



Council Committee on Economic Sustainability

06.07.24

The Council Committee on Economic Sustainability exists to support opportunities to put Chapel Hill's people to work and create economic prosperity for all, now and in the future.

-  **Minority Business Summit**
-  **Annual Incentives Report**
-  **Development Finance Presentation
by Jim Spaeth, UNC Kenan-Flagler**

Greetings from



Minority Vendor Summit

Council Interests

Prioritize an equity lens when exploring small business support and long-term development.

- October CCES: Staff presented several HUB-engagement approaches by other municipalities.
- This research, combined with Council feedback, directly informed the planning & execution of the Minority Vendor Summit.

Minority Vendor Summit

- Participating Town departments included Economic Development, DEI, Business Management & Manager's office.
- Partnering agencies included OWASA, UNC, and the Town of Carrboro.
- Connected with 50+ vendors, most of whom have not done business with any of the participating public agencies.



Economic Development Incentives

IMPROVING COMEDY
CLASSES & SHOWS
BUILD CONFIDENCE!
MEET NEW FRIENDS!
TEENS - ADULTS - SENIORS
IMPROV YOUR LIFE!™
FRANKLIN ST - CHAPEL HILL
ThePIT-ChapelHill.com

Incentives Policy

Goals

- Create quality jobs
- Strengthen the economy & build community wealth
- Sustain a high quality of life

Targets

- Research and Development
- Applied Sciences
- Start-ups
- Technology
- Retail*

Performance Measures

- **Wegmans**

- Job creation
- Tax base growth
- Sales volume

- **Carraway Village**

- Amount of commercial space built
- Percentage of road improvements

- **Well Dot Inc.**

- Investment
- Jobs created

- **Glen Lennox**

- Amount of office space built

Economic Development Incentives

Town Council has approved 4 economic development incentives, all performance-based with individual terms for each project.

- Total expenditures NTE \$1,183,928 per fiscal year

Development Agreement	FY21 Planned	FY22 Planned	FY23 Planned	FY24 Planned	FY25 Planned
Carraway Village	\$ 154,892	\$ 206,523	\$ 206,523	\$ 206,523	\$ 206,523
Wegmans	\$ 400,000	\$ 400,000	\$ 400,000	\$ 400,000	\$ 400,000
Glen Lennox	\$ -	\$ 446,160	\$ 446,160	\$ 446,160	\$ 446,160
Well Dot*	\$ -	\$ 131,245	\$ 131,245	\$ 131,245	\$ 131,245
TOTAL	\$ 554,892	\$ 1,183,928	\$ 1,183,928	\$ 1,183,928	\$ 1,183,928

Economic Development Incentives

Town Council has approved 4 economic development incentives, all performance-based with individual terms for each project.

Development Agreement	FY20 Actual	FY21 Actual	FY22 Actual	FY23 Actual	FY24 Actual
Carraway Village	\$ 60,867	\$ 132,694	\$ 200,955	\$ 204,258	-
Wegmans	\$ -	\$ -	\$ -	\$ 391,930	\$ 390,500
Glen Lennox	\$ -	\$ -	\$ 57,570	\$ 72,286	\$ 79,210
Well Dot*	\$ -	\$ -	\$ -	\$ -	\$ 131,245
TOTAL	\$ 60,867	\$ 132,694	\$ 258,524	\$ 668,474	\$ 600,955

Level Setting: U.S. Office Supply

The 'under-construction' pipeline has shrunk by nearly 40% in the last two years.

Factors include:

- Falling office demand
- Increasing capital costs; and
- Tightening standards for construction loans

Level Setting: U.S. Office Demand

Office sales & lease activity continues to wane in 2024.

- Trends expected to remain for the next 2-3 years.
- As demand for employment growth offsets corporate downsizing, the market is expected to shift towards more balanced conditions.

CommercialEdge, March 2024

JLL Global Real Estate Perspective, May 2024

An aerial photograph of a city street scene, featuring a blue semi-transparent overlay. The overlay contains the text 'Development Finance' in white, bold, sans-serif font. A large, light blue 'DRAFT' watermark is oriented diagonally across the entire image. The background shows a street with cars, a brick building with a 'SPANNY'S' sign, and a white van with 'MEDITERRANEAN DELI & CATERING' text. The sky is blue with scattered white clouds.

Development Finance

Real Estate Development Dynamics

Prepared for Council Committee on Economic Sustainability, Town of Chapel Hill, June 7 2024

Jim Spaeth, Professor of the Practice in Real Estate Finance, UNC Kenan-Flagler Business School

- **Who Am I?**
- **Real Estate Development Dynamics**

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Work History

- **4 years working as an investment banking analyst in the real estate sector**
- **9 years developing retail, office, and senior housing projects in Florida**
- **13 years advising and teaching students at UNC Kenan-Flagler Business School**
 - **2 years advising MBA real estate and investment banking students and employers**
 - **10 years running the Wood Center for Real Estate Studies**
 - **4 years teaching MBA and undergraduate real estate courses, including capstone development course to 2nd year MBAs**

Academic History

- **MBA from University of Florida**
- **BSBA in Finance from University of Florida**
- **BA in Political Science from University of Florida**

Personal

- **Chapel Hill resident since 2011**
- **Wife teaches in CHCCS system**
- **Son at UNC-Chapel Hill and daughter at East**



Why does development occur?

- **Control land (site looking for a use)** – example is University Place



- **Control knowledge or tenants (use looking for a site)** – example is The Hartley at Blue Hill



Why does a developer do?

