DATE: June 25, 2008

TO: Board of Commissioners

FROM: Bruce A. Warner, Executive Director

SUBJECT: Report Number 08-81
Approving Modifications to Terms of a Loan to The Heritage Building, LLC, for Redevelopment of 3934 NE Martin Luther King, Jr. Blvd in the Oregon Convention Center Urban Renewal Area

EXECUTIVE SUMMARY

BOARD ACTION REQUESTED

Adopt Resolution No. 6602

ACTION SUMMARY

The Portland Development Commission (PDC) and The Heritage Building, LLC (Developer) executed a Loan Agreement on September 29, 2005, for $2.45 million in funding (PDC Loan) for the purchase and redevelopment of property at 3934 NE Martin Luther King, Jr. Blvd. The lien securing repayment of the PDC Loan is subordinate to a $1.9 million senior loan from Albina Community Bank (Albina). This proposed action will authorize

- the modification of the terms of the PDC Loan to accommodate a replacement of the Albina senior debt with a loan to be provided by Bank of the West in the estimated principal amount of $2.1 million,
- the execution by the Executive Director of such documents as shall be necessary to implement the modification of the terms of the PDC Loan, and
- changes to the Developer ownership and management. Recently, the Developer elected a new Manager from among the members, and one member has offered to purchase the interest of another member (leaving five Developer members).

The existing Albina senior loan and the PDC Loan are currently both in default because the requirements were not met for conversion of the construction loans to permanent. While construction at The Heritage Building is complete, the lease-up has been slower than projected and is the major reason the loans did not convert. The Developer has secured a letter of interest (term sheet) from Bank of the West (BOTW) to obtain a loan from BOTW to repay the Albina senior debt, and thereby avoid losing control of the Heritage Building in a foreclosure sale (currently scheduled for July 22, 2008).

The BOTW term sheet requires PDC to subordinate its loan to the proposed BOTW senior loan, to modify payment terms and to reduce the amount of the PDC Loan that may be secured by the Heritage Building property. Amendment documents for the PDC Loan will be drafted after the Developer has met all of BOTW’s conditions to refinance the senior
debt. Documentation will be prepared and executed to modify the existing PDC Loan only if the senior debt refinancing occurs prior to the scheduled foreclosure sale, which may be extended or postponed at Albina’s discretion.

On May 8, 2008, the PDC Loan Review Committee (Loan Committee) recommended approval of the PDC Loan changes to the Executive Director and the Board of Commissioners (Board). The Board has previously approved requests for this project; most recently, the Board approved a third amendment to the Agreement for Disposition and Development of Property: 3934 NE Martin Luther King, Jr. Boulevard dated January 14, 2003 (DDA), between PDC and the Developer (Resolution 6238, May 11, 2005).

PUBLIC BENEFIT

The redevelopment of the Heritage Building has provided the following public benefits:

- The Heritage Building is a key component of PDC’s efforts to redevelop NE Martin Luther King, Jr. Blvd and is identified in the MLK Action Plan.

- The rehabilitation and expansion of building that has been vacant for decades has activated a key node on NE Martin Luther King, Jr. Blvd. The building was recently awarded Leadership in Energy and Environmental Design (LEED) Gold certification.

- Achievement of 31 percent construction employment of minority-owned, women-owned and emerging small businesses (M/W/ESB), exceeding PDC’s M/W/ESB utilization goal of 25 percent for the project. In addition, nearly 3,000 hours were worked by State of Oregon registered apprentices.

- Contribution to wealth creation for a development team that resides or owns property in North or Northeast Portland.

- Opportunities for jobs in approximately 25,000 sq. ft. of commercial space. Recently, leasing activity has significantly improved and current tenants include Research into Action, Portland Community College, Community Cycling Center, and No Limit Martial Arts. Golden Key Toys is expected to move into the Heritage Building in June or July 2008.

- Property tax revenue has been substantially increased to $26,403 in 2007, now that the Real Market Value has increased from less than $200,000 in 2004 to $2.65 million in 2007.

