



THE USE OF MASTER DEVELOPERS: OUTSOURCING BASE REUSE

James R. Musbach and David W. Zehnder
Economic & Planning Systems, Inc.
Berkeley, California

Prepared for:
The National Association of Installation Developers (NAID)

August 10, 1999
Jacksonville, Florida



THE USE OF MASTER DEVELOPERS: OUTSOURCING BASE REUSE

OVERVIEW

As Local Redevelopment Authorities (LRAs) implement their Reuse Plans, many are discovering that the process often involves substantial complexity, risk, and public investment. As a result, it is critical that the LRA make judicious decisions regarding how to efficiently allocate resources to conduct development. One effective approach is to outsource major development tasks to private-sector master developers. This paper seeks to answer the following questions:

- When are LRAs best advised to outsource development?
- What should they aim to achieve by bringing in a developer?
- How can the LRA best structure the developer selection process?
- What are the key elements of the development and disposition agreement?

FINANCIAL EXPECTATIONS FOR BASE REUSE PROJECTS

Too often, it is assumed that reuse projects will generate substantial short-term sales and lease proceeds. In reality, these projects often take several years to generate positive cash flow, which may be more modest than expected when it does materialize. This is due to a myriad of factors, including the “cherry picking” of key assets by federal and other public agencies, the high cost of rehabilitation or demolition of military buildings, and backbone infrastructure that is unsuitable for reuse. In addition, jurisdictions often find that there are extensive costs associated with the operation and maintenance of utility systems, provision of public services, and the time required from a jurisdiction’s legal, planning, public works, and administrative staff.

PROJECT GOALS: WHAT TAKES PRIORITY?

Short-term financial returns typically are not the overriding objective of LRAs. If LRAs can create attractive and dynamic projects, create jobs, diversify the employment base, and bolster the tax base without requiring substantial infusions of public investment, this outcome is considered a success. To the extent that an LRA can accomplish these things and generate net cash flow for the larger community, all the better. Therefore, LRAs usually prioritize their goals and objectives to look beyond the maximization of net development proceeds. Priority goals may include:

1. **Convert obsolete facilities to a viable reuse project.** Military bases invariably have obsolete buildings and infrastructure that need to be rehabilitated or demolished and replaced. These preconditions make the execution of a Reuse Plan a complex and challenging process. Creation of a viable reuse project entails numerous activities, including demolition, site preparation, development of a regulatory framework, negotiation of land and building transactions, securing financing, providing public services, and maintaining land and capital.
2. **Stimulate the local economy.** Military base buildings and land can provide unprecedented opportunities to rural and urban LRAs through the provision of airports, air cargo facilities, hangars serving a diverse array of tenants, and land areas capable of accommodating large-scale, mixed use projects in urban infill locations. The net effect can be resurgence in the local economy through new and diverse jobs, an expansion of the housing stock, and associated economic effects.
3. **Improve community urban form.** Over the years, military bases have often created local districts that have distinctly different qualities than surrounding communities. A major challenge of any LRA is to weave these former bases back into the fabric of surrounding neighborhoods.
4. **Improve the local tax base.** The leasing of buildings, opportunities for new development, and spin-off effects in the local economy give many LRAs an opportunity to improve the local tax base to the benefit of the entire community.
5. **Create revenue sources to provide long-term benefit to local jurisdictions.** If a reuse and redevelopment plan is well conceived, supported by requisite market conditions, properly executed, and well negotiated so as to reward both public and private entities, it is likely that a community can derive a net financial gain from a former military base land asset, at least over the long term.

Achieving these goals requires a concerted blend of public and private-sector skills, as development is inherently a public/private process whenever a land asset is initially owned by a public entity. As discussed in the next section, LRAs must conduct a thoughtful assessment of their capabilities in determining the most appropriate outsourcing strategy.

OPTIONS FOR OUTSOURCING

Major development tasks can be divided between the LRA and private developers in a variety of ways. Options range from the LRA carrying out all master developer functions in-house, to turning over master development entirely to the private sector through a simple bulk sale disposition, with many alternative hybrids.

