DRAFT REPORT

Laurel Hill Adaptive Reuse Area Master Plan Financial Assessment

LEADERSHIP • PROBLEM SOLVING • VALUE CREATION

OCTOBER 9, 2009

Submitted by:

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October 9, 2009

Mr. Chris Caperton and Ms. Leanna O'Donnell
Fairfax County Government
Department of Planning and Zoning
12000 Government Center Parkway
Fairfax, VA 22035-0074

DRAFT REPORT
Laurel Hill Adaptive Reuse Area
Master Plan Financial Assessment

Dear Mr. Caperton and Ms. O'Donnell:

Alvarez & Marsal Real Estate Advisory Services, LLC, (A&M) is pleased to submit this Draft Report of our firm's financial assessment of the proposed master development plan for the Laurel Hill Adaptive Reuse Area in Lorton, Virginia. The Draft Report outlines our approach, our findings, and our recommendations as to the validity and sustainability of the project.

As outlined in the following report, the methodology used by the Alexander Company to estimate the financial gap of the master development plan is based upon reasonable financial assumptions and sound real estate fundamentals given the current state of the economy. The findings of the assessment are supported by specific comments and recommendations.

Should you have any questions, please call me at (202) 729-2110 or Brian Kish at (202) 729-2115.

Very truly yours,

Alvarez & Marsal Real Estate Advisory Services, LLC

Jay Brown
Managing Director

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1.0 APPROACH AND OVERALL FINDINGS

1.1 Background

Fairfax County retained the Alexander Company in May 2008 to prepare a master development plan for the adaptive reuse of the former Lorton Reformatory and Penitentiary site, also known as the Laurel Hill Adaptive Reuse Area. Under the scope of their contract with the County, the Alexander Company was tasked with creating a financially feasible plan for a world-class development of residential, retail, commercial and educational space that preserves the historic elements of the site. In addition, the Alexander Company was asked to develop a plan that minimizes the burden on the taxpayer and takes advantage of innovative funding mechanisms as necessary. The Madison, Wisconsin-based firm is experienced in adaptive reuse and historic preservation with regional experience as the developer for the National Park Seminary site in Silver Spring, Maryland. Upon completion of the master plan the County has the option to enter into a development agreement with the Alexander Company or another development firm.

In July 2009, The Fairfax County Department of Planning and Zoning (DPZ) hired Alvarez & Marsal Real Estate Advisory Services, LLC (A&M) to review the financial aspects of the Alexander Company's proposed master development plan.

1.2 Approach

The financial assessment of the Laurel Hill Master Plan was organized around the following topics:

1. Project Viability
2. Financial Assumptions
3. Financing Options

The financial assessment included evaluating the reasonableness of the following information provided in the developer's financial model and gathered from discussions with individuals from the Alexander Company, its sub-contractors, the County, and local real estate professionals:

1. Project Viability
    a. Assess the viability and sustainability of the proposed density of residential, commercial, and retail development.
    b. Assess the viability of the projected commercial and retail lease rates for the project.
    c. Assess the short-term and mid-term viability of the proposed residential rental and owner-occupied units, office space, and retail uses.
2. Financial Assumptions
    a. Assess the reasonableness of the master plan financial projection and assumptions, and their use in determining a potential financial commitment range from county.
    b. Assess the reasonableness of the costs associated with the rehabilitation and maintenance of historic structures and the impact on residential and commercial tenants.
3. Financing Options
    a. Assess the feasibility of a special tax district or tax increment financing to help close the project's financial gap.
    b. Identify financial risks that may accrue to the County through implementation of the project or associated financial tools.
    c. Evaluate the reasonableness of cost-benefit impact of the proposed project as it relates to net tax gain, potential bond impact, and County liabilities.
    d. Provide advice on the appropriate form of public financing on investment to achieve County goals.

The assessment included the following activities:

1. **Meeting with County personnel**. An initial meeting and follow-up teleconferences provided the project background, access to County information, and the Master Plan documents prepared by the Alexander Company. In addition, a site visit and tour of the immediate area around the site was conducted with the County and Alexander Company representatives.
2. **Review of public background material, Master Plan documents and the financial analysis prepared by the Alexander Company.** The review of the financial models included a review of the accuracy of the formulas used to determine the costs to develop the proposed master plan and the estimated financial gap. The financial model review also included checking all the assumption and data linkages, and ensuring the model's variables were correctly sourced within the model.
3. **Financial Inquiries.** After reviewing the financial models and third party market research, phone interviews were conducted with The Alexander Company to discuss a list of questions regarding the financials of the master plan. In addition, The Alexander Company provided follow up information clarifying their assumptions and analysis.
4. **Discussions with local Real Estate Professionals.** Several real estate professionals with experience in the market provided input to the overall assessment of the proposed development. Specifically, these professionals include brokers from the leasing community, general contractors, private developers, and research analysts that cover the area.
5. **Review of Real Estate Market Data.** Market data from several highly regarded real estate brokerage and research firms was referenced for information regarding the current market and projections for the future. Specifically, reports from Transwestern, CBRE, PricewaterhouseCoopers and Portfolio and Property Research were used to capture a comprehensive outlook of the market for all use types programmed for the site.

The assessment included the following interviews and documentation review:

Figure 1.1 Chart of Interviews Conducted and Documents Reviewed

Interviews Conducted	Documents Reviewed
▪ Brad Elmer, The Alexander Company ▪ Jeff Kruse, BE&K ▪ Local developers (2) ▪ Local general contractors (2) ▪ Local real estate brokers of office and retail space (4) ▪ Research analysts (2)	▪ Fairfax County Comprehensive Plan, Lower Potomac ▪ Fairfax County's Principles for Public Investment in Support of Commercial Redevelopment ("16 Principles") ▪ Financial Feasibility Analysis (Updated July 16, 2009) ▪ Summary of Findings (September 10, 2008) ▪ BBPC Associates market review (June 9, 2008) ▪ BBPC Associates retail pad market review memo (November 20, 2008) ▪ Real Property Research Group market study (June 2008) ▪ Financial models produced by Alexander Company for the Laurel Hill project ▪ CDA/TIF Presentations for the Mosaic District at Merrifield ▪ Springfield Redevelopment Study (October 21, 2005)

1.3 Overall Findings

The assessment of the Alexander Company's Financial Feasibility Analysis found the study to be based upon reasonable market assumptions and reflective of sound real estate fundamentals and decision making given the preliminary nature of the "master plan" scope of services and the status of the planned development program. The assumptions for the analysis are based on extensive market research in the local area and the financial assumptions are generally well supported by third party studies and prior experience with similar development projects. The analysis logically sums the estimated financial surplus or gap for each use with the infrastructure and other costs of the overall development to estimate the overall financial gap of the project.

Following a brief summary of the Project Background, the Overall Findings are supported in Sections 2 - 4 by specific comments for each principle assessed during the assessment of the model.

1.4 Project Background

The Adaptive Reuse Area is owned by the Fairfax County Board of Supervisors and is comprised of the now vacant Lorton Prison Reformatory and Penitentiary Buildings. The approximately 80-acre parcel, part of the larger Laurel Hill property, was purchased by Fairfax County and transferred from the Federal Government in 2002. The County Re-Use Plan, prepared at the time of transfer, included a commitment that the County preserve and reuse the majority of the buildings associated with the Adaptive Reuse Area.

The Fairfax County Board of Supervisors, Fairfax County staff, and a series of citizen task forces, including the Laurel Hill Adaptive Reuse Citizens Advisory Committee (CAC), have extensively studied the reuse of the parcel, culminating in the *Recommendations for the Adaptive Reuse Areas within Laurel Hill* completed in 2004. The publication documents the Committee's two-year process of soliciting input from community stakeholders and working with planning professionals to create a plan for Laurel Hill.

The *Recommendations for the Adaptive Reuse Areas within Laurel Hill* describes the redevelopment of the former Penitentiary and Reformatory sites into a mixed-use development. The recommended uses include residential, including magnet housing, professional office, educational, and retail in a village center concept. The Recommendations were adopted as an amendment to the Fairfax County's Comprehensive Plan in May 2006. The table below represents the density and uses called for in the Plan.

Figure 1.2 Comprehensive Plan Programmatic Summary

Recommendations for the Adaptive Reuse Areas within Laurel Hill

Land Use Type	Total Square Footage (SF) of Development or Number of Units
Housing (Magnet and Market Rate Apartments and Condominiums/Lofts)	50 - 155 units
Commercial (Neighborhood Retail and Office)	40,000 - 60,000 SF
Education	50,000 - 125,000 SF

For comparative purposes, the figure below outlines the land uses and densities included in the master plan proposed by the Alexander Company.

