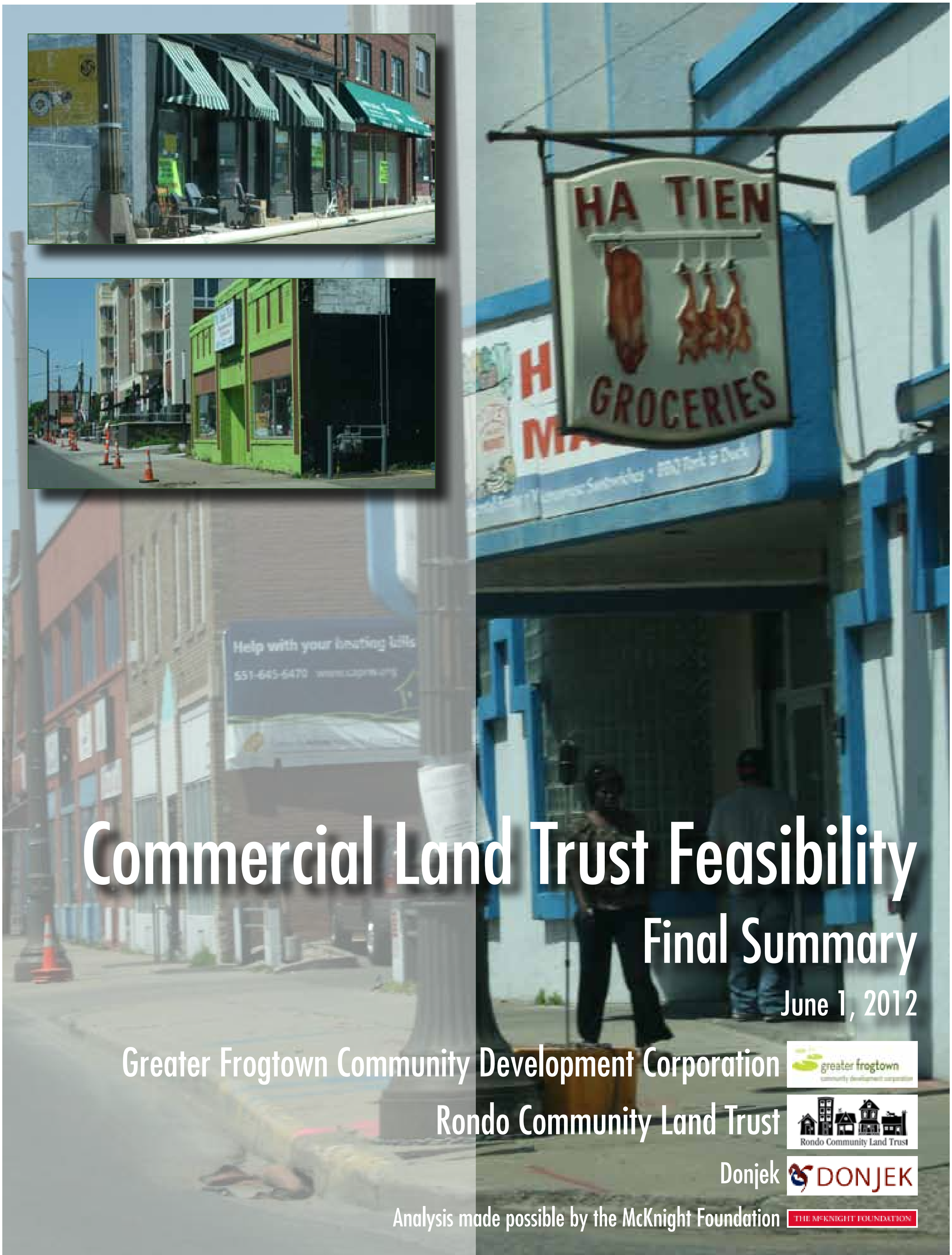

Commercial Land Trust Feasibility

Final Summary

June 1, 2012

Greater Frogtown Community Development Corporation

Rondo Community Land Trust

Donjek

Analysis made possible by the McKnight Foundation

Introduction

"By facilitating participation in market activity, neighborhoods expand wealth creation…A healthy neighborhood is a neighborhood that performs its functions well, connecting its residents to larger economic, social and political systems."

