STATE UNIVERSITY SYSTEM OF FLORIDA
BOARD OF GOVERNORS
Project Summary
University of South Florida
USF Student Village Public-Private Partnership Project

Project Description:

The proposed student village project (the "Project") consists of a 525,000 square-foot student housing facility with 2,165 beds (1,039 replacement and 1,125 new), parking and dining facilities, a fitness center and pool, and retail space comprising approximately 53,000 square feet.

The Project will be owned by HSRE-Capstone Tampa, LLC (the "Owner"), a joint venture between Harrison Street Investor Corporate Member and Capstone Development Partners, LLC. ***The University of South Florida ("USF" or "University") will enter into a 51-year Ground Sub-Lease with the Owner to design, construct, finance, and maintain the Project on the USF campus.*** The Ground Sub-Lease is subject to the approval of Board of Trustees for the Internal Improvement Trust Fund, which holds title to the property on behalf of the State of Florida. USF has a 99-year lease for the property, which expires in 2073. ***USF will enter into a separate Management Agreement with the Owner whereby USF will operate and perform custodial maintenance of the Project while the Owner retains responsibility for major repair and replacement costs.*** The Project is included in the campus master plan and supports USF's institutional philosophy that living on-campus supports student success. ***USF will rescind its current on-campus residency requirement prior to completion of the Project.***

The Owner will demolish the existing Andros complex and its adjacent support buildings to construct a village-style complex with multiple residential buildings, parking and dining facilities, a fitness center and pool, and retail space with landscape architecture elements and outdoor gathering spaces. To support the new complex, USF will construct 650 surface parking spaces, which will be added to the existing parking system for use by any student with a residential decal. USF will receive $2,275,000 from proceeds of the Project's financing toward the cost of the parking spaces. However, USF will contract with the Owner to operate the Project under a Management Agreement that overlaps the term of the Ground Sub-Lease. USF will receive reimbursement for operational costs of $1,300 per bed and

reimbursement of custodial maintenance of $4.08 per gross square foot.

Upon substantial completion, USF will be given the right to possess and occupy the dining facility and the fitness center. USF's Campus Recreation Department will operate the fitness center with revenues from existing student fees and user charges. USF's food service vendor will operate the dining facility. The Owner is required to make payments to a repair and replacement account for capital maintenance of these facilities which will total about $14 million over the life of the lease or $3.5 million on a net present value basis. The Owner will own, lease and maintain the retail spaces, with USF having the right to refuse a retail tenant (primarily to ensure no competition arises and voids existing University contracts).

Project Site Location: The Project will be located on the site of the existing Andros student housing complex on USF's main campus in Tampa.

Projected Start and Completion Date: Demolition and construction will commence in May 2016 with completion scheduled for Fall 2017. If the Project fails to open on schedule, the Owner must provide temporary housing, storage, and transportation costs for residents until completion of the Project. The lease allows the Owner to recover some of the cost of these expenses from rent payments if the temporary housing is of a similar quality as evaluated by USF and is located within one mile of the Project. As a result, ***completion risk is not fully transferred to the Owner if temporary housing costs are recoverable from student housing charges.***

Project Cost: ***The total Project cost is estimated at $132.7 million***, including construction and hard costs of approximately $113.3 million. Of the $113.3 million in construction costs, the University indicates the additional amenities (parking and dining facilities, a fitness center and pool, and retail space) is about $14.7 million indicating about $98.6 million is for construction of the housing facility. Other Project costs include planning, equipment and other estimated soft costs of $7.0 million, financing and legal costs of $3.4 million (including $2.3 million for construction loan interest), contingency costs of $4.6 million, and a developer fee and overhead of $4.35 million (3.28% of the total cost). The Project will not generate revenues during

construction therefore it's reasonable to include the $2.3 million in the permanent financing despite the fact it increases the loan amount when executed. The total cost per bed is approximately $61,293.

(See estimated Sources and Uses of funds.)

