

PDC

PORTLAND DEVELOPMENT COMMISSION

DATE: May 27, 2009

TO: Board of Commissioners

FROM: Bruce A. Warner, Executive Director

SUBJECT: Report Number 09-65
Acquisition of Senior Loan from Albina Community Bank for the Heritage Building in the Oregon Convention Center Urban Renewal Area for \$1.836 Million

EXECUTIVE SUMMARY

BOARD ACTION REQUESTED

Adopt Resolution No. 6708

ACTION SUMMARY

This action will authorize the Executive Director to acquire a loan (Albina Loan) from Albina Community Bank (Albina) for \$1,836,375.54. The Albina Loan is secured by property at 3934 NE Martin Luther King, Jr. Blvd. (Property) and is senior to a loan made by the Portland Development Commission (PDC) to the building's owner, The Heritage Building, LLC (Developer), for redevelopment of the Property.

PDC's motivation in acquiring the Albina Loan is to further implementation of the Oregon Convention Center (OCC) Urban Renewal Area (URA) goals and allow PDC to protect its own investment in the Property in the event of another loan default or foreclosure proceeding. PDC's redevelopment objectives remain incomplete for the Property as the building is only fifty-six percent leased, and PDC holds \$76,387 in loan proceeds that could be used to fund tenant improvements for prospective tenants. Current economic conditions will make further lease-up more challenging.

Another default of the Heritage loans is possible within the next six to twelve months based on cash flow concerns, and PDC's acquisition of the senior debt will allow PDC to control the timing and method of any foreclosure action. The risk to recovering the Albina Loan in a near-term loan default or foreclosure proceeding is minimal, but a significant portion of the PDC Loan would probably not be recovered.

PDC and Albina have negotiated an Agreement to Transfer Loan and Preliminary Closing Instructions (Agreement) to effect the acquisition of the Albina Loan by PDC and expect to execute it by June 15, 2009. After execution of the Agreement the Developer will be obligated, under the Albina Loan, to pay \$2,049,116.15 plus interest to PDC rather than to Albina.

The most recent PDC Board of Commissioners (Board) action related to the Property occurred on July 9, 2008, when the Executive Director was authorized to bid on behalf of PDC to acquire the Property at a foreclosure sale (Resolution No. 6619). The Developer filed for Chapter 11 bankruptcy on July 21, 2008, one day prior to the scheduled foreclosure sale, which was then cancelled.

This action does not make further changes to the PDC Loan, and will not affect PDC's efforts to assist with locating tenants for the building.

PUBLIC BENEFIT

PDC's motivation in acquiring the Albina loan is to further implementation of the OCC URA goals and allow PDC to protect its own investment in the Property in the event of another loan default or foreclosure proceeding. Many of PDC's objectives for the Property were achieved when the building rehabilitation was initially completed in 2007 (see Background section). But until lease-up is complete and tenant improvements are finished, all urban renewal objectives will not have been achieved. In addition, there will be opportunities to support job creation in Northeast Portland and increase pedestrian activity on NE Martin Luther King, Jr. Blvd. through ground floor activation. To date, only about half of the ground floor is leased.

This action will support the following PDC goals:

- Sustainability and Social Equity
- Healthy Neighborhoods
- A Vibrant Central City
- Strong Economic Growth and Competitive Region
- Effective Stewardship over our Resources and Operations, and Employee Investment

PUBLIC PARTICIPATION AND FEEDBACK

The OCC Urban Renewal Advisory Committee and the Martin Luther King, Jr. Blvd. Advisory Committee have been advised of this proposed action to acquire the Albina Loan. The OCC Urban Renewal Advisory Committee voiced concern about the current FY 2008-2009 Budget Amendment for the loan acquisition, as it required a shifting of resources. Funding was reduced from FY 2008-2009 community economic development activities, FY 2009-2013 Development Opportunity Services program funding, and FY 2010-2011 Killingsworth Streetscape construction to release resources for the loan acquisition. As the Albina Loan is repaid, the program income can be used to restore funding in future budgets for these projects.

