FINAL REPORT

Laurel Hill Adaptive Reuse Area
Developer Fee, Return on Investment (ROI) and Financial Capacity Assessment

LEADERSHIP • PROBLEM SOLVING • VALUE CREATION

MARCH 25, 2014

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March 25, 2014

Mr. Chris Caperton
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FINAL REPORT
Laurel Hill Adaptive Reuse Area – Developer Fee and Return on Investment Assessment

Dear Mr. Caperton:

Alvarez & Marsal Real Estate Advisory Services, LLC, (A&M) is pleased to submit this Final Report of our firm's assessment of the master developer's proposed fee structure, anticipated return on investment, and capacity to provide financial guarantees. To complete this assignment, we reviewed budget and pro forma information submitted by The Alexander Company and transmitted to A&M on February 14, 2014, and financial documentation submitted by Elm Street Development and transmitted to A&M on November 13, 2013. Additionally, we had telephone discussions with representatives from both companies to clarify our understanding of their financial information.

As outlined in the following report, fee structure and anticipated returns associated with the Laurel Hill Reuse are reasonable and commensurate with the Developer's scope of responsibilities, assumed risk, and financial contributions to the project. Additionally, the Elm Street Development entity which will provide financial guarantees for infrastructure portion of the project, Elm Street Holdings II, LLC ("ESH II"), possesses the financial capacity to do so.

A&M appreciates the opportunity to remain involved in this exciting project. Should you have any questions or require additional information, please do not hesitate to contact me at (202) 729-2110.

Very truly yours,

Jay Brown
Managing Director
Alvarez & Marsal Real Estate Advisory Services, LLC

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1.0 Executive Summary

1.1 Background and Scope of Work

The Laurel Hill Adaptive Reuse Area is a County of Fairfax Public-Private Education Facilities and Infrastructure Act ("PPEA") project located at the former Lorton Prison Reformatory and Penitentiary. The County and its master developer, The Alexander Company ("Alexander"), signed an Interim Agreement on November 4, 2011, setting forth the requirements, obligations, and timelines for negotiating and completing a Master Development Agreement ("MDA"). The Alexander Company, in conjunction with its development partner, Elm Street Development/Elm Street Communities ("Elm Street") (collectively "Developer"), are in the process of completing all necessary land use planning, design, budget, and financial analyses to obtain Entitlement Approvals.

The Developer has prepared and provided to the County final financial information to support their Development Plan. In December of 2013, the County engaged Alvarez & Marsal Real Estate Advisory Services, LLC ("A&M") to perform a third-party assessment of the reasonableness of the development and management fees paid to and the projected return on investment (ROI) earned by the Developer based on the Developer's final financial pro forma. Additionally, A&M was tasked with assessing the financial capacity of Elm Street to provide completion guarantees for infrastructure development and satisfy their development requirements.

The agreed upon scope of work includes the following four tasks:

Task 1 – Identify and calculate the following fees based upon the financial pro forma provided by the Developer:

- Development fee
- Construction fee
- Asset management fee
- Property management fee
- Return on investment ("ROI") measured in terms of an internal rate of return ("IRR"), which would take into account their cash contribution relative to net cash flow distributions and residual (resale) value at the end of the lease or other period.

Task 2 – Benchmark the fees and ROI against industry standards utilizing industry data sources.

Task 3 – Assess the financial capacity of Elm Street Development to provide completion guarantees for infrastructure development and satisfy their development requirements. This assessment will be based upon the Elm Street financial statements provided to A&M by Fairfax County on November 13, 2013.

Task 4 – Prepare a summary report on the reasonableness of fees and ROI addressing each of the areas in Task 1 and the benchmarks identified in Task 2.

1.2 Findings

A&M's assessment of the Developer's anticipated fees and ROI concludes that they are reasonable and commensurate with the Developer's responsibilities, assumed risk, and financial contributions to the project. As this report details, the Developer, based on the documentation reviewed by A&M, will collect the majority of its proceeds from this project through preferred returns that constitutes both a return on contributed equity and a traditional development fee for the multifamily and commercial portions of this redevelopment project. To approximate the long-term value of those project components, A&M calculated sales prices of the Developer's ownership interest in Year 10 of project operations, net of outstanding debt and cost of sales. The Developer's contributed equity, property cash flow/preferred return projections, and the calculated Year 10 net sales price were incorporated into a calculation of internal rate of return ("IRR"). The IRR for the multifamily portion of the project is 11.2%, 24.2% for the commercial portion of the project, and 27% for the for-sale residential components. As discussed in detail in the following sections, A&M believes those IRRs to be reasonable compared to industry benchmarks and considering the degree of project risk. Furthermore, A&M has concluded that the Developer's proposed developer, construction management, asset management, and property management fees are generally within standard industry ranges and regulatory maximums and are reasonable in the context of the Laurel Hill Reuse project.

