



A EPS Addendum

Final

The Economics of Land Use



**Addendum:
Reuse Feasibility Study,
Nelles Correctional Facility
Redevelopment
(Supplemental Report)**

Prepared for:

Brookfield Residential and the City of Whittier

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OVERVIEW

Context

EPS was retained by Brookfield Residential (Developer) to assess the financial feasibility for the historic preservation and adaptive reuse of eight structures located at the former Nelles Correctional Facility in Whittier, California. In August 2014, EPS submitted a draft Report titled "Reuse Feasibility Study, Nelles Correctional Facility Redevelopment," which considered the feasibility of retaining each structure individually and the overall financial impact on the project of retaining all eight structures. This EPS Report was included in the Draft Environmental Impact Report (DEIR) for the development plan. The following analysis, which is an Addendum to the original EPS Report, considers additional impact scenarios featuring different combinations of structures for retention. This Addendum was prepared at the request of both Brookfield and the City to respond to a number of comments made on the DEIR during the public review process, most notably comments made by the Whittier Conservancy. Except where noted and discussed, all backing documentation for underlying assumptions and analytical methodology, which have been omitted here for brevity, can be found in the original Report. In addition, as part of the original report from August 2014 ("EPS Report") and this "Addendum Report", EPS reviewed the following reports and documents: (i) 2011 Page & Turnbull Report; (ii) MACK5 Report; (iii) and the Gruen Gruen + Associates Report. These documents are hereby incorporated by reference as if set forth in full, and it is our understanding that this Addendum and these cited documents will be included as part of the Final EIR.

The Project as described in the Draft Environmental Impact Report (the "Lincoln Plan") includes the retention of two structures: the Administration Building and the Superintendent's Residence. The original EPS Report concluded that it would be financially infeasible to retain the remaining six structures not included as part of the Lincoln Plan.

These conclusions rested on several feasibility tests, including:

- a **construction costs** analysis, which showed that the costs of rehabilitation for each of the six structures for a possible/likely intended new use exceeded the costs of new construction for similar uses;
- a financial returns analysis, which showed that the costs of rehabilitation exceed the estimated market value of each rehabilitated structure;
- and a displaced land value analysis, which estimated lost land sale revenues if the structures are retained rather than their underlying land being available for new development.

The original Report also concluded that together, retention of all six additional structures would lower expected total project returns from an estimated return on costs of 25 percent to a margin between 9 percent and 11.5 percent (with the range reflecting whether or not the project obtains 20 percent Historic Tax Credits). This was calculated by deducting the net cost of retaining each structure (computed as the subsidy required for each retained structure plus the un-realized land sale revenue associated with retention) from an expected overall project return. EPS based this overall project return on a high-level estimate of finished pad value (based on market comparables), and on an assumed financial return of 25 percent on project costs ("return on

costs”) to approximate the Developer’s priority (but not guaranteed) financial return of a 25 percent Internal Rate of Return (“IRR”) as noted in the purchase and sale agreement with the State. See **Table 1** for a summary of findings from the original EPS Report.

For this addendum, EPS has revised the assumptions underlying the estimated overall project return, basing them instead on internal and actual Brookfield pro forma estimates for land sale revenues and total costs for site acquisition, entitlement, and improvements. In addition, as suggested by the Whittier Conservancy in its comments on the DEIR, EPS factored in demolition costs avoided for each building retained. See **Table 2** for a revised summary of findings, incorporating the new Brookfield cost and revenue numbers.

Comparing **Tables 1 and 2**, one can see that the land value assumed by EPS in the August report (\$125.5 million) is near but somewhat higher than the land value assumed in Brookfield’s pro forma (\$120.2 million). Moreover, the August report inferred that project costs would be roughly \$100 million if Brookfield were to generate the targeted 25 percent return on costs. The Brookfield pro forma estimates costs at \$101 million, as shown at the bottom of **Table 2**. These figures suggest that EPS’s August report assumed similar but slightly more optimistic revenue and cost estimates than Brookfield is actually using to underwrite the project.