Orchestrates a creative process to generate economic value by answering four main questions:

- What can be built?
- What cash flow stream will it create?
- How much will it cost?
- How will I pay for it?

What are the phases of the development process?

- **Pre-Development** – Developer identifies land, has idea, lays out development plan and pursues entitlements and approvals. (This is the riskiest part of the process for the developer.)
- **Development** – Developer achieves land control, capital (debt and equity), executes construction and lease-up to stabilization.
- **Stabilized Operations** – Developer turns over to property management and decides on future sale or long-term financing.

What are the phases of the development process?

Pre-Development

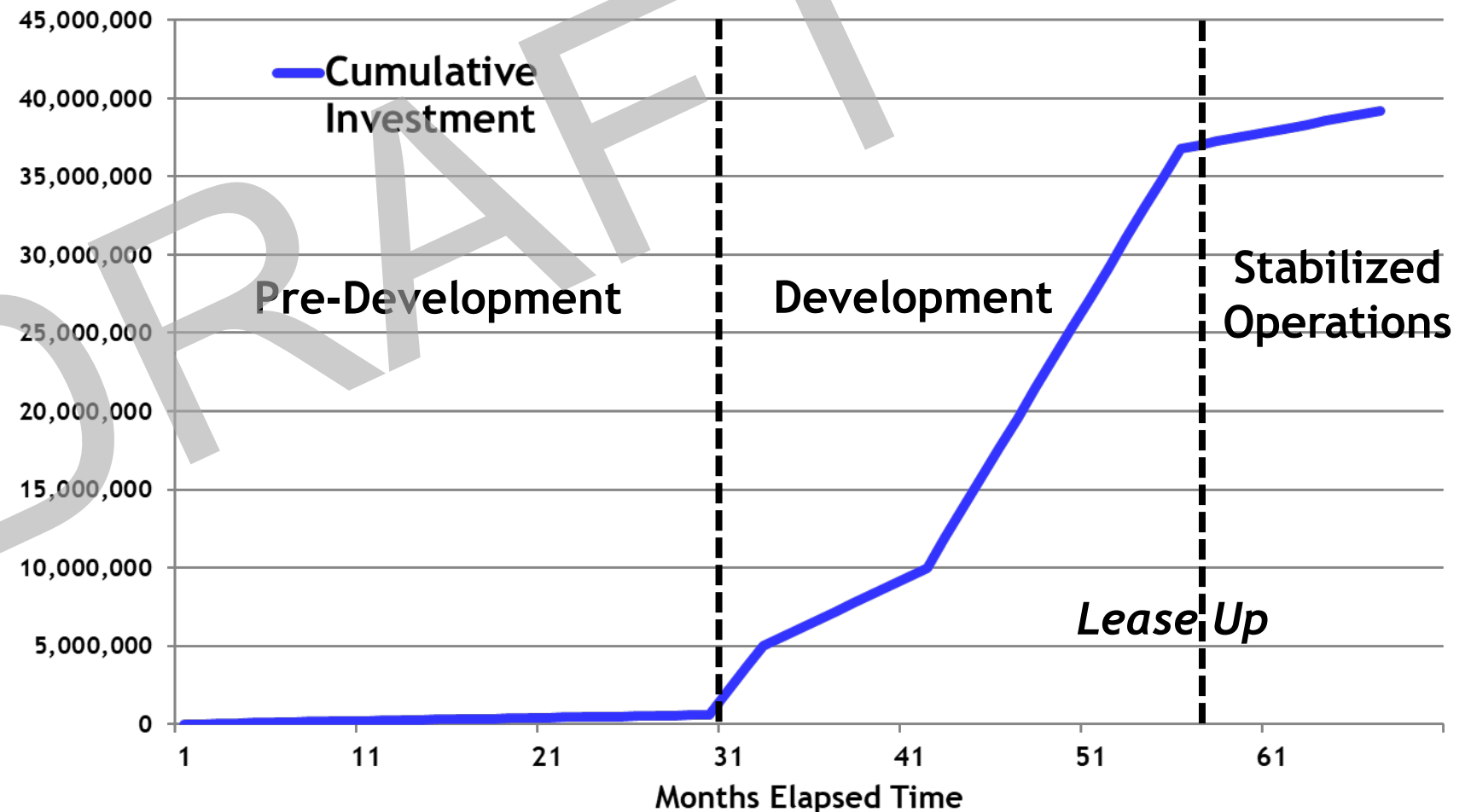
- Idea Inception
- Idea Refinement
- Feasibility Study
- Contract Negotiation

Development

- Formal Commitment (Land Closing)
- Construction
- Completion and Formal Opening (Lease Up)

Stabilized Operations

- Property Management
- Asset Management
- Portfolio Management



What are the primary cost components?

- **Hard costs (construction)** – generally 60-80% of total cost
- **Land** – generally 10-30% of total cost
- **Soft costs** – generally 10-20% of total cost

Interest Expense	Real Estate Taxes
Operating Deficit	Insurance
Title Insurance, Recording & Closing	Financing Fees
Due Diligence	Marketing & Leasing
Legal	Development Fees
Architecture & Engineering	Entitlements, Permits & Impact Fees
Contingency	

How are developers compensated?