COMPLIANCE WITH ADOPTED PLANS AND POLICIES

Not Applicable

FINANCIAL IMPACT

The Fiscal Year 2008-09 Amended Budget for the OCC URA is adequate to cover the expenditure to acquire the Albina Loan. The current FY 2008-09 Amended Budget for the Heritage Building (project #25535) is \$2,087,759, and will be amended in a final budget amendment to fully cover projected expenditures of \$2,138,336 (as shown below). The amount available in Contingency can cover this budget increase of \$50,577 without impacting other OCC projects.

Total Projected Heritage Building Expenditures (FY 2008-09)

Legal fees and other costs incurred during the loan default period and for acquisition of the Albina Loan	\$14,201
PDC loan proceeds disbursed	211,372
Remaining PDC loan proceeds	76,387
Acquisition of Albina Loan	1,836,376
Total	\$2,138,336

The expenditure to acquire the Albina Loan is in addition to previous years' loan disbursements to the Borrower for redevelopment of the Property in the amount of \$2,162,241. Remaining PDC loan proceeds of \$76,387 will be used to fund tenant improvements at the Property.

Payments on the Albina Loan after PDC's acquisition have not been included in the OCC URA revenue budget (for FY 2008-09 or any future fiscal year). Adding the loan payment revenues will be considered for a future budget amendment and dependent on an analysis of the likelihood and timing of payments. According to terms in the First Modification to Debtor's Second Amended Plan of Reorganization (Reorg Plan), the Developer is obligated to make payments on the Albina Loan as follows:

- Interest-only payments for a twelve month period beginning February 1, 2009, at a rate of 6.50% per annum,
- Principal and interest payments of \$13,835.78 for forty-seven months beginning February 1, 2010, and
- A balloon payment of approximately \$1,903,099.42 due on January 1, 2014.

The Developer is current on loan payments through May 1, 2009, and Albina will represent in the Agreement that the loan is current as of the date of execution.

The Financial Summary for the OCC URA has been included as Attachment A.

RISK ASSESSMENT

PDC staff and legal counsel have reviewed the Albina Loan documents and bank files relating to the loan, and have sent estoppels to the Developer and current building tenants. This due diligence will ensure that no additional agreements (formal or informal) exist between Albina Bank and the Developer or between the Developer and the tenants, and that no disagreements exist between the parties.

Significant risk remains that there will be a default on the Albina and PDC loans again, because so much of the Property is unoccupied and the current economic downturn will make attracting new tenants challenging. While another default should not put recovery of the Albina Loan at risk, much of the subordinate PDC loan balance may be unpaid in a foreclosure action.

Likelihood of another loan default: PDC staff is concerned that there is a likelihood of default on the loans within the next six to twelve months because the cash flow from operations will barely cover debt service and other obligations. Until the building is more fully leased, the average monthly cash flow is very low, as shown below. The developer is actively seeking tenants for the building and managing expenses, to avoid another default.

Monthly rent (current tenants)	19,568
Average Expenses (2009 est by Developer)	(7,422)
Albina interest-only loan payments	<u>(11,312)</u>
Current estimated cash flow	834

The PDC Loan is scheduled to convert to permanent in July 2009, and interest-only monthly payments on PDC Loan Note A of \$3,625 could begin as soon as August 1, 2009. The Developer will also be obligated to fund reserves annually, and the monthly amount in 2009 will be \$2,242.

Current Tenant	Location	Sq Ft	Monthly Rent
Portland Community College	Basement	3,250	\$3,525
No Limit Martial Arts	Ground Floor	2,100	3,050
Golden Key Toys	Ground Floor	2,200	3,300
Yoga Mandiram	Second Floor	975	1,700
Research into Action	Second Floor	3,520	5,393
Community Cycling Center	Second Floor	<u>1,818</u>	<u>2,600</u>
Total occupied square feet		13,863	\$19,568
Vacant Space	Ground Floor	3,915	
Vacant Space	Second Floor	2,132	
Vacant Space	Third Floor	5,000	
Total square feet		24,910	

One tenant (No Limit Martial Arts) has vacated the space, although the business owner continues making lease payments. The Developer is actively working to re-lease the space, as well as the remaining vacant space.