A&M's assessment of Elm Street's capacity to guarantee completion of its infrastructure development focused on the Elm Street Holdings II, LLC ("ESH II"), an Elm Street entity whose purpose is to have an asset base available to provide financial guarantees on debt incurred by the Elm Street Development Entities. A&M has concluded that, based on the information provided by Elm Street, ESH II has sufficient capacity to accommodate the maximum liability associated with the required guarantee, estimated by to be approximately $22 million (total of Developer's share of infrastructure costs). Furthermore, this review concluded that, such guarantee will not cause the entity to violate any disclosed existing covenants related to liquidity, valuation or total amount of financial obligations.

2.0 Development Fees and Return on Investment

2.1 Identification of Development Fees

Identify and calculate the following fees based upon the financial pro forma provided by the Developer:

- ***Development fee***
- ***Construction management fee (if applicable)***
- ***Asset management fee (if applicable)***
- ***Property management fee (if applicable)***
- ***Return on investment (ROI) measured in terms of an internal rate of return (IRR).***

This analysis identifies and calculates relevant fees that will be collected by the Developer based on a review of the Developer's final budget and pro forma submittal as received by the County in February 2014. The Developer, as is common in the context of a mixed-use development, prepared separate budgets and pro formas for the rental residential (i.e., multifamily) and commercial (i.e., retail and office) portions of the development. Those project components are the main drivers of Developer returns, and as such, are the main focus of the following analyses. Since the single-family homes and townhomes will be for-sale properties, as opposed to income-producing assets that the Developer will continue to own, the ROI will primarily be a function of the pace of sales relative to related expenditures. Analysis on the following pages determines calculates an estimated ROI for the for-sale project components based on assumptions provided by the Developer and formulated by A&M. Operational metrics, such as property management fees, are not relevant for the for-sale project components, since the related responsibilities and costs will be borne by the ultimate purchasers and occupants.

<u>Development Fee and Return on Investment (ROI)</u>

In the context of an owner-developed real estate project, the concepts of "returns" or "profits" generally refer to the return on investment (ROI) on that developer's contributed capital (i.e., equity) in the project. In such projects, the developer typically achieves its return through collection of distributable cash flow from the project[1]. Such projects, including the Laurel Hill Reuse, often also incorporate development fees as a mechanism for the developer to collect distributable cash flow. Often, again including in the case of Laurel Hill, this development fee is a preferred return on distributable project cash flow, as opposed to a lump sum payment or a payment upon development completion. Therefore, distributable cash flow paid as a preferred return (i.e., deferred development fee) constitutes one component of the developer's ROI, with the remainder coming from its share of excess distributable cash flow. Due to their interconnectedness, this assessment considers development fees and ROI jointly; however, important distinctions about the preconditions for and certainty of payments should be noted, as described below.

[1] In cases where the developer is not the project owner, and that developer does not have equity contributed to the project, it is common for the developer to collect a straight fee irrespective of ROI. Development fees for such fee-only developments are not necessarily analogous to the Laurel Hill project, due to the absence of developer capital at risk.

For the Laurel Hill Reuse project, the Developer intends to collect separate development fees for the multifamily and commercial portions of the development, 16% and 11.5%, respectively, rather than a single development fee covering both[2]. Such a structure is appropriate given the disparate capital sources that will fund each project component. Given that both components of the project will utilize proceeds from the sale of State and Federal tax credits for a portion of the project funding (historic and low-income housing tax credits for residential, historic only for commercial), the Developer is required to spread the payment of development fee over ten years in order for the development fee to count toward the basis eligible for tax credits, which determines the size of the proceeds ultimately available for funding). The Developer has utilized a structure as described above, in which the development fee is structured as a preferred return against distributable cash flow.

Although the development fee for the multifamily and commercial portions of the project may be contractually guaranteed, as a practical matter, the Developer is not guaranteed to receive any amount of it. This is for two reasons:

1) Structuring the fees over ten years, instead of collecting a lump sum upfront (likely funded through permanent financing), requires distributable cash flow for any payments to be made against the development fee outstanding balance. Such distributions are the lowest priority on the cash flow statement, and they can only be made provided that all operating and non-operating expenses (including contributions to replacement reserves) and debt service (payment to satisfy outstanding principal and interest) are satisfied first. In the event of insufficient distributable cash flow, the outstanding balance "carries" into the next year; however, the Developer still bears the risk that distributable cash flow may never reach sufficient levels.
2) The Developer does not have recourse to collect its development fee from a third-party entity, since it is the Developer that controls the project. Any claim that the Developer made to recover owed development fees is effectively a claim against itself or a sister entity.

The sources of uncertainty described above represent risk assumed by the Developer, as opposed to by the County. Although the County is invested in the success of the project, the assumption of this uncertainty by the Developer protects the County from performance risk, and instead transfers it to the Developer, which, in this case, is the party best-equipped to mitigate and manage said risk.

As compensation for assumption of that risk, the Developer will receive distributable excess cash flow above and beyond its development fee to the extent that project performance allows. Given that there is no certainty that the Developer will even receive the development fee, excess cash flow of this sort is considered highly uncertain and risk-laden. Given that uncertainty and the scope of this assignment, A&M utilized the Developer's forecasted cash flows for the first ten years of the project. In addition to

[2] The Developer has forecasted nominal rent for a storage use for the power plant and chapel. Those assets are grouped with the Developer in the multifamily portion of the project. For purposes of this report, references to the multifamily portion or component of the project should be understood to include the power plant and chapel, despite those assets' non-residential intended uses.

incorporating ten years of cash flow forecasts, A&M calculated a Year 10 Capitalized Value (based off of pro forma net operating income) to approximate an achievable sale price. To maintain consistency with the Developer's pro forma, along with recognition of the challenges of forecasting a capitalization rate ("cap rate") a decade in the future, A&M utilized a cap rate of 9% for the commercial portion of the project. In recognition of the relative strength of the housing market in the vicinity compared to commercial, A&M applied a 7% cap rate to the residential portion. Finally, A&M deducted the outstanding loan balance from the capitalized value to derive a terminal value. Using that cash flow data, terminal value, and the initial equity investment from the developer, A&M calculated a levered[3] internal rate of return ("IRR") for the multifamily and commercial portions of this project. This full calculation is included as Appendix A to this report. The table below summarizes the development fees and projected IRRs associated with each portion of the project.

Figure 1. Summary of Development Fees and Anticipated IRR

	Commercial	Multifamily	For Sale Residential
Development Fee (%)	11.5%	16%	N/A
Development Fee ($)	$2,235,910 (over ten years)	$5,639,885 (over ten years)	N/A
Anticipated IRR	24.2%	11.2%	27%

These calculated IRRs should be interpreted in the context of overall project operations, and relative to the risk assumed by the Developer. Specifically, the IRR calculations above consider only the contributed equity that the Developer has allocated or will allocate to that portion of the project, along with that portion of the project's cash flow from operations and long-term value.

It should also be noted that the assumed cap rate for purposes of calculation of terminal value has an enormous effect on the calculated IRR for the project. The table below demonstrates the effect of changing the assumed cap rate on the IRR for each component (baseline assumptions are highlighted yellow.)

In addition to the rental multifamily and commercial components of this project, the Laurel Hill Reuse will include 157 townhomes and 24 single-family detached homes that are projected to sell at $540,000 and $725,000 per unit, respectively. The costs associated with building each unit are $357,000 for townhomes and $430,000 for single family detached homes, producing net proceeds of $183,000 and $295,000 per unit, respectively. However, those per unit calculations do not fully reflect the impact of necessary infrastructure and other costs, as explained below.

[3] A&M excluded unlevered IRR from this analysis. Due to the complex nature of the financing for this project, and resultant restrictions on multifamily rental rates, calculation of unlevered IRR would necessitate analysis of an impossible hypothetical. The analytical value of such calculation was considered negligible, therefore A&M elected to only calculate levered IRR in this assessment.

Figure 2. Cap Rate vs. IRR Sensitivity Analysis

Commercial			Multifamily	
Assumed Cap Rate	IRR		Assumed Cap Rate	IRR
7.0%	28.4%		5%	20.9%
7.5%	27.3%		5.50%	18.6%
8.0%	26.2%		6%	16.2%
8.5%	25.2%		6.50%	13.8%
9.0%	24.2%		7%	11.2%
9.5%	23.2%		7.50%	8.2%
10.0%	22.3%		8%	4.6%
10.5%	21.4%		8.50%	Negative IRR
11.0%	20.5%		9%	Negative IRR
11.5%	19.6%		9.50%	Negative IRR
12.0%	18.7%		10%	Negative IRR

In the budget and pro forma information provided to A&M by the Developer, costs associated with infrastructure, site design and engineering, demolition and stabilization, and fees owed to the County (collectively "site work") are not attributable to any specific component of the development. In consultation with the Developer, it was decided that the Developer's cost of infrastructure, estimated to be $22 million, was allocated solely to the for-sale townhomes and single family homes. After allocating the infrastructure cost and taking into account construction costs, sale prices, and pace of sales, A&M calculated the IRR on the for-sale homes at 27%.

Construction Management Fee

The Developer has indicated that construction management fees will be paid to the construction contractor – not to the Developer. While it is a cost to the project, it is not earned by the Developer. Nonetheless, the developer budget and pro forma applies different construction management ("CM") fee amounts and structures to the multifamily and commercial project components. For the multifamily component, the development budget includes a Contingency/Construction Management Fee line item (10% of hard costs), which A&M has interpreted to mean that the construction management team will be effectively "construction manager at risk," that is, the construction management fee will be the balance of the unused contingency account. There are no additional contingencies identified by the Developer for this component of the project.

For the commercial component of the project, the Developer has utilized a simple construction management fee (4.5% of hard costs, including contingencies). The Developer will allocate separate contingencies for commercial new construction (5% of hard costs) and historic reuse commercial construction (10% of hard costs). Those fees are summarized in the table below.

Figure 3. Summary of Construction Management Fees and Budget Contingencies

	Commercial	Multifamily
CM Fee (%)	4.5% hard costs	Balance of 10% hard cost contingency
CM Fee ($)	$717,104	Up to $3,272,611
Additional Contingencies	5% hard, new const. 10% hard, reuse	None

Asset Management Fee

Asset management generally refers to the monitoring and preservation of value of tangible or intangible assets. In the context of real estate, asset management can apply to both tangible assets, such as buildings and land, and to intangible assets, such as tax credits. Both categories of asset management fee are relevant to the Laurel Hill Reuse project, although the Developer only stands to collect asset management fees related to some tangible assets.

Facilities are generally leased to tenants on either a *gross* or a *net* basis. A gross lease (sometimes referred to as a "full-service lease") means that the landlord (in this case, the Developer) funds real estate taxes, insurance, and all operating expenses for the project. The gross lease rate should be sized to cover those costs for the landlord; however, there are no reconciliations or reimbursements for any costs in those categories. Under a net lease, the tenant, instead of the landlord, is financially responsible for real estate taxes, insurance, and all operating expenses. In the case of multi-tenanted buildings, net leases also incorporate common area maintenance ("CAM") charges, which are typically shared pro rata between tenants. The landlord often funds some or all of these expenses upfront, and receives reimbursements through reconciliations. The performance of gross leased buildings is more susceptible to landlord operating decisions than a net leased building, since the majority of operational responsibility has been shifted to the tenant in the latter category. Because of these distinctions, it is near-universal for gross leased buildings to utilize dedicated asset managers; net leased buildings experience more variability because of the diminished efficiency returns associated with such a function.

For the multifamily portion of the project, the Developer intends to incur an asset management fee starting at $5,000 and escalating annually at 3%. During the first year of operations, this constitutes a fee equivalent to 1.1% of total revenue. Starting in the second year of operations, during which period the asset management fee increases to $5,150, the fee percentage drops to 0.2%, at which it remains during the ten years forecasted in the pro forma. This fee is assumed to be self-paid, in that it would reimburse the Developer for costs associated with in-house asset management.

For the commercial portion of the project, the Developer does not forecast a specific asset management fee. The Developer does include a CAM Administrative Fee as a portion of its CAM expenses, however that specific figure is not distinguished from the remaining CAM expense items. Given that the CAM Administrative Fee will ultimately become a pass-through line item paid ultimately by tenants, market discipline typically keep such fees in check, and the fee levels may even be among terms included in

lease negotiations between the Developer and potential tenants. It is assumed that such an administrative fee would be self-paid, in that it would reimburse the Developer for costs associated with the allocation of CAM expenses and associated records keeping.

Figure 4. Summary of Asset Management Fees, Tangible Assets

	Commercial	Multifamily
Asset Mgmt. Fee (%)	CAM Admin fee included in CAM expenses	Approx. 0.2% total revenues
Asset Mgmt. Fee ($)	Unknown, believed to be nominal	$57,319 (during first ten years of project)

For both the multifamily and commercial portions of the project, the Developer anticipates funding asset management costs associated with Federal and State historic tax credits and low-income housing tax credits (LIHTC). However, a full discussion of tax credit intricacies surpasses the scope of this study. It is common practice, and sometimes a requirement, for landlords and developers to utilize third-party tax credit asset managers for the benefit of tax credit investors, which is the basis for the assumption that this asset management cost, unlike those above, will be paid to a third party, and therefore was not compared to industry benchmarks in subsequent sections of this report.

Property Management Fee

The need for property management at a given real estate project, similar to asset management, is often a function of the leases through which tenants occupy the space. In the context of a net lease, under which tenants are assuming the majority of operational responsibility for the property, it is unusual for the landlord to devote much if any resources to property management; it is the responsibility of that property's tenant(s) to allocate resources as needed for management of those premises. On the contrary, in a building occupied by gross lease tenants, the landlord will typically fund property management directly, with the associated costs being reflected in the gross lease rate. Accordingly, the Developer does not anticipate funding a property management function in the commercial, net-leased, portion of the project. However, for the multifamily portion of the project, property management is forecasted at a cost of 6% of effective gross income ("EGI"). During the first year of operations, that amounts to approximately $28,000; in the second year, as revenues increase, that figure rises to approximately $175,000. As it is the Developer's practice to manage its own properties, it is assumed that this also will be a self-paid cost.

Figure 5. Summary of Property Management Fees

	Commercial	Multifamily
Prop. Mgmt. Fee (%)	N/A – net lease	6% of EGI
Prop. Mgmt. Fee ($)	N/A – net lease	$1,685,065 (during first ten years of project)

2.2 Industry Benchmarks

Benchmark the fees and ROI against industry standards utilizing industry data sources.

As a consultant to numerous real estate owners, operators, developers, investors, tenants, and various other stakeholders, A&M has developed knowledge of commonly applied fees and commonly expected returns, as well as an understanding of how to apply them in appropriate context. The table below displays relevant fee/return types, alongside metrics typically applied by A&M. Where appropriate, the table also includes data from trusted published sources, where available and relevant, for another point of comparison. A more detailed version of Industry Benchmarks, with comparisons to the Laurel Hill project are provided in Appendix B to this report.

Figure 6. Summary of Industry Benchmarks

Fee/Return Category	Source	Expected Amount/Range	Notes
Internal Rate of Return (IRR) (measured in terms of discount rates)	PWC Korpacz 4Q2013	18.31% national average discount rate per PwC Korpacz survey 4Q13, reported range of 10-25%, applies to land development only.	Korpacz polls are primarily geared to high-grade institutional-quality projects. Likely lower avg. risk vs. Laurel Hill.
	RealtyRates.com Developer Survey 1Q2014 (Mid-Atlantic Market)	Averages: Single Family: 29.11% Sub. Townhomes: 17.53% Suburban Office: *16.16%* Retail: 17.81% Ranges: Single Family: 19.29 - 41.36% Sub. Townhomes: 13.05 - 23.46% Suburban Office: 11.06 - 22.61% Retail: 11.95-25.14%	Based on actual averages and ranges for the Mid-Atlantic market derived from developer surveys.
Development fee (fee development/no equity)	A&M	3-5% of total development costs (hard plus soft)	Included as point of reference, but significantly less risk than capital-at-risk development.
Development fee for Low Income Housing Tax Credits	Virginia Housing Development Authority	16.5% maximum upfront	When A/E design costs are included
Construction Management Fee	A&M	1-5% of hard costs	Varies greatly depending on risk burden assumed by CM.
Asset Management Fee	A&M	0.5-1.5% collected income	Subject to high variability

Fee/Return Category	Source	Expected Amount/Range	Notes
Property Management Fee (market rate housing)	A&M	3-5% of effective gross income	based on who is defining the term. Best interpreted relative to services provided.
Multifamily Operating Expenses Ratio (included for property management fee context)	A&M, Delta Associates	30-45% of effective gross income	Building age, climate/utility costs, levels of deferred maintenance, and level of service are among the factors that affect this metric.

2.3 Summary Report on the Reasonableness of Fees and ROI

Prepare a summary report on the reasonableness of fees and ROI addressing each of the areas identified in [Section 2.1] and the benchmarks identified in [Section 2.2].

A&M's determination of the reasonableness of the Developer's forecasted ROI and fees took into account several factors:

- Size relative to those prevailing in industry;
- Appropriateness of fee in the specific context of the Laurel Hill Reuse project;
- Assumption of risk by the Developer;
- Alignment of interests between the Developer, County, and the community;
- Ability of the project to support said fee/return.