The role of the City in the master development process and the corresponding role of the private sector depend on the capabilities of the City, the complexity of the project, and the political context in which implementation will occur. Potential arrangements include:

- **In-house Development with Developer/ Consultant Input.** In this case, the LRA retains ownership and hires a private development company to provide advice. The developer functions as temporary staff and may earn a commission or flat fee, or some combination thereof. This relationship allows the City to retain control over the process as well as any revenues realized, but requires ongoing staff resources.
- **Contract Development.** Here, the LRA retains ownership of the land and hires a development company on a for-fee basis to carry out master development tasks. This allows the LRA to retain control over development as well as any upside financial returns realized. Financing would be secured with the assets of the LRA without developer equity.
- **Joint Venture.** This arrangement involves sharing of both responsibilities and revenues. Typically, the LRA contributes the land, and may or may not provide the backbone infrastructure. The developer takes on project management responsibility. Both parties secure the financing to which their status gives them access. A major advantage of this arrangement is the broader range of available financing sources. The LRA has the opportunity to share in development profits, but also assumes a degree of risk.
- **Bulk Disposition to Private Developer.** In this case, the LRA selects a private development company (or companies) through a competitive bidding process to purchase the entire property and redevelop it according to the adopted Reuse Plan. This is generally the simplest way for the LRA to acquire development expertise and minimize ongoing responsibilities. However, the City cedes some control over the redevelopment process and upside revenues it might otherwise receive.

THE LRA AS “EXECUTIVE DEVELOPER”

The division of responsibilities between the public and private sectors should be based on a careful assessment of the skills and financial tools each entity can provide to the reuse process. Generally, the public sector is good at providing land, entitlements, public services, and public financing. Additionally, it can manage developer selection and disposition processes. These functions can be categorized as “executive” level functions. If the agreement is well structured, the LRA retains ultimate oversight and control over the quality and character of development, while protecting the local jurisdiction from undue risk exposure and responsibility for development tasks it is ill-equipped to carry out.

Conversely, the private sector tends to be skilled at taking on risk in an uncertain environment, marshaling financial resources from the investment community, phasing demolition and infrastructure installation, and selling and/or building structures in a manner that is responsive to the real estate market.

In general, LRAs may be more successful in the role of executive developer, outsourcing day-to-day development tasks to a private master developer for the following reasons:

- Complex projects require seasoned experience in the day-to-day management of development. Implementation of a Reuse Plan requires skills in contract management, construction management, infrastructure planning, financing, asset maintenance, and marketing. Although expertise may be brought in-house by the recruitment of an experienced developer, this recruitment may involve substantial effort and expense.
- A complex political environment may argue for disposition to the private sector to insulate transaction and development decisions from the political process to some degree. Effective public involvement will, however, be important. The local community will likely be more willing to yield control of the redevelopment process if it has a clear understanding of the pros and cons of private-sector involvement, as well as the mechanisms available for ensuring accountability.
- Substantial financial resources are required to carry out successful redevelopment of a military base. Established private developers have access to the capital markets, including substantial existing lines of credit.

Regardless of the level of outsourcing, the LRA plays a critical role in the success of the project by providing: (1) regulatory guidance, including zoning and General Plan land use designations; (2) land and building assets; (3) low-cost financing; and (4) the ability to hold the land to enhance project feasibility. This last point relates to the ability of the LRA to be a "patient developer," as the organization, unlike private developers, has the ability to hold the land for long periods without incurring high holding costs. This ability to hold the land allows the LRA to pursue public policy and community development goals to a greater degree than could a private developer.

SELECTING A MASTER DEVELOPER

There is a five-step process for selecting a highly qualified developer for exclusive negotiations. These five steps include establishing initial economic parameters, settling on a solicitation approach, issuing the request for qualifications, structuring and issuing the request for proposals, and selecting a preferred developer from a short list of top candidates.

STEP 1: LRA ECONOMIC DUE DILIGENCE

An accurate assessment of regional market conditions and projected financial performance of a facility's land and building assets is critical to a successful developer selection and negotiation process. Some of this information will have been developed as a part of the Reuse Plan and the Business Plan supporting the EDC Application. Additional analysis should be focused on updating and augmenting baseline information, with specific emphasis on establishing a reasonable range for the residual land value of the base, supported by well-documented assumptions regarding infrastructure costs, land values, building lease projections, and other items.

By conducting detailed economic analysis at the outset, the LRA will have realistic expectations and be well informed if and when it seeks to delegate responsibilities; it will be better able to craft an acceptable financing and disposition package with the selected private developers and/or builders. Financial and economic due diligence will also help the LRA to determine whether the local jurisdiction can afford to provide public services, and whether offering access to tax-exempt financing and/or other financial resources is likely to be required to ensure project feasibility. It also will let the LRA know how much, in terms of price, amenities, and risk, it can realistically demand of interested developers.

STEP 2: DETERMINE SOLICITATION PROCESS

The competitive RFQ/RFP solicitation process offers a valuable opportunity to maximize the bid price and development quality and minimize public subsidy. Stating clear and specific requirements based on realistic expectations, establishing a consistent format for proposal submissions, providing input regarding expectations during pre-bid discussions, and evaluating past examples of candidate developers' work can all contribute to a high-quality pool of proposals.

