July 7, 2017

Mr. Tim Dempsey
Deputy City Manager
Director, Department of Planning, Building and Development
City of East Lansing
410 Abbot Road
East Lansing, Michigan 48823

Re: Due Diligence Review for Center City District

Dear Mr. Dempsey:

Development Strategies has completed a third-party review of various due diligence items for the Center City District, a mixed-use project in Downtown East Lansing proposed by a development team led by Harbor Bay Real Estate Advisors. The City of East Lansing has engaged us to provide a thorough review of this information and address the following items as they relate to the Center City District:

1. Verify developer's equity position in the project
2. Validate the proposed sources and uses of funds statement
3. Test pro forma for reasonableness of assumptions
4. Review housing market studies for appropriate methodology and reasonableness of conclusions
5. Substantiate the terms of the Target lease

This letter summarizes the findings of this review, with the developer quickly cooperating in providing significant information about the project and its development experience, financial capacity, and references.

First and foremost, based on our review of the due diligence within the scope of work specified by our agreement, the Center City District is a generally thoughtful and sound proposal. In the following points we will note our conclusions regarding our review of the due diligence items.

Developer's Equity Position

Harbor Bay and its development partners plan to contribute approximately 30 percent of the project costs as owner equity, which is on the high end of typical real estate transactions and reflects a more conservative investment position. One partner's ownership in the site will generate some of this equity, but it is yet-to-be valued. The lender will require this appraisal as part of the financing, or the development partners may have it independently valued. The bulk of the equity will come from Harbor Bay principal's own assets. Our conversations with Harbor Bay's financial partners—including major banks holding their assets—confirm adequate resources to cover over $20 million as equity.

Validation of Sources and Uses of Funds

With various aspects of due diligence and development agreement exhibits not yet finalized, the sources and uses of funds are in flux. Therefore, it is too soon for us to validate this information. The developer has provided a preliminary sources and uses of funds statement that reflects—in round numbers—potential project funding. Approximately 70 percent (excluding bonds for the parking structure) is to be financed, with the remainder provided mostly by owner equity and nominally by a Michigan Community Revitalization

Program (MCRP) Grant. The developer has had conversations with various lenders for the financing, but terms have not been finalized.

In addition to reviewing and considering this information, we also contacted lenders that will be involved in underwriting the Center City District and are also familiar with the development team. These financial partners verified the reputation and capacity of the development team to meet historic as well as prospective debt obligations.

Testing of Pro Forma

Like the sources and uses of funds statement, the pro forma has not been finalized. The developer did provide a preliminary five-year operating projection, including estimates of major fixed and variable operating expenses, replacement reserves, and total effective gross income. The provided projected revenue was a lump sum, with the developer basing it on the signed Target lease, reasonable expectations for lease rates in the remaining retail space (all yet to be leased), parking income, and the achievable rents established for the various apartments in the two market studies prepared for the developer. The developer based expense projections on the actual operations of existing properties in its portfolio and otherwise rational assumptions, as well as real estate taxes of existing properties in East Lansing. The developer also consulted the local assessor on the potential tax burden, who "was comfortable" with the developer's projection. Real estate taxes are by far the largest expense, and this new source of tax revenue supporting the tax-increment financing bond. The brownfield plan included a revenue study that further validates the developer's real estate tax assumptions.

The developer used the net operating income derived from these projections to establish preliminary estimates of value for the project. This preliminary value is significantly higher than the net project costs, which exclude the parking garage and public infrastructure costs, as well as the MCRP Grant, indicating reasonable profit for the developer. Using a more conservative capitalization rate also indicates a value exceeding net project cost, with a reasonable profit expectation.

While income and expenses will vary depending on the final development program, the current projections are sound and result in a preliminary market value above costs, which reflects the project's feasibility.

Review of Housing Market Studies

We have reviewed the two market studies prepared by Danter Company for the student-oriented and age-restricted housing components of the development program. The development team has relied on these studies for expectations of market rents, absorption of units, amenity packages, and stabilized occupancy. Redacted portions of each study have also been made public.

In each report, the Danter Company relies on standard methodologies that do not favor unique residential products such as those proposed for the Center City District. The building that will be restricted to those over 55 years will be unique in the market, with no other properties having an age restriction except those that are affordable housing (one local property has both age and income restrictions) or those providing services associated with independent or assisted senior living such as meals, housekeeping, and limited medical care, and daily activities. The proposed age-restricted housing also seeks to achieve the highest rents in the market, with comparatively few local households able to afford these rents. Placing age restrictions on the property simply further restricts demand by eliminating a large segment of the rental housing market. While much information about the apartment market is included in this report, very little focuses on how the property can best succeed in focusing on the over 55 market.

Similarly, the non-age-restricted portion of the proposed housing relies on many of the same methodologies applied to the age-restricted units. The study does provide substantial statistics regarding MSU enrollment, but this information and analysis within the report should lead to the conclusion that now or in the near future there may be too much student-oriented housing, with 933 new student housing beds nearing completion. Further, as of the date of the market study, developers had made public their plans for six other apartment properties containing 808 non-student apartment units as well as 1,200 beds of student housing. These six properties do not include Center City District's 273 units with 434 student-oriented beds or the 92-unit age-restricted component.

While we question the effectiveness of the market studies above, we are confident that there is adequate market support for the Center City District. Though unnecessary given the types and pricing of the units, an age restriction of 55 plus is reasonable for a 92-unit property. While not mentioned in the market study, older MSU alumni will find the property particularly attractive—with a significant number using it as a secondary residence. We do still have concern, however, that the rents for these 92 units likely exceed achievable levels.

The student-oriented component will have the advantage of being the closest of the four newest student-housing properties to the center of campus. While its rents will also be at the top of the market, students will appreciate the convenience of the Target store, campus, and Downtown living.

The prime location and high quality of Center City District provide support for the developer's optimism in achievable rents; there is no reason not to expect rents to exceed the current market. Our review of the developer's pro forma also finds very reasonable expectations concerning rent growth, occupancy, and expenses.

Target Lease

Approximately 22,225 square feet on the first floor of the building along the Grand River frontage will be a Target store that follows the chain's new "flexible format" and includes a grocery, prepared food selection, pharmacy, and a limited assortment of apparel and home goods. Target has recently opened this store format in urban areas such as Chicago, New York, and Philadelphia, as well as proximate to major university campuses.

We have reviewed the lease between Ballein Management (an LLC entity of the developer) and Target Corporation, signed by both parties on April 12, 2017. The lease is predicated on the completion of the Center City District in its entirety, including adjacent garage parking, stipulating the store's white box must be delivered by September 1, 2018, to avoid penalty. Store completion is expected in early 2019.

The terms, lease rates, format, and other features of the lease are consistent with standard practice. We have no concerns about the lease or other matters involving the Target store.

Summary of Review

Following our review of the due diligence prepared for the City Center District, we find no reason to question the developer's efforts to collaborate with and provide the City of East Lansing a mixed-use development of very high quality. The city and the developer have very good reason to be optimistic about the future of Downtown East Lansing, and this project will certainly assist with its positive future.

We appreciate the opportunity to assist you with this analysis and I am available to answer your questions or address any comments.

Respectfully submitted on behalf of Development Strategies,

Brad Beggs
Principal