– Weissbourd, Bodini, and He, "Dynamic Neighborhoods"

Dating to the mid-19th century, University Avenue has matched entrepreneurial people with available space, central location, ease of access, and proximity to employees and other businesses. The street has long anchored neighborhoods in both cities, including the historic Rondo neighborhood, Frogtown, and Aurora-Saint Anthony in Saint Paul. Over many years, these parts of the city have been home to African-American residents, and new Americans including those of European descent in the early 1900s, and those of Southeast Asian descent starting in the late 1900s..

Central location and a mix of new ideas and longstanding networks in the community continue to stimulate entrepreneurship and business development on University Avenue. Its central location also frames one of the largest public works projects in the State's history: Construction of light rail transit (LRT) service that will link downtown Saint Paul, the State Capitol, University Avenue, the University of Minnesota, and downtown Minneapolis. Illustrated in comparable markets, LRT service is likely to elevate demand for space and increase foot traffic substantially on University Avenue. As development increases around University Avenue, opportunities arise for business owners operating there. At the same time, increased real estate values on and near University pose a challenge to the small and emerging businesses that help give the street its character.

Project Objectives

- Explore need and interest in long-term affordable business property ownership and leasing
- Identify and evaluate models for accomplishing long-term affordability
- Chart course for preserving affordable inventory without ongoing subsidy

This report summarizes an exploration of models that could create space on University Avenue for new and existing small businesses, led by the Greater Frogtown Community Development Corporation and the Rondo Community Land Trust. Informal survey data suggest that 10% of business owners on University own the property in which they operate. While ownership can provide long-term stability of building cost for business owners, ownership is not a uniformly high priority – or even a uniformly desirable outcome – for business owners. Innovative models that blend ownership and leasing, public with private, may have a role to play in supporting entrepreneurs on University Avenue after light rail transit is in place.

The report highlights selected strategies that allow business owners to structure more stable real estate costs, either through ownership or leasing. These strategies and a more stable cost structure for small businesses allow entrepreneurs to build reserves and working capital, invest in future projects or products, and hire more employees.

The Environment

Small businesses play a central role in the economic health of regions including Minneapolis Saint Paul, and their importance is evident at the finer scale of the commercial district. While bolstered by office and institutional uses, the public face of University Avenue is dominated by smaller-scale retail businesses and restaurants.

The opening, consolidation and closing of small businesses is an essential part of economic activity. Nationally, over the last twenty years, 95% of businesses that opened and closed, and 70% of all establishments, employed 20 or fewer people. At the same time, nearly half of jobs created since 2001 have been added by firms with 50 or fewer employees. Small businesses provide a disproportionate amount of job creation and "business churn" to the economy, at the local, regional and national level.

Small businesses also create an important gateway to wealth creation, including for new Americans and disadvantaged groups who can leverage a network of customers into broader economic and social participation. Through success operating local (such as neighborhood services, retail, real estate, restaurants) and traded (exports, professional services) businesses, community members can expand economic mobility for themselves, their families, and their communities.

The Local Imperative

Most businesses need a physical location to develop and operate, if they are to create jobs and wealth in the neighborhood. Depending on ownership and capital structure, industry and business objective, small businesses currently operating on University Avenue are attracted to its attributes for many reasons. In recent decades, University has offered a substantial inventory of relatively inexpensive space for rent, rising residential population nearby, and the visibility associated with sustained motor traffic approaching 30,000 cars per day.

With its construction now underway, business owners and residents are concerned about gentrification that will accompany light rail transit service to the corridor. Research undertaken along the Hiawatha Line in Minneapolis has confirmed that within a mile of station areas, commercial property has increased in value from $36 to $56 per square foot – a 55% increase. Projections of marked increases in foot traffic and property value are benefits to businesses and residents in many respects; at the same time, these trends are likely to create challenges for small and emerging businesses operating on or near University Avenue in the form of rising rents, pressure to relocate, and rising prices of other suitable real estate on or near the street.