This action will support the following PDC goals:

- [✓] Develop healthy neighborhoods
- [ ] Provide access to quality housing
- [✓] Help businesses to create and sustain quality jobs
- [ ] Support a vibrant Central City (urban core)
- [✓] Contribute to a strong regional economy
PUBLIC PARTICIPATION AND FEEDBACK

Community stakeholders have been involved throughout the planning and redevelopment of the Heritage Building. Since the time of acquisition of the properties in 1999, staff has been regularly reporting to and updating the Martin Luther King, Jr. Blvd. Advisory Committee, the Fremont/MLK Vision Committee, and the King Neighborhood Association. A selection committee made up of community stakeholders reviewed the Request for Proposals and recommended a development team for the project.

Since completion of construction, stakeholders have been kept up-to-date on leasing progress through monthly project updates to the Martin Luther King, Jr. Blvd. Advisory Committee, as well as postings on the PDC website and the quarterly Oregon Convention Center (OCC) Urban Renewal Area (URA) Newsletter.

This action to modify the PDC Loan has not, specifically, been discussed with stakeholders due to the fact that

- the Developer’s negotiations to find a replacement senior lender have to date been confidential,
- there are no additional resources being requested for the project from the OCC URA budget, and
- the impact of changing the PDC Loan will be immaterial to the OCC financial resources.

However, the stakeholders have been supportive of the project overall.

COMPLIANCE WITH ADOPTED PLANS AND POLICIES

The redevelopment of the Heritage Building supports the following goals:

   - Target jobs and businesses created with URA financed activities to first benefit North and Northeast Portland residents (Goal 2)
   - Upgrade the setting and environment of the area to reflect the best of Portland to visitors (Goal 5)
   - Ensure that urban renewal activities work to stabilize adjacent neighborhoods; mitigating adverse impacts and striving to strengthen neighborhood values (Goal 6)

   - Focus new development at locations along transportation corridors that offer opportunities for transit supportive developments and foster good environments for pedestrians (Policy I.E)
   - Recruit, retain and encourage expansion of economic activities and institutions which enhance neighborhood livability. Conserve community assets and resources. Encourage more efficient design and utilization in commercial, institutional and industrial centers (Policy III.B)
   - Protect rich historic, cultural and architectural heritage (Policy III.B)
   • *Facilitate commercial, mixed-use development (Strategy 4)*
     Ensure the implementation of four commercial and mixed-use projects at key nodes along MLK Blvd. – Fremont, Beech, Heritage, and Vanport – by executing development agreements and transferring land (Action Item 1)

4. PDC Strategic Plan Key Actions (2007)
   • *Revitalize blighted areas through strategic partnerships and property acquisitions (Strategy 1).*
     One of PDC’s core missions is to facilitate the redevelopment of under-utilized or contaminated land. This is accomplished by removing barriers and facilitating partnerships. The redevelopment partnership between the Developer and PDC provides an opportunity to redevelop vacant and underutilized property at a key location.

   • *Invest to grow Portland’s future revenue base (Strategy 4).*
     Improved property values and the development of other taxable assets results in revenues that support Portland’s educational, health, safety, social and recreational services. This redevelopment proposal will replace vacant and underutilized property with greater, denser development, resulting in a great increase in taxable assets.

   The Developer has exceeded the goals of PDC’s Green Building Policy and Business Equity and Workforce Equity Programs. The Developer has agreed to make a good faith effort to hire and procure from the local community for services and contracting opportunities.

**FINANCIAL IMPACT**

The BOTW term sheet requires that PDC subordinate to the new proposed BOTW loan and that no principal payments be permitted to be made on the PDC Loan for five years. In addition, the amount of the BOTW loan is based on calculations of Loan to Value limits and Debt Service Coverage Ratio (DSCR) requirements, which will also affect terms of the PDC Loan. The PDC Loan consists of two notes (Note A and Note B), and the proposed changes to accommodate BOTW’s requirements are as follows:

• **Note A** currently provides for one year of deferred or interest-only payments (depending on when a DSCR threshold is met) followed by principal and interest payments. PDC staff is proposing to allow a five-year deferral of principal and interest payments followed by principal and interest payments. This will be accompanied by a change to the existing Excess Cash Flow Payment agreement currently contained in Promissory Note B that is expected to generate more Excess Cash Flow sooner than had been projected.