In addition, **Table 2** shows slightly lower re-use subsidy costs for each building than were provided in the August report, due to consideration of approximately \$135,000 in avoided demolition costs for the six buildings not included as part of the Lincoln Plan (EPS assumed \$3.00 per building square foot to be demolished). This adjustment reflects the fact that the Lincoln Plan assumes demolition of the buildings as part of its cost structure, so the retention of a given building would avoid that cost. The net effect is to slightly reduce the re-use subsidies for the eight-building program. In addition, given the slightly lower land sale values expected by Brookfield than were assumed in EPS’s August report, the costs associated with “displaced land” have decreased by an additional \$260,000. As a result, the overall costs associated with retention of the eight buildings is now shown as roughly \$395,000 less than was estimated in the August report. The difference is a roughly 2 percent reduction in the estimated cost of retaining all eight buildings.

Table 1 Original Summary of Findings (from August Report)

Historic Building	Assumed Re-Use	Restoration Scenario	Construction Costs	Re-Use Subsidy		Lincoln Plan Land Displaced by Re-Uses		Net Cost of Re-Use (Subsidy + Lost Land Revenue)																			
				Base (No Tax Credits)	With 20% Historic Tax Credits	Lost Land Area	Lost Land Revenue	Base	With 20% Historic Tax Credit																		
Administration Building	Office	Restore in Place	No	(\$472,200)	(\$191,200)	0 Sq.Ft.	\$0	Retained in Lincoln Plan	Retained in Lincoln Plan																		
Superintendent's Residence	Office	Restore in Place	No	(\$730,800)	(\$497,300)	0 Sq.Ft.	\$0	Retained in Lincoln Plan	Retained in Lincoln Plan																		
Chapel	Community Center (Public Use)	Restore in Place	No	(\$2,888,800)	(\$2,364,600)	0 Sq.Ft.	\$0	(\$2,888,800)	(\$2,364,600)																		
Gymnasium	Restaurant	Restore in Place/Lift to New Grade	No	(\$2,614,400)	(\$1,776,100)	26,659 Sq.Ft.	(\$1,253,000)	(\$3,867,400)	(\$3,029,100)																		
Maintenance Building	Assisted Living	Restore in Place	No	(\$2,253,500)	(\$1,597,700)	22,980 Sq.Ft.	(\$1,080,100)	(\$3,333,600)	(\$2,677,800)																		
Assistant Superintendent's Residence	Single Family	On-Site Relocation	No	(\$387,600)	Not Eligible	10,800 Sq.Ft.	(\$507,600)	(\$895,200)	(\$895,200)																		
Auditorium	Auditorium (Public Use)	Restore in Place	No	(\$1,139,700)	(\$905,500)	34,711 Sq.Ft.	(\$1,631,400)	(\$2,771,100)	(\$2,536,900)																		
Infirmary	Office	Restore in Place	No	(\$537,200)	(\$342,500)	36,850 Sq.Ft.	(\$1,732,000)	(\$2,269,200)	(\$2,074,500)																		
TOTAL				(\$11,024,200)	(\$8,062,500)	132,000 Sq.Ft.	(\$6,204,100)	(\$16,025,300)	(\$13,578,100)																		
Impact on Lincoln Plan Program																											
<i>Lincoln Plan Program</i>																											
Revenue on 61.3 acres of sellable land at \$47/Sq. Ft.																											
Presumed Profit margin at 20% return on revenues																											
Return on Costs																											
Re-Use Plan																											
Net Cost of Re-Use																											
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Source: Economic & Planning Systems

Table 2 Revised Summary of Findings (With Brookfield Pro forma Cost and Revenue Estimates)

Historic Building	Assumed Re-Use	Restoration Scenario	Construction Costs	Re-Use Subsidy		Lincoln Plan Land Displaced by Re-Uses		Net Cost of Re-Use (Subsidy + Lost Land Revenue)																			
				Base (No Tax Credits)	With 20% Historic Tax Credits	Lost Land Area	Lost Land Revenue	Base	With 20% Historic Tax Credit																		
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Superintendent's Residence	Office	Restore in Place	No	(\$730,800)	(\$497,300)	0 Sq.Ft.	\$0	Retained in Lincoln Plan	Retained in Lincoln Plan																		
Chapel	Community Center (Public Use)	Restore in Place	No	(\$2,852,900)	(\$2,328,700)	0 Sq.Ft.	\$0	(\$2,852,900)	(\$2,328,700)																		
Gymnasium	Restaurant	Restore in Place/Lift to New Grade	No	(\$2,586,700)	(\$1,748,400)	26,659 Sq.Ft.	(\$1,200,500)	(\$3,787,200)	(\$2,948,900)																		
Maintenance Building	Assisted Living	Restore in Place	No	(\$2,219,600)	(\$1,563,800)	22,980 Sq.Ft.	(\$1,034,900)	(\$3,254,500)	(\$2,598,700)																		
Assistant Superintendent's Residence	Single Family	On-Site Relocation	No	(\$382,900)	Not Eligible	10,800 Sq.Ft.	(\$486,400)	(\$869,300)	(\$869,300)																		
Auditorium	Auditorium (Public Use)	Restore in Place	No	(\$1,120,600)	(\$886,300)	34,711 Sq.Ft.	(\$1,563,100)	(\$2,683,700)	(\$2,449,400)																		
Infirmary	Office	Restore in Place	No	(\$523,300)	(\$328,600)	36,850 Sq.Ft.	(\$1,659,500)	(\$2,182,800)	(\$1,988,100)																		
TOTAL				(\$10,889,000)	(\$7,927,200)	132,000 Sq.Ft.	(\$5,944,400)	(\$15,630,400)	(\$13,183,100)																		
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Source: Economic & Planning Systems

Scenarios Tested

For this Addendum, nine scenarios featuring different mixes of retained and re-used structures have been tested for their impact on overall project returns.

The **Proposed Project** scenario, against which all other scenarios and return estimates are measured, reflects the proposed Lincoln Specific Plan and retains the Administration Building and Superintendent's Residence (as required by the State of California). Because the original request for bids issued by the State of California required retention of both of those buildings, the associated project economics were assumed in the Developer's original bid for the property.

Alternative Scenario 1 consists of the Proposed Project scenario combined with the in-place retention and rehabilitation of the Chapel Building and the onsite re-location and re-use of the Assistant Superintendent's Residence. This Scenario reflects a mitigation measure unilaterally imposed by the City of Whittier in the DEIR to reduce the impacts of development on those two historically significant resources.

Alternative Scenarios 2a, 2b, 2c, and 2d combine the Alternative 1 Scenario (retention of the Administration Building, Superintendent's Residence, Chapel, and Assistant Superintendent's Residence) with retention of one additional structure from the remaining four structures not included in Alternative 1. The purpose of these alternatives is to illustrate the incremental impact on project returns for each additional structure.

Alternative Scenario 3 combines the Alternative 1 Scenario (retention of the Administration Building, Superintendent's Residence, Chapel, and Assistant Superintendent's Residence) with retention, restoration, and re-use of both the Auditorium and Gymnasium buildings.

Alternative Scenario 4 combines the Alternative 3 with retention, restoration, and re-use of the Maintenance Building, for a total of seven retained structures (two from the Lincoln Plan plus five additional).

Alternative Scenario 5 assumes retention of all eight historic buildings—the two originally included in the Lincoln Plan and the remaining six. Alternative Scenario 3 is the same as that assessed in the original Report and is included here for comparison purposes.

For a summary of scenario alternatives, see **Table 3**.

Table 3 Scenario Alternatives

Scenario Alternatives		Structures Retained	
Lincoln Plan	Proposed Project	Administration Building Superintendent's Residence	
Alternative 1	Proposed Project + 2 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	
Alternative 2a	Proposed Project + 3 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Gymnasium
Alternative 2b	Proposed Project + 3 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Auditorium
Alternative 2c	Proposed Project + 3 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Maintenance Building
Alternative 2d	Proposed Project + 3 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Infirmary
Alternative 3	Proposed Project + 4 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Gymnasium Auditorium
Alternative 4	Proposed Project + 5 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Gymnasium Auditorium Maintenance Building
Alternative 5	Proposed Project + 6 Structures	Administration Building Superintendent's Residence Chapel Assistant Superintendent's Residence	Gymnasium Auditorium Maintenance Building Infirmary

Source: Economic & Planning Systems

SCENARIO FEASIBILITY

While restoration and re-use of each of the six buildings has been determined to be economically infeasible (i.e., requires a subsidy) on a building-by-building basis, overall project feasibility can also be assessed by estimating the impact of re-use on the overall Lincoln Plan, which envisions construction of 750 residential units and over 200,000 square feet of retail. This feasibility test is addressed in this analysis by posing the following question: is the total project return under various re-use scenarios sufficient to support the level of risk and investment required to improve the former Nelles property such that a prudent developer would proceed with the Project? Or, in other words, under what re-use scenarios would estimated project returns fall to a level at which a reasonable developer would make a “no-go” decision and decide to not proceed with the proposed project?

Many factors can affect the level of projected financial returns that are considered feasible by developers from project-to-project. Each project’s perceived risks are weighed, including:

- **Entitlement Risk** – A project pursued on land without entitlements typically requires a significant risk premium due to the potential for the project not to be approved. Some developers invest millions of dollars in predevelopment activity only to have entitlement requests denied by local government, or are required to make significant project revisions that reduce values and/or increase costs. Delays due to litigation and associated legal fees impose significant costs and risk of missing market windows.
- **Financing Risk** – Projects pursued during periods with scarce capital available from lenders and equitors can require higher returns. This is particularly true when alternative investment opportunities are available that may have lower risk and/or greater returns. Similarly, projects are more risky when pursued in periods when homebuyers may have difficulty obtaining financing, as has been the case following the national recession.
- **Development Risk** – Projects requiring major infrastructure investment or on previously used land (“brownfields”) that may have significant environmental issues typically require higher returns. Cost overruns can occur from general inflation, unforeseen site conditions, delays due to natural or political events, etc.
- **Market Risk** – Projects in lower-value or slower-growth communities, or proposing uses that have little “track record” of success in the relevant trade area typically require higher returns. Similarly, projects requiring buildout over multiple years and thus subject to broader economic cycles typically require higher returns.

These risk factors, as applied to the Lincoln Plan project at its inception, would include: modest home and commercial values; little recent track record of absorption of new residential development in Whittier; a large project requiring multiple years and thus subject to potential economic downturns; the high level of uncertainty regarding soil and other “brownfield”-related environmental conditions requiring remediation on the previously used Nelles site; and the lengthy and costly entitlement process. With these potential risks, EPS believes it is necessary for developers to anticipate a substantial financial return “going in,” as the actual returns are often diminished over time.

The Lincoln Plan scenario is the baseline against which other scenario impacts are measured. The Lincoln Plan, negotiated after the Developer's winning land purchase bid was accepted by the State, represents an agreement between the Developer and the State that establishes—among many other guidelines—that any return above a 25 percent Internal Rate of Return (IRR) be shared with the State. This agreement establishes and acknowledges that a financial return of up to 25 percent is reasonable for private investment in this type of project, and comports with EPS's extensive experience negotiating public/private land development transactions for both public and private sector clients. However, this 25 percent return represents an "upper bound" of a reasonable "priority" (i.e., unshared) return in the agreement with the State.

For the purpose of this EPS assessment, and based on our professional opinion and knowledge of real estate transactions throughout the country as well as the particular circumstances of the Lincoln Plan, an appropriate "target" return is defined as a 20 percent IRR or return on costs projected in the "going-in" project pro forma. In our opinion, this 20 percent return reflects the projected rate of return that justifies the level of risk and investment required to entitle and improve the former Nelles property. For substantially lower projected returns, we believe the Project would not attract sufficient capital investment, because capital markets would seek alternative projects or investments with lower risk and/or higher reward. In other words, we believe a prudent developer would not proceed with this project (i.e., would make a "no-go" decision) without forecast returns at or near 20 percent and that returns much below this threshold make the project infeasible and impracticable.

In EPS's experience, large-scale reuse projects with similar risk profiles that proceed with return targets below 20 percent often involve public financing (such as reinvested tax increment) that reduces the developer's investment cost and/or may supplement the developer's return to support or even all but ensure a minimum return level. For example, the redevelopment of the former Mueller Airport in Austin, Texas involves public financing that reinvests tax increment generated by the project to the extent available and required to achieve a 15 percent IRR or profit margin for the developer. No such public financing or ensured developer return is available for the Nelles project. (The California State Legislature eliminated redevelopment agencies three years ago, and tax increment financing is unavailable for the project.)

In the analysis below, two sets of returns are shown for each scenario considered—a baseline return, and a return assuming the Developer obtains 20 percent tax credits for qualified rehabilitation of certified historic structures. As noted in the original Report, Historic Tax Credits are extremely difficult to obtain, and a qualified rehabilitation may impose significant restrictions on improvements that limit the marketability and useability of the restored structures. Consequently, for many projects and many developers, the potential benefits from tax credits do not merit the effort and risks of pursuing them. Instead, developers typically regard tax credits as a source of potential project upside but not as a real-world factor to rely on in making a "go" or "no-go" decision.

Note that a 20 percent IRR would be similar to a 20 percent return on costs if all development costs (acquisition, entitlement, and improvement) were borne in a single year and all revenues from land sales, totaling 20 percent more than costs, were realized the following year. In practice, IRR calculations are more complicated, as both costs and revenues are spread over

several years and often overlap. Due to uncertainty regarding the timing of various expenditures and revenues for the Project, this discussion substitutes return on costs for IRR.

Findings

See **Table 4** for a summary of findings.

1. The baseline return on costs for the Lincoln Plan, representing retention and re-use of the Administration Building and Superintendent's Residence and demolition of the other six subject structures, is projected to be 19.1 percent.

The baseline return estimate is calculated from an estimated improved land value of \$120 million (from Brookfield, based on recent market data that includes several bids from commercial developers) and estimated development costs of approximately \$101 million (from Brookfield, based on improvement cost estimates and the purchase and sale agreement land acquisition terms). While this return falls slightly below the 20 percent feasibility target, it is sufficiently close that for many developers, it remains an economically rational—though risky—project.

2. The estimated return on costs for Alternative 1, which reflects a mitigation measure imposed by the City of Whittier, generates a return of 15.4 percent (15.9 percent with tax credits) that does not meet the target return threshold for feasibility.

Alternative 1 features onsite reuse and retention of the Administration Building, Superintendent's Residence, Chapel building, and onsite re-location and reuse of the Assistant Superintendent's Residence. These returns are typical for the acquisition or pursuit of fully entitled projects in strong markets or projects with external sources of subsidy (such as tax increment reinvestment), for which significant project risks have been reduced. EPS is not aware of any comparable, unentitled or unsubsidized urban infill land development projects in modestly priced, slow-growth markets in which the "going in" anticipated financial returns were at or near this low level. In other words, the returns in this scenario are below the "no-go" threshold of near 20 percent identified earlier. Commencement of such a project would require that a developer have unusual confidence in revenue growth and/or cost containment, or that the developer simply sought to recoup *some* investment on substantial pre-development costs rather than abandoning the project.

3. Alternatives 2a, 2b, 2c, and 2d further lower the return on cost estimates to a range of 11.7 to 13.3 percent (13.0 to 14.0 percent with tax credits). In other words, any structure retained and added to the Alternative 1 scenario significantly lowers already substandard project returns. As tested, the scenarios lower returns by between 31 and 39 percent (or 27 to 32 percent with tax credits) from the estimated Baseline.

4. Alternative 3 retains and restores the Gymnasium and Auditorium buildings as well as the four structures featured in Alternative 1 and shows estimated return on costs of 9.0 percent (10.6 percent assuming tax credits). This scenario lowers returns by 53 percent (or 45 percent with tax credits) from the estimated Baseline.

- 5. Alternative 4 adds retention of Maintenance Building to the Alternative 3 scenario and further reduces project feasibility to a return of 5.8 percent (8.0 percent assuming tax credits).** This scenario lowers returns by 70 percent (or 58 percent with tax credits) from the estimated Baseline.
- 6. Alternative 5, which includes retention of all eight subject buildings, lowers estimated project returns considerably to 3.6 percent (or 6.0 percent with tax credits).** The tested scenario lowers returns by 81 percent (or 68 percent with tax credits) from the estimated Baseline.

Table 4 Scenario Alternatives Impact on Returns

Scenario	Alt Structures Retained	Net Cost of Re-Use (Subsidy + Lost Land Revenue)		Profit Margin		Return on Costs	
		Base	With 20% Historic Tax Credit	Base	With 20% Historic Tax Credit	Base	With 20% Historic Tax Credit
Proposed	Administration Building	\$0	\$0				
	Superintendent's Residence	\$0	\$0				
		\$0	\$0	\$19,287,300	\$19,287,300	19.1%	19.1%
Alt 1	Administration Building	\$0	\$0				
	Superintendent's Residence	\$0	\$0				
	Chapel	(\$2,852,900)	(\$2,328,700)				
	Asst. Superintendent's Residence	(\$869,300)	(\$869,300)				
		(\$3,722,200)	(\$3,198,000)	\$15,565,100	\$16,089,300	15.4%	15.9%
Alt 2a	Admin, Super's, Chapel, Asst. Gymnasium	(\$3,722,200)	(\$3,198,000)				
		(\$3,787,200)	(\$2,948,900)				
		(\$7,509,400)	(\$6,146,900)	\$11,777,900	\$13,140,400	11.7%	13.0%
Alt 2b	Admin, Super's, Chapel, Asst. Auditorium	(\$3,722,200)	(\$3,198,000)				
		(\$2,683,700)	(\$2,449,400)				
		(\$6,405,900)	(\$5,647,400)	\$12,881,400	\$13,639,900	12.8%	13.5%
Alt 2c	Admin, Super's, Chapel, Asst. Maintenance Building	(\$3,722,200)	(\$3,198,000)				
		(\$3,254,500)	(\$2,598,700)				
		(\$6,976,700)	(\$5,796,700)	\$12,310,600	\$13,490,600	12.2%	13.4%
Alt 2d	Admin, Super's, Chapel, Asst. Infirmary	(\$3,722,200)	(\$3,198,000)				
		(\$2,182,800)	(\$1,988,100)				
		(\$5,905,000)	(\$5,186,100)	\$13,382,300	\$14,101,200	13.3%	14.0%
Alt 3	Administration Building	\$0	\$0				
	Superintendent's Residence	\$0	\$0				
	Chapel	(\$2,852,900)	(\$2,328,700)				
	Asst. Superintendent's Residence	(\$869,300)	(\$869,300)				
	Gymnasium	(\$3,787,200)	(\$2,948,900)				
	Auditorium	(\$2,683,700)	(\$2,449,400)				
		(\$10,193,100)	(\$8,596,300)	\$9,094,200	\$10,691,000	9.0%	10.6%
Alt 4	Administration Building	\$0	\$0				
	Superintendent's Residence	\$0	\$0				
	Chapel	(\$2,852,900)	(\$2,328,700)				
	Asst. Superintendent's Residence	(\$869,300)	(\$869,300)				
	Gymnasium	(\$3,787,200)	(\$2,948,900)				
	Auditorium	(\$2,683,700)	(\$2,449,400)				
	Maintenance Building	(\$3,254,500)	(\$2,598,700)				
		(\$13,447,600)	(\$11,195,000)	\$5,839,700	\$8,092,300	5.8%	8.0%
Alt 5	Administration Building	\$0	\$0				
	Superintendent's Residence	\$0	\$0				
	Chapel	(\$2,852,900)	(\$2,328,700)				
	Asst. Superintendent's Residence	(\$869,300)	(\$869,300)				
	Gymnasium	(\$3,787,200)	(\$2,948,900)				
	Auditorium	(\$2,683,700)	(\$2,449,400)				
	Maintenance Building Infirmary	(\$3,254,500) (\$2,182,800)	(\$2,598,700) (\$1,988,100)				
		(\$15,630,400)	(\$13,183,100)	\$3,656,900	\$6,104,200	3.6%	6.0%

Source: Economic & Planning Systems