The diverse and international character of eastern University Avenue, its importance as a center of entrepreneurship to business owners and their families, and the location of these businesses along a transitway are important to retain and cultivate. Using a pilot initiative to field test ownership structures on University Avenue represents one strategy toward establishing stable environments for small businesses committed to long-term operation in the corridor.

In interviews conducted during this project, entrepreneurs and economic development professionals each highlighted that ownership of commercial real estate is a benefit to business owners, but does not represent a high priority or the right emphasis for all. Organizations including the Neighborhood Development Center have demonstrated high rates of success partnering with entrepreneurs to provide business training and technical assistance, coupled with business lending and lines of credit. Interviews also revealed reservations among multiple ethnic communities operating businesses on University Avenue, who are reticent about limits on equity appreciation or on property ownership without control of the underlying land.

None of the models presented and evaluated in this report will preserve and expand affordable commercial space inventories all along University Avenue. Moreover, the anticipated increases in foot traffic and residents will deliver substantial benefits to many existing businesses on the street. Still, the public interest is served when small businesses continue to afford some proportion of space, and thrive even as price appreciation ensues in a given district. From the perspective of geographic equity, communities that have invested in University Avenue over time and through construction, deserve the ability to participate in the benefits associated with the LRT investment. Establishing even modest additional inventory of long-term affordable commercial space represents one method of unlocking local potential for employment growth and wealth creation.

Land Trust Models

National research, and interviews of business owners, economic development professionals and other stakeholders have led to identification of three models for providing long-term rent stability for University Avenue businesses. The structures presented here could be introduced in tandem to the marketplace, or implemented one at a time. Below, the report summarizes the structures and their potential for implementation, to retain and grow small business in environments like University Avenue.

Model: Land Trust as Master Lessor

Stable and predictable rent costs are an important ingredient for small businesses to thrive. Ownership, based on interviews, is not a top priority for business owners who face demands unique to their business. Some operators are attracted less to a gateway to ownership than to a stable rent structure.

Under a master lessor model, a land trust is formed to acquire property for the purpose of leasing to business operators. A building may be already suited for use, or require construction or rehabilitation, and its location and characteristics may suit it to retail, food service, office, housing, light industry, or a mix of these. A master lessor could provide space for small businesses to enter leases structured to the advantage of small operators. For example, leases could include options for a lessee to extend the agreement each year at rent levels specified at the commencement of the lease, as an alternative to multi-year terms.

A leasing model is advantageous in its simplicity and that similar public/private partnerships are relatively common. As a consequence, building support for the structure is relatively straight forward. For businesses, the capital investment in equipment or other assets can be financed by existing business lending products available in the marketplace. The model adds to a limited stock of space available at rates based on the acquisition cost of the property, rather than the highest rates the market will bear after accessibility is expanded by the light rail transit service.

A master lessor approach avoids concerns raised by some about the limited equity provisions required for ownership in a land trust model, as outlined in description of the "Nonprofit Commercial Land Trust" model below. The master lessor strategy creates a modestly priced venue for business owners to generate wealth through their business operations, but not through equity participation in the real estate itself.

Related Model: While not organized as a land trust, the Midtown Global Market in Minneapolis has since 2006 functioned as a master lessor of commercial space for small businesses in retail and food service. Partnering with a major developer and in tandem with anchor tenants Wells Fargo and Allina, the Neighborhood Development Center (NDC) has operated the market for more than five years, adjusting its tenant mix and financing structure in the process. By account of NDC leaders, the initial financing structure did not reach either the level of affordability envisioned, or the long-term stability of the cost structure for business operators, necessitating ongoing fundraising to achieve either goal.

Trust as Lessor

- Nonprofit acquires property, land into trust
- Nonprofit leases space to commercial users on stable-cost terms
- Supports wealth and job creation through long-term modest pricing
- Does not involve ownership or limited equity issues

Model: Nonprofit Commercial Land Trust

This inquiry initially focused on application of residential land trust strategies to the commercial sector, particularly in transit corridors expected to experience substantial property value appreciation and rising lease rates. Interviews and research conducted through this process support the value of creating a commercial land trust to provide an accessible way for business owners to remain and grow in transit corridors, and participate in the benefits of the property appreciation.