Value Creation

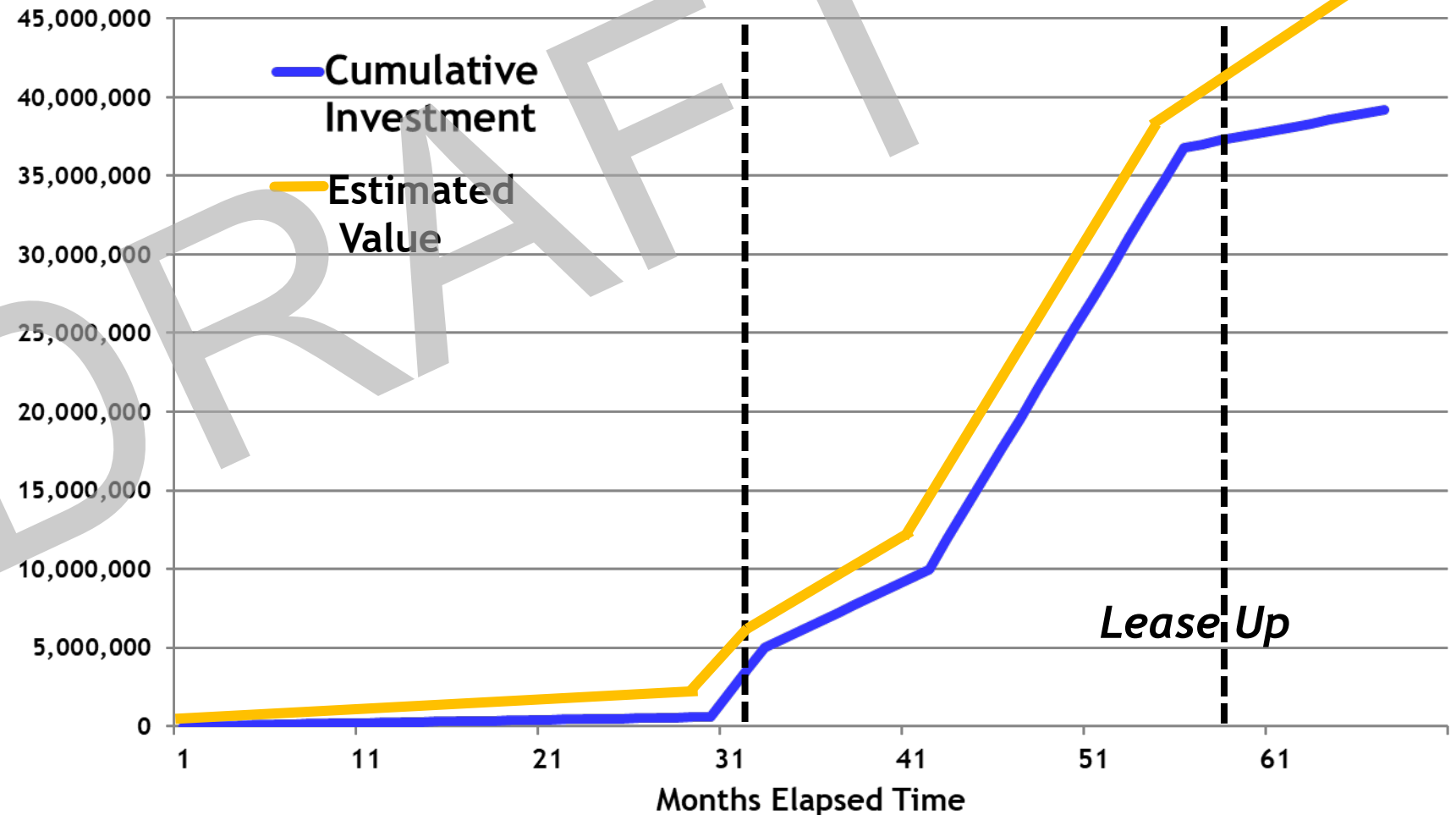
Positive difference between cost and stabilized value – biggest return component

Promote (Carried Interest)

Outsized capture of project cash flows – usually appears near end of deal – compensates for work and risk

Development Fees

Typically % of costs paid over project – keeps the lights on



Given limited time and resources, how do developers assess a deal?

- **Is the project profitable?**
- **What are the major risks?**
- **Does the spread between the stabilized project value and current market values adequately compensate the developer for the risks?**

Is the project profitable?

Rental Product

Stabilized Rents (*Market Driven*)

Minus Stabilized Expenses

Equals Stabilized Net Operating Income

Divided by Market Cap Rate

Equals Stabilized Project Value

Less Total Development Costs

Equals Profit

For-Sale Product

Gross Sales Proceeds (*Market Driven*)

Minus Sales Costs

Equals Net Sales Proceeds

Less Total Development Costs

Equals Profit

What are the major risks?

