total development budget (TDB). Government-owned land should be viewed by government officials as an investment and should expect a return on that investment. The public partner can sell the project site, or structure a long-term land-lease with a developer. Government officials should not underestimate the income which can be

advantage to properties in the San Diego region. A study completed by California State University at Fullerton indicates that "...there are premiums of 4 to 30 percent for office, retail and industrial buildings located near rail transit in Santa Clara, Dallas, Atlanta, San Francisco and Washington, D.C."

Yet many governments and private developers have failed to capitalize on the economic and development potential of transit investment. Therein lies the need for this proposed 10-part approach to structuring finance plans for TODs.

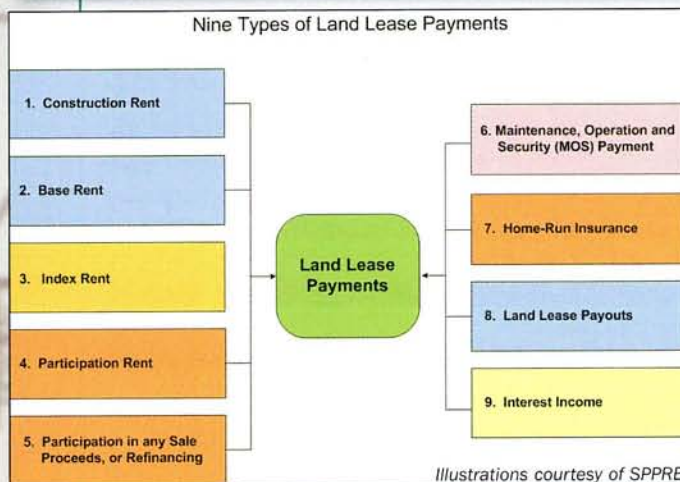
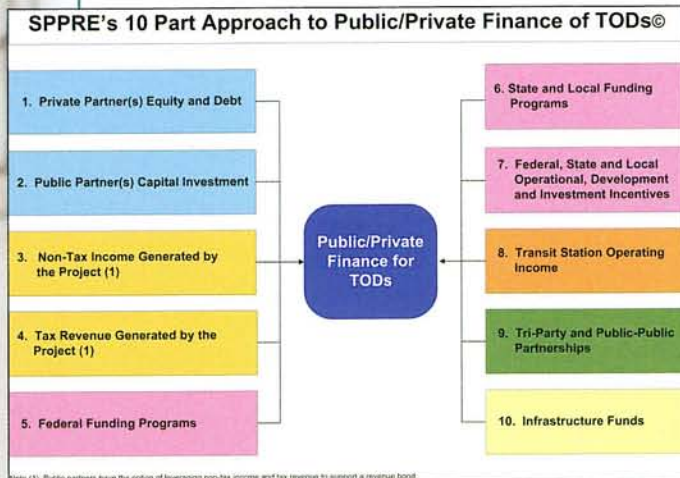
A 10-PART APPROACH TO STRUCTURE PUBLIC/PRIVATE FINANCE PLANS FOR TODS

The 10-part approach should be helpful to private developers to convert a TOD which is financially infeasible, to a project which is attractive to the equity and debt capital markets. Equally important, this approach allows transit agencies to achieve a competitive return on their investments in land located around stations, infrastructure and the transit system. This return on investment (ROI) can be used by transit agencies or operators to cover all, or a portion, of the cost of transit stations and possibly a significant portion of the transit system. In order to cover a substantial portion of the cost of the transit system, transit agencies will need to leverage the non-tax income and tax revenue generated by all of the TODs along the entire transit alignment.

PART 1: PRIVATE PARTNER EQUITY AND DEBT

Equity

Private developers and/or private investors provide at-risk cash, referred to as equity for projects. These investors expect a return on their investment. That return is dependent on their



Above, the 10 part approach to public/private finance of TODs. Below, the nine types of land lease payments.

generated from a land-lease, nor the ability to leverage the base rent, which is typically a guaranteed annual payment from the developer (See Part 3).