As in a residential land trust, a commercial land trust produces more affordable space through legal division of land and building on a given parcel. In a nonprofit model, a nonprofit organization would acquire the property and coordinate separation of the building into legal plats. The nonprofit then establishes leases of terms up to 99 years with business operators (or residents, if apartments form part of the building's program), under an agreement that grants ownership standing. Under the agreement, business owners purchase the space with a down payment and bank financing, secured by business property, equipment and potentially a personal guarantee. Over time, the business owner's equity accumulates due to repayment of principal and appreciation. The land trust agreement specifies limits on equity appreciation paid at sale of the space back to the land trust, providing a critical mechanism to protect affordability over the long term.

Benefits to the business owner include both predictable, stable rent expense, as well as the wealth creation associated with principal repayment and limited appreciation. As with the master lessor structure, a relatively low acquisition price or cost basis of the property could contribute to long-term benefit to land trust business owners in the form of predictable rent expense. Business owners are able to purchase just the space needed for operation in a land trust model, as opposed to a conventional acquisition which may require them to invest much more capital in a larger building that houses their business and others.

A nonprofit land trust model does carry drawbacks. More than in the residential environment, a commercial land trust may be subjected to criticism about fairness, criticism which arose during the project's interview phase. With finite space available, a transparent procedure for inviting interest and choosing land trust participants is critical. Also, the limits on equity that are fundamental to a land trust's long-term value prompted concerns in interviews, particularly within African-American and African immigrant communities.

Businesses investing in a commercial land trust also face not only the capital investment to build out space and grow, but also the capital required for down payment. Research and interviews indicate that education and persuasion would be required to move lenders toward making such real estate loans. The nonprofit choice to assist in financing of improvements to building and its suites could effectively cross-collateralize one business owner's space with others, compromising the structure over time.

Related Models: Exploration of commercial land trusts is occurring in multiple markets nationally. Most recently, formation of commercial land trusts (or expansion of existing land trusts into commercial operations) has included the Crescent City Community Land Trust in New Orleans and Japantown Community Land Trust in San Francisco. Exclusively commercial investment is a relatively new strategy for land trusts in the U.S., creating an opportunity for innovation within transit corridors in the Minneapolis Saint Paul region.

Model: Public Commercial Land Trust

A public commercial land trust would be designed and operated in a substantially similar way to the nonprofit commercial land trust. Under a public model, a municipality would acquire the land and building and establish a 99-year lease with a nonprofit entity for the building only, under terms designed to support the objective of expanding the inventory of affordable commercial space available in rising-demand corridors.

The more direct public role in this form of commercial land trust would provide an element of community control valuable to stakeholders in the business community and in neighborhoods. Municipal ownership would also allow the use of long-term, fixed-rate, taxable public debt (given the private purpose) to acquire the parcel, providing a stability for the nonprofit and business owners participating in the land trust.

Detractors will highlight the same objections to this model as to the nonprofit commercial land trust, described above. In addition, a direct public role in the ownership of such a land trust would likely prompt opposition, given that businesses participating in a land trust may be perceived as receiving unfair benefit in a competitive marketplace. However, the cities of Saint Paul and Minneapolis have long-standing demonstrated records both of recycling land and business development. A public commercial land trust would advance this agenda.

Related Models: While state law enables cities and economic development authorities to undertake the activities required to create a public commercial land trust, the project team is not aware of any such existing organizations.

Models: Other Structures

Communities across the country have produced innovative strategies to stimulate and support the Main Street retail and services businesses that have formed the focus of this project. While structures related to land trusts are the focus of this inquiry, three other approaches are aligned and merit mention.

Cooperatives are a business organization in existence for hundreds of years and leveraged for owners' mutual benefit. In the context of this study, business owners or employees could participate as members in a cooperative to acquire, build or rehabilitate a facility, agreeing to limit appreciation upon departure. Cooperatives are an area of substantial innovation currently: One example, the Evergreen Cooperatives of Cleveland, Ohio, include cooperatives in multiple industries, partnering employee owners with anchor institutions in education and health care to expand wealth creation opportunities. While promising, models such as Evergreen are beyond the scope of this project.