These changes to Note A will accommodate BOTW’s requirement that no principal payments will be allowed on the PDC Loan during the first five years, and provides an alternative for the additional lease-up required to cover Note A interest payments in the first five years.
• **Note B** currently provides for five years of deferred payments, followed by five years of interest-only payments and then by principal and interest payments, and no changes to the payment terms are required to accommodate the BOTW term sheet.

However, up to $487,000 of Note B cannot be secured by the Heritage Building, to comply with BOTW’s requirement that the total of all loans collateralized by the Building may not exceed 85% of its appraised value. A recent appraisal (as of March 10, 2008) estimated the stabilized value of the building at $4.78 million; if the Developer borrows $2.1 million from BOTW, only $1.963 million of the PDC Loan could be secured by the Heritage Building and the remaining $487,000 will be secured by other property controlled by two members of the Developer.

• **The PDC Loan will convert to a permanent loan** at the time that the BOTW loan closes, which requires an extension of the construction period that had expired on December 31, 2007. PDC expects that the BOTW loan will close in July 2008, prior to the foreclosure sale date, which may be extended or postponed by Albina.

A comparison of the terms for Notes A and B as currently approved and with the requested changes has been included as Exhibit A of the Resolution.

PDC staff makes the following additional recommendations in connection with PDC’s agreement to modify PDC’s loan terms:

• **PDC will subordinate its loan to a BOTW loan of up to $2.1M**, provided that the entire BOTW loan amount is used solely to refinance the Albina loan balance, accrued interest and other costs incurred by Albina, and reasonable fees and closing costs incurred by BOTW.

The Developer has requested that the portion of the $2.1 million BOTW loan funds not needed to refinance the Albina loan and pay BOTW fees and costs (estimated at $95,000) may be used to fund the cost of tenant improvements and brokers’ commissions during lease-up of the Building. PDC has agreed, so long as the Developer has first exhausted funds from operations of the Building.

• **The BOTW loan must close prior to a foreclosure sale by Albina**, currently scheduled for July 22, 2008, but which Albina may agree to extend or postpone.

• **No additional funding from PDC** beyond the current loan amount shall be necessary to close the BOTW loan or refinance the Albina loan.

In addition, PDC has agreed to allow the Developer to make a partial contribution to operating reserves in 2008, in an amount to be determined by the date of the conversion of the loan to permanent. The annual reserve contributions are defined in the Operating and Combined Reserve Agreement, executed September 28, 2005, by PDC, the Developer and Albina.

PDC will have no out of pocket expenses for the Heritage Building beyond the amounts that have previously been approved. The $2.45 million in loan proceeds has not been fully disbursed; $287,759 remains to fund primarily tenant improvements and broker’s commissions during the ongoing building lease-up. The loan funds are projected to be
disbursed in FY 2008-09. Currently, the loan disbursements are included in the Revised FY 2007-08 Budget, but will be corrected in a future budget revision.

The Resources in the OCC Proposed FY 2008-09 Budget and Forecast do not include loan payments from the Developer, and there will be no budget impact resulting from a deferral of loan payments as proposed for Note A of the loan.

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

**RISK ASSESSMENT**

If this proposed action is approved, there is a risk that the Developer will be unable to meet all BOTW requirements in advance of Albina’s scheduled foreclosure sale. If requirements for the BOTW loan cannot be met, PDC would have to consider the other options described below in the Alternative Actions section. The Developer is highly motivated to retain control of the building, however, and is working hard to replace the Albina senior loan and negotiate modifications to the PDC Loan.

The requirements from BOTW have been largely met, with the exception of building lease-up to meet DSCR requirements for a $2.1 million loan. Leasing activity has increased significantly of late, and four tenants occupy the building currently and another will move in during June or July 2008. However, one or more tenants providing approximately $7,000 in additional monthly lease revenue is required in order for Developer to meet the DSCR requirements to obtain a BOTW loan in the principal amount of $2.1 million.

