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The Arrott Building: An HTC/NMTC Case Study in the COVID-19 World



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In 2017, New Orleans-based real estate development company HRI Properties, Inc. (HRI) began the approximately four-year process of rehabilitating the historic Arrott Building in downtown Pittsburgh to serve as an upscale hotel. With the hotel's April 2021 opening, the development became HRI's latest successful implementation of twinning historic tax credits (HTCs) with new markets tax credits (NMTCs). As HRI realized after completing numerous projects with this financial model, the two economic revitalization tools serve as excellent complements to one another, seeking to accomplish shared goals and providing flexibility in funding to developers that pair them.

While construction on the Arrott Building was underway, the COVID-19 pandemic struck, creating a significant impact. Among the effects were Pennsylvania's mandated shutdown, worksite quarantines and inflated costs of materials. The challenges faced by the Arrott Building heightened the need for government assistance to offset the impact of the pandemic. The Historic Tax Credit Growth and Opportunity Act (HTC-GO), introduced in the House of Representatives in April 2021, seeks to bring relief to projects impacted by the pandemic, as well as permanent provisions that will add value to the HTC.

The Arrott Building—A Pittsburgh Landmark

The Arrott Building opened on Wood Street in downtown Pittsburgh in 1902. As one of the city's first skyscrapers, the 18-story building served as the offices of insurance agent and owner James W. Arrott. Various tenants leased space within the building, including the Safe Deposit and Trust Company. The Arrott Building

was designed by prominent Pittsburgh-based architect Frederick J. Osterling, who gained fame designing other well-known downtown buildings, like the Allegheny County Morgue, the Union Trust Building and the Colonial Trust Company Building.

Osterling's design of the Arrott Building was completed in the Renaissance Revival style, with a base, shaft and capital composition. Its prominent location at the intersection of Fourth Avenue and Wood Street resulted in ornate façades complete with granite and terra cotta detailing. Additionally, the interior features a high-style entrance lobby of terrazzo floors, marble walls with mosaic tile detailing, and a decorative plaster ceiling, all of which highlight the importance of the building and its tenants.

The Rehabilitation of the Arrott Building

HRI purchased the Arrott Building to rehabilitate the former office building into a hotel, complete with

124 guest rooms, meeting space, a restaurant and bar. Over the past several decades, HRI developed a solid reputation as an industry leader, successfully completing complex projects that often involve the rehabilitation of historic buildings. The Arrott Building serves as one example in an extensive portfolio that includes the Mayflower Building in Dallas and the King Edward Hotel in Jackson, Mississippi, among others that were completed with HTCs.

HRI's rehabilitation efforts often include a twinned HTC/NMTC financial model. The Arrott Building is the company's most recent example of this.

"Any time [HRI] can pair HTCs with NMTCs, the decision is to do so," said A. Thomas Leonhard Jr., HRI president and chief executive officer. "The adaptive reuse of older buildings is expensive, complicated and always present some gap financing needs. NMTCs, twinned with HTCs, provides critical financing, allowing these blighted historic properties to be placed back into service and help transform neighborhoods."

Kirsten Vaselaar, senior vice president – real estate and development at HRI, who directed the Arrott Building rehabilitation, echoed Leonhard's sentiments and emphasized the compatibility of HTCs and NMTCs. This is particularly true since the goal of both incentives is to revitalize communities. On the HTC side, the incentive seeks to rehabilitate historic buildings and reinvest within communities. Similarly, NMTCs look to invest in underused communities. Both, therefore, act as catalysts for further continued investment.

Vaselaar further expanded upon the compatibility of the two incentives, explaining that the timing of the investments plays a key role in their compatibility.

"The NMTC duration is seven years. Typically, that investment comes at the beginning of the transaction," she said. "If you have an 18- to 24-month construction

timeline, the timing works out with the five-year HTC, in which investment comes at the end of the project."

Leonhard expanded upon this.

"Generally speaking, the timing of the two incentives has not been an issue with investors," he said. "It is common to see the same investor, typically institutional investors, such as banks, though that is not always the case."

Vaselaar opined that these transactions are, "not for the faint of heart," as the HTC process extends from project initiation through completion, generally a multiyear process that requires sophisticated navigation. Investors with experience in the HTC realm generally understand that this process requires patience.

Additionally, both require compliance through government entities. HTCs undergo a review process between state historic preservation offices and the National Park Service that ensure the rehabilitation is appropriate to the historic building. NMTCs, on the other hand, must prove that the investment contains community benefits. HRI proudly highlights the community benefits that result from their projects. As a hotel, the Arrott Building project will result in the creation of approximately 50 jobs.

Leonhard highlighted the use of hotels and their numerous community benefits as perfect for NMTCs.

"We think hotel use for new markets is right up the fairway for the NMTC program because it creates jobs for moderate income individuals," he said. "In the hotel business there is a lot of opportunity for upward mobility in those positions." As a national firm, HRI affords employees the opportunity to move within the company. HRI's hotel developments, therefore, have resulted in numerous examples of upward mobility.

Despite HRI's extensive experience in navigating complex projects, there was no playbook for the effect of the COVID-19 pandemic. Construction on the Arrott Building was ongoing as the pandemic hit in early 2020. In Pennsylvania, a 41-day shutdown of all construction activities took place in spring 2020, which set the stage for numerous concerns that threatened the success of the project, leading Tom Leonhard to state, "Sadly, this project is the poster child for the challenges of the pandemic."

Since the outbreak of COVID, the rehabilitation of the Arrott Building withstood not just the state mandated shutdown, but further impacts resulting from positive tests among construction workers, which led to necessary quarantines, and compliance with social distancing protocols, resulting in staggered shifts among crews to minimize workers at project access points. On top of this, there were health department regulations requiring additional cleaning, labor and processes that increased project costs. These resulted in significant scheduling delays and increased costs.

What is clear, through the impacts of COVID on the Arrott Building, is that increased incentives will be necessary for developers to take on new projects in the COVID and post-COVID world. Leonhard compared the issues with funding and the inflation of construction materials to those that existed in the aftermath of Hurricane Katrina. Following the devastation of the hurricane, Congress passed the Gulf Opportunity Zone Act of 2005, which incentivized development and investment to rebuild the local economies in the Gulf Opportunity (GO) Zone of the Gulf Coast region.

"Like we saw in the southeast after Hurricane Katrina hit, there were additional incentives created in the GO Zone," said Leonhard. "HTCs, for example, rose

from 20% to 26%." Leonhard expanded upon the impact of the GO Zone, noting, "projects like the King Edward Hotel in Jackson, Mississippi, would not have been completed without the GO Zone incentives. If not for that incentive, the building would have been torn down long ago."

Similar to post-Katrina incentives, Leonhard firmly believes that the provisions of the HTC-GO Act would have a profound impact on redevelopment projects across the country. The enhanced credit would also serve to spur investment in communities where such investment would otherwise not occur. As Leonhard put it, enhancements through the HTC-GO Act, "would be critical to offset the losses incurred from the pandemic."

Conclusion

The use of twinned HTCs and NMTCs for the Arrott Building rehabilitation illustrates the compatibility of the incentives to accomplish their shared goal, economic revitalization. As it specifically relates to the Arrott Building, HRI's Kirsten Vaselaar said, "there would have been no Arrott project without twinning HTCs and NMTCs." Vaselaar further explained the importance of the financial model, stating, "NMTCs are, and will remain, critical to HTC projects, specifically those that take place in states that do not have a strong state HTC."

The impact of the COVID-19 pandemic on the development further documents the various impacts the health crisis had on redevelopment efforts over the past year. One additional challenge the pandemic has imposed upon the hospitality industry is the decrease in occupancy rates. HRI's Leonhard noted that the pre-pandemic hotel occupancy rate for hotels in urban centers was around 72%, an important statistic considering a large percentage of urban areas are NMTC-eligible census tracts. This number dropped to a pandemic low of 5% in spring 2020. Just like the Arrott Building itself

overcame the impact of the pandemic, Leonhard and Vaselaar remain optimistic that the hospitality industry will also overcome these challenges.

With the hotel's opening, one of Pittsburgh's most noteworthy downtown landmarks has been returned to its former glory. ♦

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Cindy Hamilton is president of Heritage Consulting Group.

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