DUE DILIGENCE AND RISK MANAGEMENT MEASURES FOR ECONOMIC DEVELOPMENT INCENTIVE APPROVALS

by Joe Lauber and Tom Kaleko

"There but for the grace of God go I…".[1] Much ink has been spilled in the media and the statehouse over the past year regarding the unfortunate situation in which our colleagues at the City of Moberly find themselves, as a result of the failed Mamtek project, "Project Sugar." But before anyone heaves the next stone in this matter, take a moment to consider what you might have done had you been in the exact same circumstance.

In June 2009, Randolph County that has Moberly as its largest city, experienced a spike in unemployment to 12.2 percent.[2] Throughout 2010, the year Mamtek came calling to several cities in the plains states, Randolph County's unemployment averaged 9.74 percent, higher than the statewide average 9.36 percent for the same period.[3] It probably sounded like a dream come true when Mamtek representatives estimated they might add nearly 250 employees within its first 18 months of operations. Unfortunately, that dream transformed into a nightmare. Indeed, "there but for the grace of God" goes many of us.

Without doubt, the difficult employment situation in Randolph County cannot completely justify the events that followed, but the very difficult lesson learned by Moberly in this situation serves as a poignant reminder to all of us not to get in too big a hurry when selecting our private sector partners in economic development matters. To that end, through this article we hope to provide some guideposts to follow as you navigate the sometimes treacherous path of economic development incentive approvals.

Economic development occurs within the context of the broader economy. Therefore, it is important to recognize that development lending practices changed drastically in 2008 after the real estate bubble burst. Federal banking regulations have tightened and commercial banks are far more risk averse, constraining previously available access to credit for developers. Underwriting standards have also increased, with loan to value ratio parameters dropping to as low as 60/40 from the 80/20 ratios that were commonly seen prior to the recession. Banks are virtually unwilling to take on construction risk and have increased their scrutiny of leases and tenants before extending credit. Developers are also finding that significant leverage has shifted to tenants as a result of an oversupply of space and reduced demand for new projects. With all this increased pressure from these sophisticated partners, where are developers turning for help? To cities, of course! Developers are increasingly looking for the public sector to take on a larger role in their projects through:

- substitution of public subsidies for owner equity;
- provision of credit through special assessments; and
- assumption of risk through publicly issued debt obligations backed by general obligation guarantees or annual appropriation pledges.

Sophisticated developers will bring a team of experts to pursue their requests. The city will need its own team. If needed to augment the expertise of city staff, consideration should be given to engaging a financial advisor and special legal counsel of the city's choosing to represent the city's interests. To offset the costs of these advisors, cities should adopt and follow a policy that requires developers to enter into a funding agreement to cover the city's costs of reviewing the incentives application. Funding agreements commonly have an initial deposit amount and an "evergreen" clause that requires the developer to replenish the fund as the city draws down on the deposit. While financial advisors and legal counsel both are required to adhere to strict ethics rules, cities should consider whether the consultants represent both developers and cities on a regular basis – there are firms for both professions that represent only public entities and may give additional peace of mind as to where their consultants' long-term allegiances will lie. Cities should also seek a financial advisor that has a fiduciary duty to the city by virtue of Municipal Securities Regulatory Board regulation.

At one time or another, we've all probably encountered the phrase "the best defense is a good offense," and that adage applies equally to a municipality's offering of economic development incentives. If you desire to increase economic activity in your jurisdiction, it is critical that you plan for it. One approach to doing so involves asking "six important questions" about each request for public assistance for development projects. A discussion of those questions follows. As you read through these questions, please keep in mind that (1) not every step is required in every case – this process can and should be tailored to situational needs and the characteristics of your community; and (2) the process for reviewing an economic development incentive request is a reiterative one, where information gathered in one step sets the stage for questions to ask in the next step, but also may require further investigations into any inconsistencies or gaps identified with the information you have just received. Ultimately, your goal is to reach a level of comfort (both at the city staff and elected officials level) that is sufficient to continue with the developer's proposal.

Is This Something Our Community Really Needs?

Have a plan in place before a developer comes to you with his or her vision for your community – that way you can compare the developer's vision with your own. Is your emphasis on revitalizing the older core of the community or on expansion? What kind of business do you need to strengthen the local economy and diversify the city's revenues? If you don't know the answers to these questions, now would be an excellent time to prepare an economic development plan so that you can target economic development incentives to encourage growth of the type you desire and in the place you want it. This plan can be stand-alone or part of the city's comprehensive or strategic plan.

Important tools to implement the plan are an economic development policy and practice. The policy should communicate what your community is willing (and not willing) to do to achieve its plan goals. For example, you may be unwilling to assist with property acquisition through the exercise of eminent domain, or you may not be willing to issue debt that is backed by an annual appropriation pledge of the city's general fund revenues. An economic development policy also should link the plan with an economic development practice. This practice establishes the process by which you will consider economic development proposals.