Market Risk

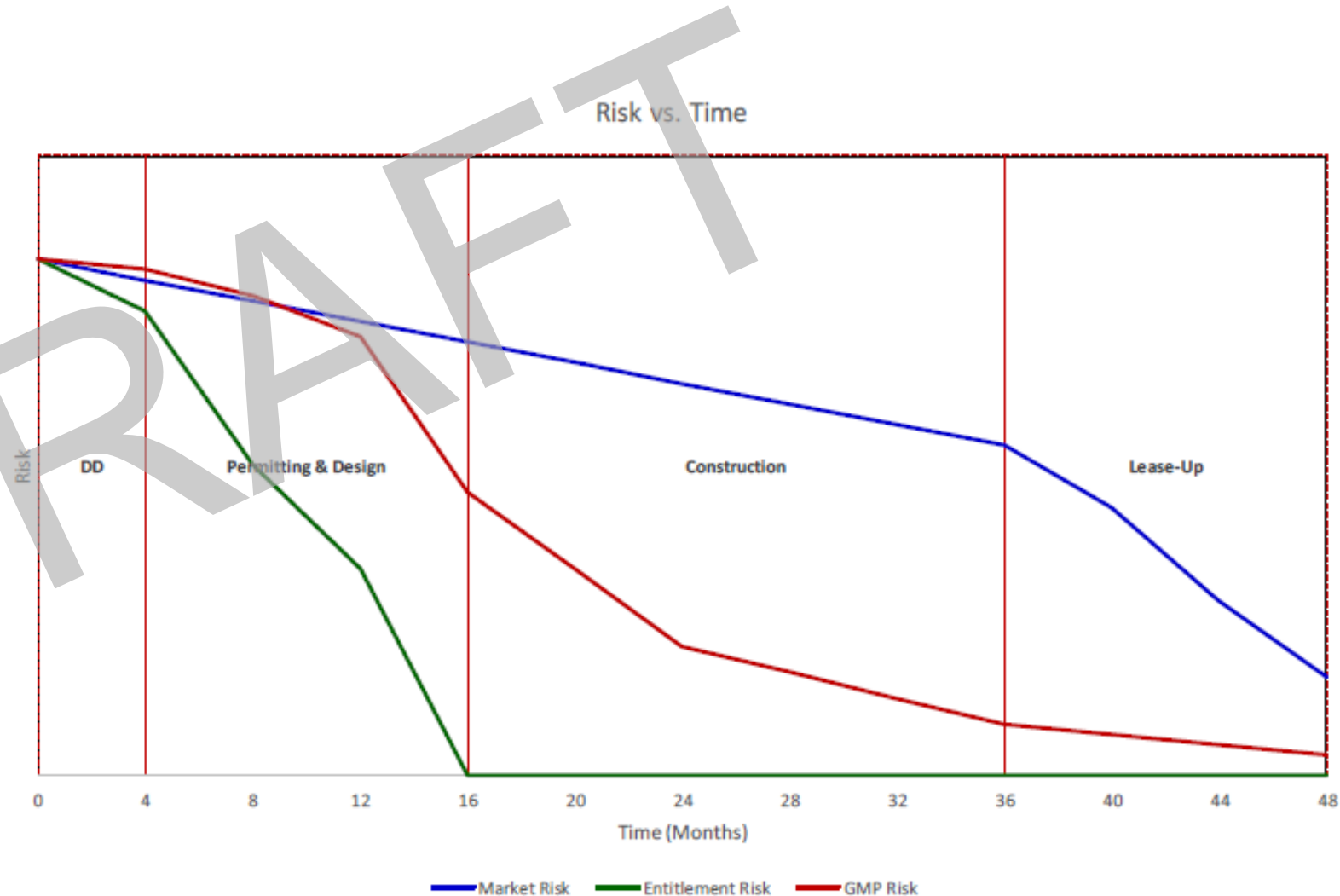
Supply and demand (dictates rents and lease-up or sales prices and velocity) as well as capital availability (debt and equity)

Entitlement Risk

Zoning/entitlements (legally feasible), site yield (physically feasible)

Construction (GMP) Risk

Horizontal and vertical construction cost



Does the spread between the stabilized project value and current market values adequately compensate the developer for the risks?

Multifamily For-Rent Product Example

Stabilized Rents	\$5,000,000	<i>Subject to market risk</i>
Stabilized Expenses	<u>(\$2,000,000)</u>	<i>Subject to market risk</i>
Stabilized Net Operating Income (NOI)	\$3,000,000	
Total Development Costs (TDC)	\$40,000,000	7.5% Development Yield (NOI/TDC)
Stabilized Project Value (NOI/MCR)	\$50,000,000	6.0% Market Cap Rate (MCR)
Projected Profit	\$10,000,000	1.5% Development Spread

Does the spread between the stabilized project value and current market values adequately compensate the developer for the risks?

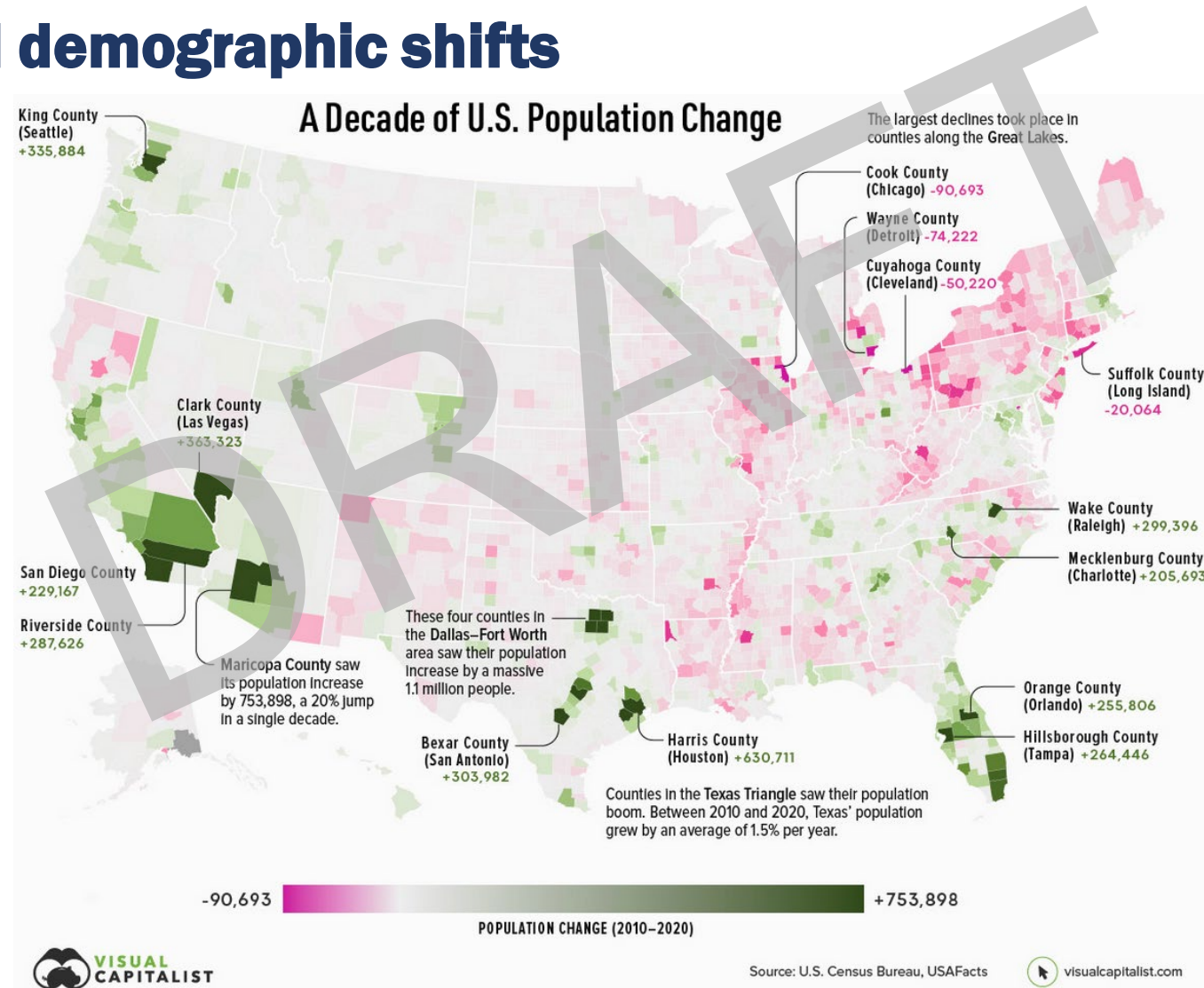
Townhouse For-Sale Example

Gross Sales Proceeds	\$20,000,000	<i>Subject to market risk</i>
Sales Costs	<u>(\$1,200,000)</u>	
Net Sales Proceeds (NOI)	\$18,800,000	
Total Development Costs (TDC)	\$15,000,000	
Projected Profit	\$3,800,000	25.3% Profit Margin

What is shaping the current real estate development landscape?

- **Population and demographic shifts** – Continued steady movement of people from Northeast/Midwest to South/West resulting in strong population and income growth in markets like the Triangle.
- **Construction cost increases** – Combination of supply chain disruptions and persistent labor shortages putting upward pressure on construction costs.
- **Interest rate increases** – Strong upward movement of both short-term and long-term interest rates leading to increased soft costs for developers as well as lower stabilized project values.
- **Insurance cost increases** – Rapid escalation of property insurance costs eroding net operating income for for-rent projects.
- **Elevated multifamily deliveries** – Record number of for-rent multifamily project deliveries in 2024 and 2025 in high-growth markets like the Triangle putting downward pressure on multifamily market rents and, consequently, stabilized project values.

Population and demographic shifts



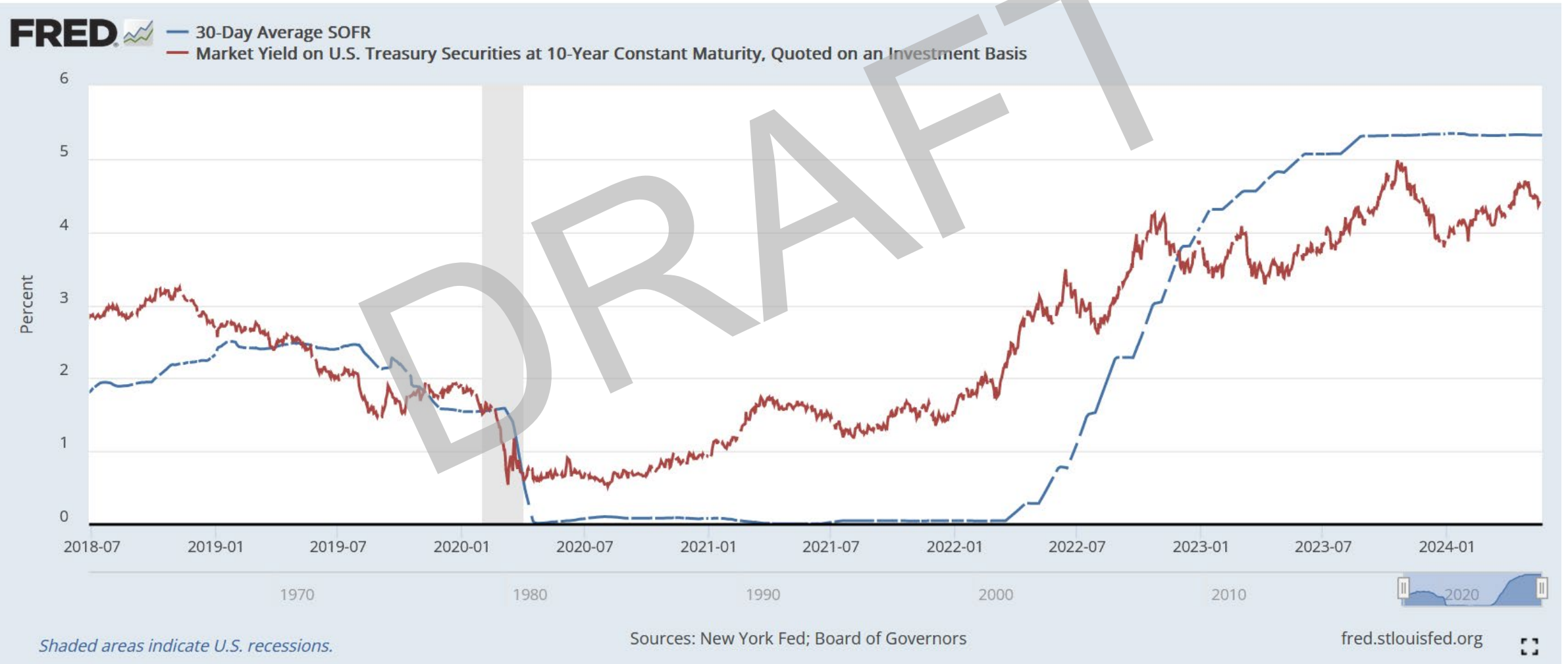
Construction cost increases

Producer Price Index, June 2023

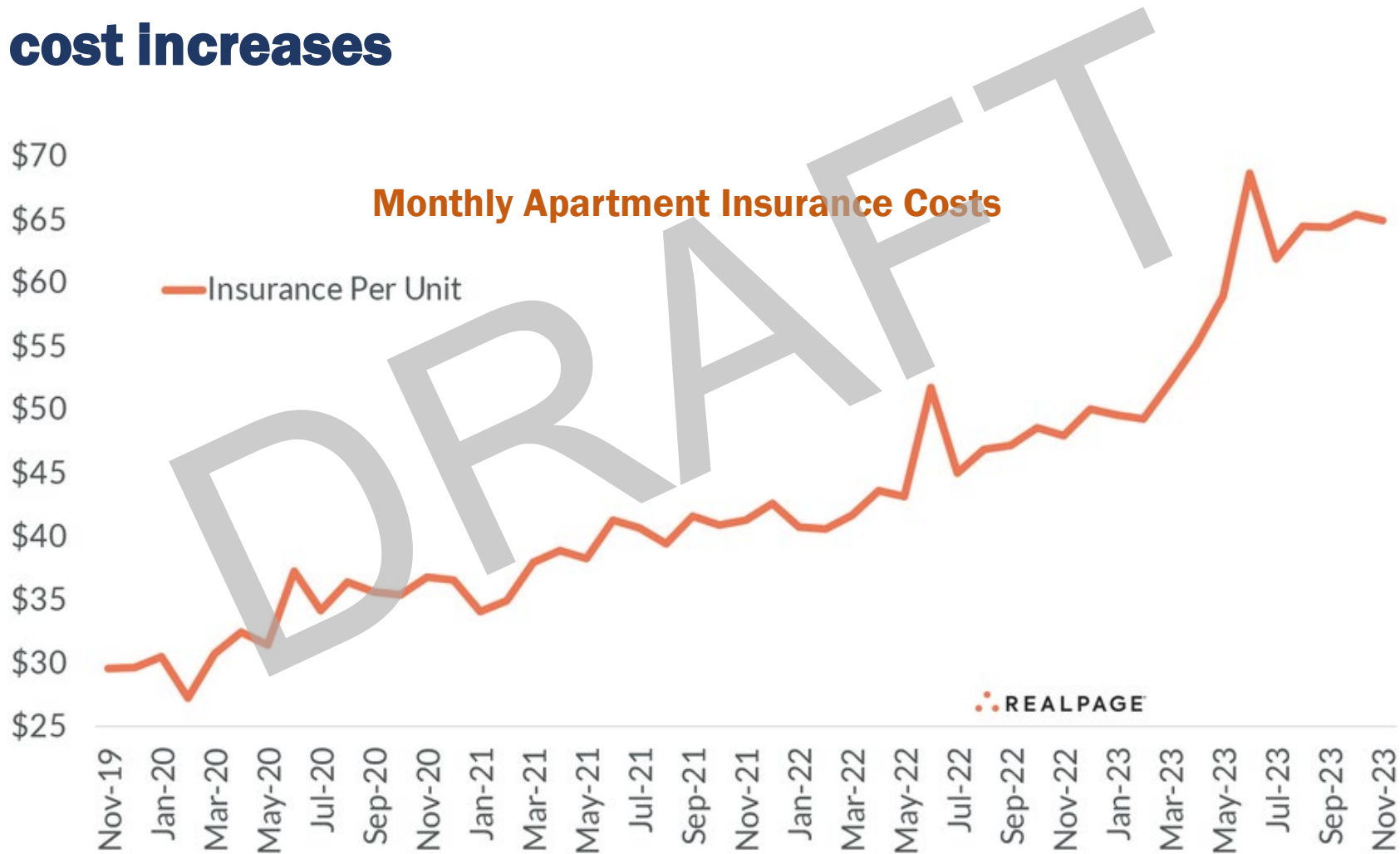
	1-Month % Change	12-Month % Change	Change Since Feb 2020
<i>Inputs to Industries</i>			
Inputs to Construction	0.0%	-4.9%	38.3%
Inputs to Multifamily Construction	0.1%	-2.0%	37.1%
Inputs to Nonresidential Construction	0.0%	-4.5%	39.2%
Inputs to Commercial Construction	0.1%	-2.5%	39.7%
Inputs to Healthcare Construction	0.0%	-2.4%	39.1%
Inputs to Industrial Construction	0.1%	-2.0%	34.7%
Inputs to Other Nonresidential Construction	0.0%	-5.2%	39.0%
Inputs to Maintenance and Repair Construction	-0.1%	-5.8%	36.5%

Source: U.S. Bureau of Labor Statistics

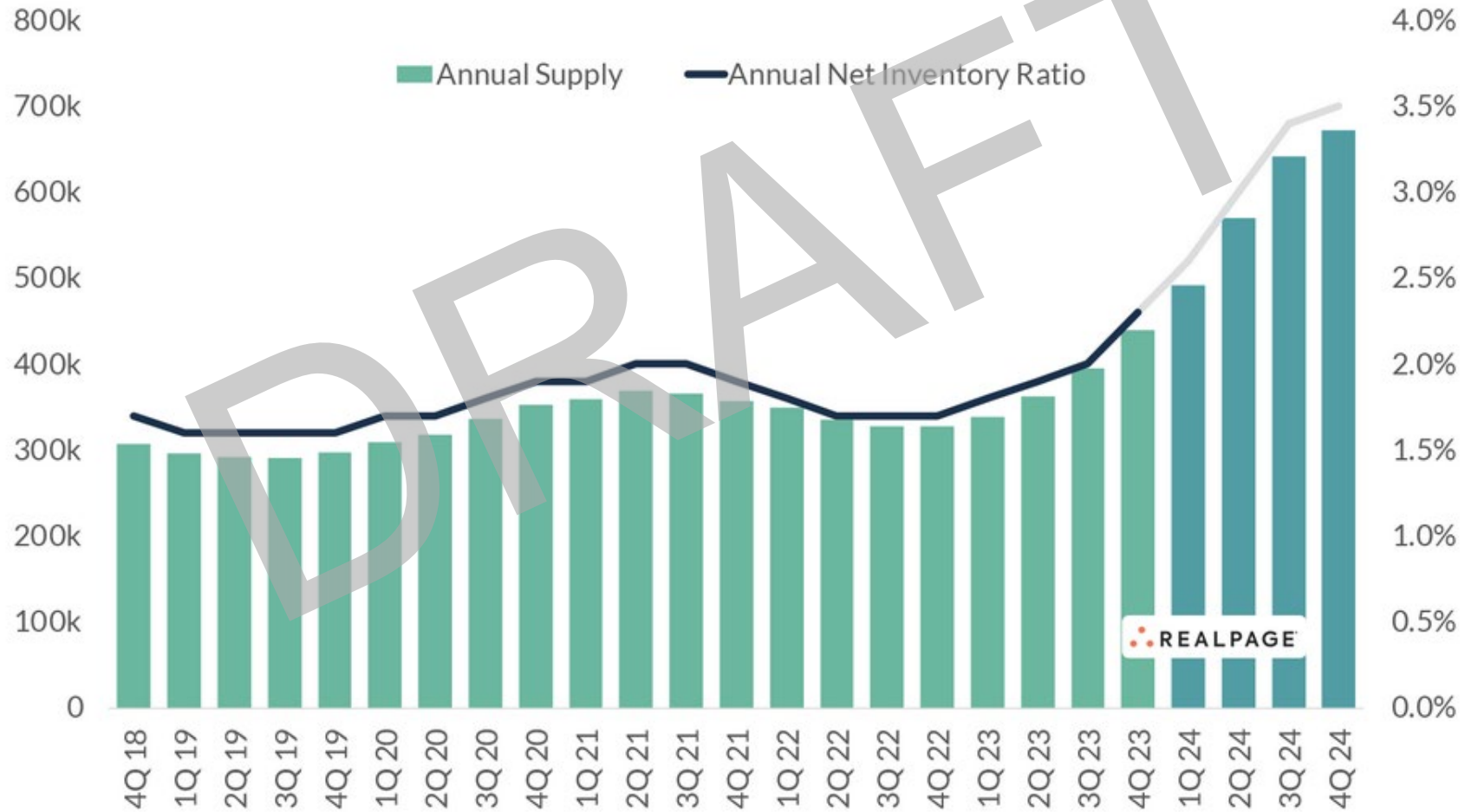
Interest rate increases



Insurance cost increases



Elevated multifamily deliveries



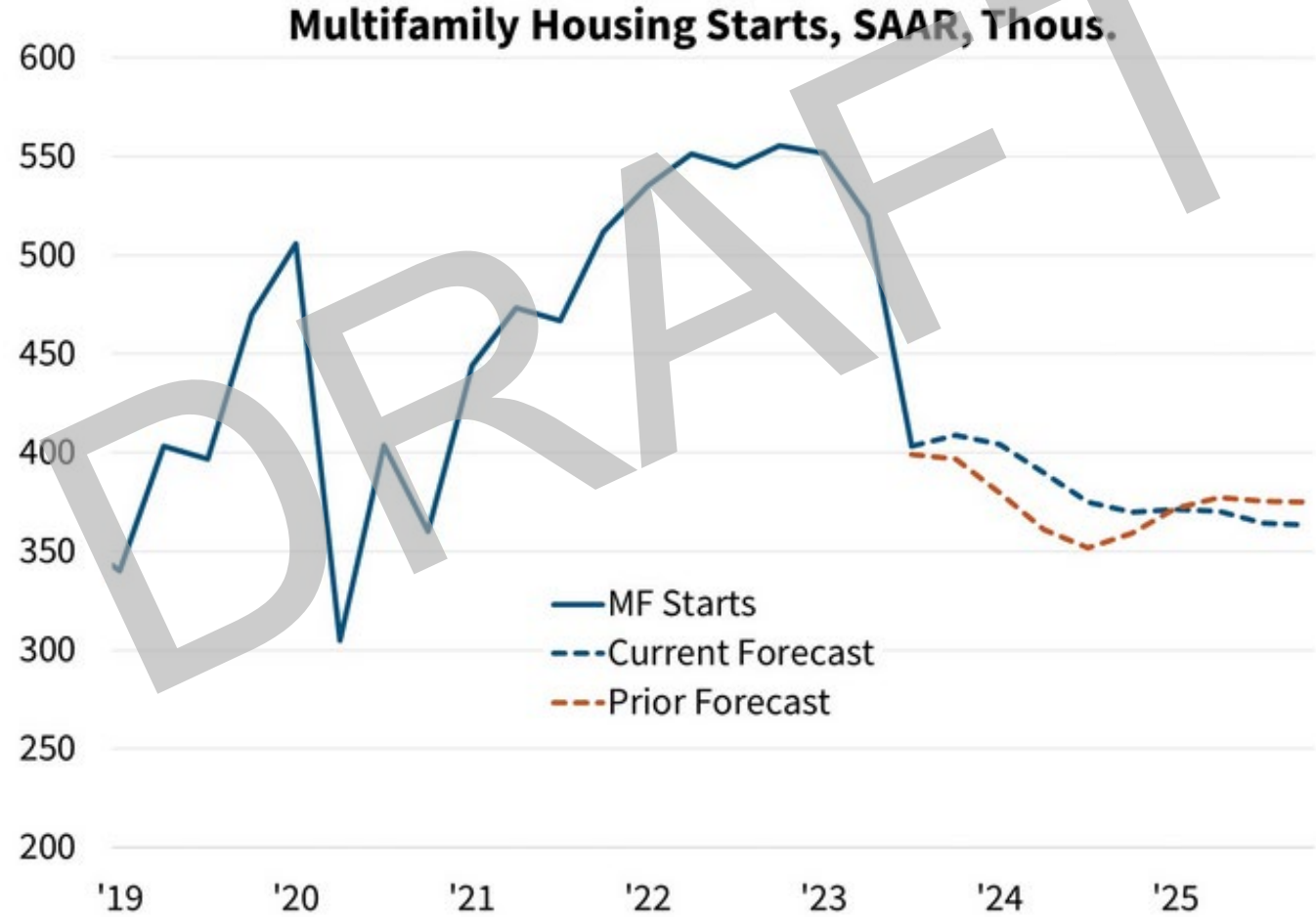
Source: RealPage Market Analytics

How do these factors affect the developer's decision?

Multifamily For-Rent Product Example

Stabilized Rents	\$4,500,000	<i>5% rent reduction</i>
Stabilized Expenses	<u>(\$2,200,000)</u>	<i>50% insurance expense increase</i>
Stabilized Net Operating Income (NOI)	\$2,300,000	
Total Development Costs (TDC)	\$46,000,000	<i>20% construction cost increase</i>
Stabilized Project Value (NOI/MCR)	\$32,900,000	<i>7.0% MCR (100 bps increase)</i>
Projected Loss	(\$13,100,000)	-2.0% Development Spread

New multifamily starts



Source: Fannie Mae

What are the key takeaways?

- **Development is feasible when a project's expected market value/net sales proceeds exceeds its total development costs** – developers must account for market risk, entitlement risk, and construction risk in evaluating this equation so **crave certainly in execution and timing**
- **Developers are primarily compensated via the spread between expected market value/net sales proceeds and total development costs** – consequently developers are incentivized to maximize value and minimize costs during the development process
- **During pre-development, developers must constantly assess due diligence and entitlement expenditures against projected development spread (profit)**
- **Current development activity is muted due to a variety of market factors** – despite population and demographic tailwinds in the Triangle, new development will be limited in the near-term until some combination of construction cost decreases, interest rate decreases, market cap rate decreases, and new supply absorption (with respect to for-rent multifamily) takes place