Community Corporations present a structure for business owners, employees or others to co-invest to accomplish an objective. A community corporation typically includes in its bylaws, provisions that direct satisfaction of key criteria such as geographic location of investments and residency of shareholders. One example is the Saranac Lake Community Store, a community-owned department store that opened in upstate New York in 2011, and modeled after Powell Mercantile of Powell, Wyoming. In each case, community members invested in real estate, equipment and inventory to advance locally owned retail.

Coworking has received much fanfare in Saint Paul and Minneapolis in recent years, with the highly successful launching of CoCo MSP, the Third Place, and Jelly. The premise of coworking is that individual members invest in and operate from a common work space, sharing overhead and more important – ideas and networks. The underlying concept reflects the commercial land trust strategy: Each is an effort to create affordable access to productive work space.

Key Issues

Detailed planning for any of these models will need to explore in depth operating issues. Research and interviews conducted during this project highlighted the following considerations for investors and policy makers.

It is critical to couple an affordable business operating space with technical assistance, training and mentorship. While substantial, rent and utilities typically comprise less than 25% of cost structure for small businesses operating on University Avenue. The value of the lease or land trust alternatives described here is in the stability of rent as well as its affordability. Demonstrated models show that partnering with businesses to provide technical assistance, mentoring, business planning, and coaching for negotiations with lenders are high-impact strategies to support small businesses.

Fully exploring the optimal mix of uses in a facility is key. The feasibility of combining a mix of housing, retail, office, or light industrial in a facility requires analysis of demands on utilities, peak hours, balancing of project cash flow, and how these uses can contribute to rather than detract from each other overall. Finally, evaluation of whether benefits of scale merit a focus on one industry – restaurants, for example – or whether diversification is a higher objective.

Operating rules are essential to define. In a residential land trust model, for example, eligibility requirements may allow members who earn up to a stated threshold of income. In a commercial land trust, it is key to establish what income or revenue test (or tests) is employed, and what is the consequence of a business succeeding and outgrowing this threshold. Tenant or owner improvements to space represent another consideration: Important to the longevity of a facility, improvements need to be financed and allocated by a consistent formula. Finally, operating rules must specify ongoing contributions to capital reserves, and provide for investment management of these accounts and a procedure for handling failure to fund the reserves.

Minnesota law was amended in 2005 to create a new, lower property tax class rate (“4d”) for qualifying low income land and buildings. A policy concept that arose during research and interviews centered on the establishment of a comparable class rate designation for real estate programmed for small business and entrepreneurial incubation.

Conclusion and Recommendation

A commercial land trust structure offers potential to retain business operating space on transit corridors, priced at rates that are stabilized over the long term. A decision to proceed with a demonstration project would, if pursued, demand a strategy specific to a parcel: Its cost, its building program and mix of uses, its best-suited users/owners. The substantial research conducted during this process clarifies that commercial application of land trusts is an innovative and high-potential opportunity to expand on past success in the provision of affordable home ownership. The project team recommends proceeding to implement a pilot nonprofit commercial land trust located on University Avenue, working with willing public, philanthropic and private partners.

Individuals Involved in Study Development

The project team for the study has included Jill Henrickson, Executive Director of the Greater Frogtown Community Development Corporation; Greg Finzell, Executive Director of the Rondo Community Land Trust; and Jon Commers, Principal of Donjek, Inc. The project team would like to acknowledge and thank the following individuals for their particular contributions to the research and analysis undertaken for this process: Suado Abdi, Stuart Alger, Josh Nussbaum, and Jason Teiken.

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Joyce Wisdom, Lake Street Business Association
Mychael Wright, Golden Thyme Coffee Shop

COMMERCIAL LAND TRUST PILOT ANALYSIS
Scenario: Nonprofit Land Trust as Master Lessor

Sources and Uses		Total	Per Ft
Sources			
	First Mortgage	100,000	17.70
	Funder Equity	522,402	92.46
	Total Sources	622,402	110.16
Uses			
	Acquisition of Land and Building	403,800	71.47
	Construction/Rehabilitation	141,250	25.00
	Construction/Rehabilitation Management	30,000	5.31
	Origination (1% of mortgage face)	1,000	0.18
	Soft Costs and Fees[1]	30,000	5.31
	Year 1 Deposit to Capital Reserves	16,352	2.89
	Total Uses	622,402	110.16