Even after full lease-up, the cash flow after required debt service is not strong, and the Borrower is obligated to pay \$87,935 to unsecured creditors in 2009 and 2010 (two years after the Effective Date of the Reorg Plan).

Risk to outstanding loans in a default: The risk to recovering the Albina Loan amount in a default is minimized because Albina's lien on the Property is superior to all liens on the Property except for unpaid property taxes, and repayment of the Albina Loan is personally guaranteed by members of the Borrower (these guarantees will transfer to PDC as part of the acquisition). Additionally, an investor would probably pay at least \$1.8 million for the property, assuming a conservative 10% capitalization rate and lease rates of only \$12 per square foot (current tenants pay an average \$16.59 per square foot). These parameters for an investor price were estimated by a local broker familiar with the project.

There has been significant risk that the PDC loan balances would not be recoverable in a foreclosure sale following another loan default, which will be mitigated when PDC acquires the Albina Loan. As the senior lender, PDC can control the timing of the disposition of the Property to maximize the recovery of the PDC loans and the achievement of URA goals and objectives.

WORK LOAD IMPACT

Except for legal counsel, all work done can be handled by existing PDC staff. Albina has agreed to reimburse PDC for up to \$2,500 in legal fees incurred, and PDC expects to incur an additional \$7,500 in legal fees to acquire the Albina Loan. If PDC takes possession of the building following another loan default, outside services (for example, for leasing assistance) will be considered as part of the disposition plan.

ALTERNATIVE ACTIONS

If the proposed action is not approved and another event of default by the Developer occurs, PDC would have to expend an additional \$212,740 to protect its interest in the Property. In a foreclosure sale, the senior lender would set an opening bid for the Property at \$2,049,116 plus fees and costs, which is the amount due from the Developer and is \$212,740 more than the acquisition cost for the Albina Loan currently proposed. No foreclosure sale proceeds would be applied to the PDC loan until bids exceed the opening bid, and PDC would probably have to bid to maximize the final sale amount. Any bid by PDC effectively returns \$2,049,116 to the senior lender.

It is not expected that the proceeds from a foreclosure sale anytime in the near future would repay the total PDC loan. The most recent appraisal of the Property was dated March 17, 2008, and projected the stabilized value with full lease-up at \$4.78 million. If the Property could be sold for this amount, the Albina and PDC loans would be repaid in full. However, as has been noted previously, the building is not yet fully leased. Additionally, the Income Capitalization Approach was considered to be the best measure of the building value in the appraisal, and the capitalization rate of 6.5% that was used is now regarded to be very low.

CONCURRENCE

PDC's internal Loan Committee recommended on February 12, 2009, that the Board acquire the Albina Loan. Additionally, this opportunity has been discussed at several OCC URA team meetings and at several internal meetings between project staff and representatives from PDC's Finance and Legal departments.

BACKGROUND

The Disposition and Development Agreement (DDA) with The Heritage Building, LLC for the rehabilitation of property at 3934 NE Martin Luther King, Jr. Blvd. was approved by the Board on January 8, 2003 (Resolution No. 5964), amended three times by Resolution (Nos. 6079, 6199, and 6238) and modified twice by letter agreement; the last minor modification was approved by the Executive Director on August 30, 2005. The Loan Agreement between PDC and the Developer providing \$2.45 million for purchase and redevelopment of the Property was executed September 28, 2005. It is subordinate to a \$1.9 million senior loan from Albina

executed on the same date. (The current amount of both loans differs from the original face value because the principal has not been fully drawn and interest and costs were added during a loan default period.)

This project is located in the center of what was the most underdeveloped stretch of the NE Martin Luther King, Jr. Blvd. Corridor, and is a significant milestone in PDC's work to jumpstart revitalization and redevelopment at catalyst sites on the Corridor. The Developer has substantially renovated a dilapidated, vacant building, added two new stories to create a total of 24,910 net square feet of office and retail space, and was awarded LEED Gold certification.

The project has not progressed thus far without its share of challenges and delays. Construction completion was originally projected for September 30, 2006, and extended due to unexpected discoveries during construction. PDC issued a Certificate of Completion on September 24, 2007, which signaled the completion of the project redevelopment as well as the termination of obligations under the DDA. Total project costs have been projected to exceed the \$4.74 million budget by \$178,000, and will use the \$272,360 "lender hard cost contingency fund" in the project budget to cover increased construction costs. PDC and Albina both amended their loan agreements to extend the construction period and allow use of the contingency for increased construction costs.