To mitigate the remaining risk, the Developer has renewed the leasing agent's contract until August 1, 2008, and has made a formal request to Albina for an extension of the foreclosure sale date. PDC supports an extension of the foreclosure sale date, in light of the real possibility that the loan defaults can be remedied with the BOTW refinance and PDC Loan changes.

**WORK LOAD IMPACT**

All work done on the PDC Loan can be handled by existing PDC staff.

**ALTERNATIVE ACTIONS**

Staff have considered other options besides subordination to the proposed BOTW loan and determined that the proposed action is the best alternative to the Heritage Building default.

Other options considered include the following:

- **PDC takes no action, and allows Albina Bank to foreclose its lien** and sell the property. PDC could expect little from the proceeds to apply to PDC’s outstanding loan balance of approximately $2.2 million. Also, taking no action could be perceived by the community as a setback to the positive momentum that has built on NE Martin Luther King, Jr. Blvd.
• **Prior to the foreclosure sale, PDC purchases the Albina loan.** PDC would step into Albina’s shoes and obtain all of their rights and remedies in foreclosing on the property. Albina has indicated that the payoff amount would be the outstanding loan balance plus other fees (currently expected to be approximately $2 million).
  - If Tax Increment resources (TIF) were used to pay the Albina loan, PDC would have to purchase the Albina loan, foreclose on the lien securing that loan and take ownership of the underlying property. [Note: TIF may be applied to purchase debt secured by property if PDC takes ownership of such property. TIF cannot be used to pay off debt of a third party.]
  - If non-TIF resources without ORS 457 restrictions were available to pay the Albina loan on behalf of the Developer, PDC could leave the Developer in control of the property.

No resources are currently budgeted to pay off the Albina loan, and other projects or programs would need to be eliminated if PDC resources were to be made available.

• **PDC bids for the property at the foreclosure sale.** PDC’s bid would cover the Albina loan balance plus other fees and the outstanding balance of PDC’s loan, approximately $4.2 million in total.
  - If PDC wins the bid, PDC could choose to lease up the remaining space and later sell the property, or to convert the building to commercial condominiums. The financial risk for either action is high, and requires a significant outlay of PDC financial resources and effort before sale proceeds could be realized. Other projects or programs would need to be delayed to make PDC resources available for the bid, and those projects or program activities could only be resumed when the sales proceeds are later available.
  - If PDC does not win the bid because another party bids in excess of $4.2 million for the property, PDC would recover its outstanding loan balance but would not control the property. Additionally, the existing businesses could be displaced by the new owner.

**CONCURRENCE**

The Developer supports all proposed modifications to the PDC Loan and other recommendations made by staff.

The Loan Committee considered the PDC Loan changes on May 8, 2008, and recommended that the Board approve the changes to Notes A and B.

This project 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

History and Context

The 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 5964) and amended three times by Resolution (Numbers 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 was executed September 29, 2005, to fund the purchase and redevelopment, and is subordinate to a $1.9 million senior loan from Albina.

This project, which substantially renovated a dilapidated, vacant building and added two new stories to create a total of 16,695 net square feet of office space and 8,215 net square feet of ground floor retail and commercial space, is located in the center of the most underdeveloped stretch of the NE Martin Luther King, Jr. Blvd. Corridor. The $4.74 million budget was funded with a $1.9 million Albina senior loan, a $2.45 million PDC Loan and $390,000 in contributed developer fees and expenses.

Construction completion by the development team is a significant milestone in PDC’s work to jumpstart revitalization and redevelopment at catalyst sites along NE Martin Luther King, Jr. Blvd. The project, however, has not been accomplished without its share of challenges and delays. Construction completion was extended due to unexpected discoveries during construction, many based on the fact the project was a rehabilitation of an old, damaged building, rather than new construction. The developers were forced to use up a significant portion of the project’s hard cost contingency early on, and total costs are 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. The largest variances between the original budget and current forecasted costs are the additional hard costs during construction and the additional tenant improvements necessary for building lease-up. The Developer has contributed their remaining cash Developer Fee of $67,614 and agreed to contribute additional cash equity to cover the remaining shortfall.