Figure 1.3 Proposed Master Plan Programmatic Summary

Land Use Type	Total Square Footage (SF) of Development or Number of Units
Housing : Single-family Townhomes Market Rate Apartments Magnet Apartments	 181 units 118 units 53 units 352 units
Commercial – Neighborhood Retail and Mixed Use[1]	81,400 SF
Office	50,000 SF

[1]Includes 20,000 SF of retail pad space and 20,000 SF of space in the chapel building

2.0 PROJECT VIABILITY

2.1 Density Viability

Assess the viability and sustainability of the proposed density of residential, commercial, and retail development.

The Alexander Company investigated several development scenarios in keeping with the recommendations of the Comprehensive Plan and the goals of the County. The plan ultimately put forth by the Alexander Company was the result of several months of community and stakeholder input. In addition, the firm incorporated significant research and feedback from the marketplace to improve the economic viability of the plan. As a result, some aspects of the plan do not adhere completely to the recommendations of the Comprehensive Plan.

The relocation of the Village Center from the area between the reformatory and the ball field to the north side of the penitentiary area differs from the Comprehensive Plan. This revision enhances the viability of the retail space since it improves visibility and access from Silverbrook Road.

In addition, the Alexander Company proposal does not explicitly identify space for educational uses. Research of education-related tenants revealed that they rarely seek space more than 6-12 months in advance which would make pre-leasing difficult for this use type and a challenge to achieve favorable rates for construction financing. Nevertheless, it is reasonable to assume education-related tenants could occupy space that is programmed for office use if there is demand in the market.

Finally, the density of residential development is higher than previously contemplated primarily through the addition of approximately 180 townhomes throughout the site. The addition of townhomes enhances the economic viability of the project since the infrastructure and rehab costs of the overall development will benefit from the added income derived from the increase in residential density.

Despite these noteworthy changes from prior concept plans, the Master Plan proposed by Alexander Company adheres to the intent of the CAC's recommendations and development guidelines in the Comprehensive Plan. In addition, the programmed use types, density, and overall layout of the proposed plan appear to compliment the land planning in the surrounding community, and generally follow a successful model implemented across Fairfax County where residential communities of similar density are anchored by a mix of neighborhood retail and commercial uses totaling 30,000-50,000 SF.

Conversations by A&M with retail leasing brokers confirm that this amount of retail space is enough critical mass to attract national retailers seeking neighborhood locations and restaurateurs pioneering into new locations. In addition, office leasing brokers indicate that this amount of retail space is a sufficient amenity to drive a premium on office rents. A key design challenge will be how well the commercial space and residential uses are ultimately connected to the retail area in order to drive foot traffic and activate the development while still affording visibility, accessibility, and ample parking for vehicle traffic. The Alexander Company's proposed master plan endeavors to address these goals.

2.2 Commercial and Retail Viability

Assess the viability of the projected commercial and retail lease rates for the project.

The Alexander Company is one of a few highly regarded development firms in the nation known for their expertise and experience in adaptive reuse. As such, they relied on many of their in-house professionals and partners in the industry to guide their analysis and design throughout the master planning process. In addition, the Alexander Company hired third party consultants to perform market studies for the retail, office, and residential uses programmed for the site and used these studies as the basis for the projected commercial and retail lease rates in their financial feasibility analysis. The studies were conducted in June 2008 and the Alexander Company has assumed these lease rates still apply in today's market.

Several informal interviews with local real estate brokers were conducted to compare the retail and office rates used in the Master Plan Financial Analysis with current trends and rate ranges in the marketplace today. Although it is clear that the development will not be completed for a few years, the commentary on today's market rates validates the approach used by the Alexander Company and sub-contractor BBPC Associates.

Figure 2.1 Commentary on Rental Rates

Use	Alexander Company estimated rates (based on BBPC Associates study)	Estimated Rates based on recent broker discussions	Commentary
Retail	Rent: $25/SF (NNN) TI's (Tenant Improvements): $20/SF	Rent: $30-35/SF (NNN) TI's: $75-100/SF	The Master Plan's overall net rent number is conservative considering what nearby retail centers are asking. The TI rates seem low based on anecdotal discussion with brokers, but the Alexander Company used a value about four times the estimated rate in the BBPC study. On balance, the Alexander Company's analysis seems reasonable.
Office	Rent: $20/SF (Gross) TI's: $20/SF	Rent: $20-30/SF (Gross) TI's: $30-50/SF	The estimate for rent is reasonable considering the comparables listed in the BBPC study. In addition, the uniqueness of the space should drive a slight premium. The TI rates seem a little low especially since landlords are giving generous concessions right now to lease space. In total, the terms are reasonable and justified.

2.3 Short-Term and Mid-Term Viability

Assess the short-term and mid-term viability of the proposed residential rental and owner-occupied units, office space, and retail uses.

Real Estate Business Cycle. The national economy has seen reduced output over the past year and significant job losses. The commercial real estate industry is in a downward cycle and has experienced value reductions, higher vacancy rates, and extended absorption projections due to limited projected job growth. It is unclear when the downward cycle will turn upward, although predictions for general economic recovery in late 2009 and early 2010 are often mentioned. However, the commercial real estate sector is traditionally a lagging indicator and may not turn the corner until late 2010 or early 2011.

Real Estate Fundamentals. Real estate across all property types nationwide has experienced value declines due to weaker tenant demand, declining rental rates, and rising overall cap rates. Overall, participants in the Second Quarter Korpacz Report speculate that overall property values will decline as much as 15.0% to 50.0% over the next 12 months across the four major property sectors – retail, office, industrial, and apartment. The average expected value loss across all property sectors over the next year is 10.0%.

The recession will not completely bypass the Washington, D.C., and northern Virginia area as fundamentals continue to weaken, but it is expected the region will hold up better than any other major market. The unemployment rate has doubled from its low in 2007 of 3%, but this market remains one of the strongest economies in the nation and a recovery will take hold earlier here improving fundamentals and values by late 2011.

Therefore, despite the daunting news in the current market, the DC metro area, including the Lorton, Virginia area, will likely experience more optimistic economic trends within the next two to three years. This outlook bodes well for the Laurel Hill project given that it will take at least three years to complete the development. In the meantime, the project can take advantage of the down cycle to work through entitlement and design issues and lock in low capital costs as labor and material prices continue to decline.

The following four sections discuss current market intelligence for the retail, office, apartment, and for-sale townhome markets.

Retail. Brokers are reluctant to provide overall assessments and projections for retail rents in the area especially because of the assorted nature of tenants in the sector; however, anecdotally, rents rates are currently undergoing a significant correction after a steep run up over the past few years. Studies indicate that retail rents overall in the area next year are expected to drop around 3%. However, by 2011 rents are expected to stabilize or rise slightly and increase around 3% in 2012 and 4-5% in 2013. Also, there are reports that national retailers who have survived the downturn are now finished retrenching and starting to put feelers out for opportunities to expand in traditionally strong markets, such as Fairfax County. As a result, there will likely be an increased interest by major tenants regarding future deals in retail centers along I-95 and in the Lorton area over the next couple of years.

Office. In the office sector, increasing vacancy and declining rental rates are expected for the remainder of 2009. Vacancy will increase due to a large amount of new and sub-lease space coming onto the market combined with tenants' reluctance to lease new space until the economic climate improves.

Next year vacancy should stabilize as some of the pipeline of new space is absorbed, although rents are projected to drop as landlords compete to fill that space. However, I-95 office space is well positioned to prosper in the long-term given its location.

Discussions with brokers and other research analysts familiar with the market and the Lorton area in particular suggest that office space will do well in the mid-term because of its proximity to Ft. Belvoir and Quantico Marine Bases, both of which will likely benefit from greater demand for office space due to public and private sector job relocations associated with BRAC. A few notable projects in the area have already leased government contractors and demand from similar tenants will likely continue. Large private sector and government tenants directly associated with BRAC are likely to relocate to the Springfield area because of its location near the Metro and due to the size of the new office developments planned for the area (as discussed in the BRAC APR process), but Lorton is not necessarily competing for those type of tenants. Instead, the Lorton office market in general will benefit from BRAC indirectly based on its location between the bases involved in the program (i.e., the Army Proving Ground, Ft. Belvoir and Quantico) and the proximity to the I-95 highway that connects these bases to Washington DC. In addition, the amenities near Lorton Station and planned for the Laurel Hill development make Lorton an attractive location for boutique firms (both BRAC and non-BRAC related) looking for an affordable alternative to the Springfield/Newington sub-market (i.e. full service rents in the low $20's vs. low $30's per SF). The Alexander Company estimate of the financial gap conservatively assumes an average rent currently achieved in the Lorton market today ($20/SF). In addition, supply in the area has been kept in check in this part of Fairfax County. In the long-term however, delivery of additional supply in the pipeline and potential base downsizings are risks.

