Financing options and strategic approach for the delivery of the Spitalka Smart District

30 June 2022

Objectives of the mandate of PwC

The aim of the cooperation with PwC was:

- to perform a **financial analysis**, and
- to recommend a **strategic approach for the delivery** of the Spitalka Smart District Project.

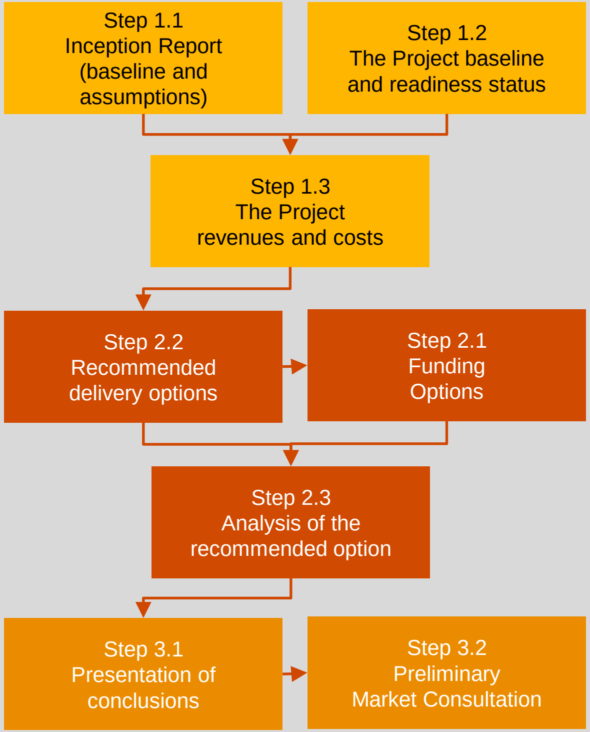
Especially from the point of view of:

1. Delivery Options	2. Financing Options
With an optimal allocation of risks and responsibilities	

Our output:

Preliminary Feasibility Study

Our approach



01

Objectives and assumptions

Project phases

Scope of the Project

Visions of the project

The City expects the Smart Neighborhood Spitalka project (**Spitalka**) to fulfill the following visions and will be:

1 ATTRACTIVE

Spitalka will be an **impulse that will make the** wider neighbourhood in the Cejl area **more attractive** and give an impetus to the overall revitalisation of the district. By blending residential, working and cultural environments, it will offer a **simplification and improvement of life** for residents and visitors.

2 INNOVATIVE

The Spitalka will be a **symbol of progress and modern technology.** It will use innovation and be a model that will show the future possibilities of urban development in the field of sustainability, environmental friendliness, the use of renewable resources and innovative technologies.

3 INSPIRATIONAL

Spitalka, by revitalizing the industrial environment, will offer a socially and culturally rich and inspiring environment for the development of work, community and individual life. Spitalka will be a project of **European significance inspiring other cities to develop**.

Objectives and assumptions of the City

The City expects the following objectives and assumptions to be met:

1. **Minimizing the amount of the City's expenditure** in the project **preparation and investment** with a preference to spread expenditures over the operational phase.
2. **Minimizing the debt burden on** the City balance sheet from the project.
3. **Maintaining ownership** of the land and new project facilities by the City, if economically at least partially feasible.
4. **Maintaining influence on the long-term functioning** of Spitalka and on the content of services and the cultural - social content of the project.
5. **Optimal balance between commercial self-sufficiency, level of ownership, influence over the project and fulfilment of the mission** - being the cultural and social project supporting community life.
6. **Possible financial support of the project from the City** where market/commercial conditions will not be sufficient > CCEH facilities.
7. **Preference for rental housing** over the sale of residential units.
8. The new buildings will have a **passive energy standard** and Spitalka will aspire to be an (almost) energy self-sufficient district.
9. Preservation of industrial character of the district.

Implementation phases

The analysis works with the following 3 phases and timeline:

0

PHASE 0: 2023-2026

Brownfield preparation and construction of transport and technical infrastructure.

1

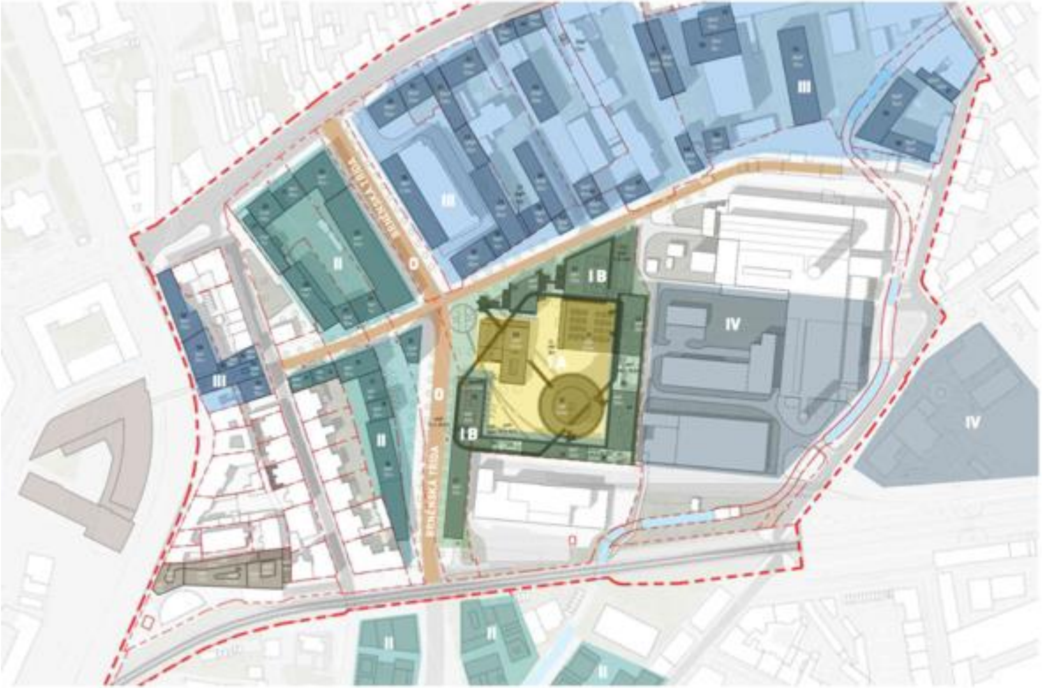
PHASE 1: 2027-2029

Delivery of the Smart District Spitalka.

2

PHASE 2: from 2028

The next phase of development of the wider area.



Phase 1: Objects of the Smart District of Spitalka

The analysis works with the following objects:

WORK & LIVE | 88 % N
Commercial rental housing | up to 530 units

WORK & LIVE | 12 % N
Affordable rental housing | up to 70 units

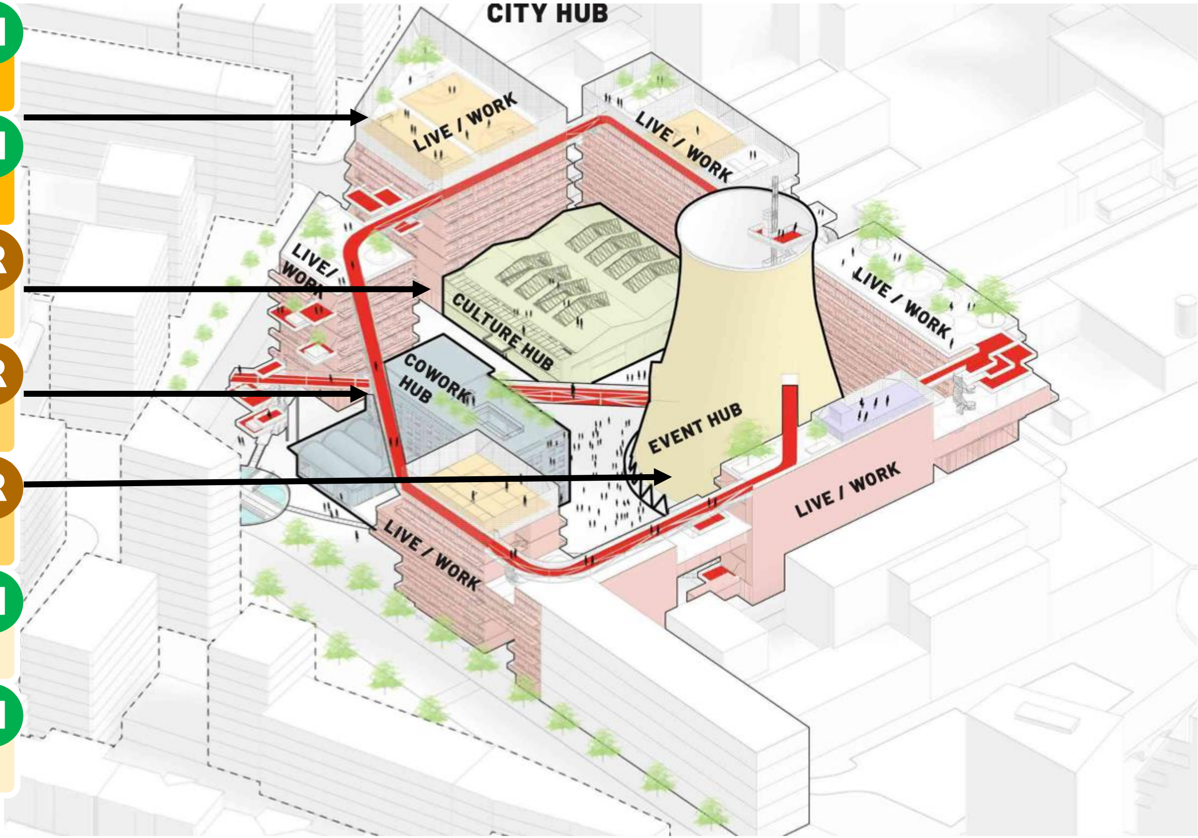
CULTURE HUB R
Multifunctional space for up to 3000 people

COWORK HUB R
Working environment | 200 people

EVENT HUB R
Space for cultural and social events

PARKING N
Underground parking

OTHER OBJECTS N
Public space, skywalk, energy



02

Limitations and threats

Recommended solutions

Constraints and threats - recommended solutions I.

LIMITATIONS AND THREATS	RECOMMENDED SOLUTION
1 UNCERTAINTY REDUCES THE VALUE • The revitalisation of Spitalka will be **the first investment** in the area and will aim to initiate change and attract the interest of residents and businesses. • A price that developers would be willing to pay would be lower now than it would be at a later stage of the development, when it is more attractive.	**HOLD&REALISE THE VALUE AT LATER STAGE** • **Not to sell the land to developers**, but instead to build Spitalka into the City ownership. • **Realize its value only at the end of the project**. the City will retain the risk of future development of the area as it has substantial influence on it.
2 LARGE INVESTMENT of EUR 127 million • Phase 1 between 2027-29 requires a large investment, which, if financed by debt, will significantly increase the City's debt burden.	**SPREAD EXPENDITURES OVER TIME** • **Spread out the City‘s expenditures over time as** development in the broader area begins to generate additional revenue for the City.
3 COMPLEX - RISK OF INTEGRATION • Spitalka is a **very complex project with a risk of integration**, which is not yet clearly defined at this stage. The entire complex will share certain technologies, while individual buildings may have different owners or operators.	**ONE STRATEGIC PARTNER** • The project will be successful if it is implemented and managed by **a single entity in the long term** that has experience in managing large investment projects and is motivated to meet the quality and functionality requirements in the long term.

Constraints and threats - recommended solutions II.

LIMITATIONS AND THREATS

RECOMMENDED SOLUTION

4 BIG INVESTMENT = BIG RISKS

- A large investment project carries **significant project risks** of hundreds of millions of EUR with a possible material impact on the City budget. The project requires professional management and transfer of responsibility. The City should assess its capabilities, experience and competences.

TRANSFER RISKS TO THE PARTNER

- Use a model that **effectively transfers the key risks of the project** to a private sector, in particular construction and cost risk, schedule risk, and operational risk.

5 FUTURE COMPETITION

- In Brno there will be **other projects that might compete** with Spitalka in the future - especially with CULTURE, COWORKING and EVENT HUB.
- The CCEH facilities are important for the development and functionality of Spitalka, but the uncertainty of future development cannot be avoided.

MANAGED RISK = FLEXIBILITY

- The City should be able to influence the strategy, function and content of services so that it can respond to changing community needs and react to competing projects in the future.
- The City should not target only commercial use, but can use Spitalka to serve the needs of the population - the cultural and social dimension.

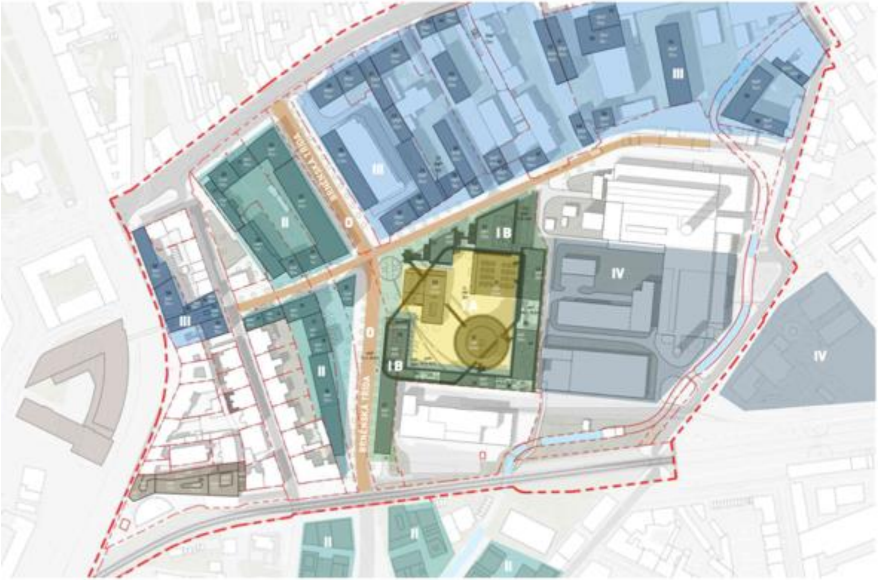
The recommended implementation model: select a **STRATEGIC PARTNER** - experienced and financialy strong, which will assume the key risks of the project - design, construction, deadlines, management and maintenance, long-term functionality and quality. The City should retain ownership and influence over the future content and function of Spitalka and <u>retain the risk of demand and rental prices</u>. This will reduce the risk profile of the project and make project financing cheaper.

03

Investment costs

CAPEX - Phase 0. investment costs– the Site preparation

- The costs for the preparation of the area, clean-up of the brownfield and construction of technical and transport infrastructure are estimated at **EUR 32 million** excl. VAT.
- The Phase 1. financial model for both the JV and PPP options <u>does not assume</u> any expenditure for the Phase 0.
- The Phase 0. risks and investments will not be transferred to the Strategic Partner. The Site preparation and land purchases will be fully managed by the City.
- The construction of technical and transport infrastructure is difficult to transfer to the Strategic Partner, as it extends beyond the Site of Spitalka .
- Certain possibility of **applying for grants** for a brownfield preparation, but only the City can apply.



CAPEX - Phase 1. investment costs – a construction of the Project

- Total Gross Floor Area: 45,400 m^2
- Total Net Floor Area: 35,600 m^2
- Construction costs of Phase 1. are expected to amount to **EUR 112 million** excluding VAT (including inflation of 2%, 2027-2029 prices).
- Operating costs during construction and financing costs increase CAPEX by EUR 14,6-18,8 million.
- **The total investment value of the construction phase** to be financed is **EUR 127 million** excluding VAT.
- This expenditure does not include any of the Phase 0. expenditures from the previous page.

Option	JV	PPP
EUR mil, nominal prices including inflation		
Investment expenditure (nominal)	**EUR mil**	**EUR mil**
Work&Live	47	47
Cowork Hub	5	5
Culture Hub	8	8
Event Hub	21	21
Parking	16	16
Ostatní	11	11
Střešní zahrady	4	4
CAPEX Sub-total	**112**	**112**
Financing costs during construction	12	11
Operating costs during construction	4	4
CAPEX Total	**128**	**127**

The nominal prices of years 2027-2029.

OPEX - Phase 1. operating cash flow - total operating margin

Revenues and operating costs (year 2031), nominal, ths. EUR excluding VAT

Facility	Income	Operating costs	Operating margin
WORK&LIVE	4 984	-636	4 348
COWORK HUB	745	-114	631
CULTURE HUB	583	-58	525
EVENT HUB	826	-328	499
PARKING	2 288	-170	2 117
Total	**9 426**	**-1 306**	**8 120**

Income takes the form of rental income.

Operating costs are net of energy costs.

Excludes financing costs, non-deductible VAT, taxes, etc.

For reference: annual cash flows in the nominal prices in 2031.

04

Options

Options of the strategic approach to the project delivery

1

Option

Joint-Venture
with a strategic partner and with a minimum income guarantee

2

Option

Public-Private Partnership
with an availability payment

Risk matrix - identical for the both options

Based on the objectives, key constraints and risks, and recommendations, we propose an optimal allocation of the transfer of key risks to the strategic partner. Almost identical for both variants.

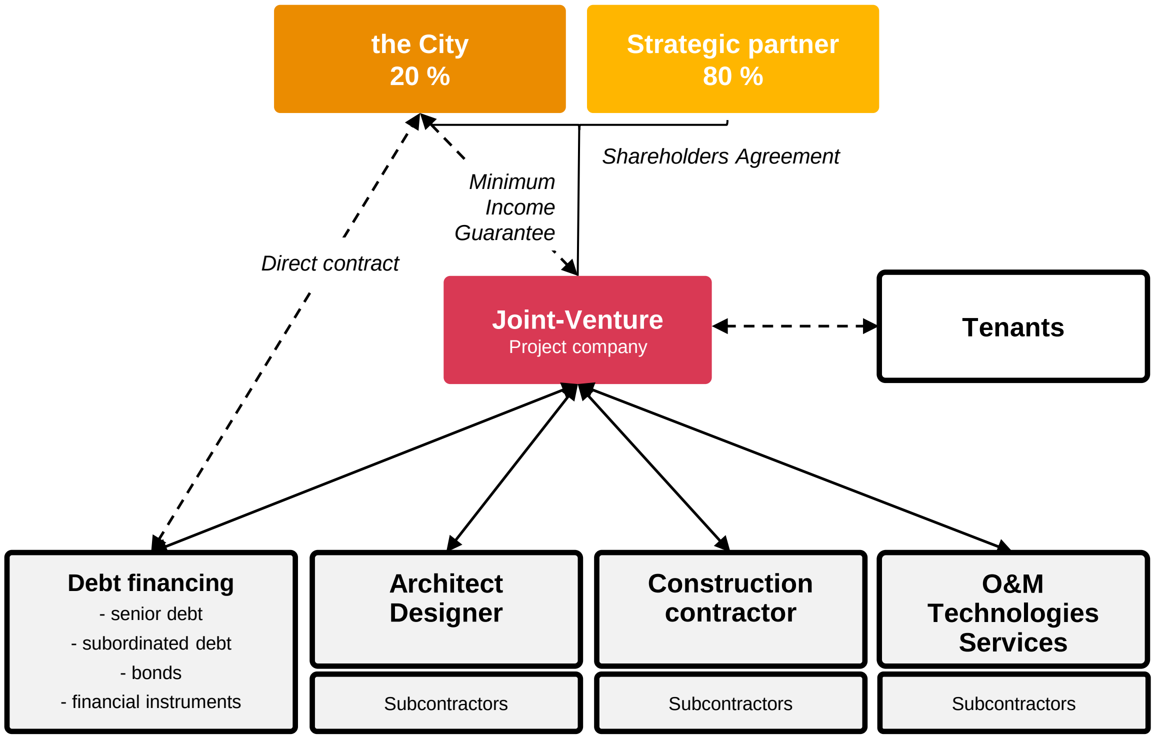
Risk	Joint-Venture	Shared	The City
Obtaining land and a planning permit			X
Obtaining a building permit	X	x	
Design and project documentation	X		
Construction (price and milestones)	X		
Technology - selection and long-term functionality	X		
Operation and maintenance - long-term quality	X		
Life-cycle costs (lifetime renewal/heavy maintenance)	X		
W&L Rental Housing - rental policy & occupancy		x	X
CCEH Facilities - rental policy & functions/services			X
Income from commercial activities - rent, operations ...		x	X
Rent collection and administration of lease contracts	X		

1

OPTION: JV

Joint venture
with a strategic partner and
with a minimum income guarantee

Option 1: Joint-Venture with a minimum income guarantee



Option 1: Description

Strategic partnership option **with <u>a minimum income guarantee</u>** with a financially strong and experienced developer/investor who will provide the majority of equity and skills of project management of long-term investments. May have a number of slightly different variations.

The implementation procedure can be as follows:

1. The City will select a strategic partner (**Partner**) from among real-estate developers or infrastructure funds in a public tender on the basis of the evaluation of the economic advantage of the offer, where the price offer will consist, for example, of the requirement for the amount of the guarantee of minimum income or a Partner's return on capital (IRR) and the amount of the development fee in the case of realization and non-realization of the project.
2. The City and the Partner will jointly establish a project limited company (**JV**). The Partner will provide a competent and professional team for project management and development of the project and will provide its share of an equity capital to the JV for development and investment.
3. The JV will design, finance and build **all objects** in its ownership.
4. The JV will ensure compliance with construction and operational requirements and will be responsible for life cycle costs and long-term quality.
5. WORK&LIVE: Rent policy is set by the City but will be compensated by JV in case of lower income against supply model - see **Guarantee**.
6. CCEH: The operation of the CCEH can be provided by the JV or by an external operator. the City will influence CCEH activities, but will compensate the JV in case of lower income against the model - see **Guarantee**.
7. The partner will be incentivised to maximise JV's commercial revenue by a profit sharing that will increase its return on capital beyond its minimum return requirement. However, the Partner's rate of return will be degressively capped, e.g.: profit sharing between min IRR and min IRR+X% will be 50:50, above min IRR+X% will be 20:80 (the City 80%), above maybe even a max cap.
8. At the end of the 30th year, the Partner's share will be transferred to the City for CZK 1.

Main parameters

Land	• i) contributed into JV or ii) remains in the ownership of the City.
Objects	• Owned by JV.
Revenues	• **JV:** income from the rental or operation of **all buildings**. • **the City:** provides JV a **Minimum Income Guarantee**. • A degressive incentive scheme for the Partner to maximise commercial profits, including a possibility of a maximum cap.
Risk	• The most perceived concern is that in the future the City, as a shareholder in the JV, could block the operation of the project. • The contract must clearly address the procedures in all critical situations of the project (default, termination …).
Offer price	• Requirement for a minimum return on Partner's capital (IRR) /or the amount of the Minimum Income Guarantee (to be verified). • Reward for development in case of realization, but also compensation in case of non-realization. • It is necessary to legally verify whether the JV will procure under the ZZVZ regime.

Principle of the Minimum Income Guarantee

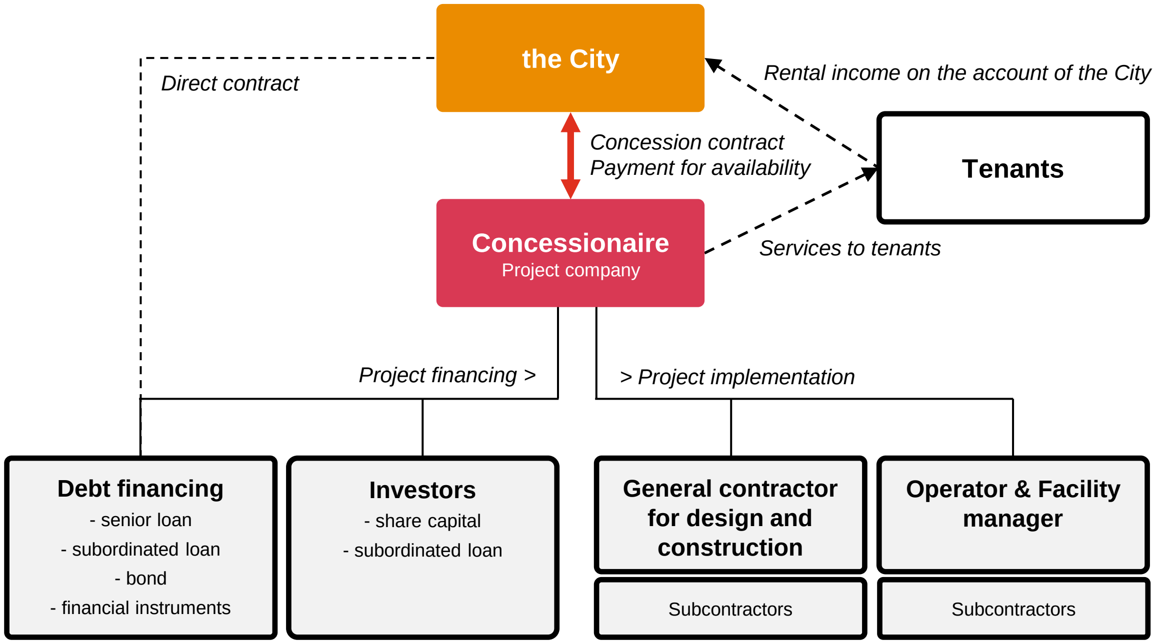
- The objective of Option 1. JV is to obtain a financialy and professionally strong partner that will ensure the construction is on budget, on time, and in quality and will be motivated to operate the facility for the long term.
- **The Minimum Income Guarantee** is the payment of the difference between the JV's actual income and the minimum income level specified in the financial model in the Partner's offer, provided that the actual income is below the minimum level.
- The City will retain an income risk for selected properties. The JV will have a certain minimum income in an event of a fall in demand or rental prices. This will ensure a substantial reduction in the cost of financing the project. The revenue risk for CCEH is borne by the City in all options.

2

OPTION: PPP

Public-Private Partnership

Option 2: PPP with payment for availability



Option 2: Description

PPP partnership option with a financially strong and experienced infrastructure investor who will provide preparation, construction, financing and operation according to the output specification, but who will not bear the risk of demand for the project. The delivery process could be as follows:

1. The City will select a consortium consisting of an infrastructure investor, a construction company, a facility manager and banks in a public tender on the basis of an evaluation of the economic advantage of the offer, where the price offer will be the net present value (NPV) of **the availability payments** to the concessionaire.
2. The winning consortium will establish a new project company (SPV=the **Concessionaire**).
3. The Concessionaire will design, finance and build **all the objects** on its own account and will manage and operate them all.
4. The Concessionaire shall ensure compliance with construction and operational requirements and shall be responsible for life cycle costs and long-term quality.
5. WORK&LIVE: the City will determine the rent policy. The concessionaire will provide services to tenants and collect rent on behalf of the City. the City will pay the availability payment.
6. CCEH: The operation of the CCEH may be provided by the Concessionaire or by an external operator (more likely). The Concessionaire will collect rent on behalf of the City.
7. The concessionaire may be partially motivated to maximize a commercial revenue by a profit share that will increase the return on its investment beyond its profitability requirement. However, the Partner's rate of return will be limited, and more so than in *Joint-Venture Option 2*, as in this option the **demand risk is fully transferred to the City.** However, it is still possible to use the commercial revenue sharing mechanism of Option 2.

Main parameters

Land	• Owned by the City.
Objects	• Owned by the City.
Revenue	• **Concessionaire:** the main income is the **payment for an availability** of objects with a penalty mechanism in case of poor quality and unavailability. Possibly with a degressive incentive scheme to motivate maximisation of commercial income. • **The City:** rental income collected by the Concessionaire to its account or the City account. In case of transfer to the Concessionaire, a Minimum Revenue Guarantee will be required.
Funding	• To be provided by the Concessionaire.
Offer price	• Net present value of availability payments (NPV).

Payment for an availability of facilities

- The Contracting Authority shall repay the project by regular payment to the Concessionaire, the amount of which is determined by the tender price in the bid. This payment is subject to 100 % availability and functionality of all objects in the predefined quality.
- In case of partial unavailability or poor quality, the contract shall clearly specify the terms of the penalty, which will reduce payments by the City.
- The first payment is due after successful completion and commencement of the operational phase.

05

Summary of variants and recommendations

Summary: The achievement of the Project objectives

The options considered differ in the extent to which the project objectives and assumptions are met. Below we summarise the assessment of the main aspects of each option with respect to the key objectives and constraints of the project. For *option 1. JV,* we also consider *sub-option 1a*, where the City does not issue a Minimum Income Guarantee to the JV and the JV bears the full income risk.

Project objectives > Variants		Getting a long-term strategic partner	Minimising the City expenditure on preparation and investment	Minimising the City debt	Ownership of land and buildings	Flexibility of change and impact on function	Transfer of the main risks associated with implementation and management	A tried and tested model	Potential for more favourable project financing
1a	**Joint-Venture with a strategic partner with NO minimum income guarantee**	Joint venture with a strategic partner.	Contribution of 20% share to the JV, possibly by credit against the land contribution.	The project does not enter the City balance sheet if compliant with ESA2010.	Land and buildings owned by JV with subsequent acquisition of 100% share.	Influence proportional to the City's ownership stake in the JV.	Risks up to the amount of the equity stake (20%), but without the guarantee of lower influence.	Model used, but exact settings need to be checked thoroughly.	Medium potential for cheaper JV financing.
1b	**Joint-Venture with a strategic partner with a minimum income guarantee**	Joint venture with a strategic partner.	Contribution of 20% share to the JV, possibly by credit against the land contribution.	The project enters the balance sheet of the City according to the ESA2010 methodology.	Land and buildings owned by JV with subsequent acquisition of 100% share.	Full flexibility to change, but changes governed by contract rules.	Risks up to the amount of the equity stake (20%), but with a guarantee of a higher influence.	The model is untested in the CR, a thorough examination of the contractual setup is necessary.	High potential for cheaper JV financing.
2	**Public-Private Partnership**	Long-term partnership with concessionaire.	Annual availability payments, where the first payment is only after successful completion.	The project does not enter the City balance sheet if compliant with ESA2010.	Land and buildings owned by the City.	Full flexibility to change, but changes governed by contract rules.	Project risks transferred to concessionaire (excluding demand and rent level risks).	The pay-for-availability PPP model is well used and proven.	High potential for cheaper JV financing.

Legend to the colour scheme for the evaluation of the variants: green - fully or to a large extent fulfils the given objective, the given limitation is not relevant; orange - medium extent of fulfilling the given objective or limitation by the given limitation; red - to a small extent fulfils or does not fulfill the given objective, or significant limitation by the given limitation.