Assumptions		Total	Per Ft
Program			
	Commercial GSF	2,000	
	Residential GSF	3,000	
	Common Areas	650	
	Total Building GSF	5,650	
	Land Area	4,356	
Rent Levels			
	Gross Rent - Commercial		15
	Gross Rent - Residential		12
	Annual Rent Escalation	1.75%	
Property Value[4]			
	Value of Land at Acquisition	126,000	29
	Value of Building at Acquisition	277,800	49
	Value of Rehabilitation	141,250	25
	Total Estimated Market Value	545,050	96
Expenses			
	Operating Expenses[3]		4.50
	Management		2.50
	Average Expense Increase		2.00%
Finance and Tax			
	WACC on 20-Year Debt	5.50%	
	Annual Property Tax Escalation[2]	4.00%	
	Aggregate Property Tax Rate	125.00%	
	Annual Property Appreciation	2.00%	
	Long-Term Inflation Rate	2.00%	

Ten-Year Operating Proforma

	Year	1	2	3	4	5	6	7	8	9	10
Income											
	Commercial Rental Income	30,000	30,525	31,059	31,603	32,156	32,718	33,291	33,874	34,466	35,070
	Residential Rental Income	36,000	36,630	37,271	37,923	38,587	39,262	39,949	40,648	41,360	42,084
	Total Income	66,000	67,155	68,330	69,526	70,743	71,981	73,240	74,522	75,826	77,153
Expenses											
	Operating Expenses[3]	25,425	25,934	26,452	26,981	27,521	28,071	28,633	29,205	29,789	30,385
	Management	14,125	14,408	14,696	14,990	15,289	15,595	15,907	16,225	16,550	16,881
	Total Expenses	39,550	40,341	41,148	41,971	42,810	43,666	44,540	45,431	46,339	47,266
Operating Income		26,450	26,814	27,182	27,555	27,933	28,314	28,701	29,092	29,487	29,887
Debt Service											
	Principal Paid	2,755	2,906	3,066	3,235	3,413	3,600	3,798	4,007	4,228	4,460
	Interest Paid	5,500	5,348	5,189	5,020	4,842	4,654	4,456	4,248	4,027	3,795
	Total Debt Service	8,255	8,255	8,255	8,255	8,255	8,255	8,255	8,255	8,255	8,255
	Remaining Principal Balance	97,245	94,339	91,273	88,039	84,626	81,026	77,228	73,220	68,993	64,533
	Debt Service Coverage	3.204x	3.248x	3.293x	3.338x	3.384x	3.430x	3.477x	3.524x	3.572x	3.621x
Deposit to Capital Reserve		16,352	16,352	16,352	16,352	16,352	16,352	16,352	16,352	16,352	16,352
Property Taxes		12,689	13,196	13,724	14,273	14,844	15,438	16,055	16,698	17,365	18,060
Net Income		5,507	5,363	5,204	5,027	4,834	4,622	4,391	4,139	3,867	3,573
Equity + Principal Repaid		522,402	549,167.84	563,104	577,426	592,148	607,284	622,848	638,857	655,326	672,272

Commercial Affordability Analysis for 1,000 Square Feet of Space

	1	2	3	4	5	6	7	8	9	10
Gross Monthly Rent	1,250	1,272	1,294	1,317	1,340	1,363	1,387	1,411	1,436	1,461
In Current Dollars	1,250	1,247	1,244	1,241	1,238	1,235	1,232	1,229	1,226	1,223
Per Foot in Current Dollars	15.00	14.96	14.93	14.89	14.85	14.82	14.78	14.74	14.71	14.67

Notes

(1) Includes legal, design
(2) Schedule begins will full occupancy for demonstration purposes
(3) Electricity, water/sewer, HVAC, plumbing, snow and trash removal, insurance
(4) Represents Pay 2014 estimated market value

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COMMERCIAL LAND TRUST PILOT ANALYSIS
Scenario: Nonprofit Land Trust Co-Owned by Business Operators

