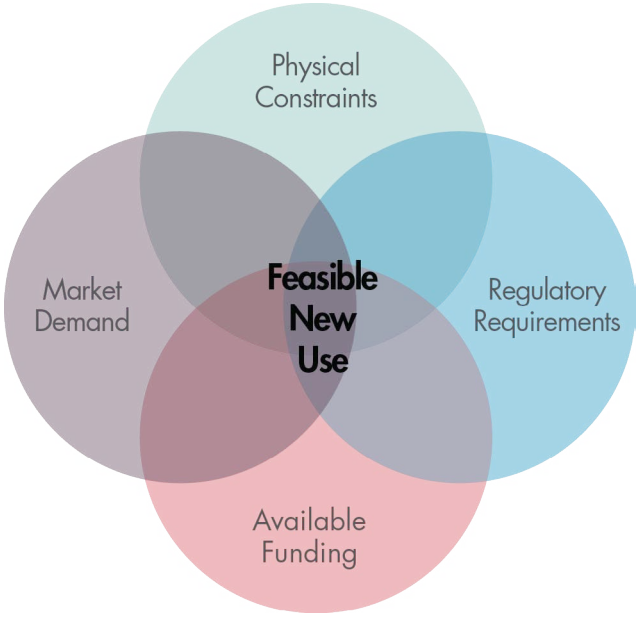
RESTORE OREGON
SAVING HISTORIC PLACES

MODULE
03

Preservation Toolkit

Creating a Viable Rehabiliation Plan

Finding a feasible new use is the most critical piece of a successful historic rehabilitation plan. A new use typically has to address four criteria for the project to be viable. These include the property's physical constraints and needs, its regulatory and legal restrictions, the local real estate market conditions, and the availability of funding sources and their associated requirements



The Physical Building & Site Constraints

Often the use that physically works the best for a historic property is its original use. A church reused as a church or a school reused as a school often necessitates much less in terms of construction interventions and therefore cost. However, most of our historic buildings are languishing precisely because there is no demand for the original use or the building has become functionally obsolete.

Whether or not the new use is similar or quite different from the building's original purpose, most historic buildings require some alterations in order to support modern uses. For both cost-savings reasons and preservation goals, the aim here is to find a use that works well with the building and does not require changes that harm its historic character. Likewise, the site may be conducive to some uses more than others due to its location, access, and parking.

Regulatory & Legal Requirements

The second component of the feasibility equation pertains to regulatory and legal requirements. These will strongly influence the types of uses that can go into a historic building. The property's zoning will stipulate the uses that are allowed outright or through the conditional use process. Most jurisdictions also have a process whereby a variance or zoning change can be requested; however, this can be a difficult, expensive, and a time-consuming endeavor. The building code will also dictate the amount of work and upgrades required to permit a historic building for a new use.

A former church in Dayton was successfully repurposed as the Block House Café

Existing buildings that are undergoing a change of use may find they have code deficiencies that have to be corrected as part of the project. The sidebar provides a list of common deficiencies, though every project is different and not all may apply to your project. That said, too often there is an overly simplistic view of rehabilitation and adaptive reuse. There is a commonly-held misconception that, for instance, an old warehouse can be converted to a loft apartment building by just adding walls, kitchens, and bathrooms. To be legal for occupancy, the conversion of a historic building to a new use – particularly if it is a very different use – will typically include many other building upgrades to enhance the building's safety and accessibility.

For some properties, the uses that physically make sense for the building and are workable based on the regulatory and legal requirements may be fairly obvious. For a typical Main Street commercial building, this often includes ground-floor retail/restaurant with offices or housing on the upper floors. When a building's potential uses are very straightforward, it is the following two components of the feasibility equation that further illuminate whether a potential project is economically viable.