PART 3: NON-TAX INCOME GENERATED BY THE PROJECT

One of the most powerful techniques to solve any “gap financing” requirements is to optimize non-tax income generated by government-owned land serving as the TOD site and from proposed public facilities on site. Public partners should view their real estate assets as a potential major source of income. Under a land-lease arrangement, the government entity or public partner is able to retain ownership of the project site and also realize any appreciation in land value achieved to date and in the future. Developers like land-lease arrangements because they can avoid upfront cash outlays required to purchase a TOD site. Depending on the results of

preparing a developer pro forma, the public partner and their consultant should structure a land-lease, which includes up to nine types of land-lease payments paid by the selected developer to the public partner, the land owner. The nine types of land-lease payments include: 1) construction rent, 2) base rent, 3) index rent, 4) participation rent, 5) participation in any sale proceeds, or refinancing, 6) maintenance, operation and security (MOS) payment, 7) home-run insurance, 8) land-lease payouts and 9) interest income.

Public partners should also be able to generate non-tax income or operating income from any on-site public facilities. Many public facilities throw off traditional operating income, such as user fees or admission charges, but there are other creative types of operating income that can be realized. These more creative types of income include:

- Introduce complimentary retail space, such as a coffee shop or a café.
- Lease advertising space in appropriate areas of the facility.
- Lease naming rights.
- If the facility or system is large enough, lease pouring rights.

Public partners should also consider leveraging selected types of non-tax income generated by the proposed commercial development and public facility. The land-lease payments which are not contingent on developer performance can be used to cover the debt service on a revenue bond. For example, the base rent described above can often be structured to be a guaranteed annual payment by the private developer to the public owner of the project site. The revenue bond supported by the base rent can be used to cover all or a portion of the cost of the transit station and/or any transit improvements required by the TOD. This revenue bond is often referred to as a land-lease-backed revenue bond.

PART 4: TAX REVENUE GENERATED BY THE PROJECT

Another important source of income from a TOD is the multiple types of tax revenue generated by commercial leasehold improvements developed on government-owned land. In addition, if the project site is owned or purchased by the private developer, the land will generate property tax annually. Depending on the building types included in the commercial development portion of the proposed TOD, projects will generate substantial tax revenue, such as:

- Property tax
- Personal property tax
- Sales tax
- Hotel occupancy tax
- Corporate income tax
- Local and state income tax
- Utility taxes

In most instances, these taxes are distributed to varying government jurisdictions, such as the city, county and state, as well as school districts and other government entities. For most public/private development projects the focus is on capturing the property and sales tax generated by the commercial development portion of a TOD. One of the most powerful economic development tools available to public partners is tax increment financing (TIF). TIF is an economic development tool available to a city (a potential partner with a transit agency) to publicly finance specific needed improvements within a defined area commonly known as a TIF district. TIF is not a new or additional tax imposed by a government entity. Therefore, citizens and property owners are not required to pay any new or additional tax. If the city is the primary public partner, city officials and their consultant will need to determine the annual tax revenue generated by the redevelopment project for each government entity. Using the results of this analysis, city officials should approach each entity receiving tax revenue from the project to negotiate using their respective portion of the property and/or sales tax increment. City officials should then leverage their portion or all of the annual tax increment to support a TIF-backed revenue bond. Like the non-tax income, the tax increment generated by the TOD can be leveraged to fully support a sizable revenue bond, which covers all or a major portion of a TOD and transit-related facilities and improvements. In other words, for many TODs, the income realized by the public partner can cover 100 percent of the transit facilities, amenities and improvements, so there is little or no capital outlay required of the transit agency.

PART 5: FEDERAL FUNDING PROGRAMS

There is a multitude of federal funding programs available from several agencies. The limitations of this article does not allow a comprehensive listing of funding programs, so the focus will be on programs directly related to TODs. The federal agencies focused primarily on real estate development include:



Illustration courtesy of J.D. Wilson & Associates

Downtown Carrollton DART station in Carrollton, Texas.