Who Are These Guys?

Every request for public incentives related to a private development project creates a partnership between the parties. Hopefully, you wouldn't go into a private venture using your personal nest egg without knowing your business partners; we owe our constituents the same protections as we enter into public-private partnerships using public funds. During this process you should evaluate the experience of the developer's team in carrying out the type of project proposed. Just because the developer's firm has a great reputation, it doesn't mean that the individuals working on your project are the "first string" players. Additionally, you should investigate the developer's financial resources, including those of the company, the ownership, and any affiliate companies (who are often transferred the development rights). Finally, the city should seek disclosures from the developer regarding any conflicts of interest or priority for other projects already in the works, as well as, defaults, law suits, judgments, bankruptcies or criminal convictions. Developers are sometimes squeamish about providing this private information to the city where it would likely be subject to release under the Sunshine Law. Your financial advisor, however, can conduct this review pursuant to a nondisclosure agreement and provide the city with a summary finding. The best developer reviews are conducted through a combination of methods including written requests for information, reference checks, independent research, developer interviews and site visits.

Is This Project Feasible?

Project feasibility is a critical issue for any development project, but is especially important when the city will be financially at risk. In fact, the statutory enabling authority for some economic incentives requires project feasibility analysis as a requirement for approval.[4] A market feasibility study is an excellent method for estimating project feasibility. A quality market feasibility study should contain the following basic elements: (1) a description of the site and neighborhood; (2) an overview of the market area; (3) a supply and demand analysis for the type of development proposed; (4) a project description and recommendations for project components; (5) market penetration analysis; and (6) a projection of income and expense for the proposed project. Market feasibility forecasts prepared by the developer may be appropriate when the developer will bear all of the financial risk. However, for projects in which the city will share the risk, the city should insist on an independent feasibility study conducted by a consultant of the city's choosing. The city can then use this independent report to carefully estimate the capability of the project to provide the public funding sources required.

Other considerations at the project feasibility stage include a plan for site control. Does the developer already control the site because of ownership or options for ownership of the site? If not, is the developer's plan for obtaining site control realistic? Will the developer request assistance with acquisition in the form of eminent domain? Is your community willing to assist if requested?

Finally, it is important to research for yourself whether appropriate authority exists for the public participation requested. Don't assume that the developer's team are experts in public incentives and public financing – often the developer's counsel or other consultants are familiar with laws related to private real estate financing, but aren't as familiar with the multitude of requirements and limitations that apply when financing is provided using public funds.

Will Our Community Benefit From This Project?

Another critical piece of the puzzle relates to the identification and measurement of project benefits and costs. The goal of the project is to strengthen the local economy and increase governmental revenues. So, will it? The approach to measuring benefits and costs varies depending upon certainty of payback, size of the project, and the financial exposure faced by the public entity. For projects with little risk, a straightforward benefits analysis may be sufficient. In this approach, the direct governmental receipts (taxes and fees) are forecasted. A more sophisticated analysis may be merited for more complex projects and projects with significant risk. The city will want to examine both the benefits and the costs associated with the project. Direct benefits and costs will certainly need to be examined. An assessment of "multipliers," the spin-off benefits and costs, also may be appropriate.

Is A Subsidy Even Needed For This Project?

The fifth important question to ask is another one that is statutorily required in some circumstances; can the project generate a reasonable profit without the requested public subsidy, within the current marketplace and time? Put another way, would the developer be expected to undertake the project "but-for" the requested incentives? The "but-for" analysis should include a projection of the developer's internal rate of return (IRR) both with and without the requested subsidy. The internal rate of return is the real estate industry's most common benchmark for measuring profitability.

The first step in an internal rate of return analysis is an examination into the reasonableness of developer's assumed development costs and income. Is the developer putting too much "padding" into his or her costs compared to similar projects in the marketplace? While some conservatism in estimating development costs and income can be helpful (may serve to reduce the risk that the project will fail), too much "padding" could result in the developer enjoying an excessive rate of return while unnecessarily using public funds.

Project cash flow is then forecasted using the cost and income assumptions. A hypothetical sale is assumed, usually after 10 years of project operation. While the project may not be sold at this point in time, this assumption is critical to placing a value on the project. A capitalization rate is applied to the estimated project cash flows to calculate the internal rate of return. The forecasted internal rate of return can then be compared to like projects in the market at the time to determine whether a public subsidy is required and, if so, whether the requested subsidy amount is appropriate.

Will The Developer Do What It Says It Will?

The final question you should ask regarding incentives approvals is whether you will get the results the developer is promising. Development deals are inherently risky, but there are precautions you can put into place in the development agreement that will help to manage that risk through the implementation of the incentives program. As you go through the incentives approval process, remain mindful of the ultimate goal and be aware of the ebb and flow of the city's negotiation leverage. You should ask yourself at what point the city's negotiation leverage is the highest—is it just before or just after the incentives program is approved?