Lease-up of the building has been slow, and the Developer attributes this to many factors:

- market challenges that are still prevalent on NE Martin Luther King, Jr. Blvd,
- the building cannot always be demised into the small spaces needed by many tenants, and
- tenants cannot always visualize the space with the improvements required to convert the raw space.

PDC staff notes that approximately 56% of the building has been leased (although one tenant space is currently vacant after failure of the business) and the Developer is acting as a commercial broker to lease the remaining space.

The Developer was unable meet the requirements of Albina's amended loan agreement to convert the construction loan to permanent by December 31, 2007, primarily because the Debt Service Coverage Ratio was not at least 1:00 to 1:00. (On December 31, 2007, there were only two tenants in the building and other prospects had not yet committed to lease space.) The Developer did not pay all principal and interest owing on the loan to prevent the commencement of foreclosure proceedings. The Developer was notified February 21, 2008, that Albina would sell the property on July 22, 2008, to satisfy the outstanding obligations. PDC issued its own notice of loan default to the Developer on April 11, 2008.

To forestall the foreclosure sale and retain control of the property, the Borrower filed Chapter 11 bankruptcy on July 21, 2008. The Borrower successfully negotiated payment terms to its creditors (including PDC and Albina) and the Reorg Plan was confirmed November 21, 2008, in US Bankruptcy Court and effective January 1, 2009.

ATTACHMENTS:

- A. URA Financial Summary
- B. Project Summary

URA FINANCIAL SUMMARY

Financial Summary

Fund Summary - Five-Year Budget Projections

	Revised FY 2008-09	Proposed FY 2009-10	Forecast FY 2010-11	Forecast FY 2011-12	Forecast FY 2012-13	Forecast FY 2013-14
Convention Center URA						
Resources						
Beginning Fund Balance	7,379,026	2,665,155	616,085	672,287	698,301	183,164
Cash Transfers In	642,259	0	0	0	0	0
Fees and Charges	2,500	0	0	0	0	0
Interest on Investments	125,000	160,000	110,000	61,000	50,000	0
Loan Collections	251,232	195,232	195,232	188,302	179,332	0
Miscellaneous	0	0	0	0	0	0
Property Income	1,050,000	126,000	4,000,000	0	0	0
Reimbursements	70,000	0	0	0	0	0
Tax Increment Proceeds	7,392,600	12,787,200	3,396,600	7,117,875	3,715,403	0
Total Resources	16,912,617	15,933,587	8,317,917	8,039,464	4,643,036	183,164
Requirements						
Program Expenditures						
Business & Industry						
Community Economic Development						
72030 Community Economic Development	150,000	250,000	250,000	300,000	350,000	0
General Business Assistance						
79020 Business Finance	900,000	1,000,000	550,000	250,000	300,000	0
79022 Business Retention	100,000	50,000	0	0	0	0
Target Industries						
79020 Business Finance	250,000	100,000	0	100,000	100,000	0
Business & Industry Total	1,400,000	1,400,000	800,000	650,000	750,000	0
Housing						
Multi-Family - For Sale						
19032 King/Parks Affordable Hsg	299,752	500,000	625,000	625,000	0	0
80003 Lloyd Cascadian Phase II	1,200	0	0	0	0	0
80010 Fremont Housing	140,000	0	0	0	0	0
80026 Grant Warehouse/Affordable Hsg	100,000	300,000	1,600,000	0	0	0
Multi-Family - Rental Housing						
80002 MFH - 2nd and Wasco	1,600	0	0	0	0	0
80042 OCC Miracles Club	1,400,000	2,085,000	0	0	0	0
80043 Rose Qtr Afford Rental Hsg	800,000	800,000	0	0	0	0
89030 Affordable Rental Housing	223,417	500,000	800,000	0	0	0
Plans and Strategies - Housing						
37921 Lloyd Hs Policy/Planning	3,800	0	0	0	0	0
Portland Housing Bureau						
28025 Administration	0	0	158,129	151,782	88,674	0
Housing Total	2,969,769	4,185,000	3,183,129	776,782	88,674	0
Infrastructure						
Transportation						
16230 Lloyd Trans Improv/Streetcar	100,000	0	0	0	0	0
16231 OCC Streetcar Planning	1,750,000	1,000,000	0	0	0	0
25525 MLK Jr Blvd Improvements	50,000	50,000	0	0	0	0
25537 MLK Jr Blvd Gateway Imprvmts	100,000	100,000	500,000	0	0	0
Infrastructure Total	2,000,000	1,150,000	500,000	0	0	0