- U.S. Department of Housing and Urban Development
- U.S. Department of the Treasury
- Federal Housing Administration
- Fannie Mae
- Freddie Mac
- Federal Home Loan Bank
- Federal Transit Administration

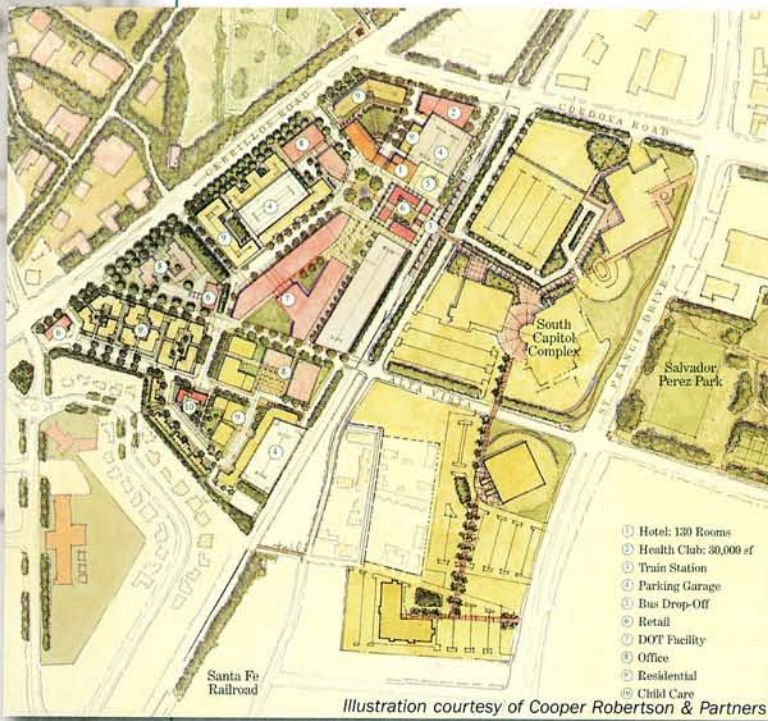
These federal agencies have established a wide variety of financial assistance techniques, including:

- Direct investment
- Below-market rate subordinate loans
- Grants (direct investment or as additional loan security)
- Interest rate buy-downs on third-party loans
- Loan guarantees
- Soft second mortgages
- Credit enhancement
- Tax credit programs
- Program to increase a homebuyer's purchasing power

Conduits for these funds vary from state and city governments, community development entities (CDE), syndication partners and private developers.

PART 6: STATE AND LOCAL FUNDING PROGRAMS

Like Federal funding programs, there are a multitude of state, county and local government funding programs and an enormous number of finance instruments. State and local governments have the power to tax and the ability to issue tax-exempt debt. Under the U.S. Internal Revenue code, the interest



\$290 million mixed-use TOD development in Santa Fe, N.M.

payments on most debt issued by state and local governments are exempt from federal income taxes. Based on this policy, investors accept a lower interest rate on tax-exempt municipal debt than on taxable debt. Debt issued by state and local government entities is categorized by the source of revenue pledged to cover the debt service. General obligation (GO) bonds are backed by the full faith and credit of the issuing government entity, while revenue bonds are backed by the pledge of specific income stream(s) generated by the project. GO bonds are used to finance facilities which are considered essential to a functioning government.

In addition to traditional municipal bonds, state and local governments provide a wide range of financial assistance to finance redevelopment projects or solve the required “gap financing.” At last count there are nearly 30 public/private finance instruments available to state and local partners to finance redevelopment projects. Instruments such as:

- Tax increment financing (TIF)-backed revenue bond
- Certificates of participation (COP)
- Assessment district bonds
- Special tax bonds (supported by the levy of special taxes)
- Lease revenue bonds
- Tax lien bonds

In addition, many state governments have established funding programs such as:

- State Infrastructure Bank (SIB)
- State revolving loan funds
- Economic development programs

PART 7: FEDERAL, STATE AND LOCAL OPERATIONAL, DEVELOPMENT AND INVESTMENT INCENTIVES

There are two fundamental types of incentives provided by government entities to private companies: tax and non-tax incentive programs. Tax-related incentives include tax credits, exemptions, abatements and deferrals. Non-tax incentives include grants, loans and/or guarantees provided directly to private companies or indirectly to communities. The primary objectives of government-provided incentives are to create jobs, income and tax revenues, which can be used to improve the quality of life of residents. Incentives can reduce cost and/or enhance cash flow for three aspects of business: 1) development of facilities and infrastructure, 2) investment in facilities, equipment and/or technology and 3) business operations.

