



## THE GREENWICH GROUP

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### **MEMO TO GARDEN CITY ON AVALONBAY'S REVISED PROPOSAL**

**November 24, 2008**

The Greenwich Group International, LLC (GGI) has been asked by the Village of Garden City (Village) to revisit our original analysis of AvalonBay's proposal for St. Paul's in light of changing market conditions and the proposed "enhancements" that AvalonBay presented to the Village on November 6, 2008. This memo summarizes our analysis and key findings.

#### **Recap of Original AvalonBay Proposal (June, 2008)**

GGI worked with the Village in the spring of 2008 to secure the following deal terms from AvalonBay, which were embodied in a term sheet executed by AvalonBay on June 4, 2008:

- 20 year PILOT with a fixed schedule of payments commencing in Year 3 after project completion
- Ground lease term of 99 years, with fixed payments of \$0
- Profit share to Village of 25% of net operating income after AvalonBay receives a 10% return on capitalized project construction costs net of any historic tax preservation credits, for the term of the ground lease.
- Capital proceeds share to Village of 25% from any sale or refinancing after AvalonBay receives a 13% unleveraged IRR on its investment.

Based on GGI's analysis of then-current market expectations regarding capital costs, rents, operating expenses, and escalation, we projected an IRR of 11.71% and a cash-on-cash return of 8.94% to AvalonBay over a 10-year period, and an income stream to the Village from PILOT payments and a share of profits worth almost \$4 million over a 20-year period on a present value basis. We found these returns and the proposed deal terms to be fair and reasonable to both parties.

#### **Review of "Enhanced" AvalonBay Proposal (November, 2008)**

GGI was asked to evaluate the means by which AvalonBay was able to significantly improve its proposal to the Village, as well as to project the returns to AvalonBay and the Village that the enhanced proposal was likely to generate under a variety of different scenarios. Our review has focused on the two major financial components of AvalonBay's enhanced proposal: its willingness to invest \$1 million in improvements to Cluett Hall or Feringa Fieldhouse and to make significantly higher Payments in Lieu of Taxes (PILOTs) beginning in the first year of project operation.

We began by adjusting our analytic model to address changes in market conditions. Given the lack of construction lending and widespread cancellations of projects in development, we anticipate a considerable slow-down in construction over the near term. Weakening global demand is likely to result in reduced prices for materials and labor, offsetting years of rampant construction escalation. The general consensus in the industry is that construction costs may decline up to 15% over the next several years. We have therefore looked at what happens to AvalonBay's and the Village's returns if construction costs decline by 0%, 5%, 10%, and 15%, respectively.

We believe that the current economic downturn is also likely to have an impact on rental revenue in the initial years of occupancy. In our previous analysis of AvalonBay's original proposal, we assumed initial market rents of \$39 per square foot per year and 4% growth from initial occupancy (2011). Our updated analysis maintains the assumed 2011 rent; however, it is more likely that rental rates will remain flat in the near term as the economy recovers. Our model therefore projects 0% growth in rents for two years and 4% growth thereafter. All other economic assumptions remain the same.

We understand that AvalonBay has indicated that its willingness to make additional concessions was motivated, at least in part, by its anticipation of reduced construction costs. AvalonBay has clearly taken \$1 million or approximately 2% out of its construction cost budget and redirected it to improving Village facilities. However, AvalonBay has also committed to paying significantly more in PILOTs, which must be paid out of operating cash flow and could therefore eat into AvalonBay's profits. It is likely that AvalonBay can afford the "enhancements" as it is anticipating that construction costs will decline by more than 2%, which is consistent with what most industry experts are forecasting. Additional declines in construction costs would reduce AvalonBay's initial investment and therefore the amount of operating cash flow required to pay AvalonBay a return. As evidenced by the chart below, AvalonBay will need to achieve construction savings of more than 10% in order to preserve the returns that were contemplated previously:

Sensitivity Analysis to Costs				
Costs % Decline	AVB IRR	AVB C on C	PV Garden City Share	1st Year of Participation
0%	9.53%	7.65%	\$5,807,466	2023
5%	10.26%	8.05%	\$6,085,545	2022
10%	11.05%	8.50%	\$6,412,863	2020
15%	11.90%	8.98%	\$6,799,603	2019
Previous	11.71%	8.94%	\$3,998,273	

It should be emphasized that the Village's returns will also improve if construction costs decline—by up to \$1 million in present value terms if a reduction of 15% is realized. This is because with a reduced initial investment, AvalonBay's preferred return requirement will be met more quickly and the Village's participation in profits will begin earlier and yield more.

However, if construction costs do not decline at all, the Village is still better off financially under AvalonBay's "enhanced" proposal than previously. With the proposed enhancements, the present value of the revenue stream to the Village over the first 20 years of the project increases by \$1.8 million, from \$4 million to \$5.8 million. As illustrated by the chart below, the effect of the enhanced proposal is to move more of the Village's return from the more speculative profit share to fixed payments like the investment in Cluett/Feringa and PILOTs:

***Present Value of Payments to the Village (years 1-20)***

	<b>Previous</b>	<b>Current</b>	<b>Difference</b>
Investment in Facilities	\$0	\$1,000,000	\$1,000,000
PILOT Payment	\$2,030,000	\$3,910,000	\$1,880,000
Participation (Profit Share)	\$1,970,000	\$900,000	– \$1,070,000
<b>Total</b>	<b>\$4,000,000</b>	<b>5,810,000</b>	<b>\$1,810,000</b>

*Discount Rate = 4%*

Thus, even under what could be seen as a "worst case," the present value of the revenue stream to the Village under the "enhanced proposal" over the first 20 years of the project increases by \$1.8 million, from \$4 million to more than \$5.8 million.

**Summary of Findings:**

- Present value of AvalonBay payments under the "enhanced proposal" to the Village has increased by a minimum of 45%
- Payments are more certain: AvalonBay's enhanced proposal provides 85% of payments in the form of a fixed investment in public facilities or PILOT and 15% in profit share; previously, 51% of payments were fixed and 49% were derived from profit share.
- AvalonBay's projected profits as measured by initial yield, 10-year IRR, and cash-on-cash return decrease:
  - Initial yield drops by approximately 50 basis points from 7.45% to 6.91%
  - 10-year IRR drops by 18%, from 11.71% to 9.53%
  - 10-year average cash-on-cash return decreases by 14%, from 8.94% to 7.65%
- Since AvalonBay is proposing to "spend" its \$1 million in anticipated construction savings on upgrading the Village's recreational facilities, AvalonBay does not benefit from these savings.
- If, however, construction prices decrease as expected and AvalonBay realizes additional construction savings, both the Village and AvalonBay will benefit. The Village will benefit due to its 25% profit share, which will start earlier and generate more revenue because there is less initial investment on which AvalonBay must earn a preferred return. AvalonBay's return on investment will also increase, as illustrated in the table on the previous page.
- AvalonBay's projected IRR of 11.71% under its previous proposal will now be achieved only if construction costs decline by more than 10% (refer to table on previous page)
- If rents increase more than anticipated, the Village's return will increase due to the profit sharing provision. However, if rents remain flat or decrease, the Village's fixed PILOT payments are protected.

## **Conclusion**

Our initial analysis concluded that the previously proposed deal was fair and equitable based on the reasonable return expectations for the redevelopment of St. Paul's at the time of the analysis. The current proposal from AvalonBay lowers expected returns to AvalonBay and increases its risk as a result of higher fixed PILOT payments. It is also apparent from our analysis that AvalonBay will need additional savings of 10% - 15% in construction costs to achieve returns expected under the previous proposal. The profit sharing arrangements negotiated with AvalonBay ensure that the Village will participate in any cost savings through a higher participation payment.

We believe that the current proposal, which provides both more revenue and higher proportion of fixed revenue to the Village, represents a more attractive offer for the Village and is fair and reasonable in light of current market conditions. Despite the extreme volatility in the market, we believe that the Village is protected on both the downside, due to the greater proportion of fixed payments, and on the upside, due to its ability to share in profits.