Apartments. The assumptions used by the Alexander Group for the residential analysis was directly sourced from a study conducted by Real Property Research Group (RPRG) in June 2008. This study focused on both rental and for sale properties and also included in-depth analysis of affordable housing. RPRG's study generally provided positive comments on the site and the proposed residential uses for the mid- and long-term.

The apartment market in the area continues to soften as rents continue to decline and vacancy approaches historical highs. Rents next year are expected to continue their decline of about 3-4%. In 2011 rents will stabilize and be on the rise again in 2012 and 2013 by 3-4%. Overall, the area's relative stability and expected long term population and household growth point to a positive forecast for the Lorton rental market starting in mid-to-late 2010.

The rent projections mentioned above for retail, office and apartment uses are based on Property and Portfolio Research (PPR) market reports for the Washington D. C., Maryland and Northern Virginia areas. The figure below summarizes the annual forecasts in these reports for 2009 to 2013.

Figure 2.2 Projected Rent Trends for Retail, Office and Apartment Uses

Use	2009	2010	2011	2012	2013
Retail	-9.4%	-3.1%	0.6%	4.3%	4.8%
Office	-6.7%	-11.5%	-1.8%	6.6%	9.5%
Apartment	-3.0%	-3.3%	-0.8%	2.2%	4.1%

Source: Property and Portfolio Research (as of 4 Aug 2009)

For Sale Townhomes. The overall for-sale residential market in the Lorton, Virginia area has been hit hard over the last year. The average sales price per square foot for the area was $178/SF, a decrease of 14.4% compared to the same period last year. The median sales price for homes from April 2009 to June 2009 was $290,000 based on 151 home sales. Compared to the same period one year ago, the median home sales price decreased 25.6%, or $99,900, and the number of home sales decreased 19.3%.

However, the average listing price for homes for sale in Lorton, Virginia was $544,783 for the week ending July 29, 2009, which represents an increase of 4.7%, or $24,483, compared to the prior week. This modest uptick in listing prices may indicate that the overall housing market has bottomed and prices will remain relatively stable and could even trend upward over the next few years.

Nevertheless, current supply on the market is moving slowly. Lorton Station, a new planned community in the area consisting of 950 homes still has not found owner-occupant buyers for about a third of the homes. To date, 831 of the homes have been sold and of that number, 155 units are occupied as rentals.

Regarding supply on the market, there are currently 154 resale and new homes in the Lorton area listed on Trulia.com, as well as 206 homes in the pre-foreclosure, auction, or bank-owned stages of the foreclosure process. The chart below illustrates the state of the for-sale townhome market within a mile of the site. The data shows the average sale price of townhomes is about $200 per square foot. This average sales price per square foot supports the Alexander Company's $400,000 price point for townhomes used in their analysis assuming an average townhome size of 2,000 SF as indicated in the Real Property Research Group market study.

Figure 2.3 Recent Townhome Sales near Laurel Hill

Recent Townhome Sales Near the Site

Address	Proximity	Sold price	Sold date	Beds	Baths	Home SF	Lot SF	Yr Built	Price/SF
8235 Singleleaf Ln, Lorton, VA	0.03 mi	$ 370,000	7-Apr-09	3	3	1,788	2,841	2004	$ 206
8860 Hibiscus Ct, Lorton, VA	0.05 mi	370,000	18-May-09	3	2	1,774	2,841	2003	208
8976 Yellow Daisy Pl, Lorton, VA	0.11 mi	325,000	18-Jun-09	3	3	2,164	3,000	2006	150
8241 Singleleaf Ln, Lorton, VA	0.03 mi	395,000	4-Mar-09	3	2	1,774	1,776	2004	222
9068 Tanyard Ln, Lorton, VA	0.41 mi	385,000	4-May-09	3	2	1,712	1,518	2002	224
8247 Singleleaf Ln, Lorton, VA	0.03 mi	370,000	10-Feb-09	3	3	1,774	2,841	2004	208
9101 Furey Rd, Lorton, VA	0.5 mi	370,000	6-May-09	3	3	1,912	2,569	2005	193
8917 Purple Lilac Cir, Lorton, VA	0.2 mi	360,000	24-Feb-09	3	2	1,940	1,976	2004	185
8909 Purple Lilac Cir, Lorton, VA	0.2 mi	417,000	18-Mar-09	3	2	2,220	2,216	2004	187
8188 Mccauley Way, Lorton, VA	0.52 mi	379,900	9-Apr-09	3	3	2,140	2,766	2006	177
8189 Laurel Crossing Ln, Lorton, VA	0.57 mi	401,000	9-Apr-09	3	2	2,220	1,914	2005	180
9102 Furey Rd, Lorton, VA	0.52 mi	390,000	14-Jan-09	3	3	1,900	1,864	2006	205
9137 Furey Rd, Lorton, VA	0.54 mi	425,000	13-Mar-09	3	3	1,912	2,700	2006	222
9172 Furey Rd, Lorton, VA	0.62 mi	300,000	24-Apr-09	3	3	2,056	2,700	2006	145
8292 Reiser Ln, Lorton, VA	0.43 mi	330,000	21-Nov-08	3	2	1,656	1,518	2002	199
8340 Jovin Cir, Springfield, VA	0.89 mi	362,000	4-Jun-09	3	3	1,740	1,500	1999	208
9103 Furey Rd, Lorton, VA	0.5 mi	425,000	21-Nov-08	3	3	1,920	1,867	2005	221
9272 Laurel Ridge Crossing Rd, Lorton, VA	0.62 mi	420,000	9-Mar-09	3	3	2,188	2,297	2006	191
9265 Laurel Ridge Crossing Rd, Lorton, VA	0.62 mi	420,000	3-Mar-09	3	3	2,188	2,396	2005	191
9217 Mccarty Rd, Lorton, VA	0.64 mi	280,000	30-Apr-09	3	2	1,448	1,440	1999	193
8173 Pasture Rose Ct, Lorton, VA	0.63 mi	385,000	23-Jan-09	3	3	1,940	1,997	2005	198
9353 Cumbria Valley Dr, Lorton, VA	0.97 mi	363,000	25-Jun-09	3	3	1,832	2,275	2005	198
9212 Lorton Valley Rd, Lorton, VA	0.59 mi	290,000	5-Jan-09	3	2	1,416	1,467	1999	204
9412 Hucks Bridge Cir, Lorton, VA	0.96 mi	412,500	8-Jun-09	3	3	2,112	2,488	2004	195
8177 Pasture Rose Ct, Lorton, VA	0.63 mi	410,000	28-Jan-09	3	2	1,968	1,848	2005	208
9260 Mccarty Rd, Lorton, VA	0.66 mi	249,000	30-Dec-08	4	3	1,360	1,340	2000	183
9349 Cumbria Valley Dr, Lorton, VA	0.97 mi	396,000	27-Apr-09	3	2	1,832	1,540	2005	216
9228 Lorton Valley Rd, Lorton, VA	0.62 mi	290,900	1-Dec-08	3	2	1,416	1,516	1999	205
8419 Carmela Cir, Springfield, VA	0.9 mi	374,900	20-Jan-09	3	2	1,720	1,500	2000	217
9207 Mccarty Rd, Lorton, VA	0.65 mi	266,000	23-Jan-09	3	2	1,421	1,440	1999	187
Average:	**0.52 mi**	**$ 364,407**	12-Mar-09	**3**	**2.5**	**1,848**	**2,065**	**2003**	**$ 198**

Source: trulia.com (http://www.trulia.com/home_values/for_sale/VA/Lorton/22079/45143104/)

In conclusion, the discussion above demonstrates that the project would be subject to the difficulties faced in the current residential and commercial real estate markets. However, the market studies completed by the Alexander Company's consultants reasonably contemplate these challenges. Furthermore, data for all use types suggest that market will be in the early stages of a recovery within two to three years. As a result, the Alexander Company's plan appears viable and the mid to long-term outlook for the project is optimistic especially considering it would likely deliver into an improving market.

3.0 FINANCIAL ASSUMPTIONS

3.1 Master Plan Financial Projections

Assess the reasonableness of the master plan financial projection and assumptions, and their use to determine potential financial commitment range from county.