P3 Justification:

USF chose a public-private partnership ("P3") to construct, finance, and maintain the Project. ***USF has indicated that three primary benefits of the P3 structure are 1) accelerated delivery; 2) reduced credit rating exposure; and 3) transfer of risk to the Owner for construction, operation, and demand.*** Each of these is described in more detail as follows:

USF evaluated one financial alternative that involved the existing housing system issuing the entire amount of debt ($132 million) in one issue. Under this approach, USF asserts it would take eight years to deliver the Project as the existing housing system lacks sufficient debt capacity to finance the Project as proposed. ***The University did not consider a phased approach to replacing and financing student housing using tax-exempt debt secured by its existing housing system.***

The University supports this statement through an analysis of the existing housing system's capacity to issue the debt and maintain annual debt service coverage of approximately 1.25x. A pro forma coverage table of the existing USF housing system shows debt service coverage of 0.90x in 2017-2018 for the first full year of operation of the Project below the BOG Debt Management Guidelines requirement of 1.20x.

USF Debt Service Coverage Ratios	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23	FY 24
Financing Entire Project ($133M)	1.42x	1.51x	1.47x	0.90x	1.06x	1.15x	1.19x	1.22x	1.26x	1.28x
Tampa After Andros Removal	1.42x	1.30x	1.23x	1.26x	1.26x	1.40x	1.46x	1.50x	1.55x	1.59x

In addition, USF indicates cash available in the housing system net of debt service reserves is about $27,000,000 (at June 30, 2015), which is insufficient to maintain current housing stock (deferred maintenance, required housing reserves, etc.) and provide cash to offset costs of the Project.

In order to finance the Project through the existing housing system in one debt issue, USF would need to reduce the scope of the Project or contribute cash to fund a portion of the Project. However, as an alternative, it may be feasible for the University to finance

construction of additional housing in phases as the housing system revenues support the debt service or just issuing debt to satisfy the deferred maintenance backlog on the Andros Complex.

The University's P3 advisor indicates if the debt were issued through the existing housing system, it would result in a one-notch downgrade to the credit ratings impairing the housing system's ability to issue additional debt or potentially increasing interest costs for future debt issuance (Moody's rating on the existing housing system's certificates of participation is A1 and S&P's rating is A+). Although the downgrade assumption is speculative, Moody's and S&P both state that rating pressure could occur with material increases in debt and/or a material decline in the pledged revenues or insufficient debt service coverage. S&P also notes that once the Project's agreement is finalized, it will evaluate the credit impact of the Project's debt on the University's rating.

The University obtained a public sector comparator to analyze the financial differences between the P3 and traditional delivery models. The analysis performed by the University's P3 advisor indicates traditional procurement and delivery would cost approximately $15 million to $25 million more than the P3 model. Brailsford & Dunlavey ("B&D") developed the traditional delivery costs by reviewing student housing projects implemented by the University and comparable projects implemented by other institutions. The estimates have not been validated. However, ***using this P3 arrangement also requires the University to share any excess cash flow after payment of operations, debt service and the cumulative preferred equity return with the Owner. The net excess cash flow will be divided 60% for the Owner (about $410 million) and 40% for USF (about $273 million)*** until the Owner achieves an internal rate of return ("IRR") of 11.50%. Once the IRR hurdle is met, the Owner will receive 40% and USF will receive 60% of the excess cash flow. This revenue arrangement occurs throughout the entire 51-year lease period, or 20 years after the loan is repaid and 16 years beyond repayment of the preferred equity. For additional analysis of the projected results of this agreement, see "Financing Structure."

Although construction risk and major capital maintenance risks are transferred to the Owner under this P3 arrangement, the Ground Sub-Lease requires USF to reimburse the Owner for 50% of the preliminary pre-construction costs should the Project not proceed due to adverse site conditions. USF estimates these costs to be between $125,000 and $1,500,000, which USF would pay from either the cash available in the

existing housing system or overhead amounts paid to the University from auxiliary funds. The Board and Bond Finance staff believe operations and demand risk transfer appears minimal. In this arrangement, the Owner will contract with USF for operations; however there are several contractual safeguards in the Ground Sub-Lease designed to ensure the Project will be well-maintained, not the least of which is that payments for maintenance are prioritized ahead of debt service. The Owner retains demand risk, which has not been analyzed, since the B&D study was conducted under the assumption that USF would maintain its policy requiring freshmen and transfer students with less than 30 hours to live on-campus. USF's commitment in the Ground Sub-Lease is to engage an outside consultant to ascertain demand prior to adding capacity to the existing housing system. ***Demand risk does not appear to be a material risk factor, given the inherent demand for on-campus housing at established, large Universities like USF.***

Financing Structure: ***The Project will be privately financed using an equity investment of approximately $40.0 million and a loan of $93.8 million.*** The Owner will execute a short-term construction loan, which upon completion of the Project will be refinanced into a long-term loan. Both the equity and loan will be provided by an affiliate of the Owner. The estimated interest rate on the loan is 5.25% and the preferred return on equity is 7.0%. The financing will not be tax-exempt.

The loan structure complies with the P3 Guidelines and BOG Debt Guidelines with interest only paid during the first year and level debt service continuing for 30 years beginning in year two when the Project is scheduled to open. ***The equity is repaid over 35 years with the preferred return on equity of 7.0%*** (equivalent to interest on a loan) being paid in years one through 10, and ***cash distributions for the return of equity plus the 7.0% preferred return beginning in year 11 and continuing through year 35*** (equivalent to principal and interest payments on a loan in years 11 through 35). After year 35, the Owner is projected to have received 100% repayment of its equity in addition to a 7.0% preferred return on its initial investment with 16 years remaining on the Ground Sub-Lease agreement. If Project cash flow is insufficient to make the required preferred return on equity payment, the obligation is carried forward and paid in a future year.

Repayment of equity is an obligation required under the terms of the Ground Sub-Lease agreement subordinate to repayment of the loan. If the Owner's equity were not provided, some form of debt would be

required to finance all Project costs. For purposes of this analysis, the Owner's equity is treated as subordinated debt because it's a required obligation and payable before any net excess cash flow is distributed to the Owner and the University. Deferring repayment of equity to year 11 of the agreement is tantamount to deferring debt. This aspect of the financing structure is inconsistent with the principles contained in the P3 Guidelines and BOG Debt Guidelines. It is unclear what benefit the deferment exception is to USF. The required equity distributions have been appropriately analyzed as subordinated debt to ensure the fundamental principles of the both the Board of Governors' Debt Guidelines and P3 Guidelines regarding debt structure are not violated based on the sources of funding the Project (i.e. debt versus equity).

The use of taxable debt, the longer repayment period and 7.0% interest rate on the cumulative preferred equity increases the total cost of the financing. Total interest costs under this P3 arrangement are approximately $168.9 million ($95.4 million for the loan and $73.5 million for the preferred equity), which increases the total interest costs of the financing over traditional tax-exempt financing by an estimated $55 million. For example, if the University financed 100% of the Project costs using tax-exempt debt, the annual debt service payment would be between $7.0 million and $8.0 million with total interest costs of about $113.3 million. This compares to the current financing for the Project where the annual loan payment is about $6.2 million and the annual preferred return on equity payment is approximately $2.8 million through year 10 of the agreement increasing to $3.4 million in years 11 through 35 (for a total combined payment of between $9.0 million and $9.6 million).

Fundamentally, the Project costs more than USF can afford. In order to make the Project affordable as proposed, an exception would be required whether USF used a P3 or issued the debt through the existing housing system. After loan payments and preferred equity distributions of 7.0%, the Owner receives 60% of the net excess cash flow throughout the 51-year Ground Sub-Lease until the 11.50% IRR hurdle is met. These required payments are analogous to a third lien on Project net revenues and are due and payable to the Owner if available after payment of operations and maintenance, debt service, and the preferred return on equity. Unlike the preferred equity return payment that carries forward to a future year, the excess cash flow distribution to the Owner and USF is only payable if available in any given year. ***Over the Ground Sub-Lease period, projections show the Owner will receive approximately $410 million in excess cash flow***

while USF receives approximately $273 million. This compares to traditional Project delivery with tax-exempt, 30-year level debt service where the University would receive **<u>all</u>** excess cash flow upon repayment of the debt, or approximately $683 million as shown in the Project's pro-forma. This is the trade-off or cost for using equity and a P3 financing structure versus financing the Project using traditional tax-exempt bonds.

Security/Lien Structure: The repayment of the loan will be an obligation of the Owner secured by net Project revenues after payment of operating expenses. The Owner's affiliate providing the loan will have a leasehold mortgage interest in the Project in the event the Owner defaults on the loan repayment. Project revenues consist of rental rates, a $300,000 annual transfer from USF for the dining facility and approximately $180,000 in revenue derived from leasing the retail space. There will be no other debt outstanding with a lien on the Project.

Taxable Debt: This Project will be financed by the Owner with taxable debt due to its operation as a for-profit entity. Although for-profit entities can utilize tax-exempt Private Activity Bonds issued through a conduit to finance public sector facilities, USF chose the debt and equity combination to finance the Project eliminating the tax-exempt debt option.

Project Rental Rates: The Project's housing rental rates for Fall 2017 are $3,295/semester for a traditional double occupancy room, $3,995/semester for a double occupancy semi-suite, and $4,595/semester for a single-occupancy semi-suite. ***These rates are approximately 5-10% higher than the next newest beds in the USF system. USF attributes 5% of the increase to the additional amenities*** (i.e. parking and dining facilities, a fitness center and pool, and retail space), however, USF believes the amenities are essential and contribute to the marketability and success of the Project.

According to USF, the higher initial rates are, in part, designed to avoid the Project cannibalizing demand from existing USF housing system. However, it appears the primary reason rental rates can be held lower, even with the financing of the additional, non-revenue producing capital improvements (i.e. dining and health and wellness facilities, parking, pool and other amenities), is because of the length of the Ground Sub-Lease agreement (51 years). The duration enables

the Owner to receive profits for 16 years after repayment of the loan and preferred equity components that finance the Project.

An advisory committee comprised of two USF representatives and three Owner representatives will set the annual Project budget including any changes to rental rates. ***There is no limit on rental rate increases to students, but changes to the budget require unanimous approval of the advisory committee.*** If the advisory committee cannot reach unanimous approval, the existing budget remains in place with rental rates increasing by CPI until USF and the Owner finalize its implementation through a dispute resolution process involving binding arbitration. Should the Owner implement 3% annual increases in rental rates assumed in the projections, the initial rate of $3,295 per semester for a traditional double-occupancy room will nearly double to $6,503 in 24 years. At the end of the 51-year agreement, the semester rental rate would be $14,445.

Pledged Revenues and Debt Service Coverage:

The Project's net revenues are estimated to begin at $8,852,776 in 2018-19, the first year of full operations providing debt service coverage of 1.42x and 1.0x preferred equity. When considering loan and preferred equity payments together, the Project's pro-forma shows limited coverages of less than 1.2x through the first eight years of operations. The coverages on the loan and preferred equity payments provide limited cushion for the Owner to meet obligations without an increase in rental rates in excess of the 3% projections, USF foregoing its reimbursement for administrative costs, or USF supporting the Project's obligations in the event of a shortfall. The Project's pro-forma assumes an annual rental rate increase of 3%, estimated occupancy of 95% during the Fall and Spring semesters, and 3% annual increases in operating expenses.

The Project's feasibility includes receipt of revenues associated with leasing the retail space (approximately $180,000) and $300,000 annual fee from USF for the dining facility. USF believes that these revenues and associated facilities are functionally related based on the use of dining revenues for the dining facility, the physical proximity of these components to housing, and the Owner's belief these components are vital to the success of the village concept.

(See Historical and Projected Debt Service Coverage, and estimated net cash flow profits to Owner)

Return on Investment: ***USF and the Owner will enter into a 51-year Ground Sub-Lease and Management Agreement. The lease term exceeds the P3 Guidelines that allow for a 40-year term by 11 years. The P3 Guidelines allow a University to extend the lease term to 50 years with appropriate justification.*** The longer lease term allows the Owner to set initial rental rates lower. The University believes rental rates would have to increase by an additional 23.2% or 8.0%, respectively over those proposed for the Project if the Owner were given a 30 year or 40 year Ground Sub-Lease.

Throughout the term of the Ground Sub-Lease, the Owner expects to receive a preferred return of the contributed equity of 7.0% and annual cash flow profits from the Project from the net operating surplus. The cumulative preferred return on the equity is subordinate only to expenses and debt service and paid prior to any receipt of excess cash flow by USF. The Owner will receive 60% and USF 40% of the excess cash flow until the Owner has achieved an 11.50% IRR, then USF will receive 60% and the Owner 40% after the IRR threshold. The Project's pro-forma shows the Owner will meet an IRR of 11.15% (not the 11.50% hurdle), indicating the Owner will retain 60% of the excess cash flow throughout the 51-year period.

The Project pro-forma shows the Owner receiving total gross distributions of $527.0 million including cumulative return on equity ($113.3 million), excess cash flow profits ($409.5 million) and developer fee and overhead ($4.35 million) while USF is expected to receive a total of $273 million, of which $140 million (51%) is expected to be received in years 41 through 51 of the agreement. USF plans to use any excess cash flow to eliminate deferred maintenance on its housing facilities estimated at $45 million after demolition of the Andros complex. The net amount USF will receive from the excess cash flow is about $257.7 million after deducting the $15.3 million made to the Owner for the dining facility.

USF has the option to purchase the Project after 10 years. However, the price to exercise the purchase option is cost prohibitive. The buyout cost is structured to ensure the Owner remains financially whole despite early termination of the contract. The University's estimate to buy the facility back at 15 years is $431.5 million. The purchase cost includes payment to the Owner for outstanding debt and preferred equity ($102.4 million) and a payment to cover the expected net excess cash flow (profits) the Owner would realize over the 51 year period to achieve its target IRR ($329.1 million). As a

result, after 15 years of operations, USF would be required to pay 3.2 times the original cost of construction to purchase the Project if it were to exercise its purchase option.

Quantitative Demand for Project:

In November 2013, USF engaged B&D to study the possibility of an on-campus mixed use project and the redevelopment of USF's existing housing system. USF believes availability of student housing and co-located mixed use, quality–of-life activities is integral to attracting and retaining students. B&D also assisted in the development of the Invitation to Negotiate (ITN) to choose a project owner and analysis of project delivery structures.

B&D's final report, following a series of focus groups, stakeholder interviews, and an internet-based survey of more than 4,900 USF students, states USF's primary intent is to better meet the needs of freshmen students. In general, the students surveyed said quality-of-life facilities were important for a comprehensive on-campus experience. According to the study, B&D projects student demand for on-campus housing in Fall 2017, when the Project is scheduled to open, will be 5,977 beds, which will result in a deficit of more than 1,200 beds. However, the B&D study does not include the effect of eliminating the freshmen residency requirement. Further, B&D recommended demolition of the Andros facility for several reasons. First, the complex has accumulated significant capital project and deferred maintenance investment needs, due to the inability of USF to economically renovate these facilities in recent years. Second, the configuration of the buildings is inconsistent with the USF Master Plan focusing on efficient land-use to accommodate 40,000 students. Third, the Andros footprint provides the best site on campus to accommodate the mixed-use village concept to meet the strategic objective of the University to positively impact connectivity between housing and academics.

As part of its analysis, B&D examined the residential communities surrounding the campus. The off-campus market is diverse in terms of rental rates and amenities offered. Private housing located closer to campus generally were found to have higher rental rates, with one-bedroom apartments within a mile of campus ranging from $742 a month (with fewer than 15 amenities) to $964 (with more than 15 amenities). Comparatively, the rate for a double-occupancy semi-suite room under the Project will be $799 a month. The lower rental

rates of the Project are achieved by having two students share one room and a private bath.

University Support of Project:

The financing will not be a legal obligation of USF or any of its Direct Support Organizations, and USF has not pledged its credit toward the Project. ***However, the rating agencies will consider the obligations associated with the proposed Project in evaluating USF's debt profile.*** USF is projected to receive $257.7 million (net of $15.3 million contributed to the dining facility) from the Project over the term of the agreement in the form of base rent, which it will use to address deferred maintenance. The lease requires the Owner to provide documentation to demonstrate how the distribution was calculated and pay the rent within 90 days of each Annual Period (from July 1 to June 30 of the following year).