BUSINESS FOR LIFE.

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KENAN-FLAGLER
BUSINESS SCHOOL

Appendix



Chapel Hill Office Market

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ReVive Plan Overview

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RESILIENT ECONOMY

Strategies
&
Successes

Support, connect, and recognize small business success

- ✓ Best of Chapel Hill event sponsorship
- ✓ Business Resource Guide
- ✓ Small business grant programs

Strengthen the innovation and startup ecosystem

- ✓ Launch Chapel Hill partnership & support
- ✓ Innovation Hub/ Flexible co-working & office spaces

Recruit employers, entrepreneurs aligned with UNC, UNC Health

- ✓ Chapel Hill Life Sciences Center
- ✓ North Chapel Hill Business Center
- ✓ [Economic incentives policy](#)

RESILIENT PLACE

Strategies
&
Successes

Develop plans, partnerships for accessibility and affordability

- ✓ Downtown Mobility & Streetscape plans
- ✓ Downtown Together Partnership

Showcase Chapel Hill to increase foot traffic in commercial areas

- ✓ Downtown Communications group
- ✓ Garden Spot

Build reputation for being open to business and welcoming to all

- ✓ Marketing & branding campaigns
- ✓ Business Ombuds support

RESILIENT PEOPLE

Strategies
&
Successes

Build a talent pipeline to connect residents, students, and employers to opportunities

- ✓ Innovate Carolina & Launch Chapel Hill events
- ✓ Durham Tech Small Business Center @ The Junction

Support community partners as they address needs of historically underrealized businesses

- ✓ Opportunity Grant for Garden Spot
- ✓ Brightpath Solutions Grant & Workshops