Master Planning Contract. In May 2008 the Alexander Company and the County contracted to conduct an intensive six month land planning process referred to as the Laurel Hill Development Plan (LHDP). Specifically, the Alexander Company agreed to provide the County with:

1) Development Plan
- Site Plan
- Narrative explaining project vision
- Additional drawings/schematic plans as appropriate

2) Financial Plan and Transactional Instruments
- Capital budget by phase
- Sources and Uses of Funds Table
- Detailed Development & Operating Pro Forma
- Structure of Public/Private Partnership

3) Operations, Maintenance, and Property Management Plan

To date, the Alexander Company has provided all of these deliverables except for the Structure of Public/Private Partnership and an Operations, Maintenance, and Property Management Plan which would coincide with the developer negotiations. The work on all the documents reviewed during this assessment was thorough, well sourced, and at the expected level of detail at this point in the land planning process. However, going forward it is recommended that the Sources and Uses of Funds Table and Development & Operating Pro Formas be consolidated to the best extent possible in order to clearly illustrate how the overall financial gap is estimated. Also, having a consolidated development pro forma will make it easier to determine how key assumptions will affect the overall project.

The Development Plan proposed by the Alexander Company appropriately incorporates a professional level of due diligence and genuinely considers a wide spectrum of feedback. Specifically, the Alexander Company has performed a variety of due diligence activities including an analysis of the retail, office, and residential markets, a review of the relevant planning and zoning documents, and an analysis of the physical aspects of the site and buildings. Additionally, the Company has solicited community feedback in several public meetings and has met with a variety of relevant stakeholder groups.

Sources and Uses. The Alexander Company summarized their financial analysis in the form of a table for Sources and Uses for each use type except for the townhome and pad site uses. This table lists the estimated costs, sources of funds, and surplus or gap associated with each use. The overall financial gap of the project, and the potential financial impact on the County, is estimated by summing the sources and uses of all use types.

The chart below is a summary of the programmed uses in the proposed Master Plan and an overview of how the financial gap was calculated for the overall project.

Figure 3.1 Proposed Master Plan Summary and Financial Overview

	FAR SF	Estimated Total Development Cost	Private Investment	Estimated Tax Credits	Estimated Surplus/(Gap)
Retail					
New	22,400	$ 4,258,634	$ 5,008,147	$ -	$ 749,513
Historic[1]	19,000	2,290,000	2,328,920	753,964	792,884
Historic Office	50,000	12,409,316	5,416,097	4,045,349	(2,947,870)
Historic Residential					-
Mkt Rate Apartments (118 units)	129,653	23,078,185	12,400,000	8,610,053	(2,068,132)
Magnet Apartments (53 units)	57,723	10,274,647	2,700,000	9,923,343	2,348,696
Mixed-Use Pad Sites (Land area: 55,000 SF)[2]	20,000	4,000,000	Land Sale		1,100,000
Townhomes (181 units, ave size 1,800 SF)[3]	362,000	63,350,000	Land Sale		10,860,000
Infrastructure and Site Costs[4]		20,168,000			(12,928,000)
Demolition		1,050,000			(1,050,000)
Extraordinary Historic[5]	20,000	1,726,000			(1,726,000)
County Fees[6]		6,004,575			(4,490,000)
Total	688,775	**148,609,357**			**(9,358,909)**

[1]Includes costs to clean-up and stabilize the 8,000 SF historic power plant

[2]Estimated surplus is based on a land sale of the pad sites to another developer and built when a specific tenant is identified

[3]Estimated surplus is based on a land sale of the townhome parcels to a single family home builder

[4]Estimated gap includes approximately $7.2 million in infrastructure costs allocated to the buyer of the townhome land parcels

[5]Includes $166,00 to repair the roof and clean-up the existing 20,000 SF Chapel building

[6]Estimated gap includes approximately $1.5 million in County fees allocated to the buyer of the townhome land parcels

The Alexander Company conducted an effective financial analysis of the proposed Master Plan to determine the viability of the project. For example:

- In estimating the capital budget, Alexander used experience in past projects and estimates from a local general contractor (BE&K), civil engineer (Walter Phillips), and traffic engineering firm (Wells & Associates) to determine the construction and infrastructure costs.
- The interest reserve on the construction loan was conservatively calculated assuming: 1) the construction loan was the same size as the permanent loan (75% loan-to-value); 2) a common rate of 7%; and 3) and an average of 50% of the principal was deployed during the construction period. These terms are appropriate in a typical lending environment and should sufficiently estimate the interest reserve required for the project.
- Based upon the size of the project, the Alexander Company also assumed the project would be developed in a cost and time effective single phase.

The biggest driver of the gap is the high costs associated with renovating space that is not income producing. This includes the infrastructure costs of rehabbing historic structures and working in and around them in order to create viable space that is attractive to the market. In addition, the combination of conservative cap rates (compared to the last several years) applied to modest rental rates results in much lower values than would be expected for a project of this size. As a result, slight increases in rents combined with cap rate compression would increase the values of these properties. Using the programmed new retail space as an example, an increase of just $1/SF in average rent combined with a cap rate compression of 500 basis points (i.e. 8.50% to 8.00%) results in an increase of over $24/SF in value, or nearly $550,000 for that component of the project alone. Thus, as the project progresses, sensitivity analysis of several market scenarios would be helpful when considering the overall financial gap.

Nevertheless, the methodology and assumptions used in the financial models are appropriate to estimate the financial gap with enough accuracy for the master planning process. In addition, the rent assumptions are based on in-depth studies by credible experts in the area market. Similarly, the cost assumptions are derived from experienced contractors who referenced actual bids for similar type projects. Therefore, the Alexander Company's models are appropriate for this level of analysis.

The following five sections discuss components of the Development Plan's financial analysis, specifically the level of private investment, tax credit equity, land sales proceeds, overall construction cost estimate and sensitivity analysis.

Private Investment. The Alexander Company estimated the amount of private investment (in terms of private equity and permanent financing) and tax credit equity the project would attract. The level of permanent financing available to the project was based on the estimated net operating income. Net operating income was calculated using stabilized rent and expense projections from the third party market research. Overall the projections appear reasonable and conservative in some cases (i.e. office rents). The estimated amount of private equity available for the project was based on the common return measures expected by investors on this type of development in a normal market, which is approximately 8% cash-on-cash and approximately 18% leveraged internal rate of return (IRR) based upon industry norms, current market trends, and our experience. Cash-on-cash return is the property's annual net cash flow divided by the net investment, expressed as a percentage, and is one of the most important ratios when evaluating the long-term performance of a property investment. IRR is essentially the rate of growth a project is expected to generate and is a method of capital budgeting that is very useful when evaluating a long term investment. Overall these return measures are common in a normal market. In the current market these return rates would likely need to be much higher to attract private equity due to all the risks associated with development.

Tax Credit Equity. The Alexander Company also estimated how much state and federal tax credit equity (from both historic and low income housing tax credits) the project would likely earn from investors. These estimates are based upon published methods for calculating tax credit eligibility and their experience in similar projects around the county. Specifically, given the qualified expenditures in the renovation budget, it is estimated that the project could receive up to $17,200,000 in equity from investors in Federal and State Historic Tax Credits. In addition, the project's 53 units of planned Magnet Housing are potentially eligible for about $6,100,000 in equity through the Low-Income Housing Tax Credit Program.

Regarding the certainty of gaining these tax credits, the state and federal agencies responsible for administering these programs cannot commit to project eligibility or what level of expenditures qualify for eligibility until after design progresses to a level of detail beyond the master planning phase. However, the Alexander Company's estimates are based on the proper application of the policies governing the tax credit programs. In addition, the Alexander Company has achieved these tax credits on several other historic and low income housing projects. Therefore, their extensive experience in this type of development and the technical approach of their analysis suggest their tax credit estimates for the gap analysis are reasonable.

Land Sale Proceeds. The Alexander Company's analysis of the townhome and pad sites did not include full development pro formas to estimate the economics of these uses. Instead, the Alexander Company assumed that these uses would be parceled off and sold in a land sale to other builders since the Alexander Company does not specialize in retail pad or townhome development. In the case of the pad

sites, it was assumed the raw land would sell for approximately $20/SF. This number is supported by a special market study by BBPC Associates of sales in the last two years of buildable commercial pad sites within 10 miles of the site. The number seems reasonable and even conservative when contrasted with some of the comparable sites that were sold for restaurant and bank sites. The townhome land sale proceeds were based on a percentage of estimated gross sale proceeds of completed townhomes. According to an experienced local townhome developer, builders will likely pay about 15% of the gross sale proceeds for the raw land. Assuming the average completed townhome would sell for about $400,000 (which is supported by market data above), each parcel would sell for about $60,000 resulting in total land sale proceeds of almost $11 million for all 181 parcels.

Overall Construction Costs. Based on discussions with local developers and general contractors in the area, overall construction costs may have trended downward by at least 15% over the last 12 months and by about 7-10% since the BE&K estimate in late 2008. It is likely that prices will inch down slightly or remain relatively stable for the next six months to a year given the slow-down of construction activity in the area and the country. If the industry experiences a normal recovery over next couple years, it is expected that annual construction cost increases will rise again at an average annual rate of 2-4%.

There are some concerns, however, about an impending spike in material and labor cost as soon as demand returns to the market. Many suppliers have gone out of business or stopped producing materials (such as drywall). As a result many materials (such as steel and copper) have already seen a modest uptick recently. Also, there is some concern that the labor market has been depleted for some trades due to workers moving out of the area in pursuit of other construction jobs. Furthermore, supply constraints of materials and labor is a possibility if government stimulus spending for new construction hits the market in the near term.

Nonetheless, general sentiment suggests that construction costs will remain stable over the next year or two. Most government stimulus-related projects are still in the planning phase and firms competing for those jobs will probably not staff up until there is more certainty in the market. In addition, existing supply and the large sub-lease market is expected to keep the demand for new construction in check. As a result, the next couple years may offer owners a unique opportunity to lock in low construction costs for projects scheduled to deliver in a rebounding economy.

Sensitivity Analysis. Sensitivity analyses are conducted to determine the potential impact on the project's financial projection from changes in the assumptions and variables used in the development pro formas. Sensitivity analyses conducted around four key pro forma assumptions assess the potential impact on the estimated overall financial gap of the project. Two of the variables deal with costs (commercial space construction costs and infrastructure costs) and the other two variables involve the projected revenue (commercial space average rent rates and average town home prices). For each pro forma assumption, financial gap values were recalculated at four different levels of variable change: -10%, -5% and +5%, +10%.

- *Commercial Space Construction Costs*. Resulting financial gap estimates from changes to construction costs for the commercial space (retail, office and apartments) indicate a sensitivity ratio of about 2 to 1. Specifically, a change of 10% in construction costs results in about a 21.6% change to the overall financial gap of the project. Based on the current budget, a change of this magnitude could add about $2 million to the financial gap. However, as stated above, conversations with contractors suggest that an increase in construction costs of 10% seems unlikely over the next couple years. Furthermore, the calculation of the current financial gap already includes a healthy construction cost contingency of 10% .

- *Infrastructure and Site Costs.* Changes in infrastructure and site costs affect the overall financial gap at about a 1 to 1 ratio. Specifically, a change of 10% in infrastructure and site costs results in a 13.8% change to the overall financial gap of the project, or about $1.3 million.
- *Commercial Space Rent Rates.* Resulting financial gap estimates from changes to the average rent rates reveal a high level of sensitivity around this variable. Changes of 10% in the rent rates resulted in overall financial gap changes of almost 34%. Based on this analysis and the PPR projections for 2010 (from Figure 2.2 above), it appears that the gap could increase in the near term by about 17%, but by 2013 the gap would shrink back to the current estimate or less.
- *Townhome Sale Prices.* Changes in average townhome sale prices affect the overall financial gap at about a 1 to 1 ratio. A 10% change in townhome sale prices results in an overall financial gap variance of about 11.6%. This impact is due to the townhome land sale proceeds being a function of 15% of the gross sales prices. Recent news nationwide suggests that we are at or near the bottom of the housing market and most signs point to at least slight increases in sale prices over the next few years. Thus, the land sale of the townhome parcels should help close the overall financial gap by the current estimate or better within the next few years.

The tables on the following two pages illustrate the results of the sensitivity analysis described above. Each table highlights the effect on the project's overall financial gap when one key assumption changes and all other assumptions remain constant.

Figure 3.2 Impact of Key Cost Assumptions on the Overall Financial Gap

Sensitivity Analysis - Change in Commercial Space Hard Costs					
Change in Variable	**Hard Costs Down 10%**	**Hard Costs Down 5%**	**Baseline Surplus/(Gap)**	**Hard Costs Up 5%**	**Hard Costs Up 10%**
Change in Financial Surplus/(Gap)					
New Retail	**1,005,916**	**877,715**	749,513	**621,311**	**493,109**
Historic Retail	**886,418**	**839,227**	792,884	**744,845**	**697,654**
Historic Office	**(2,455,720)**	**(2,701,795)**	(2,947,870)	**(3,193,945)**	**(3,440,020)**
Market Rate Apartment	**(922,130)**	**(1,495,131)**	(2,068,132)	**(2,641,133)**	**(3,214,133)**
Magnet Apartment	**2,341,186**	**2,344,948**	2,348,696	**2,352,451**	**2,356,204**
Retail Pad Sites	1,100,000	1,100,000	1,100,000	1,100,000	1,100,000
Townhomes	10,860,000	10,860,000	10,860,000	10,860,000	10,860,000
Infrastructure and Site Costs	(12,928,000)	(12,928,000)	(12,928,000)	(12,928,000)	(12,928,000)
Demolition	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)
Extraordinary Historic	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)
County Fees	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)
Total Financial Surplus/(Gap)	**(7,378,329)**	**(8,369,036)**	**(9,358,909)**	**(10,350,471)**	**(11,341,185)**
Variance ($)	**(1,980,580)**	**(989,873)**		**991,562**	**1,982,276**
Variance (%)	-21.2%	-10.6%		10.6%	21.2%

Sensitivity Analysis - Change in Infrastructure and Site Costs					
Change in Variable	**Infrastructure Costs Down 10%**	**Infrastructure Costs Down 5%**	**Baseline Surplus/(Gap)**	**Infrastructure Costs Up 5%**	**Infrastructure Costs Up 10%**
Change in Financial Surplus/(Gap)					
New Retail	749,513	749,513	749,513	749,513	749,513
Historic Retail	792,884	792,884	792,884	792,884	792,884
Historic Office	(2,947,870)	(2,947,870)	(2,947,870)	(2,947,870)	(2,947,870)
Market Rate Apartment	(2,068,132)	(2,068,132)	(2,068,132)	(2,068,132)	(2,068,132)
Magnet Apartment	2,348,696	2,348,696	2,348,696	2,348,696	2,348,696
Retail Pad Sites	1,100,000	1,100,000	1,100,000	1,100,000	1,100,000
Townhomes	10,860,000	10,860,000	10,860,000	10,860,000	10,860,000
Infrastructure and Site Costs	**(11,635,200)**	**(12,281,600)**	(12,928,000)	**(13,574,400)**	**(14,220,800)**
Demolition	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)
Extraordinary Historic	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)
County Fees	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)
Total Financial Surplus/(Gap)	**(8,066,109)**	**(8,712,509)**	**(9,358,909)**	**(10,005,309)**	**(10,651,709)**
Variance ($)	**(1,292,800)**	**(646,400)**	**-**	**646,400**	**1,292,800**
Variance (%)	-13.8%	-6.9%	-	6.9%	13.8%

Figure 3.3 Impact of Key Revenue Assumptions on the Overall Financial Gap

Sensitivity Analysis - Change in Commercial Space Average Rent Rates					
Change in Variable	**Rent Rates Down 10%**	**Rent Rates Down 5%**	**Baseline Surplus/(Gap)**	**Rent Rates Up 5%**	**Rent Rates Up 10%**
Change in Financial Surplus/(Gap)					
New Retail	**384,074**	**566,793**	749,513	**932,232**	**1,114,952**
Historic Retail	**616,404**	**704,220**	792,884	**879,852**	**967,668**
Historic Office	**(3,546,781)**	**(3,247,325)**	(2,947,870)	**(2,648,414)**	**(2,348,959)**
Market Rate Apartment	**(3,568,747)**	**(2,818,439)**	(2,068,132)	**(1,317,822)**	**(567,515)**
Magnet Apartment	**1,821,609**	**2,085,173**	2,348,696	**2,612,294**	**2,875,858**
Retail Pad Sites	1,100,000	1,100,000	1,100,000	1,100,000	1,100,000
Townhomes	10,860,000	10,860,000	10,860,000	10,860,000	10,860,000
Infrastructure and Site Costs	(12,928,000)	(12,928,000)	(12,928,000)	(12,928,000)	(12,928,000)
Demolition	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)
Extraordinary Historic	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)
County Fees	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)
Total Financial Surplus/(Gap)	**(12,527,442)**	**(10,943,577)**	**(9,358,909)**	**(7,775,858)**	**(6,191,995)**
Variance ($)	**3,168,533**	**1,584,669**	**-**	**(1,583,051)**	**(3,166,913)**
Variance (%)	33.9%	16.9%	-	-16.9%	-33.8%

Sensitivity Analysis - Change in Average Townhome Sale Prices					
Change in Variable	**Sale Prices Down 10%**	**Sales Prices Down 5%**	**Baseline Surplus/(Gap)**	**Sale Prices Up 5%**	**Sale Prices Up 10%**
Change in Financial Surplus/(Gap)					
New Retail	749,513	749,513	749,513	749,513	749,513
Historic Retail	792,884	792,884	792,884	792,884	792,884
Historic Office	(2,947,870)	(2,947,870)	(2,947,870)	(2,947,870)	(2,947,870)
Market Rate Apartment	(2,068,132)	(2,068,132)	(2,068,132)	(2,068,132)	(2,068,132)
Magnet Apartment	2,348,696	2,348,696	2,348,696	2,348,696	2,348,696
Retail Pad Sites	1,100,000	1,100,000	1,100,000	1,100,000	1,100,000
Townhomes	**9,774,000**	**10,317,000**	10,860,000	**11,403,000**	**11,946,000**
Infrastructure and Site Costs	(12,928,000)	(12,928,000)	(12,928,000)	(12,928,000)	(12,928,000)
Demolition	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)	(1,050,000)
Extraordinary Historic	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)	(1,726,000)
County Fees	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)	(4,490,000)
Total Financial Surplus/(Gap)	**(10,444,909)**	**(9,901,909)**	**(9,358,909)**	**(8,815,909)**	**(8,272,909)**
Variance ($)	**1,086,000**	**543,000**	**-**	**(543,000)**	**(1,086,000)**
Variance (%)	11.6%	5.8%	-	-5.8%	-11.6%

3.2 Historical Costs

Reasonableness of costs associated with historic structures and impact on residential and commercial tenants.

A detailed discussion with BE&K provided assurance that the cost estimates the Alexander Company used for the financial analysis were reasonable. Furthermore, the estimates are probably conservative for today's market given the notable drop in material and labor prices over the past several months. BE&K estimated that overall construction costs have dropped at least 10% since BE&K provided the estimate for the Alexander Company in December 2008, which is consistent with what other developers and contractors have stated.

BE&K used take-off estimates from their rehabilitation of the Lorton Arts Foundation (LAF) as the basis for their estimates for the Adaptive Reuse site. For example, for replacing and re-pointing brick work they calculated the surface area of the bricked buildings of the site and multiplied that number by the same actual unit costs required for similar brick work at the LAF. They applied this methodology for all historic rehab requirements and for the shell of the building. In addition, BE&K applied the lessons learned from LAF when estimating the costs of difficult to price items such as custom-built windows.

All work within the walls of the historic buildings was priced using current market data from the cost estimates on their construction projects of new space. There was no notable premium for mechanical, electrical, and plumbing (MEP), a safe assumption considering the proximity of existing utilities and the level of infrastructure work included in the overall cost estimate.

For estimates that were not easily comparable to past or current projects such as grading and utility work, BE&K applied the average cost per acre of site work at LAF to estimated total acres of site work at the Adaptive Reuse Site. BE&K noted that unforeseen issues regarding utilities and below grade conditions can easily result in the budget doubling for those line items. However, this is generally the case for most projects—new or historic—and is why a contingency should be included in the project budget. The Alexander Company's analysis carries a healthy hard cost contingency of about 10% for all use types which is reasonable for the scope of this project.

It should be noted that the County Re-Use Plan (codified in the Comprehensive Plan) outlines the County's intent to preserve and maintain the majority of the over 130 historic structures on the site. Procedures and guidelines for the review of development plans, any proposed demolition, and agency coordination are outlined in the Memorandum of Agreement (MOA) executed with the General Services Administration (GSA). The County would have to otherwise fund the preservation effort included in the Adaptive Reuse construction costs outlined by the Alexander Company.

4.0 FINANCING OPTIONS

4.1 Financing Tools

Assess the feasibility of a special tax district or tax increment financing to help close the project's financial gap.

The County can leverage two main public tools to address the project's financial gap: a special tax district administered by a Community Development Authority (CDA) and Tax Increment Financing (TIF).

Community Development Authority and Special Tax District. CDAs are authorized to acquire, establish, construct, equip, operate, and maintain certain infrastructure improvements within the boundaries of the authority and to issue revenue bonds to pay the costs associated with such improvements. A CDA may be used with or without tax increment incentives. In instances where a CDA is used without tax increment incentives, the CDA must pay all of the debt service associated with the revenue bonds through a special tax or special assessment levied on property owners receiving a "special benefit" from the improvements. This special tax or special assessment could be a one-time event or be assessed annually to service a bond to fund the improvements.

The basic calculations outlined in the chart below illustrate the estimated amount of funds an ad valorem tax of one cent per $100 of assessed value would generate annually if applied to the Laurel Hill development. In summary, one penny of ad valorem tax can support a debt capacity of about $102,000. As an example, a $0.10 tax could support about $1 million in debt. The statutory maximum limits a special ad valorem tax to $0.25. Further analysis is needed to determine the magnitude of a special assessment since it will have an impact on the revenues and viability of the project.

Figure 4.1 Funds Generated per $0.01 of Special Tax

Estimated Assessed Value	
Commercial Property[1]	$34,508,895
Townhomes[2]	72,400,000
Total Assessed Value	**106,908,895**
Special Tax Rate per $100 Ad Valorem	$ 0.01
Funds Generated Annually by Special Tax	**$ 10,691**
Special Assessment Bond assumptions:	
Term (years)[3]	20
Interest Rate[4]	6.0%
1.20 debt service coverage ratio	1.20
Maximum Bond Amount Supported by Special Tax	**$102,186**

[1]Estimated value from the Alexander Company's models

[2]Assumes estimated value of $400,000 per townhome

[3]Per the County's Priciples for Public Investment, the max term is 20 years

[4]Interest rate of proposed SA Bonds for the Mosaic at Merrifield

Tax Increment Financing. The proposed development on the 80-acre Laurel Hill site would provide a substantial increase in revenue to the County in terms of additional taxes, especially considering the site does not currently generate any tax revenue. Therefore, another method to close the financial gap of the project is through the use of TIF. TIF is a common technique used by counties and municipalities to finance capital projects from the future gains in tax revenue generated by those improvements. TIF is designed to channel funding toward improvements in distressed or underdeveloped areas where development might not otherwise occur. In the case of the development at Laurel Hill, the County could commit a portion of the increase in tax revenues (in the form of bonds) to finance infrastructure improvements (utilities, lighting, repaving streets, etc.) that would encourage the desired commercial and residential development on site. The increase in tax revenue generated by these uses would go toward the debt service of the TIF bonds.

A CDA can also be used in conjunction with TIF to provide a minimum tax guarantee. In this arrangement, debt service is first paid through tax increment revenues. In the event that tax increment revenues are sufficient to cover debt service, no special taxes are collected. If, however, tax increment revenues fall short of the required debt service in any bond year, the special tax is collected.

Based on the Alexander Company's financial feasibility analysis, the commercial and residential uses of the project could generate over $1 million in new tax revenue annually for the County. This includes $750,000 annually associated with the 181 for-sale townhomes, illustrating the significant financial impact townhomes would have on the project feasibility if public financing were involved.

A first step in determining the effectiveness of using TIF is to determine the debt capacity that results from the incremental tax increase. Using the Mosaic development at Merrifield as a guide, preliminary calculations suggest that it is potentially feasible for the project to service a $10 million bond with a term of 20 years and coupon rate of 6%, as illustrated in the following chart.

Figure 4.2 New Tax Revenues vs. Maximum TIF Bond Capacity

New Annual Tax Revenues	
Real property tax revenues (Commercial property)[1]	310,000
Real property tax revenues (For-Sale Townhomes)[2]	752,960
Total New Annual Revenues	**$ 1,062,960**
TIF Bond assumptions:	
Term (years)[3]	20
Interest Rate[4]	6.0%
1.20 debt service coverage ratio	1.20
Maximum Bond Amount Supported by New Tax Revenue	**$ 10,160,056**

[1]Estimated real property tax from commercial properties based on Alexander Company's financial models (retail, office and apartments)

[2]Estimated real property tax from 181 townhomes assuming average assessed value of $400,000 per home and tax rate of $1.04/$100 of assessed value

[3]Per the County's Priciples for Public Investment, the max term is 20 years

[4]Interest rate of proposed TIF bonds for the Mosaic at Merrifield

From this approach it seems reasonable to assume the overall project could service a $10 million TIF after the stabilization of the commercial properties and all townhomes are sold. This analysis assumes stabilization occurs three years after the bond is placed. Also, assuming a discount rate of 2.5% (per the MOU for the Merrifield Towncenter), the Net Present Value (NPV) of incremental increases in real property tax increases after servicing a $10 million bond over the twenty year term is about $3.5 million. Thus, preliminary analysis suggests the County could realize a considerable new source of tax revenue through the use of TIF at Laurel Hill.

4.2 Financial Risks

Identify financial risks that may accrue to the County through implementation of the project or associated financial tools.

Commercial real estate development is a complex and risky activity, but it often results in extraordinary benefits for all stakeholders when risks are managed appropriately. It is evident that the County is aware of the risks involved with the development of Laurel Hill and has the staff and guidelines in place to mitigate these risks. Furthermore, the County has a comprehensive list of principles used to evaluate revitalization and reinvestment opportunities—the Principles for Public Investment in Support of Commercial Redevelopment ("16 Principles"). These 16 Principles call out specific measures the County can take to promote responsible development while limiting its risk.

The tables below list the primary project risks and financing risks involved with this type of development and briefly discusses some of the issues the County has or may consider as the project moves forward.

Figure 4.3 Project Risks of Typical Development Projects

Risk Factor	Description	Discussion
Entitlement Risk	• Risk of obtaining appropriate land entitlements, construction permits and zoning approvals.	• The County should be able to mitigate most of this risk through continued involvement in the project. Coordination with the General Services Administration (GSA) is required, per the stipulations off the MOA, however, GSA expectations are not known at this time.
Construction Risk	• Materials pricing– risk that the cost of materials may vary from the original construction estimates. • Scheduling– risk that planned construction completion could be prolonged due to weather delays, labor disputes, material delivery delays, etc.	• The cost and schedule risks associated with the new and historic rehab aspects of the development are manageable and steps have been taken to mitigate these risks: 1) the project costs were estimated by the contractor with experience on similar historic structures at the Lorton Arts Foundation, 2) the master plan was prepared by the Alexander Company, a developer with extensive experience in historic rehab projects and 3) the budget includes a construction cost contingency of about 10% which is commonly recommended for projects of similar scope. • The County and the selected developer should maintain an open dialogue throughout the design and construction process with the Virginia Department of Historic Resources and the National Park Service to minimize the amount and cost of

		any scope changes needed to achieve the historic tax credits.
Leasing/Sales Risk	• Risk that forecasted absorption (leasing or unit sales) volume will not be realized. • Risk of a market-driven restructuring of leasing or sales commission rates.	• The current projected lease-up period is 6 months which may be aggressive considering the current absorption rates and the uncertain outlook over the next few years. • Securing pre-leases in the current market may preclude the County from achieving higher rents when the market recovers and the project delivers.
Operating Expense Risk	• Risk of a significant change in one or more fixed or variable expense categories such as insurance, real estate taxes, etc.	• Keep in mind the structural and mechanical inefficiencies associated with historic buildings when evaluating lease terms and drafting operating agreements.
Credit Risk	• Risk that pre-lease tenants and/or tenants' industry segment is negatively impacted during development.	• Many potential office and retail tenants (both local and national) face a great deal of uncertainty about how they will weather the current recession and what their space needs will be in the coming years.
Event Risk	• Risk of a physical, economic, or other event occurring that materially impacts asset operations value. Weather, discovery of previously unknown environmental contamination, exodus of major employment providers, and terrorism comprise a sampling of such events.	• Consider a full utility mapping survey of the Adaptive Reuse site to reduce the risk of uncovering subsurface issues. • The residential market outlook for the Lorton area is notably influenced by the expected Ft. Belvoir BRAC expansion. As a result, unforeseen policy changes to BRAC plans could negatively impact the Lorton market.

Figure 4.4 Primary Financial Risk Factors

Risk Factor	Description	Discussion
Partnership Risk	• Risk that accompanies any ownership less than 100% due to a myriad of factors regarding control, revenue distributions, etc.	• The County can mitigate this risk by carefully drafting a development agreement that address each partner's economic interests and how disagreements will be handled throughout the duration of the project.
Capital Market Risk	• Interest Rates–risk of a change in interest rates during the development period that results in increased financing costs. This could affect cost of construction or, in the case of townhome sales, the buyer's ability to obtain suitable purchase price financing. • Alternative investment risk–risk that investor allocations or rates of return for alternative investments will change resulting in shifts in capitalization and discount rates.	• Interest rates are at historic lows and the Fed will likely face pressure to combat inflation over the next few years. As a result, the County should consider how rising rates will impact the different financing options. • The alternative investment risk must be factored into the feasibility of financing a TIF bond; private institutional investors may price the bonds at a rate that cannot be supported by the incremental tax revenues.
Valuation Risk	• Risk that a lack of applicable, current market data exists to accurately value the subject property especially due to the	• The valuation of the property will influence the size of the permanent ("take-out") loan available to the project and the overall financial gap.

	unique nature of the site.	
TIF Risk	• Risk of default on bonds—risk that the TIF investment does not spur enough private development required to create the tax increment needed to service the bonds. • Political Risk—risk that elected officials do not approve TIF because of public opposition.	• Per the guidance of the 16 Principles, the TIF bonds can be structured such that the County's general fund and bond rating are not impacted in the event of a default. • The tax revenue of the project is highly dependent on the real property tax generated by completed townhomes. Market factors could force the home builder to sit on the vacant land for several years delaying the collection of a major source of incremental tax revenue. • Transparency and public input is critical to gaining public support and ensuring elected officials make the best decision regarding public financing.
CDA Risk	• Risk of default in the development start-up phase. • Risk of insufficient sales to fee bond repayment revenue stream. • Risk that property value declines reduce the bond repayment revenue stream. • Economic downturn could hurt the prices or sale of property within the CDA.	• Per the guidance of the 16 Principles, any special assessment bonds created under the CDA can be structured such that the County's general fund and bond rating are not impacted in the event of a default. • In addition, the 16 Principles address these risks through guidance related to the negotiation and structure of the development agreement.

4.3 Cost-Benefit Impact

Evaluate the reasonableness of cost-benefit impact of the proposed project as it relates to net tax gain, potential bond impact, and County liabilities.

A cost-benefit analysis is a useful method to determine the net benefit of the County's investment in the Laurel Hill project. From a financial standpoint, the County mainly benefits through new tax revenue sources and by not having to incur the financial obligations of preserving the site per the MOA.

The Alexander Company's analysis provides a reasonable estimate for the real property. It is also important to consider the benefit the project will have on the property values and corresponding tax revenues of the area surrounding the Adaptive Reuse site, albeit more difficult to measure with certainty.

In addition, personal property taxes, sales taxes and business, professional and occupational license (BPOL) taxes will contribute to the net tax gain along with other taxes resulting from the commercial and residential aspects of the development such as transportation taxes, etc. The analysis below assumes residents of each housing unit pays personal property tax on $20,000 of assessed motor vehicle value at a rate of $4.57/$100 of assessed value. Estimating sales taxes and BPOL tax revenue sources at this point in the development process is more difficult because they are highly dependent on changing market dynamics and the type of tenants that occupy the site. Thus, a more involved study might look at several different leasing scenarios to estimate the type of businesses and the corresponding sales projections for this type of development. Also, the project will likely create new jobs and improve economic output in Laurel Hill area. Specifically, the construction jobs during development and permanent job creation after stabilization may result in a net increase in business activity in the County. Further analysis is necessary to estimate the magnitude of these employment and wage benefits.

Another benefit to the County involves the cost savings associated with preserving the site. The County's ongoing costs to preserve the site are substantial and, as a result, the immediate financial cost of doing nothing to the site is significant. The Fairfax County's Facility Management Division has spent about $5.4 million on security and maintenance of the site since the site was acquired in 2002, which is over $700,000 annually. A developed site would be maintained by private sector owners and relieve the County of this ongoing financial burden.

From a cost standpoint, the development will result in new liabilities for the County in the form of additional operation and service costs due to additional administrative, public safety, education, and other expenses. The costs are difficult to project without fixed and variable cost estimates from the several municipal agencies affected and a separate study is recommended to determine the magnitude of these liabilities. Some costs may be offset by the County Fees and Proffers that the Alexander Company has included in their development budget.

The figure below summarizes the estimated benefits of the County's investment in the project. In total, it is likely that the County will realize at least $1.2 million annually in net benefits not including the other tangible and intangible benefits of revitalizing the underdeveloped Laurel Hill site.

Figure 4.5 Estimated Annual Net Benefit to the County

New Annual Real Property Tax Revenues		
Real property tax revenues (Commercial property)[1]		310,000
Real property tax revenues (For-Sale Townhomes)[2]		752,960
Total	**$**	**1,062,960**
Debt Service for $10,000,000 TIF Bond[3]	**$**	**(871,846)**
Net Real Property Tax Increment	**$**	**191,114**
Personal Property Tax Revenue[4]	**$**	**275,000**
Cost Savings From Not Having to Maintain & Secure Site	**$**	**700,000**
Sales, BPOL and Other Tax Revenues[5]		**TBD**
Net Benefit to County [6]	**$**	**1,150,000+**

[1]Estimated real property tax from commercial properties based on Alexander Company's financial models (retail, office and apartments)

[2]Estimated real property tax from 181 townhomes assuming average assessed value of $400,000 per home and tax rate of $1.04/$100 of assessed value

[3] Assumes annual payment of a bond with a rate of 6.0% and term of 20 years

[4] Assumes the average tax levy per vehicle is $408 and the average number of vehicles per household is 1.99 (Fairfax Coutny Department of Tax Administration)

[5] Further analysis needed to estimate the amount of these tax revenue sources

[6] Assumes new operating costs to the County are offset by fees and proffers included in the Alexander Company's budget

4.4 Public Financing

Provide advice on the appropriate form of public financing on investment to achieve County goals.

The Alexander Company's analysis illustrates that there will be a financial gap associated with the Laurel Hill development. As a result, the project will not proceed unless there is a sufficient level of public financing. However, a brief analysis suggests that it is possible to use one or more forms of public financing to close the gap and spur private development of the site.

Per the County's 16 Principles, a development entity such as CDA which includes a self-tax is the preferred funding method for this type of project. Therefore, maximizing the use of a CDA ad valorem tax or special assessment should be considered before assessing the use of TIF as a supplement to close the remaining gap. The statutory maximum and the terms of a development agreement will dictate the required amount of each source of financing.

As illustrated in Figure 4.1, a special assessment of $0.01 per $100 of assessed property value generates around $10,000 in funds annually and could reasonably service $100,000 in bond proceeds. This ad valorem tax rate could be scaled up to the statutory maximum of $0.25 to fund about $2.5 million of the financial gap. The remaining gap could be closed or partially funded by a special assessment depending on the economic impact on the project. In addition, the calculations in Figure 4.2, suggest that the project can conservatively service a $10 million TIF bond if necessary. In total, some form of this combined approach is expected to yield sufficient funds to close the gap as currently estimated by the Alexander Company.

Regardless of which public financing mechanism or mechanisms are employed it is beneficial to evaluate the project through the lens of the County's 16 Principles for Public Investment. The table below briefly discusses how the project measures up to these Principles and identifies areas that may require additional attention.

Figure 4.6 County's Principles for Public Investment

Principle Summary	Discussion
1. Project located in an area of strategic importance.	Board of Supervisors establishment of a task force and PAC to oversee the development of the project demonstrates the importance of Laurel Hill.
2. The project is deemed to be a "Pioneer Project" that results in area wide benefits.	In addition to providing neighborhood amenities to the community, the development of the Adaptive Reuse Site will have a positive impact on the area by making the site an enjoyable destination and reducing the stigma associated with Lorton due to the former prison site.
3. The project is consistent with County's Comprehensive Plan.	The proposed master plan conforms to the intent of the Comprehensive Plan's recommendations and amendments to the Plan may be necessary to further the revitalization and redevelopment of the site by making it more economically viable.
4. Public purpose and benefits defined as measurable.	Much of the infrastructure costs associated with the development of the site are needed regardless of the development program to maintain and preserve the historic buildings per the agreement with the GSA.

5. Fund of public facilities.	There are infrastructure costs in the master plan that call for public civic space and amenities available to the general public.
6. No negative impact on the County's bond rating.	Public investment could be structured through a CDA so that the bond is not folded into the County's general obligation base; institutional bond investors shoulder the risk.
7. The CDA has sufficient debt capacity.	A Laurel Hill CDA is projected to have the debt capacity using a special tax, special assessment and TIF, if necessary, to close the financial gap.
8. No direct or indirect liability to the County.	Based on the Merrifield example, bonds can be structured such that there will be no recourse to the County.
9. Financial feasibility.	Preliminary analysis of the master plan indicates that the development is viable with around $10 million of outside funding. Further analysis will need to be performed with updated cost and market data before funds are committed.
10. CDA self-tax should be used if any TIF is proposed.	Additional analysis must be conducted to determine how much self assessment the project could sustain and remain economically feasible.
11. CDA assumes risk for insufficient tax increment revenues.	Per the Merrifield example, the CDA could impose an obligation on the developer for any shortfall in tax increment revenues and a special tax could be implemented if the special assessment revenue is insufficient.
12. Minimum period to repay TIF bonds.	Preliminary calculations suggest the incremental increase in tax revenue of the project could repay at least $10 million in bonds within 20 years assuming a coupon rate of 6%.
13. Reasonable return to the County.	More analysis and a MOU of the terms are needed to make this determination, but initial analysis suggests this is achievable.
14. County to receive tangible benefits.	The use of a CDA and TIF will permit a development in an underutilized part of the County and allow the County to meet its obligation to preserve the historic elements of the site.
15. CDA remains in existence to repay incremental taxes.	The MOU must contain the provisions necessary to ensure the repayment of incremental tax loss to the County's General Fund.
16. Developers grant full access to records.	The Alexander Company or other developer selected for the project must grant full access to financial information for the project. Based on their cooperation to date, this should not be a problem if they are selected to execute the proposed development plan.

As demonstrated above, an initial review of the proposed Laurel Hill project suggests that the County's 16 Principles are within reach. As a next step beyond the master planning process, it is recommended that the County begin an assessment of the project based on its published two-tiered process for the Evaluation of Public Investments in Support of Commercial Redevelopment. The earlier the County begins this evaluation the easier it will be to objectively address the potential use of public financing and ensure that the ultimate development plan conforms to its investment principles.

5.0 CONCLUSIONS AND RECOMMENDATIONS

The assessment of the Alexander Company's Financial Feasibility Analysis found the study to be based upon reasonable market assumptions and reflective of sound real estate fundamentals and decision making given the preliminary nature of the "master plan" scope of services and the status of the planned development program. The assumptions for the analysis are based on extensive market research in the local area and generally well supported by third party studies and prior experience with similar development projects. The analysis logically sums the estimated financial surplus or gap for each use with the infrastructure and other costs of the overall development to estimate the overall financial gap of the project.

It is important to note that projecting the financial gap at this stage in the pre-design and planning process is not a precise science due to the dynamic nature of the market, especially during these turbulent times. As a result, the conclusions of the Alexander Company's feasibility analysis and this assessment are not intended to produce precise results, but rather, reasonable estimates of the financial gap and a general idea of the economic impacts to Fairfax County.

Given the drastic correction in market rents recently, rising cap rates, and a depressed for-sale market, values are likely lower than estimated by the Alexander Company. However, this drop in value is offset by the drop in construction costs over the past several months. Thus, on balance, the financial gap is still estimated to be within the $9-12 million range if the project was to be financed today.

In any event, the market will recover and general consensus is that it will recover sooner and stronger in the DC area relative to the rest of the nation. Furthermore, any hint of a recovery will push rents higher and cap rates will compress as money on the sidelines eagerly waits for any positive sign to jump into the DC market. As a result, it will not take much of an increase in rent before values improve significantly and the financial gap of the project closes. There is a fair probability that this will happen as the project is being entitled, designed, and delivered over the next two to three years.

The recommendations listed below refer to next steps the County should consider as the project progresses through the pre-development phase. These recommendations build off of the work that has already been performed by the Alexander Company and are not essential to evaluating the proposed master plan at this time.

Recommendation – Financial Assumptions

Update Market and Construction Data. Although the Alexander Company's market studies were detailed and appeared to contemplate the difficult economic environment in 2008, the outlook for the future has changed over the last year. As the project evolves beyond the proposed master plan, new market and construction cost estimates for the development period and the leasing period should be incorporated.

Conduct Sensitivity Analyses. Although the Alexander Company's analysis used reasonable and available data for its financial assumptions, there is a great deal of uncertainty about these variables over the next few years. Thus, as the project moves forward, Fairfax County should ensure that the project developer conducts sensitivity analyses around individual variables to determine which variables pose the greatest financial or project risk to the County.

Recommendation – Discounted Cash Flow Analysis

Combine the analyses of the development (construction and lease-up) and operating periods of the overall project into one discounted cash flow (DCF) before a development agreement is structured. A DCF analysis is critical to understanding overall value of the project over time and determining its viability in the near and mid-term. In addition, one consolidated model will allow for greater transparency and understanding of how each use affects the financing gap/surplus. Also, cash flow segmented into quarterly or monthly time periods will better illustrate when debt and equity funds are needed.

Recommendation—Discounted Cash Flow Analysis from an Investor/Joint-Venture Perspective

Develop multiple scenarios for how the public/private partnership would be structured between the developer and Fairfax County. This analysis would identify how much construction, capital market, valuation, lease-up, and operating risk each party assumes and when.

Recommendation—Fee Simple Transfer of Townhome to Buyers

Ensure the ability to transfer townhomes through a fee simple sale. Leasehold ownership of townhomes is very rare in Virginia and the Mid-Atlantic region and there are a limited number of buyers in the market familiar with this type of ownership structure. As a result, the requirement to use a leasehold structure would likely impair the value of the townhome property. Even in states where leasehold ownership is more common, such as in Hawaii, there is a still a great deal of uncertainty regarding this type of sale and market values often suffer as a result.