



March 5, 2020

David Pearson
The Historic Trust
750 Anderson Street
Vancouver, WA 98661

Re: Laundry & Boiler Buildings at the Academy Site

Dear David,

On behalf Meritus Consulting (formerly Venerable Properties), thank you for the opportunity to present this feasibility analysis for the Laundry and Boiler Buildings located at the Providence Academy site. My opinion is based on over 25 years of company experience in commercial real estate development, with significant expertise in historic properties. Our firm has tackled some of the most challenging historic rehabilitation projects in Portland, including the White Stag Block, Washington High School, and the Ladd Carriage House. My role in the company is one of project manager and historic preservation specialist. I'm passionate about finding creative solutions for challenging historic buildings; however, my experience with project budgeting, financial structuring, and construction management also grounds this passion in the realities of economic feasibility. Because of my unique real estate development expertise, I have taught a graduate seminar in the University of Oregon's Historic Preservation Program on this topic for many years. Additionally, my article in the *Forum Journal* titled "Meeting the Secretary's Standards for Historic Rehabilitation: The Developer's Perspective" provides insights into the challenges that come with repurposing historic buildings in an economically sustainable fashion. (<https://tinyurl.com/sf67j8b>)

My familiarity with the Laundry and Boiler Buildings dates back to 2012 when my firm assisted the Trust with their due diligence for the Academy site acquisition. At that time, both buildings were noted to be in a state of significant deterioration and lacking structural integrity. Reviewing the state of the buildings in 2020, their condition is unchanged. In order to reuse the buildings and make them ready for occupancy, almost all building materials need significant repairs or replacement. Code-mandated fire life safety, seismic, and ADA upgrades will be required. All new systems and utilities are needed, including a sewer connection and electrical service. The brick walls of the Laundry Building need extensive repair and repointing. Both buildings require significant roof work (the Boiler Building currently has no roof or roof structure). They also both need new windows and doors, as well as new interior finishes throughout.

The cost to rehabilitate the buildings was priced by a contractor experienced in historic rehabilitation in 2012. I've applied an appropriate escalation factor recommended by a knowledgeable contractor to these construction estimates in order to generate rehabilitation costs appropriate to 2020. As is to be expected, the cost of the work is high due to the condition of the buildings and the fact that they have very little residual value. In round numbers, total construction costs, including expected tenant improvements, are estimated at approximately \$3.3M for the Laundry Building and \$1M for the Boiler Building. Except for some of the interior finishes, the majority of these costs would be required for any use in the building. Whether the occupants are office workers or artists, the buildings must be safe, secure, and meet the requirements of the building code.

In addition to their deteriorated condition, the buildings pose several additional challenges to a financially feasible rehabilitation. First, there has been no market interest in the buildings to date. I understand the Trust has reached out to commercial real estate brokers and other developers known for their interest in historic buildings such as McMenamins. I am also aware that the Trust hired a real estate professional for two years who was pursuing opportunities to develop the land around the Academy. These efforts did not produce any leads.

Second, the location of the buildings places limitations on their reuse potential. Being located in Vancouver, their ability to generate the necessary income to yield a reasonable return on investment is less robust compared to markets like Portland or Seattle, yet construction costs in Vancouver are not proportionately less. The buildings are also located at the interior portion of the Academy site and the reduced visibility and connectivity to the grid makes them less desirable for commercial uses. They are poorly suited for any retail/service uses that thrive on visibility and ease of access.

Third, the size and shape of the buildings is also problematic. They are relatively small and so there is not very much square footage over which to spread the costs of rehabilitation. With an interior width of only 22 feet, the Laundry Building's long narrow shape makes it challenging to reuse efficiently. When you add in a corridor for circulation, the possibilities for the types of spaces you can deliver are increasingly limited. Depending on the use, the Laundry Building has 4,400-5,000 of rentable square footage. The Boiler has about 1,600 sf.

As part of this feasibility analysis, I created a conceptual development budget and pro forma for each building (attached). The budget includes 1) an assumed amount for the Trust's basis in the building, 2) shell and core construction costs that do not include any interior demising or finishes, 3) costs associated for the build-out of the building interior depending on use, 4) soft costs including architectural, professional consultants, permits, etc., assumed to be 25% of construction costs, and 5) financing costs including interest and fees.

Total development costs for the Laundry Building rehabilitation, which includes soft costs and financing costs, range from \$4.6M to \$4.8M. Total development costs for the Boiler Building rehabilitation range from \$1.4M to \$1.5M.

For the income side of the analysis, I considered the likely uses, including small office and apartments in the Laundry Building, and single-tenant office and restaurant use in the Boiler Building. I used rates that were at the upper end of the market for Vancouver. For all uses, I assumed an 8% vacancy/collection loss rate. For the small office space in the Laundry Building, I assumed the leases were full service and operating expenses were \$8 per square foot. Looking at the Laundry Building as apartments, I assumed the expenses would equal 30% of gross receipts. For the Boiler Building, it was assumed that a single-tenant user would have a NNN lease and pay for the building expenses. All of these assumptions are typical in the current market.

As a result, the net operating income (NOI) for the Laundry Building is between \$85,000-\$87,000 annually. The NOI for the Boiler Building is between \$37,000 - \$40,000. These amounts are extraordinarily low given the level of investment the buildings require. It should be noted that making minor adjustments to the pro forma assumptions, such as lowering the operating expenses or boosting the rent by a few dollars per square foot, has no appreciable effect on the return because the level of required investment is so high.

A projected value for the buildings at completion and stabilization was done taking the NOI and dividing it by a 6% capitalization rate, as income is the primary driver of value in commercial real estate. The completed value for the Laundry Building is estimated at \$1.4M and for the Boiler Building it would be in the range of \$610,000-\$660,000. This demonstrates that the cost to rehabilitate the buildings is significantly higher than their value.

The value of the building also dictates the amount of conventional financing that can be used to fund the rehabilitation. A bank will specify a loan-to-value ratio for the loan amount and a debt coverage requirement for the debt service payments. Typically, a loan-to-value would be no higher than 70% and net operating income would need to be at least 1.2x the debt service. As the pro formas demonstrate, a significant portion of the funding strategy to rehabilitate these buildings would have to come from equity and other non-debt sources due to their collateral values being so much lower than the rehabilitation costs.

Historic tax credits are often a tool that developers turn to when there is gap between cost and value. Given that the Laundry and Boiler Buildings are listed in the National Register of Historic Places, any rehabilitation work is potentially eligible for the federal 20% historic tax credit. This is an incentive I'm very familiar with, having used it to help fund several major historic rehabilitation projects in Portland. However, the historic tax credit would not substantially close the gap for the Laundry and Boiler Buildings. Factoring in current investor pricing and transaction costs including legal, accounting, and processing fees paid to the National Park Service, the historic tax credit could only provide about 12-13% of the needed funding. Tax credit applications and investor deal structuring are complicated and the process lengthy, which adds costs in staff and/or consultant time.

In completing this feasibility analysis, my conclusions are as follows:

- A rehabilitation of the Laundry and Boiler Buildings carries a high level of risk. All real estate development is risky; however, the risk increases when working with existing buildings, especially those that are significantly deteriorated.
- A majority of the cost to rehabilitate these buildings will apply to any use. Because the buildings need significant repairs and upgrades for even the most basic types of users, there is no feasible "light touch" rehabilitation scenario.
- In order for these buildings to be rehabilitated in financially feasible manner, the costs to do so would need to be substantially closer to their values at completion. However, it is fundamentally impossible to improve the buildings at such a low cost when they are in need of such significant repairs and upgrades.
- The return on investment is almost zero, so there is no financial upside to taking on the risk to rehabilitate these buildings. This is the reason why there has been no interest from other developers in the market to acquire and invest in these properties for any use.
- Any funding strategy for this project would necessitate a large amount of equity and other non-traditional sources due to the inability to finance the project based on the buildings' at-completion values.
- While historic tax credits can be a beneficial funding tool, they are unable to have an appreciable effect on closing the large gap between cost and value for this project.

David, thank you again for the opportunity to provide you with this feasibility analysis. I believe the numbers show conclusively that there is no economically sound way to rehabilitate these buildings.

Sincerely,

A handwritten signature in black ink that reads "Jessica Engeman". The signature is written in a cursive style with a large, sweeping initial "J".

Jessica Engeman

LAUNDRY BUILDING

Office				Apartments			
Rentable SF			5,046	Rentable SF			4,456
Basis/Acquisition			400,000	Basis/Acquisition			400,000
Shell & Core Construction			2,882,200	Shell & Core Construction			2,882,200
Interior Build Out			378,450	Interior Build Out			504,600
Soft Costs			815,163	Soft Costs			846,700
Financing Costs			163,033	Financing Costs			169,340
TOTAL Development Costs			4,638,845	TOTAL Development Costs			4,802,840
	SF	Full Service Rent per SF	Annual Rent		550-650 SF	Average Monthly Rent	Annual Rent
Office 1	562	\$ 27.00	15,174	Apt 1		\$ 1,400	16,800
Office 2	632	\$ 27.00	17,064	Apt 2		\$ 1,400	16,800
Office 3	632	\$ 27.00	17,064	Apt 3		\$ 1,400	16,800
Office 4	632	\$ 27.00	17,064	Apt 4		\$ 1,400	16,800
Office 5	632	\$ 27.00	17,064	Apt 5		\$ 1,400	16,800
Office 6	632	\$ 27.00	17,064	Apt 6		\$ 1,400	16,800
Office 7	632	\$ 27.00	17,064	Apt 7		\$ 1,400	16,800
Office 8	692	\$ 27.00	18,684	Apt 8		\$ 1,400	16,800
Vacancy/Collection Loss			<u>(10,899)</u>	Vacancy/Collection Loss			<u>(10,752)</u>
Gross Income			125,343	Gross Income			123,648
Expenses			(40,368)	Expenses			(37,094)
Net Operating Income			84,975	Net Operating Income			86,554
Projected Value Based on NOI & 6% Cap Rate			1,416,244	Projected Value Based on NOI & 6% Cap Rate			1,442,560
Loan Amount			906,396	Loan Amount			923,238
Historic Tax Credit Equity			610,394	Historic Tax Credit Equity			634,009
Net Equity			3,122,056	Net Equity			3,245,593
Debt Service			(70,288)	Debt Service			(71,594)
Net Income			14,686	Net Income			14,959
Cash on Cash Return			0.47%	Cash on Cash Return			0.46%

BOILER BUILDING

Office

Rentable SF		1,599
Basis/Acquisition		200,000
Shell & Core Construction		891,240
Tenant Improvement \$	40.00	63,960
Soft Costs		238,800
Financing Costs		<u>47,760</u>

TOTAL Development Costs

1,441,760

Restaurant/Café

Rentable SF		1,599
Basis/Acquisition		200,000
Shell & Core Construction		891,240
Tenant Improvement \$	75.00	119,925
Soft Costs		252,791
Financing Costs		<u>50,558</u>

TOTAL Development Costs

1,514,514

	SF	NNN Rent	Annual Rent
Office	1,599	\$ 25.00	39,975
Vacancy/Collection Loss			<u>(3,198)</u>
Gross Income	1,599		36,777
Expenses			-
Net Operating Income			36,777
Projected Value Based on NOI & 6% Cap Rate			612,950
Loan Amount			380,029
Historic Tax Credit Equity			178,813
Debt Service			(29,470)
Net Income			7,307
Net Equity			882,918
Cash on Cash Return			0.83%

	SF	NNN Rent	Annual Rent
Restaurant	1,599	\$ 27.00	43,173
Vacancy/Collection Loss			<u>(3,454)</u>
Gross Income	1,599		39,719
Expenses			-
Net Operating Income			39,719
Projected Value Based on NOI & 6% Cap Rate			661,986
Loan Amount			410,431
Historic Tax Credit Equity			189,290
Debt Service			(31,828)
Net Income			7,892
Net Equity			914,793
Cash on Cash Return			0.86%