MUNICAP, INC.
PUBLIC FINANCE

Memorandum

To: Stan Milesky

From: Keenan Rice

Date: October 4, 2016

Re: **Response to Report from TischlerBise, Inc.**
Proposed Downtown Columbia TIF

TischlerBise, Inc. (Tischler) conducted a review of information provided by MuniCap and county staff to County Council related to the proposed tax increment financing proposed for Downtown Columbia. Their review was summarized in a report dated September 20, 2016. First, we want to thank Mr. Glendenning and Tischler for their review. We appreciate their comments and questions. We note that Tischler did conclude that the TIF proposal represents an appropriate use of tax increment financing. They also believe the project will have a net positive fiscal impact on the County. We do believe some factual clarifications are warranted to the Tischler report. The analysis for the proposed tax increment financing has been conducted over an extensive period of time and there is a great deal of information that has been developed related to the proposal. Given the limited time available to Tischler, it is understandable that they were not able to master all of this information. Accordingly, we hope the additional information provided in this memorandum is helpful in clarifying questions raised by Tischler. We would like to note that we made ourselves available to answer any questions Tischler had regarding the TIF analysis and encouraged Tischler to contact us so they could be factually accurate in their report.

The following headings correspond to the headings in the main body of the Tischler report (with the first heading on page 8).

Calculation of Market Values

Tischler notes that there are few comparable properties (comps) provided to estimate, in particular, the values of the apartments proposed to be developed in Downtown Columbia. This is a common issue with TIFs. In most cases, when tax increment financing is being used, the proposed development sets a different, higher standard than the development that has occurred in the past. If the same development is to occur with the TIF as has been occurring in the past, there would be no need or justification for a TIF. The apartment product proposed for development in Downtown Columbia does not currently exist in Howard County (other than the Metropolitan). There are a few examples in Anne Arundel County, with additional examples in Montgomery County, Baltimore County, and the City of Baltimore in urban locations. Tischler suggests we were projecting values representative of a built-out, urban environment. That is not correct, we specifically did not use comps for similar properties located in existing urban areas. The four comps we used for the apartments were the only similar type properties located in

surrounding suburban locations then on the tax rolls. That is why we used these four properties.

Tischler evaluated the estimated values by eliminating Crosswinds at Annapolis Town Centre, using the three remaining comps to estimate a revised value. Let us take a closer look at the comps. Crosswinds is the same type of apartment, relatively new, similar type of construction, structured secure parking, and comparable finishes and amenities. Most importantly, the rents are similar. For example, a unit with 977 square feet is renting for $2,377 at Crosswinds, a similar unit with 983 square feet is renting for $2,258 at the Metropolitan. A unit with 705 square feet is renting for $1,838 at Crosswinds. A unit with 716 square feet is renting for $1,660 at the Metropolitan. The rents at the Metropolitan are about 8% lower than the rents at Crosswinds on a per square foot basis. Now let's compare the values. The state assessor has valued Crosswinds at $248 per square foot. We have used a value for Downtown Columbia of $207 per square foot, more than 16% less than the value of Crosswinds, although the rents are only about 8% lower.

We can make a similar comparison to the Residences at Arundel Preserves. This property is located proximate to Arundel Mills. The property is the same type of apartment, newer, similar type of construction, structured secure parking, and comparable finishes and amenities. The rents at Arundel Preserves average $2.01 per square foot. The rents at the Metropolitan average $2.18 per square foot, 8% higher than Arundel Preserves on a per square foot basis. The state assessed Arundel Preserves at $238 per square foot. We have used a value of $207 per square foot for Downtown Columbia, almost 15% less than the Preserves, although the rents at the Metropolitan are 8% higher.

Tischler left the two properties in Odenton in its sample, although they are not in the same sub-market as Downtown Columbia, its reason for removing the Crosswinds. MuniCap works on the Odenton Town Center project, we are very familiar with the development. It is an exciting transit project; however, it is not the same market as Columbia and will not achieve the same rents or values. For example, a unit at the Haven at Odenton Gateway with 907 square feet has a base rent of $1,522. This compares to a rent at the Metropolitan for a unit with 917 square feet of $1,921, 25% higher than the rent at the Haven on a per square foot basis. A unit at the Flats 170 with 1,372 square feet has a base rent of $2,258. A unit with 1,393 square feet at the Metropolitan rents for $2,881, 26% higher than the rent at Flats 170 on a per square foot basis. If any properties are not comparable to Downtown Columbia, it is not Crosswinds, it is the two properties in Odenton.

MuniCap used these four comps because they were the only similar types of apartments in surrounding suburban locations on the tax rolls. The two Odenton projects represent the bottom of this market. Crosswinds and Preserves represent the top of the market. By using all four properties, we obtained an average value, assuming a position for Downtown Columbia in the middle of the market. In fact, comparing rents achieved by the Metropolitan, properties in Downtown Columbia will be at the top of the suburban market for similar properties. Contrary to the claim by Tischler that the values are high, a more in-depth analysis, as prepared by MuniCap, demonstrates the conservative values assumed for apartment properties in Downtown Columbia.

More data would be good, but only if it is meaningful, and it would only be meaningful if it represented a similar type of property able to obtain similar rents. The additional comps suggested by Tischler are not the same type of construction or quality of project and do not obtain the same rents. They are not valid comps to the development proposed for Downtown Columbia.

Since completing our analysis for the proposed TIF, SDAT has posted the assessed value for the first phase of the Metropolitan. This value supports the conservatism of the MuniCap estimates. MuniCap estimated the value of apartments in Downtown Columbia based on an average of $207 per square foot, resulting in an assessed value of $85,900,000 for the first phase of the Metropolitan. The assessor has determined the value of this phase to be $97,300,000, an average value of $235 per square foot. This valuation demonstrates that MuniCap's estimated value was not high, but was instead conservative, as our analysis indicated it would be.

Special Tax and General Obligation Bonds

Tischler states that there should be more transparency regarding the special taxes expected to be collected in the proposed TIF. The projected special taxes are shown in the fiscal impact projections, which were attached to the staff report provided to the County Council. Additionally, the collection of special taxes has been extensively discussed with the County Council, particularly in regards to discussions relating to the set aside of tax increment revenues to pay for the proposed elementary school at the Faulkner Ridge site. The point has been made to the County Council that tax increment revenues will be set aside to pay the debt service on $30 million of GO bonds to be issued for the school, and this will require the property owner to pay special taxes in this amount unless it produces tax increment revenue in excess of the projected tax increment revenue. This has been shown in several PowerPoint documents provided to the County Council. Tischler has obviously not been able to participate in these discussions; however, we do believe the County Council and HRD understand the expectation regarding the collection of special taxes.

Economic Impact Analysis

Tischler has a number of comments related to the economic impact analysis prepared by CohnReznick for HRD and submitted with its application for tax increment financing. MuniCap similarly believes values were not sufficiently conservative in this analysis. As a consequence, the CohnReznick economic impact analysis was not relied upon in any way for the evaluation prepared for the proposed Downtown Columbia TIF. The information submitted to the County Council did not cite or rely on the CohnReznick report in any way.

Tischler also comments on a fiscal impact analysis prepared by CohnReznick as being "extremely high-level . . ." We agree, and for that reason, did not in any way rely on this fiscal impact analysis.

The county requires an application to be submitted by the property owner or developer

for a proposed TIF. The application requires the applicant to provide its estimates of values, rents, jobs, and other information. HRD submitted the CohnReznick reports with the TIF application in response to these requirements. That is the reason the CohnReznick report is attached to the application. We reviewed these studies, but did not find them adequate for the County's evaluation of the TIF proposal.

Use of Inflation

Tischler acknowledges that including estimates of inflation may be important to TIF projections, but suggests using constant dollar projections for the fiscal impact analysis. The most significant revenues and costs in the fiscal impact analysis are the projected revenues and debt service in the TIF projections. It would not be realistic to use these numbers inflated, while showing other revenues and costs without inflation.

A review of the Consumer Price Index for the last 100 years shows there is no extensive period in which the cost index has not increased. There is no historical basis for assuming there will be no inflation. Projections that extend over several decades with no inflation greatly misstate the likely impact of the development and the TIF. MuniCap prepared projections using both two percent and three percent inflation. These sensitivity projections provide a likely range for the impact of inflation on the projected revenues and costs. Zero percent inflation is not in, or close to, the likely range for this long period of time. Tischler recommends alternative scenarios elsewhere in its report to address uncertainty. It does not take that view with inflation, although there is no question sensitivity projections, as prepared by MuniCap, better represent real expectations.

Revenue Calculations

Tischler states that the estimated assessed values used by MuniCap are "high," specifically referring to the values of the apartments. As explained previously, MuniCap used an estimated value of $207 per square foot for the apartments in Downtown Columbia. The actual value established by SDAT for the Metropolitan is equal to $235 per square foot.

The basis for Tischler's claim that the values estimated by MuniCap are too high is reference to a market study prepared by RCLCO, which projects rents of $2.02 per square foot for the Metropolitan. This market study is dated, and a more recent market study has been prepared by RCLCO. The market study referred to by Tischler was prepared prior to the lease-up of the Metropolitan and projected future rents. The Metropolitan outperformed these projections by RCLCO. The more recent market study prepared by RCLCO notes that the actual rents achieved by the Metropolitan are $2.18 per square foot. This is in contrast to the rents cited by Tischler of $2.02 per square foot.

Tischler believes that using apartment values that are too high may also result in other estimated revenues, such as income tax revenues, being too high. This comment was based on their assumption that rents at the Metropolitan are only $2.02 per square foot. This assumption is mistaken. As explained previously, the actual rents at the Metropolitan are currently $2.18 per

square foot (these rents represent lease-up, not stabilized rents). Rents at the Palisades at Arundel Preserve and Crosswinds at Annapolis Town Center are either comparable to or higher than the rents estimated by MuniCap at stabilization.

We would also note that MuniCap included no income tax revenues from the employees who will work in Downtown Columbia. There is over 3.0 million square feet of office development proposed within the TIF. This space is estimated to include over 11,000 employees, who are estimated to earn over $800 million a year in income. No income taxes were included in the fiscal impact analysis from this $800 million in annual income. This is a very conservative assumption and almost certainly means that MuniCap has substantially underestimated income tax revenue to the County.

Costing Methodology—Operating Costs

The method of estimating costs in the fiscal impact analysis prepared by MuniCap is the same methodology used by the County in the fiscal impact methodology the County prepared for the evaluation of the Downtown Columbia plan. Tischler points out that 96% of the costs in the County's budget are projected to increase as a result of the development, which is an unusually high percentage. Tischler states this methodology may "actually overstate the costs associated with the development." We agree this is a conservative approach, assumes more costs will be impacted than typical or even likely, and may overestimate the increase in costs of public services. We used this approach as we believed it made sense to allow the County to evaluate the proposed TIF on the same basis as it had evaluated the Downtown Columbia plan.

Tischler also suggests estimating an increase in operating costs on the basis of projecting when new employees would be hired, the salaries of these employees, and other related costs. As stated previously, MuniCap utilized the methodology used by the County when it evaluated the Downtown Columbia plan, which is not the methodology recommended by Tischler. We believe the approach recommended by Tischler would make a pretense of more information being available than actually exists to make these projections. The services being provided by the County are not limited to Downtown Columbia. Projecting the actual year when additional police, or as shown in the example from Tischler, environmental technicians, equipment operators, general crew leaders, and general managers, are hired is a calculation that we are doubtful can be made with high enough of a degree of confidence to provide meaningful information. We do not see the value in making estimates with such great uncertainty.

Tischler did not state they believe we underestimated costs. To the contrary, they indicated our cost estimates if anything were likely to be high. The alternative methodology proposed by Tischler is very time consuming and the impact marginal. We believe that limited time and budget resources were better spent on the much more significant issues evaluated for the proposed TIF. There are many aspects of the TIF analysis prepared by MuniCap that are very thorough and in depth. These aspects tend to be those that are most material, not only to the fiscal impact analysis, but also to the proposed tax increment financing.

Capital Costing Methodology

Tischler states that capital costs are "accounted for in the analysis using an average costing approach." It explains that this approach was used to estimate the share of costs to be included in the fiscal impact analysis. It states "it is our opinion that the entire costs should be reflected in the analysis." In fact, MuniCap prepared its analysis both ways.

I want to clarify that we did not use average costing to estimate the need, cost, or timing of capital facilities. These were all calculated on the basis of a case study approach. We prepared a fiscal impact analysis that estimates the share of the costs of public improvements for the property in the TIF, which is not all of development proposed for Downtown Columbia. We would not agree that the property in the TIF, which is not even all of Downtown Columbia, should bear 100% of the costs of these improvements. (Tischler may not have been aware in making their recommendation that the development in the TIF represented only a portion of the development in Downtown Columbia.) We did prepare an alternative analysis that included 100% of the costs of the capital facilities in the projected impacts of the proposed development, but used all of Downtown Columbia for this scenario.

The methodology we used of allocating a portion of the costs of new capital facilities to development in the TIF was utilized in the fiscal impact analysis prepared by the County for the evaluation of the Downtown Columbia plan. As stated earlier, we adopted that same methodology. We do believe this methodology reflects the fiscal impact of the proposed development. For one, the development in the TIF is only a portion of the proposed development in Downtown Columbia. For another, many of the facilities serve a larger population that just the development in the TIF. For example, the police substation is intended to serve one-third of the County. The transit center will serve more than just the development in the TIF, and will provide an important benefit to transit users and the County that impacts more than just the development in the TIF. The arts center, similarly, will serve more than just the development in the TIF. The costs for all of these improvements were based on facilities to serve more than just Downtown Columbia (and certainly more than just the development in the TIF). Imposing the entire costs of these facilities on the development in the TIF would not fairly represent the value of the proposed development and the public facilities.

The larger County will benefit from the public improvements to be provided in conjunction with the development in the TIF, so it does fairly represent the fiscal impact to allocate these costs to the service population. Still, the County must be able to afford the costs of these facilities without imposing a burden on other tax payers in the County. For this reason, we also prepared an alternative analysis allocating 100% of the costs of these facilities to Downtown Columbia. This is consistent with the recommendation by Tischler (it was our recommendation as well).

Need for Alternative Scenarios

Tischler acknowledges that MuniCap conducted a number of alternative analyses (we prepared approximately 50 scenarios); however, it believes additional scenarios would be

helpful, specifically addressing slower absorption, such as might occur in an economic downturn. While we did evaluate alternative absorption scenarios, we believe it would be helpful to further elaborate on the TIF bond approvals and issuance process in Howard County, which are relevant to Tischler's comments.

The legislation before the County Council does not authorize all of the proposed bonds for the Downtown TIF, only those bonds proposed for Phase I. Additional legislation will be required for additional bonds to be issued. In conjunction with this future legislation, the TIF analysis will be updated to reflect actual plans at that time. The bonds that are proposed to be authorized at this time are expected to be issued as a single bond issue next year. It is possible these bonds could be issued in two issuances, still likely to occur over the next few years. The bonds will not be issued unless the development necessary to support the bonds is ready to proceed. The plans for the projects will have to be prepared and approved, the work bid out, permits obtained, and financing in place.

TIFs in the County are evaluated according to a number of public policy criteria. Among these criteria are provisions to mitigate risk. Tischler does correctly identify a potential risk. What it did not mention are the public policy criteria in place to protect against this risk. These criteria include obtaining County Council approval only for those bonds expected to be issued in the near future, and only issuing those bonds if development is ready to proceed. The risk explained by Tischler of bonds being issued, but development not proceeding, will not happen, because bonds will not be issued with the hope that development will then occur. The development must prove it is ready to proceed before bonds will be issued. The schedule for the development to support the bonds will be known when the bonds are issued.

Tischler gives an example of four scenarios it prepared for a light rail station project in Colorado. This example does not appear to represent the circumstances regarding the proposed TIF for Downtown Columbia. Specifically, the question Tischler was evaluating has already been addressed with regards to the TIF for Downtown Columbia. With the project in Colorado, scenarios were considered where the light rail would be constructed upfront, with development to follow over some unknown period of many years in the future. These scenarios did not provide a positive fiscal impact, resulting in a recommendation to delay the construction of the light rail station until sufficient development had occurred. This conclusion has already been reached for the Downtown Columbia TIF. It has been addressed in the manner it should be for the issuance of bonds. The policy criteria for TIF bonds issued in Howard County provide that bonds may not be issued until the development necessary to support the bonds is ready to proceed.

Pro Forma Analysis

Tischler believes that the developer's financial pro forma should be a discounted cash flow analysis. This conclusion fails to take into consideration the question being answered by the pro forma analysis, HRD's business model, and the financial markets in which the parent company, Howard Hughes Corporation (HHC) operates.

First, just as notes of clarification, MuniCap did not prepare the financial pro forma for the proposed development. HRD prepared the pro forma for their proposed development. MuniCap prepared a summary of our evaluation of this pro forma. The Tischler report mischaracterizes MuniCap's summary as being a pro forma. It seems to be confused regarding the developer's pro forma and MuniCap's summary of our analysis of the pro forma, although it was provided the developer's pro forma, and we did explain our analysis was not a pro forma, but a summary of our evaluation of the developer's pro forma. Second, MuniCap did provide the returns with and without a TIF. These returns were reported to the County Council and provided to Tischler as being 5.35% without a TIF and 5.94% with a TIF.

The question being answered by the pro forma analysis is whether the developer is likely to proceed with the proposed development without a TIF. Since the question is whether the developer will proceed, we ask for and review the developer's pro forma. We could prepare our own pro forma, but it would be an academic exercise, as the owner is not going to invest approximately $600 million in just Phase I of the development based on a pro forma prepared by MuniCap (or Tischler), they will make their investment based on their analysis.

While we did not prepare the financial pro forma for the project, we did evaluate whether the form of the developer's pro forma is appropriate and consistent with the market. In this case it is, and Tischler's opinion to the contrary fails to understand HHC's business model and the financial markets in which it operates. First, HHC's business model is to develop property to hold and generate ongoing income. The discounted cash flow analysis proposed by Tischler, as they acknowledge, requires making an assumption as to when the owner will sell the property it develops. HHC's business model does not generally anticipate the sale of the property it develops.

HHC's business model is to produce ongoing income. The reason for this is that it is a publicly traded company. The stock market does not value temporary income efficiently. For example, a common model for evaluating stock prices is the price earnings ratio, which is a ratio of a stock price to earnings per share. The premise of this ratio is that the income is permanent. The ratio does not work with temporary income. The model that HHC uses to evaluate the project looks at operating income to required investment. This is simply the inverse of the price earnings ratio. With this metric, HHC can compare the ratio of income to required investment, and determine whether its investment in the project is likely to result in an increase or decrease in the share price of HHC's stock.

HHC invests billions of dollars in real estate. Tischler might consider that HHC probably has some understanding of how to evaluate investment in real estate for their company. The reality is that the approach suggested by Tischler would be meaningless. It does not represent how HHC evaluates making an investment in real estate, which is the question we are seeking to answer, it does not reflect HHC's business plan, and it does not represent real estate value in the financial markets in which HHC operates.

There is another problem with the approach proposed by Tischler. The market rate of return for real estate development is different, and much higher, than for owning operating real

estate assets. Tischler proposes a pro forma that combines the development period with a projected holding period for the developed property. The market rates of return for these two types of investment are very different. When we review a discounted cash flow pro forma (the type of pro forma recommended by Tischler) for a development project, it reflects a business model appropriate for that type of a pro forma. This would be a business model to develop and sell property. A typical project would be a land development, where the developer will obtain the land use approvals, install the major infrastructure, and sell parcels to builders or sub-developers. This type of pro forma is limited to the development period. There is a consistent rate of return that is appropriate for this period.

The approach recommended by Tischler also fails to understand that the County's interest is future investment, not past investment. The Tischler recommended approach includes carrying costs on the prior investment made by HHC in the property (these are the only carrying costs, which it recommends be included). This is not relevant to the County in evaluating a TIF. The purpose of a TIF is not to rescue a bad investment made by the developer, if that were a problem. The County is interested in future investment. The question for the TIF is whether the developer will make the future investment required by the Downtown Columbia plan. This future investment is the cost of the buildings to be built. These are the costs included in the developer's pro forma. It is this investment that is evaluated. The carrying costs that Tischler proposes to add would not be appropriate to be subsidized by the TIF, as these relate to investment that has already been made. Had the developer included these carrying costs in its pro forma, we would have removed them in our evaluation for the TIF, as our concern was future investment, not carrying costs on past investment.

MuniCap has reviewed developer's pro formas for hundreds of proposed TIFs. The type of model prepared by HRD is a very common method of preparing a pro forma to evaluate development where the property is being developed to be held for long term investment and not sold. As examples, the financial pro formas prepared by the developers for the Harbor Point project in Baltimore, the redevelopment of the Ballston Commons Mall in Arlington, and the Mosaic project in Fairfax County, all used a similar methodology as used by HRD for its development in Downtown Columbia.