For purposes of redeveloping a former military base into a vital part of the community, the RFQ/RFP approach is clearly superior to simply putting property on the market. In particular, by screening developers using pre-determined criteria, the LRA has a better chance of realizing development of consistent quality, which is responsive to the City's expressed goals and objectives. In fact, the direct sales approach is particularly ineffective where property has complicated constraints to development, as the City will likely receive a highly discounted price for the land due to the amount of risk a developer would be taking on. Alternatively, the initial offer may be dramatically reduced once the developer has conducted due diligence.

STEP 3: ISSUE THE RFQ

At this stage, the LRA should structure an RFQ and distribute the document to a list of candidate master developers, asking for qualifications relating to the following key attributes:

- Experience in managing and controlling large-scale land assets.
- Development experience associated with multiple land uses.
- Experience conducting master planning, developing design/use guidelines, and securing entitlements.
- The financial capability to absorb high front-end costs and to hold property over long periods of time.
- The capability to provide effective marketing, brokerage, and asset management services.
- Initial development concept.

Assuming the RFQ solicits interest in the project among a sufficient number of well-qualified developer teams, the LRA should review qualifications alongside its criteria and narrow the field to three or four teams. Depending on the level of in-house expertise, some LRAs may want to conduct the qualifications review with the assistance of consultants knowledgeable about base reuse and that have the capability to compare and evaluate financial information included within the qualifications packages.

STEP 4: ISSUE THE RFP

The RFP process should strive to secure as much agreement as possible on deal terms during the competitive process. To the degree possible, the RFP should seek to obtain developer commitment to a bid price and development and investment schedules prior to developer selection. This provides a more precise basis for evaluation and reduces the need for lengthy negotiations that may result in a deal less favorable than expected. Market conditions will affect how much burden can be imposed on candidates during the RFP process without limiting the pool of respondents.

Key Elements of a Successful RFP

At this stage, the LRA should have a thorough understanding of the underlying economic dynamics of the base reuse project and should include the following information in the RFP:

- land use and other regulatory constraints
- the status of current land improvements
- functions the LRA intends to perform
- current market expectations
- preliminary phasing concepts
- infrastructure costs

- available public financing
- LRA risk management parameters
- acceptable deviations from the Reuse Plan
- required public facilities

If a base is well located within a dynamic market area, the LRA may have the latitude to require developer due diligence (market, engineering, financial, and planning) as a part of the proposal. This approach was used successfully by the City of Orlando for the Orlando Naval Training Center. In other cases, this level of developer due diligence may need to wait until an exclusive negotiation agreement (ENA) is signed with the preferred developer team. In any case, the RFP should incorporate a schedule with regular check points by which the LRA can monitor progress and offer interim feedback.

Where possible or appropriate, the LRA should foster competition among short-list developers prior to the ENA. The LRA can summarize information received and judiciously provide general feedback to competing firms, without disclosing sensitive or proprietary information. Developers will therefore be cognizant of what their competitors are offering, which may have the effect of increasing their respective offers. The LRA can also use the expertise of bidders to bolster and reaffirm market assumptions, the LRA's planning approach, the optimal approach toward phasing the development of infrastructure and land, and methods of financing improvements. The information provided by short-list developers can thus raise the overall quality of the LRA's planning assumptions, which can be used to the benefit of both public and private parties during subsequent negotiations.

The RFP should establish a uniform response format, including categories of costs and revenues, and should specify desired public facilities and design features. As a result, developers' conceptual plans will mirror City requirements regarding required infrastructure improvements, land use densities and mix, and requirements for parks, schools, open space, and other amenities. This will help to limit unexpected adjustments to the net land value during negotiations with the preferred developer.

STEP 5: SELECT TOP-RANKED DEVELOPER FOR EXCLUSIVE NEGOTIATION

Key criteria for choosing the most appropriate candidate should be articulated in relation to specific goals of the City and the project. In general, important considerations include:

- **Responsiveness to Master Plan Goals.** It must be clear from the outset that the developer understands and is committed to the objectives of redevelopment. Whether these include strengthening of the tax base, development of a cohesive new neighborhood, or the creation of a vibrant community center, successful realization

of the reuse plan must begin with a firm understanding of these objectives and their incorporation in a developer's approach to the project. This is especially true if the developer will have flexibility in adapting the plan over time.

- **Effective Approach to Proposed Role.** The LRA may elect to have a private developer perform certain functions, such as infrastructure improvements and marketing, while retaining some functions in-house. The developer's proposed approach to working with the LRA in the specified role, and the method and magnitude of compensation for those functions, should be key selection criteria.
- **Financial Capacity.** The financial capacity of the developer and affiliated investors is a key criterion. This may be critical to their ability to carry the project forward through business cycle fluctuations.
- **Development Experience.** Overall, general management skills and the ability to raise financing and acquire entitlements are as important to success as physical construction and marketing. However, demonstrated experience with the specific land uses proposed in the reuse plan can also be an important selection criterion, particularly for affordable housing or town center commercial development, for example. In some cases, it may be advantageous for a development team to include partners with special expertise in certain types of development.
- **Public Involvement Skills.** The preferred developer must demonstrate the ability to work alongside and gain the trust of public-sector staff and the community. This will be critically important in maintaining support for the development in cases where special interests are opposing aspects of the plan.

NEGOTIATING WITH THE PREFERRED DEVELOPER

In general, a well-structured negotiation will clearly distinguish assumptions required for an objective assessment of market, cost, and financial characteristics from business terms. Parties should work to agree on assumptions as soon as possible (preferably during the RFP process) and focus the negotiation on business terms. Examples of assumptions include the improved value of land, inflation and discount rates, infrastructure and demolition costs, operations and maintenance costs, and public financing terms. These items should be resolved as an initial goal of negotiations.

Once these assumptions are identified, subsequent negotiations can focus on key business terms. These include such items as minimum prices, the take-down schedule, risk management provisions, requirements for public improvements, other performance requirements, the required return on investment used to define net development proceeds (if applicable), and the formulas for distributing development proceeds.

THE DEVELOPMENT & DISPOSITION AGREEMENT

Key agreement provisions to be negotiated with the selected master developer include:

Price Consideration

The negotiated value of the land is usually derived through a detailed analysis of residual land values, taking into account market assumptions and development costs. Unexpected changes in these assumptions can significantly affect the bottom line.

Where there is disagreement in these factors, alternative approaches may be used. One is to set minimum prices for the land and provide for upside participation (e.g., net proceeds exceeding an established developer rate of return) to the LRA, as is being done at the Fleet Industrial Supply Center in Alameda, California.

Depending on the breadth of activity to be undertaken by the private-sector master developer, there may be alternative methods of payment. For example, the master developer at Mather Air Force Base in Sacramento, California, receives an hourly fee for asset management, planning, and development management assistance; a commission for lease revenues, land sales, and building sales; and cost-reimbursement for their on-site property management and marketing office. Finally, price consideration may include a tiered compensation structure based on a percentage of gross or net proceeds to each pertinent party at specified points in the project.

Property Take Down Schedule

The developer must specify the rate, price, and other terms (such as subordination clauses) pertaining to the purchase schedule. The LRA can negotiate the inclusion of penalties or extension payments if the schedule is not adhered to, and they may want to stipulate the right to negotiate with another developer if conditions are violated. In some cases, coordination with the federal government is necessary to ensure that the parcel release schedule permits the developer's assumed development schedule.

Risk Management

The LRA and the developer must assess the risks inherent in the project. These include capital risk, business risk, and market risk. Subsequently, the question of how to allocate risk must be answered. In general, the LRA must ensure that public funds are not jeopardized by potential market downturns, cost overruns, unexpected construction problems, and delays in the property clean-up schedule. The transaction terms will necessarily reflect the risk/reward tradeoff appropriate to the LRA's role in the development.

Public Policy Objectives

The LRA must establish requirements for the provision of key public facilities and amenities, including but not limited to parks, schools, and open space. In addition, it is important to establish the status of in-tract roads (either dedicated to the City or

maintained as private assets), maximum development densities, and other considerations.

Other Provisions

There are a number of other standard provisions that are typically addressed in the DDA and worth mentioning here. Examples include:

- Performance standards. This can include the deadline for a refined development proposal, employment incentives, absorption targets, and other considerations.
- Parcel remediation and release schedule. Here, coordination with the federal government is necessary to ensure that the take-down schedule is synchronized with toxics remediation. In some cases, a section 334 early transfer may be called for.
- Thresholds for additional environmental review associated with changes to the Reuse Plan.
- Deed restrictions, including timetables for federal action if necessary.
- Covenants clearly specifying federal government responsibility for toxics remediation.
- Dispute resolution mechanisms.

CONCLUSION

The base reuse and other large scale urban infill projects that are moving forward across the nation represent remarkable opportunities to improve communities, to bolster the local tax base, to expand and diversify job markets, and to create sources of long-term revenue benefiting local jurisdictions. As LRAs move forward with the implementation of these projects, a strategic juncture is reached in the decision whether to conduct major development tasks in-house, versus outsourcing these tasks to a private-sector master developer. In many cases, where development challenges are substantial and in-house resources are limited, outsourcing can be an effective way to meet community goals in a cost effective manner. The LRA, as executive developer, can achieve the effective and expedient realization of the Reuse Plan through the careful crafting of the RFQ and the RFP, strategic handling of the selection process, and informed negotiation of business terms.