ITEM #10, EXHIBIT B. VILLAGE COURT APARTMENTS
PLANNING & DEVELOPMENT SERVICE
PLANNING DIVISON
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TO: Mountain Village Town Council

FROM: Paul Wisor, Town Attorney and Michelle Haynes, Planning and Development Services Director

FOR: Town Council Meeting, May 20, 2021

DATE: May 7, 2021

RE: Community Housing Initiatives – Exhibit B. Village Court Apartments

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OVERVIEW

The Town Council has discussed during a series of public meetings the best approach to managing Village Court Apartments going forward. Specifically, Town Council has discussed four possible scenarios with respect to VCA: 1) sell VCA to a third party who would operate VCA and likely develop Phase IV of VCA; 2) lease VCA to a third party who would pay a lump sum to the Town for the right to operate VCA for a defined period of time and potentially develop Phase IV; 3) hire a third party management company; and 4) maintain Town ownership of VCA and either seek a third party developer for Phase IV or develop Phase IV with the Town serving as the developer. The considerations associated with these options are more fully discussed in a memorandum to Council dated December 4, 2020, which is attached hereto as **Exhibit A**.

As discussed further below, the Town's ability to pursue any of these options is largely tied to the outstanding debt associated with VCA. No matter which option Council chooses to pursue, the Town will need to take some action with respect to its debt.

OUTSTANDING DEBT

The Town, through the Housing Authority, issued debt for the purposes of financing the construction of VCA. This debt was issued (and refinanced) on a tax-exempt basis, meaning it is subject to a myriad of rules under Section 103 of the Internal Revenue Code. As most relevant here, Section 103 prohibits a third party from receiving more than 10% of any revenue generate from a project financed by tax-exempt debt. As such, if the Town were to pursue a sale, lease or management agreement related to VCA, it would be required to pay off the debt upon executing sale, lease or management documents.

There is currently approximately $12 million outstanding on the VCA debt. In the event the Town enters into an agreement with a third-party developer, either for sale or lease, a portion of the proceeds of the transaction must be simultaneously applied to the outstanding debt upon closing of the transaction with the third-party developer. While it is beyond the scope of this memorandum to speculate on an ultimate transaction price, we do know the amount to the Town will be $12 million less than the amount paid by the third-party developer. This obviously dilutes the Town's ability to meaningfully address other community housing needs with the transaction proceeds.

Even if the Town decides to maintain complete ownership and control of VCA, the Town will still need to take action with respect to the outstanding debt. The Town will be required to pay a balloon payment in 2024 in the amount of approximately $12 million, at which time the debt will be defeased. The reality is that the Town will not be able to make this payment, so it will be necessary to refinance the outstanding debt in order to avoid the balloon payment.

Staff has worked with the Town's financial advisors to preliminarily structure the debt with a few features that will make the debt more advantageous for the Town going forward. First, the debt will feature level debt service, meaning the Town will make equal annual principal payments so as to avoid a large balloon payment at the end of the term of the debt. This will allow the Town to eliminate this debt altogether rather than continually refinancing it.

Second, it is possible for the Town to subdivide Buildings 8 and 9 of VCA along with Phase IV. In doing so, the Town could carve out Buildings 8 and 9 from the overall project and essentially allocate early payments of the new debt to Buildings 8 and 9. These early year payments would then relieve Buildings 8 and 9 from the restrictions of the Section 103 of the Internal Revenue Code, and permit them to be commoditized and sold to current owners or individuals.

Finally, staff has suggested any RFP for bank loans include a construction draw facility as a component of the overall financing package. Given the Town is not in a position today to commit to financing Phase IV, the draw component would allow the Town to access capital to undertake such a project in the future, but the Town would not be obligated to ever access such capital.

RESTARTING VCA PHASE IV
Regardless of Council's decision to pursue a third-party agreement or maintain ownership and control of VCA, the Town should discuss timing of the Phase IV development process. The need for community housing has not dissipated since Council began considering the project. However, construction costs have certainly increased to extraordinary levels. While some of these costs are driven by supply issues stemming from the pandemic, it is unlikely construction costs will return to 2015 levels anytime soon.

CONCLUSION
As has previously been discussed, there are several substantive considerations Council must address in deciding whether to enter into a third-party agreement or maintain ownership and control of VCA. Regardless of Council's decision, it is clear Council will either need to pay off existing VCA debt immediately or refinance such debt in the near term. Were the Town to pursue a refinancing, there are several steps the Town could take to facilitate access to capital for purposes of constructing Phase IV – the timing of which Council should address.

/pw & mbh

EXHIBIT A

MEMORANDUM

To:	Town of Mountain Village Town Council
From:	Paul Wisor, Town Attorney;
	Michelle Hayes, Director of Planning and Development Services
Re:	Proposed Village Court Apartment Sale
Date:	December 4, 2020

This memorandum is provided in connection with the Town of Mountain Village's (the "Town"[1]) ongoing discussion with respect to the ownership, development and operation of the Village Court Apartments ("VCA"), and in particular the proposed Request for Proposal (the "RFP") for Ownership and Operation of VCA.

Background

Currently, the Town owns and manages VCA subject or rental caps imposed by a Beneficiary and Rent Use Restriction recorded by the Department of Local Affairs that runs with the land through 2042,[2] associated with 95 of the 222 rental units. Although there have been occasional dips in the quality of management services, Council has recently recognized Town staff is efficiently managing VCA.

However, in response in multiple unsolicited requests, in late 2019 and early 2020 the Town circulated a draft RFP for the sale of VCA. The RFP contemplated a third party would purchase VCA and become the owner and operator of VCA with no future Town involvement. It is anticipated an additional 42 units will need to be constructed to address the ongoing attainable housing shortage in the community, and it is expected any third party owner, as part of the agreement to acquire VCA, would be required to construct these additional units at an anticipated cost of $14-$16 million.

The Town engaged in significant public outreach to receive feedback on the draft RFP. The Town received comments from VCA residents and the Mountain Village Community as a whole. In part due to these comments, and in part due to the COVID-19 pandemic, the Town ceased its effort to finalize and publish the RFP.

Given this pause in the RFP process, this memorandum is provided to Council in order to provide a broader array of options available to Council with respect to VCA. Specifically, this memorandum examines the details related to 1) the sale of VCA; 2) the long term lease of VCA

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[1] Within the context of this memorandum, the Town shall be synonymous with the Mountain Village Housing Authority.

[2] The current Rent Covenant contained within the RFP contemplates the rents will be tied to a certain percentage of Fair Market Value ("FMV"). A FMV valuation may be beneficial to the Owner, but it does little to protect the residents, particularly in a community like Mountain Village or San Miguel County more broadly. Real estate prices and rents within the Town continue to rise; however, in most mountain communities, salaries fail to keep pace with property values. In order to protect VCA residents, rent covenants should be tied to percentages of Area Median Income. Not only will this approach be more equitable for VCA residents, but it is the approach required by the Beneficiary and Rent Use Restriction.

under a Development Management Agreement; 3) entering into a Management Agreement and 4) maintaining the status quo.

I. Sale of VCA

The Sale of VCA would certainly address many of the concerns that led to the Town drafting the RFP. Sale proceeds would allow the Town to retire VCA debt. In addition, the Town would be relieved of the ongoing maintenance and operation costs associated with VCA, and the Planning and Development Services Department would be freed to pursue other planning and development initiatives. However, as detailed below, there are several drawbacks associated with the sale of VCA, and selling VCA brings many intricacies that are not immediately evident. The sale of VCA, while an easy choice, should be approached with caution.

State Law and the Town's Ongoing Ownership Interest in VCA

While the current RFP provides for a standard Contract to Buy and Sell Real Estate (Residential), future Owner will have interests in VCA that far exceed the acquisition of the property itself. Although owners and operators of affordable housing projects are generally interested in acquiring the "sticks and bricks" of a particular affordable housing project at a good price, the Owner will be more concerned with the ultimate capitalization rate or "cap rate" of VCA.

That is, the Owner will be concerned with the percentage return the Owner will receive on its cash purchase of VCA. The higher the percentage return the better. In order to evaluate whether or not its initial investment is a good one, the Owner will take the purchase price of VCA and divide it by VCA's net operating income (the "NOI"). So, to simplify things, if the Owner purchases the property for $10MM and VCA has a NOI of $400,000, VCA will have a cap rate of 4%. If the NOI is $800,000, then the cap rate will be 12.5%. Thus, the higher the NOI, the higher the cap rate, and the more attractive the deal is for the Owner.

NOI of a property is calculated by subtracting the total operating expenses of a property from the total revenue of the property. Therefore, the Owner will have an incentive to drive expenses down as much as possible in order to achieve a higher NOI, and thus a higher cap rate. According to the 2019 VCA budget, current operating revenue was projected to be $2,386,958. Total expenditures were expected to be $2,063,558.[3] Thus, the 2019 budget would provide for a NOI of $323,400.

However, this NOI does not account for property taxes, which the Town is exempt from paying. Based on an assessed valuation of $7,107,480,[4] property taxes for VCA for 2019 were $364,990. Were the Town required to pay these taxes, the NOI for VCA would be wiped out, and the VCA would operate at an annual loss of roughly $42,000.

[3] This amount does not reflect the additional $784,777 in debt service currently paid for by the Town, but which debt the Owner would likely need not account for as it will either be paid off upon acquisition of VCA or remain the Town's debt.

[4] We believe this to be the correct valuation, but the legal description on the Contract to Buy and Sell Real Estate (Residential) and the legal description on the Assessor's website do not match.

Obviously, the property tax will make acquisition of the VCA by affordable housing owners and operators a significantly less than appetizing proposition. However, Colorado state law[5] provides that if a governmental entity has an ownership interest in a company that owns an affordable housing project, such project is exempt from real property taxes as well as certain sales and use taxes.

Therefore, in order to maximize the cap rate, and at the very least achieve a profit, the Owner will need to establish a new entity (the "LLC") to own the VCA, and admit the Town as a nominal member (likely a 0.005% membership interest) of such LLC. By doing so, the Town will have an ongoing ownership interest in VCA, and the Owner will be able to avail itself of the property tax breaks provided in state law.

It is not uncommon for affordable housing projects to be structured with a municipality having a membership interest in the ownership group. It is, however, common for many municipalities to enter into such partnerships without properly valuing their participation. At the very least, San Miguel governmental entities will forgo over $360,000 in revenue each year, $100,000 to the Town alone. In addition, the property tax exemption has significant value to the Owner. To the Owner, the $364,990 represents over $9,000,000 when valued through the lens of the 4% cap rate the Owner is likely attempting to achieve.

For these reasons, the Town should be prepared to factor the value of its ongoing participation in the LLC into its overall pricing of the transaction. It should be similarly prepared to protect itself if and when it becomes of a member of the LLC.

<u>Town Compensation</u>

While the Town and the Owner will agree on a purchase price for the VCA property, the Town should negotiate for separate compensation for its membership in the LLC. The mechanisms proposed below should compensate the Town for the tax revenue it will forgo on an annual basis and account for the additional profit the Owner is able to realize by virtue of the Town's participation.

Payment In Lieu of Taxes

It is unlikely the Owner will be able or willing to quantify its need for the tax exemption, and the Town should require a Payment In Lieu of Tax (the "PILOT") provision in the LLC Agreement. Under the PILOT, the Town should be entitled to a payment equal to 50% of the property taxes not paid by the Owner in any given year, which would amount to approximately $180,000. The Town could covenant to dedicate these funds to the Community Service Fund to directly benefit VCA or other affordable housing efforts. In the alternative, the funds could be directed to the Transportation Fund given the Town provides bus service to VCA throughout the year.

Admission Fee

[5] *See* C.R.S. §§ 29-1-204.5(10), 29-4-226, 29-4-227, and 39-26-704(1.5).

While a PILOT would allow the Town to claw back some of the property tax exemption in the future, the Town should also seek immediate compensation. One mechanism to achieve this goal would be to require a fee to be paid upon admittance into the LLC. This admission fee could be a flat fee representing the Town's percentage interest in the LLC. The admission fee could also be based off a percentage, perhaps 3%, of the property tax exemption that will be realized over the next thirty years. There are obviously other ways in which an admission fee could be calculated, but the general concept of an admission fee should be considered.

Cash Flow

In addition to or in lieu of an admission fee, the Town could request that it benefit from LLC membership by seeking a percentage of the LLC's annual profits. Unlike municipalities entering into new projects with developers, the Town has the benefit of having access to the financial data of VCA. However, it will be difficult to determine the profit margin the Owner is seeking, so it may be challenging to determine how much gross revenue the Town can claim before the transaction becomes unattractive to the Owner. The Town can explore this further with the Owner, or alternatively, require a flat annual fee. A fee equal to the cost of constructing one deed restricted unit in the Town would be a reasonable starting place for negotiations.

Exit Fee

As detailed below, it is possible the Town would exit the LLC at some point. Accordingly, the Town should push for an exit fee. An exit fee would be payable in the event the Town is required to withdraw, which would only arise if the Owner engaged in severe mismanagement of VCA. An exit fee would provide additional incentive to the Owner to avoid such mismanagement. It is possible the Owner could infuse the LLC with significant debt, so any exit fee language should be calculated based on gross revenue so debt and other miscellaneous management fees are not included when calculating the Town's payout.

<u>Contractual Provisions</u>

While the Town should negotiate for additional compensation, it should also insist on certain protections upon entering the LLC. The Town Attorney has prepared to detail these provisions, but such discussion is beyond the scope of this memorandum.

<u>Loss of Control</u>

The biggest drawback to selling VCA is obvious – loss of control. Once the Town sells VCA, the Town no longer controls this important asset. Even if the Town were to record a right of first refusal against VCA, it is unlikely the future price tag on a future sale would be palatable to the Town given the ever increasing cost of real estate. As the last year has shown all of us, Town ownership is invaluable to VCA. It is highly unlikely a third party owner would have forgiven rent for a month, provided free cable or taken any of the other steps the Town has taken to ease the burden on current VCA residents. While we hope to never repeat the extreme circumstances of 2020,it seems likely VCA residents and the community as a whole will benefit at some point in the future from an owner who is not solely driven by profit motives.

Other Considerations

In addition to considering the compensation and covenant provisions suggested above, the Town should discuss some additional macro issues before pursuing the RFP.

Condominiumize Mountain Munchkins

The RFP contemplates the Owner will lease back the VCA units currently dedicated to Mountain Munchkins. The Town should strongly consider retaining ownership of these units. Affordable housing is arguably the biggest challenge for any mountain resort community; however, a close second is the shortage of childcare and early childhood educational programming. The proposed lease may seem long term, but it will end at some point. When that time comes, the Owner may repurpose the space or seek rents that are higher than economically feasible for an early childhood program, and the amount of land available within the Town to build a new facility to accommodate the program will have significantly diminished. The Town would be wise to consider retaining this particular asset rather than turning it over to the Owner who may have no real interest in facilitating early childhood education in the future.

Appraisal and Brokers

Before the Town takes any other step in connection with a potential sale of VCA, the Town should seek and independent appraisal of VCA. The RFP process may give the Town a sense of security that they are receiving a reasonable offer for VCA, but the Town will not truly know if they are receiving fair value for VCA without an appraisal. Along those lines, the Town should also engage a broker to evaluate VCA and help market VCA, or at least the RFP process, to affordable housing developers and managers across the country. The Town simply does not have the resources to create a truly competitive bidding process that will yield a fair offer price.

II. Leasing and Development Management Agreement

The current RFP makes clear the Town's ultimate goal is to sell the VCA property. Given the current debt load of the property, this is logical. The rationale to sell is bolstered by the fact the Town spends a significant amount of resources acting as a property manager, which places a considerable amount of pressure on the Community Development Director's time. Further, as noted the above, the sale of VCA is more complicated than first blush, and comes with the permanent drawback of losing control of VCA as a Town and community asset. The Town can address all of these issues by entering into a long term lease with a developer who will not only manage the property, but will likely be willing to develop the remaining 42 units as well.

Under the most likely scenario, the Town would enter into a ground lease for the land where the 42 units are to be located, which ground lease would last for 50-75 years. The Developer would then be responsible for financing the construction of the new 42 unit building. The Developer would likely finance this construction utilizing a Colorado Housing Finance Authority ("CHFA") loan, which would allow the Developer to leverage certain affordable housing tax credits. The Developer would have exclusive control of the 42 units, so the Developer would repay the loan from rent revenue. As further described below, the Developer would also serve as Manager of the units and will likely collect a management fee on top of rent revenues. While the new units would be subject to a deed restriction capping rents, the Developer would charge the maximum rent allowed in order to make debt payments in as well as generate a profit.

Concurrently with entering into the ground lease for the 42 units, the Developer will enter into a long term Master Lease for the rest of VCA. Under the Master Lease, the Developer will have the exclusive authority to collect and retain rents. As with the ground lease, the Developer will also collect a management fee. Again, while VCA is subject to a deed restriction, the Developer will increase rents to the maximum mount permitted under the deed restriction to generate a profit.

The fact the Developer will likely seek a CHFA loan is useful to the Town in that CHFA will require annual reporting requirements and minimum maintenance standards. However, the Town will need to ensure the Master Lease provides for stringent reporting and maintenance standards above those required by CHFA.

Under the leasing arrangement, the Developer will bear the cost and risk associated with financing the construction of the 42 units. The Developer will also bear all ongoing maintenance and operations costs. As such, there is tendency for Developers to at least be perceived to cut corners in order to guarantee rent revenues are sufficient to cover these costs. In the event the Developer proves less than a desirable for the VCA community, there will be little the Town can do other than enforce reporting and maintenance covenants in the Master Lease.

Unlike a sale of VCA, leasing VCA likely will not be accompanied by a large up front payment. The Town, therefore, will lack the cash infusion necessary to pay off existing VCA debt.

III. Management Agreement

While leasing VCA does not result in a permanent loss of control of VCA, it undoubtedly locks the Town into a long-term relationship with a developer for a period that will likely exceed the tenure of even the youngest members of Town staff. Entering into a Management Agreement with a Manger may provide the Town with some of the efficiency gains the Town is seeking and reducing the workload of the Community Development Department while avoiding the necessity of a long term commitment.

Under a Management Agreement, the Town would engage a third party to manage and operate VCA. The term of such agreement likely would need to initially be for two or three years, but the Town would not have future commitments. The scope of these responsibilities would include leasing VCA units, qualifications of tenants, on-site management, enforcement of leases, and payment of expenses and collection of rent. Essentially, the Town would no longer be involved in the day to day operations of VCA. The Management Agreement would also provide the Manager would be responsible for all maintenance and operations expenses, to be paid pursuant to established scheduled, subject to amendments, and as further directed by the Town as necessary.

The Town may find it is able to generate more efficient operations of VCA through the compensation structure contained in the Management Agreement. Typically, the Manager will seek a fixed Management fee of between 4% and 6% of gross rent. The Manager would be further entitled to an Incentive Fee, pursuant to which the Manager would receive a percentage (60%-80%) of all revenues in excess of maintenance, payroll and other fixed costs. Of course, some believe an Incentive Fee would lead to the Manager cutting corners, in which case the Town could increase the fixed fee.

It should be noted that currently VCA employees would likely become employees of the Management Company. The Town could attempt to negotiate the structure of these employees' compensation, but ultimately the terms of continued employment would be determined by the Management Company.

Of course, entering into a Management Agreement would not address the outstanding need to construct the additional 42 units at VCA. The Town would ultimately have to determine the best way to finance such construction. Though, with interest rates hovering at historic lows, now would not be the worst time to make such a financial commitment.

IV. Status Quo

At the end of the day, the Town may simply choose to pursue the status quo. Though management of VCA has proven difficult in the past, it appears from Council's own assessment that many of these issues have been addressed. As other entities in the community have noted, the residents of VCa have received more compassion from the Town than they would have otherwise received for a third party management company. This community minded approach has allowed the Town and other local businesses to retain workers throughout a pandemic in which many communities saw many critical workers leave due to a lack of housing or recognition of the need for rent relief. The Town thus must determine how to best address its outstanding debt while managing the cost of additional units. The Town may want to consider increasing its capacity to consistently oversee and forecast the financial condition of VCA. While affordable housing is certainly a pressing issue, the Town is not required to pursue construction at this moment, and could wait to undertake such an effort only after the existing debt is paid off.

Conclusion

The Town undoubtedly has good reasons for selling the VCA property. However, if the Town pursues a sale, the Town must continue to keep in mind it is bargaining for more than just the sale of a housing complex. It is likely soliciting an invitation to a long term membership in a corporate entity. Accordingly, the Town should be prepared to negotiate for fair compensation for its participation in such an entity and for essential protections for the Town, the residents of VCA, and the local families that rely upon Mountain Munchkins for childcare and early education. The Town should also be clear with itself that a sale means a permanent loss of control of one of the most important community assets.

That said, not of the remaining options are panaceas. A ground lease/master lease relationship would address the construction of the 42 units as well as ongoing management issues.

However, it would not solve the issue of the current outstanding debt. In addition, the Town would effectively lose control of VCA for the foreseeable future.

A management agreement would not address the construction of the 42 new units nor existing debt. It would, however, take the Town out of the day to day details of operating VCA. The Town would not be committed to a long term relationship with a management company, and the Town would continue to benefit from a portion of the revenue generated from VCA rent.

The status quo, obviously, does address construction of the 42 units, existing debt, or current and future management issues. However, it does leave the Town in control of their own destiny. The status quo also almost certainly guarantees the best stewardship of VCA now and into the future.