Obviously, the forgoing was a rhetorical question— the city's leverage is always higher before the governing body has committed to the project through an ordinance approving the incentives. Considering this, the city should attempt to get as many of the most critical terms related to the deal established in a preliminary "terms sheet" that is used in the approval process. If the developer is requesting annual appropriation backed bonds, this is the perfect time to specify that such bonds would only be issued subject to certain criteria, including signed sales contracts or leases for the development that include a covenant to open by a date certain and are based on revenue projections provided by a third-party revenue consultant. For manufacturing facilities, you might require pre-sold contracts for goods. Additionally, you might consider requiring supplemental debt service reserve funds, insurance coverage for the project in amount to cover replacement costs and require the insured to use any proceeds towards restoring the project to its original condition. For projects promising job creation you can include "clawbacks" that require the developer to pay back certain incentives if the promised results aren't achieved.

You also might consider including a public participation provision, which is a term that acknowledges the fact that the project is the result of a public-private partnership that would not have occurred but for the inability of the project to produce enough return to make it feasible for the developer to undertake the development without incentives. In the event an "excessive" rate of return is actually incurred by the developer, a public participation provision would require the developer to share the excess with the city in an amount proportional to the public investment in the project. Keep in mind, however, that any risk management technique used that requires a payment from the developer could be viewed as a "private payment," and therefore affect any tax exempt debt that was issued in conjunction with the project. It is always a good idea to include express authority in the agreement to waive any terms that might have such affect, and to consult your bond counsel prior to final negotiation and approval of the development agreement to ensure that the protections you put in place don't have unintended consequences at later stages of the financing.

2012 Legislative Activity

As was mentioned in the introduction to this article, fallout from the Mamtek project caused a stir in the statehouse over the winter. Both the Senate and the House convened special committees on government oversight to look into possible legislative solutions to the issues raised by Mamtek. The committees held hearings and took testimony in January 2012, and both the House and Senate committees released their reports in mid-February.[5] Nearly a dozen bills were introduced into the General Assembly this session to implement the findings and conclusions of these committees.[6] These bills sought various changes that included a requirement for a public hearing before a city could issue annual appropriation backed debt, and several new requirements for the Missouri Department of Economic Development's interaction with local governments, including third party verification of financial information, background checks on principals of start-up companies, information sharing about companies seeking subsidies in state-local incentive deals, and the creation of a 5-star rating system for state-local projects. Most of the provisions ultimately wound up in HB 1865 that passed the House in late April, but became tangled in tax credit reforms in the Senate where it died as the session ended on May 18.

Conclusion

In one of the early news stories emerging from the Mamtek matter, an economic development official from North Dakota, who also was approached by Mamtek, was quoted as saying "the business of economic development is full of carpetbaggers and scallywags … you just have to be cautious."[7] That seems like a pretty grim characterization of those involved in economic development; however, as in all industries, you will occasionally encounter individuals with compromised scruples. If you have a plan that identifies the things you need and don't need; establishes what you are and are not willing to do to get those things; and a procedure for vetting each request you'll be prepared to face developers of all kinds. By developing and executing programs such as the one described here, municipalities can retain local control of how best to utilize economic development incentives in their respective communities and demonstrate that statewide legislation is not an absolute requirement for prudent administration of public incentives.❑

Endnotes:

1. This quote is commonly attributed to the martyr John Bradford of the 16th century. See e.g., http://www.phrases.org.uk/meanings/there-but-for-the-grace-of-god.html (last visited May 25, 2012).

2. See http://www.labor.mo.gov/des/tool/ui_ben_stats.asp?Submit=Yes (last visited June 4, 2012).

3. Extrapolated from http://www.labor.mo.gov/data/statArchives.asp (last visited June 4, 2012).

4. See, e.g., § 99.810.1(5), RSMo (TIF); § 99.942.3(6), RSMo (MODESA).

5. House committee report: http://house.mo.gov/billtracking/bills121/commit/report498/Mamtek%20Report%20Feb.%202012.0150i.arc.pdf (last visited May 29, 2012); Senate committee report: http://www.senate.mo.gov/12info/comm/reports/GAFO_Mamtek.pdf (last visited May 29, 2012).

6. See e.g. http://www.columbiatribune.com/news/2012/feb/21/bills-follow-mamtek-review/ (last visited May 29, 2012);

7. Rudi Keller, *Moberly Officials Mostly Mum on Mamtek*, Columbia Daily Tribune, September 20, 2011(available at http://www.columbiatribune.com/news/2011/sep/20/moberly-officials-mostly-mum-on-mamtek/ (last visited June 4, 2012)).

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