Based on A&M's assessment and the application of information presented in Sections 2.1 and 2.2 of this report, the fees and ROI projected by the Developer are reasonable and commensurate with the Developer's scope of services performed, assumed risk, and financial contributions to the Laurel Hill Reuse project. Specific commentary on each fee and return category is presented below.

<u>Development Fee and Return on Investment (ROI)</u>

Real estate development projects, such as the Laurel Hill Reuse project, are inherently more risky than other types of real estate investments (e.g., purchasing a fully-occupied, stabilized asset). Above and beyond that inherent risk, developments involving the adaptive reuse of historic structures pose the risk of unforeseen construction complications and other risks that generally drive the required returns for this type of project. The approximately 18% national average for institutional-quality development projects cited in Section 2.2 highlights those risks. As previously discussed, the Developer will have invested capital at risk during the project, meaning that the development fee should not be compared to those associated with fee-only development projects. The Developer's anticipated IRR of approximately 24% for the commercial portion of the project, 12% for multifamily, and 27% for the for-sale residential components are within the reported benchmark ranges for these property types, as shown in Table 6 above and further detailed in Appendix B, Table 9. While the IRR's for commercial and for-sale

components of the Laurel Hill Reuse project are at the higher end of industry benchmarks, these returns are reasonable considering the added risk associated with the historic reuse nature of the development, regulatory requirements of the PPEA, and the transfer of risk from the County to the Developer, particularly lease-up risk for the commercial portion.

Construction Management Fee

The construction management fees proposed by the Developer (although they are not paid to the developer) are considered to be reasonable. For the commercial portion, the 4.5% of hard costs is within the 1-5% range typically encountered by A&M; project risk and complexity, largely driven by the historic reuse nature, justifies a figure on the high end of the range. The 10% of hard costs that covers construction management fees and contingency for the multifamily component is considered reasonable based on the assumption that at least half of that budget item will be used as contingency.

Asset Management Fee

The Developer's asset management fee of approximately 0.2% of revenues for the multifamily portion of the project is extremely modest compared to common industry benchmarks, which range from 0.5-1.5%. The Developer's exclusion of an asset management fee in favor of a CAM administrative fee for the commercial portion is appropriate based on the net lease nature of those assets.

Property Management Fee

The Developer's property management fee of 6% of EGI for the multifamily component is higher than the 3-5% typically encountered by A&M. However, given that the overall operating expense ratio for the multifamily portion is expected to remain at or near 40%, which is a reasonable expense ratio, especially considering the historic reuse nature of the project, the Developer's proposed property management fee is not believed to imperil the health of the project. In addition, the 3-5% property management fee cited refers to market rate rental housing. Given that a portion of the multifamily component will be affordable housing, it is not unreasonable to factor in a buffer of an extra 100 basis points for activities related to compliance and tenant relations.

3.0 Assessment of Financial Capacity

3.1 Summary of Information Provided for Consultant Review

The assessment of financial capacity focused on the entity that would provide completion guarantees for the project infrastructure, Elm Street Holdings II, LLC ("ESH II"). A&M also reviewed the financial statements for a related entity, Elm Street Holdings, LLC, and operating statements for two projects also subject to guarantees from ESH II. A full list of financial information reviewed is presented below:

- Consolidated financial statements for ESH II, dated December 31, 2012;
- Consolidated financial statements for Elm Street Holdings, LLC, a related entity, dated December 31, 2012;
- Financial Covenants for ESH II;
- List of local banks that have approved ESH II to guarantee financial obligations related to the business of Elm Street Development;
- Operating statements for the following properties:
    - Oakton Gable; and
    - Eden at Lancaster;
- Verification of Liquidity;
- ESH II Contingent Liability Report; and
- Calculation of ESH II Borrowing Capacity.

The financial statements reviewed for ESH II and Elm Street Holdings were reviewed by an independent accountant prior to submittal of each to Fairfax County. The independent accountant's report notes that "[a] review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the consolidated financial statements as a whole. Accordingly, we do not express such an opinion." Although this comment did not alter the interpretation of financial statements for purposes of A&M's review, care should be taken to distinguish between independent accountant review and a formal audit. In addition, sections of both sets of consolidated financial statements utilize methodologies which deviate from Generally Accepted Accounting ("GAAP") principles. Specifically, application of those methodologies is limited to derivation of fair values for property interests owned by the subject entities. These methodologies did not undermine the credibility or perceived accuracy of the financial information provided; however, this deviation from GAAP should be noted in interpretation of these financial statements.

3.2 Assessment of Financial Capacity

Assess the financial capacity of Elm Street Development to provide completion guarantees for infrastructure development and satisfy their development requirements.

One of the Developer member entities, Elm Street Development, through its ESH II affiliate, will provide completion guarantees for infrastructure. Although Elm Street will complete the infrastructure and for-

sale portions (i.e., townhomes and single family homes) for the Laurel Hill Reuse project, their completion guarantee only applies to the infrastructure component. The maximum liability associated with this guarantee is estimated to be $22 million.

ESH II, as well as Elm Street Holdings, LLC, are investment holding companies, both of whose purpose is to have an asset base available to provide financial guarantees on debt incurred by the Elm Street Development Entities. As such, both entities have existing obligations guaranteed, and both are bound by financial covenants regarding liquidity, valuation and the total amount of financial obligations.

ESH II, as per the submittal letter to Mr. Joe LaHait from Mr. James Perry dated October 21, 2013, as of June 30, 2013, is capable of providing financial guarantees of up to a limit of $207 million, and that the outstanding balance of all obligations guaranteed by ESH II as of that date is $37 million. A&M's review of the financial documents listed above supported this affirmative statement regarding ESH II. Furthermore, this review concluded that, based on the information provided to A&M, ESH II's guarantee of up to $22 million will not cause the entity to violate any covenants related to liquidity, valuation or total amount of financial obligations.

Appendix A – IRR Calculations

Figure 7. Derivation of IRRs and Supporting Calculations – Multifamily and Commercial Rental

	Commercial						Multifamily					
	Contributed Capital	CF from Operations	Capitalized Value	Outstanding Principal	Cons. Cash Flow	Cash on cash	Contributed Capital	Distributed Cash Flow	Capitalized Value	Outstanding Principal	Cons. Cash Flow	Cash on cash
Year 0	($1,788,728)				($1,788,728)		($3,479,962)				($3,479,962)	
Year 1		$191,981			$191,981	10.73%		$0			$0	0.00%
Year 2		$199,613			$199,613	11.16%		$279,718			$279,718	8.04%
Year 3		$218,184			$218,184	12.20%		$306,572			$306,572	8.81%
Year 4		$236,859			$236,859	13.24%		$332,844			$332,844	9.56%
Year 5		$255,793			$255,793	14.30%		$912,820			$912,820	26.23%
Year 6		$274,987			$274,987	15.37%		$386,427			$386,427	11.10%
Year 7		$294,445			$294,445	16.46%		$389,421			$389,421	11.19%
Year 8		$314,168			$314,168	17.56%		$280,888			$280,888	8.07%
Year 9		$334,161			$334,161	18.68%		$308,909			$308,909	8.88%
Year 10		$354,427	$15,937,021.88	($7,907,232)	$8,384,216	468.73%		$282,363	$25,870,642.29	($21,417,159)	$4,735,846	136.09%
Year 10 NOI	$1,434,332			NPV	$2,602,160		$1,810,945			NPV	$255,953	
Reversion Cap Rate	9%						7%					
IRR					24.2%						11.2%	

Figure 8. Derivation of IRRs and Supporting Calculations – For-Sale Units

Initial Site/Entitlement Investment & State TC Equity				Number of Units	Cost/Unit	Sales Price/Unit	Total Unit Cost	Total Proceeds	Sales Pace/Qtr.	Sales Pace/Year	# Years Req'd
Penitentiary/Reformatory (Net)	-$1,498,652										
Infrastructure	-$12,720,446		Townhomes	157	$357,000	$540,000	$56,049,000	$84,780,000	15	60	2.62
Site Design/Engineering	-$4,140,000		Single Family Detached	24	$430,000	$725,000	$10,320,000	$17,400,000	6	24	1
Demo/Stabilization	-$4,080,000		Totals	181			$66,369,000	$102,180,000			
County Fees	-$800,000										
State Historic TC Equity	$1,616,598										
Net	-$21,622,500										
Year 1 Infra Spend	-9,730,125		Year 1 For Sale Costs	$0.0		Year 1 For Sale Revenue	0				
Year 2 Infra Spend	-5,405,625		Year 2 For Sale Costs	-$31,740,000		Year 2 For Sale Revenue	$24,900,000				
Year 3 Infra Spend	-4,324,500		Year 3 For Sale Costs	-$21,420,000		Year 3 For Sale Revenue	$41,100,000				
Year 4 Infra Spend	-2,162,250		Year 4 For Sale Costs	-$13,209,000		Year 4 For Sale Revenue	$32,400,000				
						Year 5 For Sale Revenue	$3,780,000				
			Year 1 Net	-$9,730,125							
			Year 2 Net	-$12,245,625							
			Year 3 Net	$15,355,500							
			Year 4 Net	$17,028,750							
			Year 5 Net	$3,780,000							
			IRR	27%							

Appendix B – Summary of Comparison to Industry Benchmarks

Figure 9. Summary of Comparison to Industry Benchmarks

Fee/Return Category	Source	Expected Amount/Range	Notes	Laurel Hill Anticipated	Comments on Reasonableness
Internal Rate of Return (IRR) (measured in terms of discount rates)	PWC Korpacz 4Q2013	18.31% national avg. 10-25% national range Applies to land development only	Primarily high-grade institutional-quality projects. Likely lower avg. risk vs. Laurel Hill.	Commercial: 24.2% IRR Multifamily: 11.2% IRR For-Sale: 27% IRR (See notes regarding site work cost allocation and exit cap rates.)	Commercial, multifamily, and for-sale residential IRRs in line with industry standards and commensurate with risk. Commercial IRR is at the higher end of the Mid-Atlantic range, but this is reasonable given the historic reuse Multifamily is lower end of the Korpacz national range, as well as the lower end of the Mid-Atlantic ranges surveyed by RealtyRates. This is understandable due to the regulatory profit limits required by the tax credit programs For-sale residential is above the Mid-Atl. weighted avg. (20%) and at the high end of the Mid-Atl. weighted avg. range (14% - 27%)
	RealyRates.com Developer Survey 1st Quarter 2014	**Single Family**: *National:* 35.47% avg; 15.54-55.04% range *Mid-Atl:* 29.11% avg; 19.29-41.36% range **Sub. Townhomes:** *National*: 20.57% avg; 10.26-29.87% range *Mid-Atl:* 17.53% avg; 13.05-23.46% range **Suburban Office:** *National*: 19.4% avg; 8.70-28.78% range *Mid-Atl: 16.16%* avg; 11.06-22.61% range **Retail:** *National:* 21.43% avg; 9.40-32.01% range *Mid-Atl:* 17.81% avg; 11.95-25.14% range	Based on Actual Rates for new residential, office, and retail developments derived from developer surveys		

Fee/Return Category	Source	Expected Amount/Range	Notes	Laurel Hill Anticipated	Comments on Reasonableness
Development fee (fee development/no equity)	A&M	3-5% of total development costs (hard plus soft)	Included as point of reference, but significantly less risk than capital-at-risk development.	Preferred returns: Commercial: 11.5% Multifamily: 16%	Reasonable preferred returns based on project risk and contribution of equity capital. Development fees as a standalone line item not relevant for this project due to Developer's equity stake.
Development fee for Low Income Housing Tax Credits	Virginia Housing Development Authority	16.5% maximum upfront	When A/E design costs are included		Development fee within the maximum allowed by VHDA . Developer is deferring 50% of the fee $3.4M) for 10 years, even though VHDA allows upfront payment
Construction Management Fee	A&M	1-5% of hard costs	Varies greatly depending on risk burden assumed by CM.	Commercial: 4.5% of hard costs Multifamily: 10% of hard costs cover CM fee and contingency	Reasonable, especially given risk associated with historic reuse assets. Multifamily CM-at-risk structure promotes efficiency and cost discipline.
Asset Management Fee	A&M	0.5-2% collected income	Subject to high variability based on who is defining the term. Best interpreted relative to services provided.	Commercial: Nominal CAM Admin fee included in CAM expenses Multifamily: Approx. 0.2% gross income	Multifamily fee is below industry standards. Lack of commercial fee appropriate given net lease context.
Property Management Fee (market rate housing)	A&M	3-5% of effective gross income		Commercial: N/A Multifamily: 6% gross income	Multifamily fee slightly higher than industry standards, but justifiable in light of overall OpEx spend (see below) and hands-on nature of managing affordable and historic properties. Lack of commercial fee appropriate given net lease context.

Fee/Return Category	Source	Expected Amount/Range	Notes	Laurel Hill Anticipated	Comments on Reasonableness
Multifamily Operating Expenses Ratio (included for property management fee context)	A&M, Delta Associates	30-45% of effective gross income	Building age, climate/utility costs, levels of deferred maintenance, and level of service are among the factors that affect this metric.	Multifamily: 40-43% during first 10 years of project, once stabilized	See above.