TOWN OF CHAPEL HILL
GRUBB PROPERTIES EAST ROSEMARY REDEVELOPMENT REVIEW

Executive Summary

Background

The Town of Chapel Hill’s Economic Development Department retained Noell Consulting Group (NCG) in late April to conduct an independent third-party review of the planned Grubb Properties Downtown Development known as The East Rosemary Redevelopment. As we understand it the development entails:

- A property exchange of 1.6 acres of Town owned property at 150 East Rosemary (the Wallace Deck) for 1.6 acres of property at 137 East Rosemary (the CVS deck plus adjacent land). While values of these properties are similar, the Town’s piece has a slightly greater value given greater hourly parking revenue potential being closer to Franklin Street businesses, and the potential for easier entitlements for future development given the lack of adjacent single-family homes. This value will be paid to the Town by Grubb Properties to make up the difference.
- Grubb Properties to fee develop (4%) for the Town a new 1,100 space parking deck. This deck will consolidate 800 existing spaces and create 300 net new spaces, of which Grubb Properties will commit to leasing 250 spaces at market rate.
- Grubb Properties will then privately construct a new 200,000 SF office and wet lab facility above a 200-space parking podium on the 150 East Rosemary property (located in an Opportunity Zone). This development will also utilize their 250 leased spaces in the new public parking deck. The building will feature a minimum of at least 25% wet lab space. Separate from this transaction Grubb Properties is also proposing to renovate the existing office space located at 136-137 E. Franklin into an Innovation Hub primarily serving UNC. This Innovation Hub would also commit to spaces in the new public parking structure, and is hoped to fuel tenant demand for the new office/wet lab facility.
- Grubb Properties is proposing the following community benefit impacts along with the development itself:
  - A new town green at the SW corner of Rosemary and Henderson Streets;
  - A new urban pocket park between Varsity Alley and Rosemary Street; and
  - An enhancement of Varsity Alley

Analysis

In our view, the property exchange balances out with the additional payment to the Town, and the 4% development fee being paid to Grubb Properties for the new parking structure is in line with current market conditions and inline with past Town endeavors. Additionally, there is no request from Grubb Properties for the Town to aid in the renovation of 136-137 E. Franklin at this point. That said, this comes down to an analysis of if the Town is receiving enough community benefits from the development of the new office/wet lab, and how can the Town best minimize their risks associated with this development.

Construction of a new 8-story commercial building (6 floors of office space above 2 floors of parking podium) of the proposed quality and scale is estimated to cost $250/SF in hard cost for the office portions, $280/SF in hard costs for the wet lab portions, $25,000/parking space for the parking podium, plus an estimated $7 million in additional site costs and tenant improvement allowances resulting in a total estimated hard cost number of $63.5 million. In
addition, the development will have an estimated 20% in soft costs, plus the underlying land value being paid of $31.80/building SF, for a total development budget of approximately $86.9 million, not including community benefits. At a minimum, private developers and their investors/lenders would need to see an estimated 7.5% return on cost (ROC) in today’s environment for this to be considered a development worthy of the risk associated with its undertaking. This is a 150-basis point spread above an estimated exit cap rate of 6%. This means the building will need to produce an NOI of at least $6.5 million. After estimating for operating expenses, leasing commissions, and reserves this will require achieved rents of $35.32/SF Triple Net (net of taxes, insurance, and CAM), or $45.32/SF Full-service (Gross).

Current top of market office rents in Downtown Chapel Hill can be found at Carolina Square where asking rates are $36.50/SF Full-service, or an estimated $26.50 Triple Net. Top of market exit cap rates (while not in Downtown) can be found in the January 2019 sale of The Station at East 54 for a 6.25%, making 6% a reasonable estimate for a Downtown exit cap rate.

Based on current market conditions and the financial analysis of the proposed development, Grubb Properties will need to achieve a 24.2% rent premium over the current market leader, Carolina Square, in order for this development to be financeable even with no community benefits. We believe this is feasible, albeit aggressive, given that Carolina Square is now three years old, and does not feature wet lab space. That said, 200,000 SF of speculative space at these top of market rents is aggressive in a market that has only averaged 18,610 SF of annual Class A office absorption since 2000.

Utilizing this same financial model we can see that for every $250,000 worth of additional cost to the project (from community benefits, cost over runs, delays, etc) the rental rate will need to be raised by an additional $0.12/SF, or the anticipated ROC will need to drop to unfinanceable levels.

Conclusion

We believe the currently proposed development entails significant market risk by Grubb Properties, and estimated development costs for the project make it extremely difficult for it to support significant community benefits beyond what can be absorbed in the current development budget. We believe the creation of the two new community green spaces are covered in the current land and site costs assumed in this model, and the development of a state of the art, top of market office/wet lab facility in meeting with all current Town design guidelines can be achieved. Additional community benefits beyond those currently proposed would represent a financial burden likely to make the development unfinanceable without comparable value engineering to the design or construction. In interviews with multiple other southeastern office developers (Jamestown, Seven Oaks, Third and Urban, New City) we have confirmed that not only are community benefit requirements on office developments unlikely in other markets, but often the reverse, an incentive package typically with a property tax abatement is offered for the economic development gains of adding new employees to the market. As such, we recommend the Town proceed with the current MOU as it outlines a strong deal for the town. Should additional community benefits still be required consider a focus on win-win elements such as increased design or sustainability features that will also potentially boost the value of the building on an exit sale, and thus allow for a direct recoup of the added investment.

Additionally, it should be noted that the market risk of this development is high with little historical evidence of absorption potential at these high rents. Increased costs of community green spaces, higher design standards, and a minimum percentage of wet lab space only increase these risks further. We believe it is highly likely that Grubb Properties has or will secure an anchor tenant prior to moving forward, and that tenant is most likely to be UNC. Additional focus should be on that likely scenario and any additional community concerns/needs that come with it. Is their risk of a market perception that the town is “in bed” with UNC, or green lighting the ability for UNC to get an
anchor foothold on Downtown? Could there be concern that the Town allowed a private developer to have financial gains from a deal that could have been made directly with the University? Could these jobs be just relocated from campus and not net new gains for the Town?

Risk for the Town increases if Grubb Properties does not have an anchor tenant. If no anchor is secured financing for the development is unlikely, and the town could be left with a vacant lot for the foreseeable future. If financing is somehow secured without an anchor, market risk could result in a largely empty building for many years.

Finally, a note on the impact of the Opportunity Zone on the development. As noted earlier the development sits in a federally designated Opportunity Zone, and as such qualified investment placed into the development receives federal tax breaks after a 10-year holding period. Multiple interviews with other commercial developers confirmed that this has marginal benefit on the development economics today, and does little to nothing on aiding support of an increased cost basis through community benefits or other increases. The benefit results in a greater leveraged return for the equity investors after 10 years, but market fluctuations/risk and uncertainty result in little benefit to the initial underwriting today.

***This opinion letter was written prior to receiving Grubb Properties draft of their May 13th presentation, however after review of that presentation we do not see any reason to change the opinions stated above. We believe their presented development budget of $104 million in that presentation has been inflated likely in the categories of tenant improvements and leasing commissions, and thus artificially lowered the ROC to a 6.05% which we do not believe is financeable in today’s market. That said, backing into the rent from the listed development budget and ROC proves they are assuming comparable rents to our opinions stated above in the $35-36 NNN range.