Real Estate Market Conditions

The local real estate market influences the demand for leasable space, rental rates, and vacancy rates. All of these factors contribute to the value of a property. A feasible rehabilitation will be one that creates enough value to justify the costs associated with the project. For instance, a historic theater that costs $750,000 to rehabilitate, but only generates $40,000 of net operating income, will have some hurdles to overcome because that income amount may only translate to a

Common Code Deficiencies in Historic Buildings

- Lack of elevator
- Insufficient number of fire exits, enclosed stairs, and/or code-compliant egress
- Insufficient ADA accessibility at building entrances, restrooms, stairwells, and elsewhere
- Unreinforced masonry construction that requires seismic strengthening
- Insufficient number of plumbing fixtures
- Outdated mechanical and electrical systems
- Inadequate fire separation and/or fire suppression systems
- Lack of venting and grease interception for restaurant use
- Energy code upgrades (particularly when spaces were previously not conditioned, such as historic warehouses)
- Some jurisdictions may have requirements for landscaping, bicycle facilities, trash rooms, parking lots, and other nonconforming upgrades.

This former Ranger's Station cabin near Bend was converted into a vacation rental property

property value of $575,000—substantially less than the project costs.

In considering an appropriate new use, understanding current supply and demand in the market is important. What is the need or demand for retail, office, housing, restaurant, theater, hospitality, artist studios, or other light manufacturing/workspaces in your community? What is the going lease rate for these types of uses? Sometimes a building may scream "cool restaurant space" or "one-of-a-kind loft apartments," but market conditions may not be conducive for that use. For instance, during the most recent recession, the need for office space in many smaller towns was very low and while there were plenty of Main Street buildings with vacant upper floors suitable for office use, the market conditions were such that most projects were not feasible unless they were being built for a specific tenant that had preleased the space.

In some cases, there may be a very apparent unmet need identified by the City, neighboring businesses, and/or community members. However, untapped market needs are typically not free of barriers. There's usually a reason why a particular use or business does not exist even when people wish it did! But this is no reason to abandon a good idea. It usually takes perseverance and ingenuity to pioneer change in your community.

Funding

At the end of the day, a rehabilitation project may suit the building, align with legal and regulatory requirements, and also have uses that are in demand. However, if funding cannot be secured, the project is not feasible. While the health of the real estate market and the availability of funds are linked, the demand for project funding is not always in sync with the supply. For instance, after the recent recession, it took quite a while for lenders to actively resume lending even when there was an appetite for more commercial space. The lending/investing climate, the type of project, the type of new use, the quality of the tenants, and the experience and creditworthiness of those who are financially responsible for the property can all have an effect on the availability and affordability of funds. Sometimes it is just a matter of finding the right creditworthy partner or putting together an experienced development team in order to open the doors to the funding sources needed.

Beginning the Feasibility Assessment Process

Where does one begin to assess the feasibility of a historic rehabilitation project? We've outlined some key questions that need to be addressed for each of the four feasibility components. Some of this information may be initially determined without the assistance of other professionals, but quickly the need for a team of consultants will be apparent (see Module 6). In particular, an architect and their sub-consultants (such as a structural engineer, historic preservation specialist, etc.) will be important team members to advise you on rehabilitation work scope, regulatory requirements, and preservation matters. A contractor will advise on costs, timing, and the feasibility of the work proposed. Working with a real estate developer, commercial broker, appraiser, and/or lender will help with procuring information related to economically viable uses that are supported by the market and funding sources.

This former Portland saloon was transformed into apartments with first floor community spaces

Important Feasibility Analysis Questions

The Property

- What condition issues and deferred maintenance are apparent?
- Is the building constructed of unreinforced masonry and therefore may require seismic strengthening?
- What types of uses are conducive to the building's existing layout and circulation patterns? What uses are conducive with some remodeling that does not gut the interior?
- Does the building's location and access preclude certain uses?
- What is the parking and transportation situation? Does the potential new use need additional parking in order to be economically viable?
- What environmental contaminants are present such as heating oil tanks, asbestos, and lead-based paint? What is the likely cost to remove these (if necessary)?
- What important historic features and materials are present that must be retained and protected, and does this preclude or make certain uses less feasible?
- What is the magnitude of cost associated with the building's rehabilitation and new use?