Financial Summary

Fund Summary - Five-Year Budget Projections

	Revised FY 2008-09	Proposed FY 2009-10	Forecast FY 2010-11	Forecast FY 2011-12	Forecast FY 2012-13	Forecast FY 2013-14
Revitalization						
Community Outreach - Revitalization						
11601 Community Outreach	20,000	20,000	20,000	20,000	10,000	0
Plans and Strategies - Revitalization						
25607 MLK Jr Blvd Action Pln Implmnt	10,000	10,000	0	0	0	0
60041 Eastside Central City Plan	75,000	57,000	0	0	0	0
60042 N/NE Economic Dev Initiative	11,000	63,000	0	0	0	0
Redevelopment						
16237 HQ Hotel	1,900,000	4,000,000	500,000	0	0	0
25533 Vanport Redevelopment	20,000	15,000	0	0	0	0
25535 3934 NE MLK Renovation – Heritage Project	2,087,759	0	0	0	0	0
25536 3510 NE MLK Fremont Redevel	237,000	0	0	0	0	0
25605 MLK Jr Blvd Commercial SiteDev	30,000	50,000	0	0	0	0
25606 Lloyd Commerical Develop	20,000	10,000	0	0	0	0
25610 Bee Car Rental Redevelopment	7,000	7,000	7,000	0	0	0
25611 OCC Blk 47/49 Redevel	10,000	0	0	0	0	0
25612 King/Parks Commercial	0	0	700,000	0	0	0
25613 Rose Quarter Revitalization	0	35,000	0	3,500,000	1,900,000	0
27001 Storefront Grants	250,000	250,000	250,000	250,000	150,000	0
27050 DOS Grants	100,000	100,000	100,000	100,000	100,000	0
28030 Redevelopment Loan Projects	1,500,000	1,000,000	500,000	1,000,000	680,023	0
Revitalization Total	6,277,759	5,617,000	2,077,000	4,870,000	2,840,023	0
Administration						
Finance						
98001 Debt Management	24,717	25,953	27,250	28,613	30,044	0
Administration Total	24,717	25,953	27,250	28,613	30,044	0
Total Program Expenditures	12,672,245	12,377,953	6,587,379	6,325,395	3,708,741	0
Personal Services	957,696	886,759	267,604	256,861	150,063	0
Indirect Cost	2,517,521	2,052,788	790,647	758,908	443,368	0
Total Fund Expenditures	16,147,462	15,317,500	7,645,630	7,341,164	4,302,172	0
Contingency	765,155	616,087	672,287	698,300	340,864	183,164
Ending Fund Balance	0	0	0	0	0	0
Total Requirements	16,912,617	15,933,587	8,317,917	8,039,464	4,643,036	183,164

PROJECT SUMMARY

- Project Name:** Heritage Building
- Description:** This project is located in the center of the most underdeveloped stretch of the NE Martin Luther King, Jr. Blvd. Corridor, and is a significant milestone in PDC's work to jumpstart revitalization and redevelopment at catalyst sites on the Corridor. The Developer has substantially renovated a dilapidated, vacant building, added two new stories to create a total of 24,910 net square feet of office and retail space, and was awarded LEED Gold certification.
- Location:** 3934 NE Martin Luther King Jr. Blvd
- URA:** Oregon Convention Center
- Current Phase:** Construction has been completed and building lease-up is underway.
- Next Milestone:** Acquisition of the senior loan
- Outcome:** Substantial redevelopment of vacant and underutilized site in prominent location.

Site/Project Map:

