

COMMUNITY FACILITY FUNDING UNCOVERED

Acquisition Cost Demystified

Background

Economic evaluation of a development proposal for a single building with different areas for non-profit and profit use involves different rules for each portion. To justify zoning waivers for the for-profit portion, a New York City property owner must prove that it cannot make a reasonable profit under existing zoning restrictions.

In support of Congregation Shearith Israel's waiver application to the NYC Board of Standards and Appeals (BSA), Freeman Frazier Associates submitted analyses relying on a rights Acquisition Cost assessed against the for-profit portion in order to mold perception of financial returns to desired levels. This memo explains that this is a confusing, unnecessary, and misleading concept.

Summary

The Congregation's proposal, approved by the BSA on 26 August 2008, projected condo sales income of \$34.2 million from the for-profit portion, five luxury residential condominiums. That exceeds associated costs by \$19.2 million, more than covering an estimated Community Facility cost of \$16.1 million.

The role of Acquisition Cost in funding the Community Facility (CF) has been misrepresented by the Synagogue and misunderstood by opponents and, apparently, the BSA. A more helpful view is that the proposed residential condo (RC) profit does, in fact, fund the CF portion, but the use of Acquisition Cost as the mechanism is just confusing, and leads to false conclusions.

The Congregation's Proposal

The projected cash Income and Expense figures for the Congregation's proposed New Building are shown in the table. Figures for both the Residential Condominiums (RC) and the Community Facility (CF) uses of the New Building are included.

This whole-building schedule differs from those presented by Freeman Frazier Associates which only provided figures for the RC part. That approach fails to reveal that the

I/E Item	Values	Totals
INCOME		
Net Condo Sales	34,210,000	
		34,210,000
EXPENSE		
Condo Base Construction	7,938,000	
Condo Soft Construction	6,322,000	
Condo Carrying Cost	664,000	
Condo Tax	661,000	
Comm. Facility Base Construction	11,551,602	
Comm. Facility Soft Construction	4,000,000	
Comm. Facility Carry Cost	500,000	
		31,636,602
PROFIT		2,573,398

overall project produces a net profit of about \$3 million to the Synagogue. As shown in the table above, the RC portion produces the revenue of \$34.2 million at an expense of \$15.6 million (the sum of the four condo expense items) leaving a profit of \$19.2 million

for the Condo portion. See table in “Separate Condo Figures” section below.

In several presentations and documents, Shelly Friedman of Friedman Gottbaum stated that the luxury condominiums were

necessary to fund construction of the Community Facility. The table demonstrates that his goal is realized by the proposed New Building configuration, with \$2.6 million left over.

Acquisition Cost

Consider the effect of an Acquisition Cost as presented by Friedman and Freeman. It is a non-cash expense to the Condo part of the building and, as explained by Friedman, is income to the CF part.

The effect is seen in the table on the right, again from the overall project, Congregation viewpoint. The Acquisition Cost is a payment to the CF portion of the project by a putative condo developer (actually, the Congregation), increasing income to \$46.6 million. It also shows as an expense because it has been charged against the RC portion of the project.

There is no net effect as can be seen since the ‘bottom line’ to the Congregation as owner is the same as in the first table. Nothing changes. The Acquisition Cost is a wash. This truth is exposed by looking at the building as whole; it is hidden when looking only at the Condo use, as explained in the next Section.

If the forecast income and expense is realized, the Congregation ends up with \$2.6 million in the bank. If not, the \$2.6 million is a

cushion. In addition, the Congregation will have a new Community Facility, and an income stream from classroom rental of roughly \$1 million per year.

I/E Item	Value	Totals
INCOME		
Net Condo Sales	34,210,000	
Acquisition Payment	12,347,000	
		46,557,000
EXPENSE		
Sum of expense from above table	31,636,602	
Acquisition Cost	12,347,000	
		43,983,602
PROFIT		2,573,398

Separate Condo Figures

The engine powering the whole development is the net income from the condos. See the (real) cash figures for the Condos alone in the table on the right:

The Condo development is so inherently profitable, even without leveraging, that it funds CF construction leaving money left over as profit.

But Here's the Trick

Many would think that a \$18.6 million profit on expense of \$15.6 million would be a good deal. Freeman is faced with possible rejection of waiver requests that produce an \$19.2 million profit. So, he adds \$12,347,000 in Acquisition Expense to reduce profit to \$6,818,000.

Cash profit	\$19,165,000
Less Acq. Cost	<u>12,347,000</u>
Net stated	6,818,000

With the stroke of a pen this reduces reported profit by 281%.

Freeman then divides the \$6.8 million by the largest number available, the \$27 million total expense, and finds a modest 10.9% profit rate, after adjusting to an annual figure.

The Freeman result contains many errors, discussed elsewhere. Two are worth mention here. First, the claimed 10.9% figure is not a Return on Equity as required by BSA instructions and sound financial analysis. The actual RoE is 111%.

Second, the denominator, a so-called project expense is inflated by the \$12,347,000 Acquisition Cost, which is not, in fact, a real expense. It does not represent a sum actually paid. Even if it were paid, it would be paid to the Congregation from the Congregation, an imaginary, non-economic, transaction having no effect.

Without the imaginary load of \$12,347,000 added into project expense, the project

I/E Item	Value \$	Totals \$
INCOME		
Net Condo Sales	34,210,000	
		34,210,000
EXPENSE		
Condo Base Construction	7,938,000	
Condo Soft Construction	6,322,000	
Condo Carrying Cost	664,000	
Condo Tax	661,000	
		15,045,000
CASH PROFIT		19,165,000

return reported by Freeman would be 20.3%.

Effect on Waivers

Whether accepting Freeman's figure of a 10.9% return on some real and imagined expenses, or 20.3% on real expenses, or accepting the 111% Return on Equity, the Congregation's desired Residential Condominium proposal for five units appears profitable.

But Freeman uses the same technique to show that two-unit and seven-unit alternatives, which require no zoning waivers, are not sufficiently profitable. He has manipulated the figures so that the Congregation's proposal threads the needle to success, while the alternatives possible within existing zoning do not.

This is accomplished by assessing all Condo developments, regardless of size, with the same imaginary \$12,347,000 'expense', then also including it in a divisor to further decrease the paper return. This amounts to a double discount, each part of which is invalid.

Conclusion

By ignoring its own guidelines, previous decisions, and obvious, sound financial analysis, the BSA has delivered a \$19.1 million grant to the Congregation.

Notes

- (1) For an explanation of the 111% RoE, see VastPastNY.com>CSI_Issues>Return_on_Equity.html
- (2) As mentioned in Alan Sugarman's Memorandum of Law, 23 Sept. 2008, page 49 and elsewhere, Freeman's source and value of an acquisition cost is incorrect. Sugarman asserts that the value should be the price paid for the property when purchased. That amount was reported to be less than \$60,000, perhaps as low as \$11,762. The figure used by Freeman is an imputed market value, the size of which has also been challenged.
- (3) Freeman states that his analysis represents a project carried out by an independent developer. However, Friedman has stated that the Congregation is the developer. See 2002 transcript of hearing to Landmark Preservation Commission. Further, Sugarman (Verified Petition dated 23 Sept. '08.) points out that the analysis must represent the owner's view, not some other entity.
- (4) Except where noted, the figures use are those presented by FFA in their letter to the BSA dated 8 July 2008. The FFA typo on Condo tax corrected using earlier value. Condo Base varies — 11 Mar 08 figure used. CF Soft and Carry Costs (over) estimated; not provided by FFA.