Legal & Regulatory Requirements

- Are there any legal limitations on the property such as deed restrictions, covenants, easements, etc.?
- How is the property zoned and what are the permitted uses? If a use that appears to be a good fit with the property is not allowed under current zoning, what is the likelihood that the zoning can be changed or a variance secured?
- Does the zoning code require parking for the use(s) you are considering?

- What types of building code upgrades are likely to be required for a particular new use? What is the building's current occupancy rating on file with the local jurisdiction? Often when a building has a low occupancy rating—such as warehouse—and gets repurposed for a much more intensive use—like housing, many code upgrades are required.
- How will the building's historic designation affect the redevelopment of this property? Will a local review be required? It should be noted that some cities afford greater flexibility to buildings that are designated historic.

Real Estate Market

- What is the condition of the real estate market currently? What uses or types of spaces are in demand?
- What are the associated lease rates and expenses with those uses? How does this affect the value of your building?
- What uses are nearby that could help support or potentially hurt the new use of your building?
- What uses does the community need and/or want?
- What is the level of risk or difficultly in realizing any of the above uses in your historic rehabilitation project?

Funding

- How much outside funding for the project is likely to be needed?
- Are lenders/investors actively funding projects in your market?
- Do certain uses or users make it easier or more difficult to obtain funding?
- Are there pre-leasing requirements?

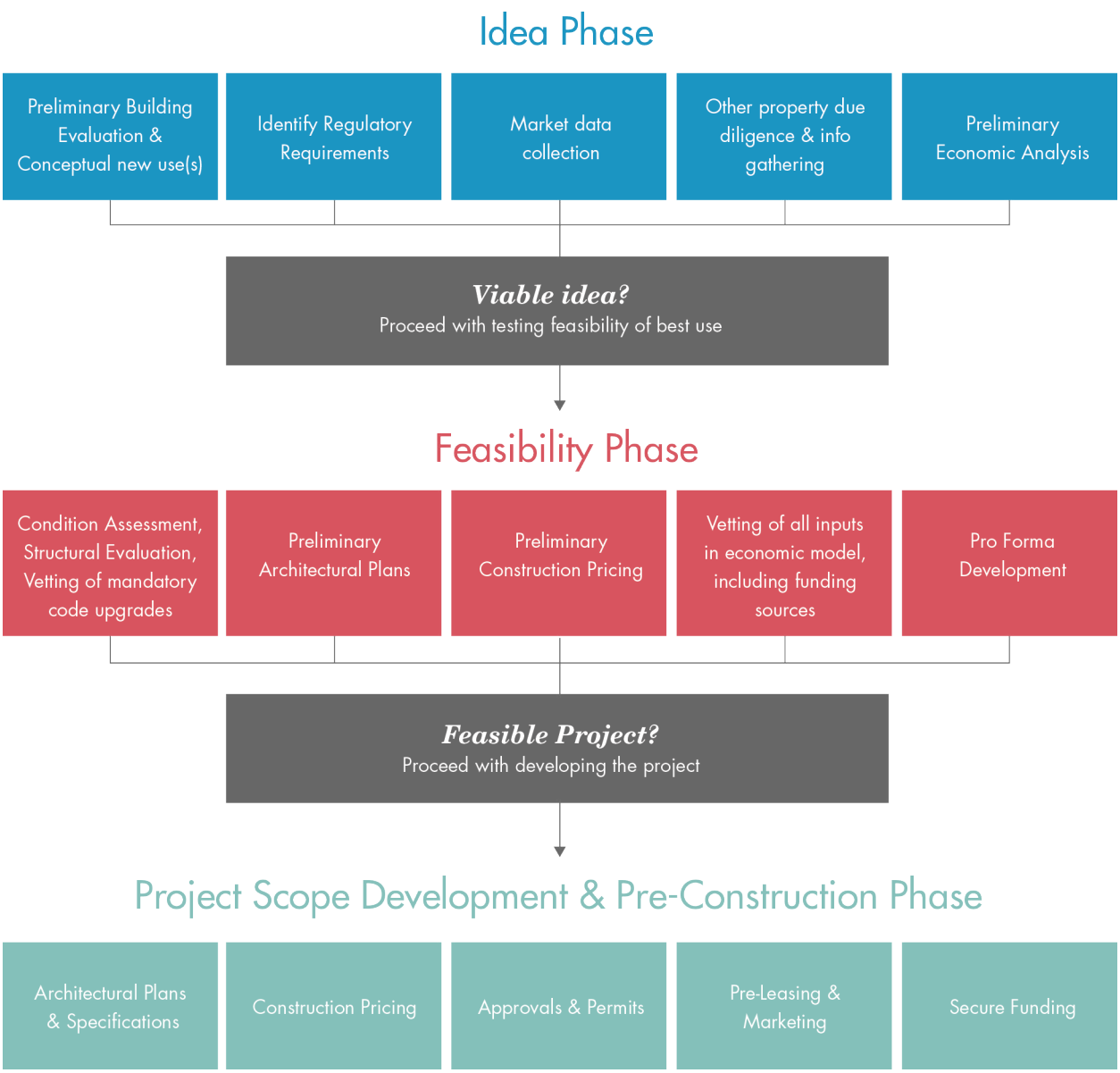
- Do the responsible parties for this project have sufficient creditworthiness/net worth to secure funding?
- Does the experience of your project team meet the requirements of your funders?
- Are any incentives monies or grants available? How do the requirements of those programs potentially affect your project?