Sources and Uses		Total	Per Ft
Sources			
	Funder Equity for Land and Rehabilitation[5]	343,602	60.81
	Business Owner Contributions	281,237	49.78
	Total Sources	624,838	110.59
Uses			
	Acquisition of Land and Building	403,800	71.47
	Construction/Rehabilitation	141,250	25.00
	Construction/Rehabilitation Management	30,000	5.31
	Origination (1% of mortgage face)	3,436	0.61
	Soft Costs and Fees[1]	30,000	5.31
	Year 1 Deposit to Capital Reserves	16,352	2.89
	Total Uses	624,838	110.59

Assumptions		Total	Per Ft
Program			
	Commercial GSF	5,000	
	Residential GSF	-	
	Common Areas	650	
	Total Building GSF	5,650	
	Land Area	4,356	
Ownership			
	Number of Commercial Units	5	
Property Value[4]			
	Value of Land at Acquisition	126,000	29
	Value of Building at Acquisition	277,800	49
	Value of Rehabilitation	141,250	25
	Total Estimated Market Value	545,050	96
Expenses			
	Operating Expenses[3]		4.50
	Management		2.50
	Average Expense Increase		2.00%
Finance and Tax			
	WACC on 20-Year Debt	5.50%	
	Annual Property Tax Escalation[2]	4.00%	
	Aggregate Property Tax Rate	125.00%	
	Annual Property Appreciation	2.00%	
	Long-Term Inflation Rate	2.00%	

Ten-Year Operating Proforma

		1	2	3	4	5	6	7	8	9	10
	Year	1	2	3	4	5	6	7	8	9	10
Property Owners' Payments											
	Per Unit										
	Total Debt Service	4,643	4,646	4,650	4,654	4,658	4,663	4,669	4,675	4,681	4,689
	Remaining Balance	54,698	53,060	51,328	49,497	47,561	45,513	43,348	41,057	38,634	36,070
	All Units										
	Total Debt Service	23,215	23,232	23,250	23,270	23,292	23,317	23,344	23,374	23,407	23,445
	Remaining Balance	273,489	265,299	256,641	247,485	237,805	227,567	216,740	205,287	193,171	180,351
Expenses											
	Operating Expenses[3]	25,425	25,934	26,452	26,981	27,521	28,071	28,633	29,205	29,789	30,385
	Management	14,125	14,408	14,696	14,990	15,289	15,595	15,907	16,225	16,550	16,881
	Total Expenses	39,550	40,341	41,148	41,971	42,810	43,666	44,540	45,431	46,339	47,266
Deposit to Capital Reserve		16,352	16,352	16,352	16,352	16,352	16,352	16,352	16,352	16,352	16,352
Property Taxes		12,689	13,196	13,724	14,273	14,844	15,438	16,055	16,698	17,365	18,060
Total Payments by Property Owners		91,805	93,121	94,474	95,866	97,298	98,772	100,290	101,853	103,463	105,122
Property Owner Principal Repaid											
	Per Unit	1,549	3,187	4,919	6,750	8,686	10,734	12,899	15,190	17,613	20,177
	All Units	7,747	15,937	24,596	33,751	43,432	53,669	64,497	75,950	88,066	100,886
Funder Equity		343,602	357,483	364,633	371,925	379,364	386,951	394,690	402,584	410,636	418,848

Commercial Affordability Analysis for 1,000 Square Feet of Space

Gross Monthly Costs	1,530	1,552	1,575	1,598	1,622	1,646	1,672	1,698	1,724	1,752
In Current Dollars	1,530	1,522	1,513	1,506	1,498	1,491	1,484	1,478	1,472	1,466
Per Foot in Current Dollars	18.36	18.26	18.16	18.07	17.98	17.89	17.81	17.73	17.66	17.59

Notes

(1) Includes legal, design
(2) Schedule begins will full occupancy for demonstration purposes
(3) Electricity, water/sewer, HVAC, plumbing, snow and trash removal, insurance shown as 30% of building total (common areas are 11%)
(4) Represents Pay 2014 estimated market value
(5) Includes land, rehabilitation cost and management, soft costs and Year 1 deposit to capital reserve

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