To repay the construction costs of the dining facility (approximately $5 million) and offset the Owner's contributions to the repair and replacement maintenance account, USF is obligated to transfer $300,000 per year to the Owner for 51 years. USF intends to use revenues it currently receives from its food service vendor to make the payment. USF will not need to amend its current contract with its food service provider. The costs of meal plans at USF will not increase as a result of the additional dining facility. However, a new future food service contract could eliminate this revenue, requiring USF to make the payment from another source. According to USF, the $300,000 annual payment to the Owner over the term of the agreement equates to a net present value of $5,008,000 discounted at 5.25% or a gross total of $15,300,000.

In addition, USF will construct 650 parking spaces (572 new spaces and 78 spaces to account for displaced spaces) to support the Project with funding from the financing in the amount of $2,275,000. USF estimates the funding contributed from the financing will fully cover the cost of construction. If construction costs are in excess of this amount, USF will contribute the overage from its existing parking system.

USF is not legally obligated to pay debt service or maintain the Project. However, given the location of the Project on the USF main campus in Tampa and the importance of student housing to the University, USF may feel obligated to take over the Project or provide

some other form of support should the Owner fail in its responsibilities.

Analysis and Conclusion:

Staff of the Board of Governors and the Division of Bond Finance has reviewed the information provided by the University with respect to the request for Board of Governors approval for the Project. The demand for the Project appears adequate given its location on the main campus of an established University. ***However, the B&D study does not include the effect on demand from eliminating the freshmen residency requirement. The Owner will construct, finance, and maintain the Project*** throughout the 51-year Ground Sub-Lease; ***however, USF will operate and provide custodial maintenance of the housing facility through the Management Agreement*** that overlaps the term of the Ground Sub-Lease.

Project costs will be financed with debt and equity including a preferred return on equity equal to 7.0%. The 35-year repayment and deferral of equity distributions on the cumulative preferred equity are principles that are inconsistent with the BOG Debt Guidelines and the P3 Guidelines regarding deferring payments that effectively extend the duration of the obligations. Additionally, ***the use of taxable debt, the longer repayment period and 7.0% interest on the preferred return on equity increases the total cost of the financing*** by an estimated $55 million over a traditional, tax-exempt debt structure.

The 51-year term of the Project Ground Sub-Lease exceeds the allowable term in the P3 Guidelines by 11 years. The benefit to the University by extending the ground sublease beyond 40 years is that the Project can be immediately built at the full scope that the University believes is necessary to improve its housing stock. Additionally, ***USF asserts the longer lease term allows the Owner to set initial rental rates lower*** and would be 23.2% higher if the lease term were 30 years and 8.0% higher with a 40-year term. However, it appears the primary reason rental rates can be held lower, even with the financing of the additional, non-revenue producing capital improvements (i.e. parking and dining facilities, a fitness center and pool, and retail space), is the 51-year period enables the Owner to receive profits for 16 years after repayment of the loan and preferred equity components that finance the Project. Projections indicate that over the 51 year term, the Owner will receive gross distributions of nearly $527 million ($113.3 million in preferred equity, $409.5 million in excess cash flow, and $4.35 million for developer fee and overhead)

whereas USF will receive $257.7 million net of the $15.3 million contributed for the dining facility. If financed through USF's existing housing system, USF would retain all excess cash flow following repayment of the debt, or an estimated $683 million.

The University's public sector comparator analysis shows traditional procurement and delivery of the Project would cost approximately $15 million to $25 million more than the P3 model based on a review of other housing projects implemented by the University and other institutions of similar size to USF. These estimates have not been validated. ***However, this P3 structure requires the University to share 60% of the excess net cash flow generated from the Project with the Owner over the 51 year period which it would otherwise retain if the Project were financed via its existing housing system. This is the trade-off or cost for using equity and a P3 financing structure versus financing the Project using traditional tax-exempt bonds.***

The Board should consider the foregoing information in determining whether to approve the Project as proposed.