The process of figuring out the best use for a building and whether it is a feasible one is often fluid and iterative, but for purposes of illustrating the nature and flow of the process we have broken it down into distinct phases, depicted in the graphic below.

The first phase, or "Idea Phase," is where you collect information and begin testing your idea(s). At the end of this phase you should have a conceptual idea of what you can and cannot do with the building, a rough sense of what it might cost, some information about the income and expenses to operate the building, and an understanding of the magnitude of funding you will need. Particularly for a property you do not already own and would be buying, this is the time where you would perform your buyers "due diligence" and assess the risks and limitations that come with the property, including any environmental contamination. This phase ideally includes starting an economic model that pulls this information together in the form of project costs, project funding sources, income, and expenses to begin to understand if you are pursuing an idea that makes financial sense. (More detail on economic modeling to follow.)

What happens when a particular use does not test well in the Idea Phase? First, go back and reexamine your assumptions. You might find an area of weakness where you need to obtain more information. In another scenario, your reuse idea might look as if it could be feasible—that is, it's not a complete non-starter—but the outcome isn't entirely clear. Often the only way to get clarity is to move forward with more study and analysis. In a third situation, it may become very apparent that your idea is not feasible. In this case, you can start the process over, test a new use/idea, or you may have to wait for certain factors to change.

It is important to realize that exploring the feasibility of a project is an endeavor that costs money. The deeper you dig to get more accurate information, the more it typically costs. This is one of the reasons why it is important to begin the economic analysis early, so that you are continually in touch with the probable feasibility of the project and have a keen sense of where to focus your efforts in refining your information and assumptions.



The second phase of feasibility assessment involves similar information as the first phase, but with greater detail and accuracy. This may entail a professional condition assessment, structural evaluation, and a deeper vetting of mandatory upgrades for the building. Preliminary architectural plans would be drawn up for a contractor to provide pricing. Information would be collected on all project costs. The viability of different funding sources would be explored. If the information from this exercise comes together in a favorable way, the project can move forward.

The last phase depicted in the graphic shows the remaining tasks and project scope development in order to get to the point where construction can commence. This stage requires even more investment in the creation of architectural plans, obtaining permits, marketing the property, securing funding, and so forth.

Economic Modeling

As the information begins to come together, the most valuable way to begin to truly test the project's feasibility is through an economic model. This can begin in a back-of-the-napkin fashion, but for most projects—particularly those with outside lenders and/or investors—a full financial model or "pro forma" will be needed that incorporates solid economic inputs obtained from qualified professionals.

The Hillcrest Barn outside Medford was converted to the Roxy Ann Winery tasting room

If you are considering several different use options, a rough economic model can help you gauge whether one use might make more financial sense than another. Additionally, working through the numbers illuminates all the information that must be gathered to create an accurate economic model. If you are working within particular financial constraints—such as having a cap on the amount of funds that you yourself or your organization can put into the property—this can help you work backwards to determine a maximum budget for your project.

Restore Oregon has developed economic feasibility worksheets you may find helpful: a Preliminary Economic Analysis for use in the Idea Phase; and a more detailed Commercial Real Estate Economic Model, or pro forma, for use in the Feasibility Phase. Both can be downloaded from our website.

In order to start an economic analysis for a particular use such as retail, office, or housing, you have to be able to quantify the following at a minimum:

1. **How much will the rehabilitation project cost, including construction costs, soft costs, financing costs, and acquisition costs?** Even if these are rough estimates, you will begin to have a working number for your total development costs.
2. **What are the funding sources that will pay for the costs of the project?** If some of these are unknown at the outset, the model will at least tell you the magnitude of funding you may have to seek.
3. **What will the estimated value of the property be when the project is completed?** An estimated value is critical as it will help inform the amount of debt that might be secured and it helps frame whether the project costs are in line or in excess of the value. A building owner/investor typically does not want to have more money in a property than it is worth.

4. **How much income will the property generate after expenses are paid and vacancy and uncollected rent are factored in?** The value of an income-producing property is directly tied to the money it generates. Quantifying the income and expenses are critical to not only understanding the property's value, but also understanding how it will continue to support its ongoing operations and maintenance in the years and decades to come.

It is important to approach the findings of early economic modeling with the expectation that the numbers will change as more information is known and to move diligently toward establishing numbers that can be relied upon.

You might be wondering if there is a magic number that will result in an economic model that is "financially feasible." While there is no set threshold or return on investment, there are several factors that typically converge in a project that makes financial sense:

- **The project must be able to operate "in the black"—**that is, it must turn a profit that is sufficient to pay operating expenses, debt service (i.e. loan payment), and build up a reserve account for future capital-intensive projects like replacing the roof or the mechanical systems when they reach the end of their lifecycle.
- **The project pays rewards to its investors that are commensurate with the risks.** Real estate projects are capital-intensive and have a high level of risk. An owner, developer, or investor who puts capital on the line to fund the rehabilitation of a historic building is going to want to ensure the project has a high likelihood of success. When all the expenses are paid, the people or entities that put up money and have a stake in the building's ongoing operations will want a return on their investment, typically in the 6%-12% range. In the case of a nonprofit organization, the profit motive may be different from the private equity investor; however, even nonprofits should be cautious of undertaking a project that skates on financial thin ice.
- **The project can meet the terms of the lender.** When a lender is involved, the parameters for what constitutes feasible or acceptable become much more standardized. Lenders only lend on projects that generate sufficient, reliable income, typically at least 1.25x the loan payment.
- **The value of the project at completion is greater or equal to its cost, or there are tax credits and other financial incentives to fill the gap.** Historic projects are notorious for costing more than they are worth. Not only are they typically more labor-intensive and require greater craftsmanship in their rehabilitation, but structural and accessibility upgrades can be costly. Projects that cost more than their value are rarely financially feasible unless other incentive monies are part of the funding sources, including tax credit equity, urban renewal dollars, and grants.

Definitions for Financial Modeling

For use with the downloadable Preservation Toolkit feasibility worksheets from the Restore Oregon website.

Term	*Definition*
Acquisition Costs	Acquisition costs consist of the price and all fees and closing costs required to obtain a property. Examples of closing costs include attorney's fees, loan fees, appraisal costs, and title insurance.
Amortization	The paying off of debt with a fixed repayment schedule in regular principal plus interest installments over a defined period of time.
Appraised Value	The property's value as determined in an appraisal report prepared by a professional appraiser who looks at features such as size, type of construction, location, condition, income, expenses, and recent sales of comparable properties in the vicinity.
Asset Management Fee (Historic Tax Credit)	A fee to the Historic Tax Credit equity investor that is paid annually until the investor exits the ownership structure. A common fee is $5000.
Cash flow	The number of dollars a property generates in a given year after all cash outflows (operating expenses, debt service, etc.) are subtracted from cash inflows (rent payments, expense reimbursements, etc.).
Cash-on-cash return	A simple measure of investment performance calculated as cash flow before taxes divided by the initial equity investment.
Certificate of Occupancy	A document issued by a local government agency or building department certifying a building's compliance with applicable building codes and other laws, and indicating it to be in a condition suitable for occupancy by tenants.

Construction Loan	A short-term loan for the purpose of funding the costs associated with construction of a building, as well as the interest on the loan during the construction and lease-up period. Upon completion of the construction and the lease-up of the property, long-term or "permanent financing" is used to pay off the short-term construction loan. A duration of 18-24 months would be typical for a construction loan.
Contingency	A predetermined amount or percentage of project costs held for unforeseen conditions and changes in the project scope. The contractor often builds a contingency in the project to cover estimating discrepancies. It is good practice for an owner/developer to carry a separate contingency(s) for unforeseen conditions and soft cost overruns.
Debt Service	The cash required for a particular time period to cover repayment of interest and principal on debt. In other words, it is the loan payment. This is typically expressed in a pro forma as an annual amount.
Debt Service Coverage Ratio	The ratio of the property's net operating income (NOI) to annual debt service. This ratio is important to lenders because it ensures that the property has the necessary cash flow to cover the loan payments.
Draw Factor	A construction loan is typically taken in draws, slowly accumulating to the total loan amount. Because interest is paid monthly on the total amount that has been drawn on the loan, the interest is less than if the loan was provided as an upfront lump sum. A typical draw factor for a construction loan is 60%.
Due Diligence Period	A specified amount of time where a buyer thoroughly investigates a property to determine if they are satisfied with its condition and other constraints before finalizing the purchase.
Financing Costs	Those costs associated with securing a loan on the property. These include loan fees, bank inspection fees, construction-period interest, and interest during the lease-up period.
Gross Scheduled Income	The maximum income that would be collected from a rental property with all units 100% occupied and rented.

Gross Square Footage	Total area of a building, including rentable and non-rentable areas.
Hard Costs	Costs exclusively related to the physical construction of a project. In addition to labor, materials, and mark-up charged by the general contractor, hard costs can include environmental remediation, tenant improvement costs, and the owner/developer's contingency.
Lease Rate	Typically expressed as an annual dollar amount per square foot of space per year.
Lease Type	Three common lease types are "full service," "modified gross," and "triple net." Full service leases typically include all expenses including janitorial in their monthly payment. With a modified gross lease, the tenant typically pays their utilities and janitorial, and may be responsible for their share of other expenses. In a "triple net lease," the tenant is responsible for their pro rata share of property taxes, insurance, and building expenses, as well as their own utilities.
Lease-Up Period	The time period for a newly-available property to attract tenants and reach stabilized occupancy.
Load Factor	A portion of the building's shared spaces applied to a tenant's usable square footage, generally in the 10-15% range.
Loan-to-Value Ratio	The ratio of the total loan amount borrowed in relation to the appraised value of the property. This is an important metric that lenders use to determine the amount they will loan on a property.
Net Operating Income (NOI)	The annual income generated by an income-producing property minus all expenses incurred from operating the property.
Operating Expenses	All cash expenditures required to operate the property and command market rents, such as property taxes, insurance, management fees, repairs and maintenance, utilities, etc.
Placed in Service	The date of a building's readiness and availability for a specific function. Often this coincides with the end of construction and receipt of a certificate of occupancy from the local jurisdiction.