In addition to increased construction costs, lease-up of the building has been slower than expected, though interest in the building has picked up substantially in recent months. Slow lease-up is in part due to the market challenges still prevalent on NE Martin Luther King, Jr. Blvd, and in part due to higher lease rates necessitated by current construction costs. Approximately 50% of the building has been leased. The Developer expects that the building will be fully leased by the fourth quarter of 2008.

PDC amended its Loan Agreement on September 19, 2007, to approve the use of the $272,360 “lender hard cost contingency fund” for increased construction costs and extend the construction period of the PDC Loan from March 31, 2007, to December 31, 2007. On October 19, 2007, the Developer and Albina executed Amendment No. 1 To That Certain Addendum to Construction and Business Loan Agreements (Albina Amendment), which extended the construction period for the Albina loan until December 31, 2007. Albina added additional provisions in the Albina Amendment, including hiring a real estate broker and adding a DSCR requirement of at least 1:00 to 1:00 as a condition for conversion to a permanent loan.
The Developer failed to satisfy all of the Conversion Conditions of the Albina loan by December 31, 2007, and the primary Conversion Condition which was not satisfied was the Debt Service Coverage Ratio of at least 1:00 to 1:00. (At 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 intends to 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.

ATTACHMENTS:
   A. OCC URA Financial Summary
   B. Project Summary

CC: L. Bowers, Interim Development Department Director
    F. Wearn, Senior Development Manager
    S. King, Development Manager
    D. Elott, Interim General Counsel
    J. Jackley, Executive Operations Manager
## Financial Summary

### Fund Summary - Five-Year Budget Projections

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<td><strong>Convention Center URA</strong></td>
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<td>Beginning Fund Balance</td>
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<td>Loans - Interest Earned</td>
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<td>97,818</td>
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<td>Loans - Principal Collection</td>
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### Requirements

**Project Expenditures (does not include Personal Services or Indirect Cost)**

#### Development

- **16212 - OCC Community Outreach**: 20,000, 20,000, 20,000, 20,000, 20,000, 20,000, 10,000
- **16217 - Lloyd Area Planning**: 20,000, 0, 0, 0, 0, 0, 0
- **16239 - Lloyd Trans Improve/Streets**: 100,000, 0, 0, 0, 0, 0, 0
- **16231 - OCC Streetscar Construction**: 1,500,000, 1,700,000, 1,500,000, 0, 0, 0, 0
- **16237 - HQ Hotel**: 200,000, 41,000, 0, 0, 0, 0, 0
- **16241 - OCCURA DOD Program**: 153,450, 125,000, 125,000, 125,000, 125,000, 125,000, 125,000
- **26555 - MLK Jr Blvd Improvements**: 506,000, 50,000, 0, 0, 0, 0, 0
- **26553 - Vanport Redevelopment**: 330,000, 0, 0, 0, 0, 0, 0
- **26556 - 3304 NE MLK Renovation**: 453,103, 0, 0, 0, 0, 0, 0
- **26537 - SE10 NE MLK Fremont Redevelopment**: 237,117, 0, 0, 0, 0, 0, 0
- **26957 - MLK Jr Blvd Gateway Improvments**: 130,000, 160,000, 500,000, 0, 0, 0, 0
- **26956 - MLK Jr Blvd Commercial Sites Development**: 50,000, 5,000, 0, 0, 0, 0, 0
- **26935 - Lloyd Commercial Developer**: 40,000, 10,000, 10,000, 0, 0, 0, 0
- **26937 - MLK Jr Blvd Action Plan Development**: 26,000, 10,000, 10,000, 10,000, 10,000, 10,000, 10,000
- **26938 - OCC Redevelopment Loan Program**: 642,868, 700,000, 3,000,000, 1,090,000, 0, 0, 0
- **26941 - Sale Car Rental Redevelopment**: 7,000, 7,000, 0, 0, 0, 0, 0
- **26911 - OCC Bldg 4749 Redevelopment**: 0, 300,000, 0, 0, 0, 0, 0