Tax Credits

Tax credit programs are increasingly important to private developers, and while the limitations of space in this article does not allow a detailed description of the tax credit industry, public and private partners of redevelopment projects should be aware of the four primary federal tax credit programs: 1) historic preservation tax credits, 2) federal brownfield expensing tax credits, 3) new market tax credits (NMTC) and 4) low-income housing tax credits (LIHTC).

PART 8: TRANSIT STATION OPERATING INCOME

There are at least five types of non-farebox income that transit agencies should attempt to capture in order to enhance cash flow, or solve a financing shortfall. These sources of income other than the farebox include:

- Tenant lease income from support retail space for commuters.
- Income from advertising placed on the exterior and interior of transit stations and commuter parking facilities.
- Income from the shared use of commuter parking facilities.
- Income from naming rights and possibly pouring rights for the entire transit system.
- Interest income from land-lease payouts (a payment based on the present value of the land-lease payment for land under condominium housing developments).

If the financial feasibility of the TOD and/or transit station is in the balance, these types of non-farebox income could be the difference between a “go” and “no-go” decision.

PART 9: TRI-PARTY AND PUBLIC-PUBLIC PARTNERSHIPS

Another source of funding or cost sharing is “public-public” partnership(s), or intergovernmental agreements between a transit agency and other governmental entities, such as a city, county or state government. With public-public partnerships, a transit agency could share the cost, risks and responsibilities for financing, designing, developing and constructing a TOD. Before transit agencies approach a potential public partner, they should document how the TOD will generate economic benefits and improve the quality of life for local residents.

For situations where a transit agency does not own any, or adequate, land around a transit station, the agency may have to structure a tri-party agreement between the agency, private landowner(s) and a private developer. If the transit agency does not have sufficient funds to acquire the land, it will need to demonstrate the financial return for the landowner(s) to provide the land in exchange for an equity position in the TOD.

PART 10: INFRASTRUCTURE FUNDS

Over the last few years infrastructure funds have been formed in the capital market. Infrastructure funds allow investors to own part of a professionally managed portfolio of infrastructure assets, such as:

- Rail facilities and other transport assets
- Toll roads
- Utilities
- Airports
- Communications assets, such as broadcasting towers
- Materials handling facilities

Most of these funds include one to three asset allocations: transportation, utilities and building development.

The five largest funds include:

Goldman Sachs:	\$6.5 billion
Macquarie:	\$4.0 billion
Deutsche Bank/RREEF:	\$3.0 billion
JP Morgan:	\$3.0 billion
CIT Group:	\$2.5 billion

THE BASIS FOR GOVERNMENTS TO RECEIVE A RETURN ON THEIR INVESTMENTS

Transit agencies and governments nationwide have made substantial investment in land, infrastructure and transit systems. Commercial developments at tran-



Downtown Carrollton DART station in Carrollton, Texas.

sit stations or TODs should generate enormous amounts of non-tax income and tax revenue for the participating government entities. In other words, private developers of TODs should provide a competitive ROI to the government entities that invest in the land around transit stations, infrastructure required by the TOD and the transit system. The transit system can be heavy rail, light rail and/or bus rapid transit (BRT). In addition to the major government investments, private developers are achieving premium rental rates for housing, retail and office space at TODs.

SUMMARY

The proposed 10-part approach to structuring the financing of TODs and transit-related developments provides a multitude of funding sources, ways to generate additional income and enormous flexibility, all of which should lead to creative public/private finance plans for TODs, transit systems and transit-related facilities. ■

John Stainback is president/CEO of Stainback Public/Private Real Estate, LLC (SPPRE). Will Reed is a vice president for finance with SPPRE.