Preferred Return	A mechanism for measuring a negotiated level of cash flow payment due to an equity partner in a real estate transaction. For historic tax credits projects that bring in an equity partner who provides cash in exchange for historic tax credits, the equity partner typically requires a preferred return of at least 2-3% of its equity contribution.
Permanent Loan	Long-term debt that is usually not available until the property has reached stabilization. Sometimes both construction and permanent financing are committed in combination by one lender. This is called a "mini-perm" or "construction-permanent" mortgage which will often amortize on a 20- or 25-year schedule with a balloon payment 10 to 15 years after the construction loan converts to a permanent loan.
Pre-leasing	The process of securing leases on the spaces in a development project prior to the commencement of construction. Many lenders require a certain percentage of pre-leasing before providing a loan.
Prorations	Prorations appear on a property purchase contract and typically include real estate taxes, insurance, utilities, rent, etc. With these prorations, the buyer is reimbursing the seller for prepaid items during the time period the seller will not own the property.
Pro Forma	An economic model designed to predict the profitability of a project by analyzing project costs, financing sources, stabilized cash flow, and return on investment.
Rentable Square Footage (RSF)	The total of all usable square footage PLUS a portion of the shared space (lobbies, restrooms, hallways, etc.). A commercial tenant will pay for a portion of the shared space and thus their rent is calculated on RSF. The increase in RSF above the usable square footage is referred to as the "load factor."
Replacement Reserves	Funds set aside for the periodic replacement of building components that wear out more rapidly than the building itself and therefore must be replaced during the building's economic life such as the roof, heating, ventilation, air conditioning systems, parking lot resurfacing, etc.

Soft Costs	Those costs not directly related to construction. Soft costs can include: architectural and engineering; historic preservation consultant; environmental consultant; fees related to permitting, systems development charges and design review; legal and accounting; construction-period taxes and utilities; insurance; lease commissions and marketing; project management; appraisal and title insurance/ closing fees for construction loan; operating expenses during the lease-up period, and a soft cost contingency.
Stabilization/ Stabilized Occupancy	Stabilization refers to occupancy levels after the initial lease-up period that are reasonably expected to continue into the future. A construction loan typically cannot be converted to a permanent loan until a property reaches stabilization. Lenders will define stabilization in the loan documents. 90%–95% occupancy is a common threshold.
Tenant Expense Reimbursement	A tenant expense reimbursement is a payment to the landlord for a tenant's pro-rata share of all or certain operating expenses, as stipulated in their lease.
Tenant Improvement Allowance	The amount a landlord is willing to spend so that the tenant can customize their leased space. It is often expressed in a per-square-foot dollar amount.
Usable Square Footage	Usable square footage is the actual tenant space occupied from wall-to-wall, not including the load factor.
Vacancy/ Collection Loss	Income-producing properties always have a loss or reduction in income due to vacancy, turnover, and nonpayment of rent. Even in high-demand markets when vacancy rates are low, there will always be some vacancy and collection losses. Appraisers factor in an allowance (appropriate to market conditions) in their income and expense estimates which affects a property's appraised value.

Notes

This module is part of the Preservation Toolkit developed by Restore Oregon to provide a general orientation to the decisions and processes of historic preservation and reuse. Every project is unique and the information presented does not attempt to address all the aspects or variables that may be encountered. The engagement of a qualified preservation professional is encouraged.

If Historic Places Matter to You, Join Restore Oregon!

Since 1977 Restore Oregon has worked to preserve, reuse, and pass forward the historic homes and buildings, bridges and barns, churches and Main Streets that make Oregon, Oregon.

As a nonprofit, our ability to advocate, deliver programs, and produce materials like the Preservation Toolkit depends on the support of people like you. We invite you to stand up for the historic places that matter to you and become a member by visitng us at restoreoregon.org/join.

Thank you!

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