**Development Total**: 4,773,338, 7,237,000, 3,865,000, 1,155,800, 155,000, 145,000

#### Economic Development

- **25521 - OCC Storefront Grants**: 438,462, 250,000, 250,000, 250,000, 250,000, 250,000, 250,000
- **70010 - OCC Business Finance**: 2,300,000, 1,000,000, 1,000,000, 500,000, 250,000, 250,000
- **70241 - OCC Business Retention**: 117,268, 100,000, 100,000, 100,000, 50,000, 50,000
- **70290 - OCC Business Development**: 500,000, 0, 0, 0, 0, 0, 0
- **70501 - OCC Community Equity Development**: 0, 500,000, 500,000, 500,000, 500,000, 500,000, 500,000
- **70751 - OCC Target Industry Development**: 0, 100,000, 100,000, 100,000, 100,000, 100,000

**Economic Development Total**: 3,355,780, 1,520,000, 1,520,000, 1,450,000, 1,150,000, 1,150,000

#### Housing

- **16032 - Piedmont Place/Affordable Hsg**: 1,583,050, 350,000, 0, 0, 0, 0, 0
- **25203 - North OCC Housing**: 11,077, 0, 0, 0, 0, 0, 0
- **37021 - Lloyd Ha Policy/Planning**: 10,000, 5,000, 0, 0, 0, 0, 0
- **36002 - MFP - 2nd and Wasco**: 1,800, 0, 0, 0, 0, 0, 0
- **36003 - Lloyd Cascade Financial Planning**: 1,100, 0, 0, 0, 0, 0, 0
- **36036 - MFP Lloyd Opportunities**: 176,980, 0, 0, 0, 0, 0, 0
- **36077 - OCC Affordable Rental Housing**: 1,060,023, 0, 0, 2,000,000, 100,000, 0
- **80100 - Fremont Housing**: 140,000, 0, 0, 0, 0, 0
- **80236 - Grant Warehouse/Affordable Hsg**: 2,100,000, 0, 0, 0, 0, 0
- **80289 - Affordable Homeownership**: 950,000, 0, 0, 0, 0, 0

*Economic Development Total*
## Financial Summary

### Fund Summary - Five-Year Budget Projections

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<td><strong>Convention Center URA</strong></td>
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<td>00012 - Miroslo Club</td>
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<td>Central Services Total</td>
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<td>25,953</td>
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<td>Executive</td>
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<td>00039 - OCC Eastside/Central City Plan</td>
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<tr>
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<td><strong>Total Project Expenditures</strong></td>
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<td>11,166,717</td>
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<td>3,302,055</td>
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<td>1,396,121</td>
<td>593,167</td>
<td>339,170</td>
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<td>Total Fund Expenditures</td>
<td>17,183,410</td>
<td>14,468,772</td>
<td>9,372,915</td>
<td>6,228,401</td>
<td>2,826,780</td>
<td>1,664,814</td>
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<td>Contingency</td>
<td>545,535</td>
<td>500,121</td>
<td>37,230</td>
<td>14,930</td>
<td>3,764</td>
<td>428</td>
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<tr>
<td>Ending Fund Balance</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td><strong>Total Requirements</strong></td>
<td>18,733,945</td>
<td>14,969,893</td>
<td>9,401,745</td>
<td>5,963,341</td>
<td>2,840,544</td>
<td>1,664,842</td>
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</table>
PROJECT SUMMARY

Project Name: Heritage Building

Description: The Developer renovated a dilapidated, vacant building and added two new stories to create a total of 20,551 square feet of office and 9,000 square feet of retail and commercial space. The property is located in the center of the most underdeveloped stretch of the NE Martin Luther King, Jr. Blvd Corridor.

Location: Blocks 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: Conversion of construction loans to permanent

Completion Target: Prior to July 22, 2008, unless this foreclosure sale date is extended or postponed.

Outcome: Substantial redevelopment of vacant and underutilized site in prominent location.

Site/Project Map: