



## MEMORANDUM

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Date: March 9, 2012

To: Thomas Rogers and Arlinda Heineck, City of Menlo Park

CC: Mark Hoffheimer, Perkins + Will

From: Sujata Srivastava, Principal, Strategic Economics

Project: 0834 Menlo Park El Camino Real/Downtown Specific Plan Update

Subject: Task G Public Benefit: Financial Feasibility Analysis

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### PURPOSE OF STUDY

This memorandum report summarizes the methodology and results of a financial feasibility study prepared by Strategic Economics with support from Perkins + Will, intended to inform the El Camino Real/Downtown Specific Plan. This analysis updates a previous financial analysis conducted by Strategic Economics in 2009, including using 2012 inputs and incorporating the Draft Specific Plan's zoning standards. **The purpose of the analysis is to test in a general way how allowed intensities, or floor-area-ratios (FARs), are likely to affect the feasibility of new development in the Specific Plan Area, and the resulting potential to garner public benefits in addition to inherent project benefits such as affordable housing or increased revenue generation. Because market conditions and development costs fluctuate over time, and because development opportunities vary from property to property, the results of this analysis are not necessarily directly applicable to a specific project.** However, the findings of this study can be extrapolated and applied to the overall Specific Plan area boundaries

More specifically, the objectives of the analysis are 1) to test the financial feasibility of a variety of building types and intensities in order to assess the recommended base and maximum FARs as designated in the Specific Plan; and 2) to assess the potential for developing a methodology for extracting additional benefits from private development projects that receive FAR bonuses.

## About Financial Feasibility

Financial feasibility analysis is often used by cities to test the impact of regulatory mechanisms, such as zoning, parking requirements, and height limits on private development activity. The financial feasibility study is not intended to be prescriptive about the type of projects that should or will occur in the study area; nor is it representative of every development project or building type that could be possible. Each site and development project has unique circumstances, just as each developer has his/her own financial objectives, and those nuances are not possible to capture in this type of analysis. Rather than being a predictive model of the future, this financial feasibility analysis is a planning-level tool that allows decision-makers to compare different types of development projects and help them make regulatory decisions that are congruent with the community's vision and objectives for the study area. The analysis is based on judgments about what may be possible in the study area given current construction costs, land costs, and market conditions, obtained through interviews with developers, brokers, and published secondary sources.

The results of this financial feasibility analysis are strongly influenced by conditions in the real estate and construction materials markets. The market for real estate tends to be cyclical in nature and the region's housing market is still experiencing declines in both condominium and single-family home prices, according to the latest Case-Shiller Home Price index.<sup>1</sup> While the commercial office market in the San Francisco Peninsula is showing signs of recovery, the overall vacancy rate remains over 10 percent according to a recent CBRE report.<sup>2</sup>

These factors, combined with tight credit markets, persistent unemployment, and weak national economic indicators, continue to slow down real estate development activity in the Bay Area; consequently, it is difficult to anticipate when the real estate market will be strong enough to attract a significant amount of new development. However, while current market conditions are not conducive to new development, the Specific Plan is a long-range document, and development projects affected by the policies therein will not be constructed and occupied until 2013 at the earliest. It is therefore important to consider not only what may be feasible given current market conditions, but also the likely feasibility once the market is restored. Where development was found to be infeasible in the current market, it was also tested with revenue increases and lower capitalization rates, in order to assess if the building types are likely to become feasible in the short- to medium-term.

## KEY FINDINGS

The financial feasibility of each development scenario is summarized in Tables 1 and 2. Detailed pro forma statements are presented in Appendix B of the report. The following summarizes the key findings from the analysis:

- Mixed-use residential development with the proposed Draft Specific Plan's base FARs is feasible given current land values.** The proposed base FAR of 1.1 for the ECR NW site for residential development is shown to generate sufficient revenues to offset the development and land costs. The proposed base FAR of 1.25 for the ECR SE site falls just slightly short of the threshold residual land value, but requires only a 0.3 percent increase in revenues to exceed development and land costs. Therefore, this report concludes that the base FARs for residential development on both ECR NW and ECR SE sites is feasible in the short term.

<sup>1</sup> Case-Shiller Home Price Index, November 2011. <http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff-p-us--->

<sup>2</sup> CBRE, MarketView San Francisco Peninsula Office, 4<sup>th</sup> Quarter 2011.

- **Residential development with the proposed Draft Specific Plan's bonus FARs for both parcel types appear to be more feasible than the base FAR scenarios, given current market values.** Housing developments at the bonus FARs (1.5 for the ECR NW site and 1.75 for the ECR SE site) can be reasonably expected to be built in the project area in the short term.
- **Development costs generally go up as density increases.** While higher FAR projects do generally produce higher revenues by allowing for more density on the site, these projects are also more costly to build because they require a higher number of underground or podium parking spaces. This pattern is applicable to residential and office projects.
- **Mixed-use office projects at the proposed base and bonus FARs appear not to be feasible on the small and larger parcels.** For the ECR NW and ECR SE sites, office projects at the base FARs of 0.55 and 0.625, respectively do not appear to be feasible based on current achievable office rents. Office buildings with bonus FAR (0.75 for the ECR NW site and 0.875 for the ECR SE site) were also not found to be feasible at this time. Even office buildings with FARs exceeding the proposed bonus density (1.5 on the ECR NW parcel and 1.75 on the ECR SE parcel) were unable to meet the threshold for feasibility. Therefore, under current market conditions, it is unlikely that new office development will occur in the study area for most small and large parcels. It should be noted that long-term property ownership, construction costs, parcel size/configuration, and other factors may make it more feasible for some properties to be developed into office use. It is also possible that office projects at these low densities could still be built in the project area, but without generating profits for the developer.
- **The financial performance of office development does not improve with projected growth in rents, largely due to the difficulty of building larger-scale office buildings on smaller infill sites.** With increased revenues of ten percent, as well as a more favorable capitalization rate of seven percent, office development still appears to fall short of feasibility, at the proposed, bonus, and full FARs for both ECR NW and ECR SE parcels. The high cost of providing underground parking for office buildings on parcels such as the ECR NW and ECR SE sites exceeds the revenues that can be generated from the office rents.
- **The proposed bonus density residential development generates a higher residual land value than base density. This added value to increased density suggests that there is potential for the city to pursue strategies to negotiate public benefits with developers that seek to maximize density for residential projects.** However, because of the added costs associated with meeting the Draft Specific Plan's design requirements, such as underground parking, and variability of financial performance from project to project, the value is likely to vary. In addition, the City should consider how such strategies could affect the Plan's ability to achieve inherent project goals, such as the provision of additional housing of a variety of types, and the activation of the station area and downtown. Such strategies would not be as likely for office developments, which do not currently generate sufficient revenues for developers even with the proposed bonus FAR.

While there are various strategies for cities to receive public benefits from private development, few of them tie density bonuses to the provision of public benefits. One of the few examples of such a program is from San Diego, where the local redevelopment agency - Centre City Development Corporation (CCDC) – has implemented a voluntary FAR Bonus Payment Program that allows developers to purchase additional FAR for projects in the Downtown Community Plan Area. Under the program all payments go into a fund that is

primarily used for the acquisition of land and construction of public parks, but can also be used for other infrastructure improvements in the Downtown Community Plan Area. It is important to note that this program has not replaced development impact fees or developer agreements, but rather is complementary to those other funding sources for community facilities, amenities, and infrastructure. With the dismantling of the California redevelopment agency, the program will be transferred to the City of San Diego and remain in effect.

## **RECOMMENDATIONS FOR SPECIFIC PLAN REVISIONS**

Perkins + Will, in association with Strategic Economics, analyzed and confirmed the proposed base and bonus FARs of the Draft Specific Plan. Perkins + Will and Strategic Economics do not recommend any revisions to the FARs set in the Draft Specific Plan at this time. However, the consultant team does recommend a periodic review of the base and bonus FARs every five years to ensure that the Plan's policies are responsive to market conditions.

Table 1: Results of Financial Feasibility Analysis on Small El Camino Real Parcel

Program Assumptions for Small Parcel - ECR NW	Proposed Base FAR & New Zoning Standards		Proposed Bonus FAR & New Zoning Standards		Maximum Office
	Residential over Retail	Office over Retail	Residential over Retail	Office over Retail	Office over Retail
Land use					Office over Retail
Density or FAR	\$1.10	\$0.55	\$1.50	\$0.75	\$1.50
Number of Stories	\$3.00	\$2.00	\$3.00	\$2.00	3 (11.5 ft ceiling hts)
Net Revenues	\$12,041,688	\$7,697,738	\$15,896,938	\$9,452,813	\$13,400,288
Net Costs (including Developer Profit)	\$9,761,878	\$8,370,342	\$12,980,756	\$10,317,964	\$15,359,295
Residual Land Value per sq ft	\$116	-\$34	\$148	-\$44	-\$100
Land Value	\$100	\$100	\$100	\$100	\$100
Estimated Market Value of Land	\$1,966,200	\$1,966,200	\$1,966,200	\$1,966,200	\$1,966,200
Revenues Minus Costs	\$313,609	(\$2,638,805)	\$949,982	(\$2,831,352)	(\$3,925,207)
% Increase in Revenues Needed	none	34.3%	none	30.0%	29.3%

Source: Perkins + Will, 2012; Strategic Economics, 2012.

Table 2: Results of Financial Feasibility Analysis on Large El Camino Real Parcel

Program Assumptions for Large Parcel - ECR SE	Proposed Base FAR & New Zoning Standards		Proposed Bonus FAR & New Zoning Standards		Maximum Office
	Residential over Retail	Office over Retail	Residential over Retail	Office over Retail	Office over Retail
Land use					Office over Retail
Density or FAR	1.25	0.625	1.75	0.875	1.75
Number of Stories	3	3	4	3	4
Net Revenues	\$25,575,438	\$13,863,713	\$34,820,438	\$18,087,023	\$30,146,483
Net Costs (including Developer Profit)	\$21,862,421	\$15,272,284	\$30,226,031	\$20,003,459	\$34,768,031
Residual Land Value/SF	\$98	-\$37	\$121	-\$51	-\$122
Estimated Market Land Value per sf	\$100	\$100	\$100	\$100	\$100
Estimated Market Value of Land	\$3,785,600	\$3,785,600	\$3,785,600	\$3,785,600	\$3,785,600
Revenues Minus Costs	(\$72,583)	(\$5,194,171)	\$808,806	(\$5,702,037)	(\$8,407,148)
% Increase in Revenues Needed	0.3%	37.5%	none	31.5%	27.9%

Source: Perkins + Will, 2012; Strategic Economics, 2012.

## METHODOLOGY AND ASSUMPTIONS

The following section provides the methodology and key development assumptions used in the financial feasibility analysis, including a description of the process used to create the hypothetical development programs tested.

### Residual Land Value Method

Financial feasibility was tested using a pro forma model that measures the **residual land value** of a given development project. Many pro forma models are structured to solve for the financial return for the developer or investors (internal rate of return). In contrast, the residual land value method of analysis solves for the value of the land. This method recognizes that the value of land is inextricably linked to what can be built on it, and that development potential is heavily influenced by zoning as well as lot size and configuration, neighborhood context, and other factors. The residual land value can be calculated using a static or multi-year model. A static pro forma model, which was used for this analysis, tallies all development costs (minus land) including construction costs, “soft” costs, and developer fees. Revenues from unit sales or rental leases are then summed. The total project costs are then subtracted from the total project revenues. If revenues exceed costs, the balance is the residual value, representing the price a developer would pay for the land if pursuing that project.

The residual land value is typically expressed on a per-square-foot basis. In order to understand what this measure says about feasibility, the residual land value is compared with the expected sales price for a particular site. If the residual value is higher than the market value, the project is feasible. If the residual value is lower than the market price, then the project is infeasible. While sales prices for land in Downtown Menlo Park and on El Camino Real can vary widely depending on the specific property, based on a survey of transactions and interviews with brokers and developers active on the Peninsula, the average land value in the study area is estimated at \$100 per square foot.

### Building Types Tested

Perkins + Will conducted site accommodation studies for prototypical parcels in the Study Area, to understand the types of projects that could be reasonably developed on the sites within proposed building height restrictions, setback and open space requirements, and parking standards for the various zoning districts identified in the Draft Specific Plan.

The prototypical parcels analyzed in the accommodation studies may assume some land assembly would be required in order to facilitate development parcels of a suitable size for development.

*Table 3: Prototypical Parcels Studied*

Parcel Prototype	General Location	Dimensions	Total Area
Small El Camino Real Parcel	ECR NW	113 feet x 174 feet	19,662 square feet
Large El Camino Real Parcel	ECR SE	182 feet x 208 feet	37,856 square feet

Source: Perkins+ Will, 2012

Perkins + Will’s site accommodation studies developed building types at a range of densities, measured as dwelling units per acre for residential buildings, and FARs for office buildings. **These building types represent potential development projects that could be built on the prototypical parcels given the physical limitations of size, configuration, and other characteristics, but they are not intended to be inclusive of every possible building type, nor predictive of how the study area will be developed in the future.** In addition to studying the proposed base and bonus FARs for each mixed-use residential and mixed-use office projects on each parcel, Perkins + Will also tested a maximum office FAR scenario for both sites that exceeds the proposed bonus FAR to understand the financial performance of projects that maximized the full building envelope that could be

accommodated on the sites. The site accommodation studies can be found in Appendix A of this report. Based on inputs from the site accommodation studies by Perkins + Will, Strategic Economics tested the financial feasibility of 10 building types, each with its own development program. These development programs are described in detail in Table 4 for the small parcel (ECR NW) and in Table 5 for the large parcel (ECR SE).



Table 4: Building Types Tested for El Camino Real Small Parcel – ECR NW

Program Assumptions for Small Parcel - ECR NW	Proposed Base FAR & New Zoning Standards		Proposed Bonus FAR & New Zoning Standards		Maximum Office (reduced office floor heights)
	Residential over retail	Office over retail	Residential over retail	Office over retail	Office over retail
Land use					
FAR	1.10	0.55	1.50	0.75	1.50
Zoning standards	25 du/acre	(1/2 of Base FAR 1.1)	40 du/acre	(1/2 of Base FAR 1.5)	NA
Site area in sq ft	19,662	19,662	19,662	19,662	19,662
Site developable area (minus setback area) in sq ft	16,837	16,837	16,837	16,837	16,837
Total buildable area in sq ft	21,628	10,814	29,493	14,747	29,493
Landscaped area in sq ft <sup>1</sup>	10,300	8,275	4,700	4,745	6,025
Ground floor retail area (in sq ft) <sup>2</sup>	4,100	5,300	5,300	5,300	2,500
Gross office area (in sq ft)	0	10,814	0	14,747	26,993
Net office area (in sq ft) <sup>3</sup>	0	9,192	0	12,535	22,944
Gross residential area (in sq ft)	17,528	\$0.00	24,193	\$0.00	0
Net residential area (in sq ft)	14,899	\$0.00	20,564	0	0
Number of units <sup>4</sup>	11	0	15	0	0
Net unit size (in sq ft)	1,354	0	1,371	0	0
Number of stories <sup>5</sup>	3	2	3	2	3 (11.5 ft ceiling hts)
Surface parking spaces	0	0	0	0	0
Podium level spaces (level 1)	34	22	20	22	30
Podium level spaces (level 2)	0	0	23	0	0
Underground level spaces (level 1)	0	43	0	57	41
Underground level spaces (level 2)	0	0	0	0	42

The Total Buildable Area for Residential over Retail development type adds up the total gross residential and retail area to maximize the available FAR.

The Total Buildable Area for Office over Retail development type maximizes half the allowable FAR for office use and adds an appropriate retail space that counts against the remaining available FAR.

The Total Buildable Area for Office over Retail development type, in particular the Maximum Office scenario, adds up the total gross office and retail area to maximize the available FAR.

<sup>1</sup> Landscaped Area is calculated based on one potential accommodation study for each development. At the minimum the 30% open space requirement for ECR SE is met.

<sup>2</sup> Ground Floor Retail is calculated based on a 40 feet deep retail space. The length of the Retail Area is the lot width minus the length required for entries, lobbies and any parking garage front as necessary.

<sup>3</sup> Net Office and Residential Area are considered to be 85% of Gross Office and Gross Residential Area respectively

<sup>4</sup> Residential unit area is assumed to be a 2 bedroom condominium unit of approximately 1,350-1,400 sf in size. The specific average unit size for each scenario was calculated based on the accommodations study's parameters, which take into account the physical constraints of the site, as well as zoning standards, including parking.

<sup>5</sup> Floor to ceiling height for residential = 10' and office/retail = 15'. In the maximum office development type, the ceiling heights are 11.5' to remain within the building height limit.

Source: Perkins + Will, 2012; Strategic Economics, 2012

Table 5: Building Types Tested for El Camino Real Large Parcel – ECR SE

Program Assumptions for Large Parcel- ECR SE	Proposed Base FAR & New Zoning Standards		Proposed Bonus FAR & New Zoning Standards		Maximum Office
	Residential over retail	Office over retail	Residential over retail	Office over retail	
Land use	Residential over retail	Office over retail	Residential over retail	Office over retail	Office over retail
FAR	1.25	0.63	1.75	0.88	1.75
Zoning standards	40 du/acre	(1/2 of Base FAR 1.25)	60 du/acre	(1/2 of Base FAR 1.75)	NA
Site area in sq ft	37,856	37,856	37,856	37,856	37,856
Site developable area (minus setback area) in sq ft	28,576	28,576	28,576	28,576	28,576
Total buildable area in sq ft	47,320	23,660	66,248	33,124	66,248
Landscaped area in sq ft	14,000	14,200	14,000	14,200	11,300
Ground Floor Retail area (in sq ft)	6,100	6,100	6,100	6,100	6,100
Gross office area (in sq ft)	0	23,660	0	33,124	60,148
Net office area (in sq ft)	0	20,111	0	28,155	51,126
Gross residential area (in sq ft)	41,220	0	60,148	0	0
Net residential area (in sq ft)	35,037	0	51,126	0	0
Number of units	26	0	37	0	0
Net unit size (in sq ft)	1,348	0	1,382	0	0
Number of Stories	3	2	4	3	4
Surface parking spaces	0	0	0	0	0
Podium level spaces (level 1)	40	42	40	51	51
Podium level spaces (level 2)	34	0	54	0	0
Underground level spaces (level 1)	0	73	0	100	102
Underground level spaces (level 2)	0	0	0	0	101

Note - The Office over Retail Development Type uses only half the allowable FAR for the office use. The retail use area is counted against the remaining allowable FAR.

The Total Buildable Area for Residential over Retail development type adds up the total gross residential and retail area to maximize the available FAR.

The Total Buildable Area for Office over Retail development type maximizes half the allowable FAR for office use and adds an appropriate retail space that counts against the remaining available FAR.

The Total Buildable Area for Office over Retail development type, in particular the Maximum Office scenario, adds up the total gross office and retail area to maximize the available FAR.

<sup>1</sup> Landscaped Area is calculated based on one potential accommodation study for each development. At the minimum the 30% open space requirement for ECR SE is met.

<sup>2</sup> Ground Floor Retail is calculated based on a 40 feet deep retail space. The length of the Retail Area is the lot width minus the length required for entries, lobbies and any parking garage front as necessary.

<sup>3</sup> Net Office and Residential Area are considered to be 85% of Gross Office and Gross Residential Area respectively

<sup>4</sup> Residential unit area is assumed to be a 2 bedroom condominium unit of approximately 1,350-1,400 sf in size. The specific average unit size for each scenario was calculated based on the accommodations study's parameters, which take into account the physical constraints of the site, as well as zoning standards, including parking.

<sup>5</sup> Floor to ceiling height for residential = 10' and office/retail = 15'. In the maximum office development type, the ceiling heights are 11.5' to remain within the building height limit.

Source: Perkins + Will, 2012; Strategic Economics, 2012

## Land Uses Tested

This study tested the feasibility of mixed-use development consisting of ground floor retail with residential floors or office space above. The residential land use is defined as for-sale condominiums. The office land use includes conventional Class A professional offices but does not consider medical offices, due to the additional Draft Specific Plan restrictions on medical office uses.

## Typical Residential Unit Size

For the residential component of the prototypes development, several simplifying assumptions were made. The analysis assumed average unit sizes of between 1,350 and 1,400 square feet. This size range was determined based on a survey of recent development projects in the Menlo Park and Peninsula housing markets. For each prototype, the specific average unit size was calculated based on the accommodations study's parameters, which take into account the physical constraints of the site, as well as zoning standards, including parking.

## Zoning Assumptions

Assumptions regarding setbacks, parking, heights, and other zoning requirements were based on the standards established in the Draft Specific Plan.

## Development Cost Assumptions

### Hard Costs

Project construction costs are based on Strategic Economics' research, published estimates from RS Means, and interviews with Peninsula developers engaged in building the construction type represented by this analysis. The objective of this exercise was to establish an average construction cost. One could expect that this average is roughly in the middle third of actual costs though it is possible to envision specific projects that would have costs outside this range. Table 6 shows the gross hard costs used for this analysis by unit type.

Table 6: Estimate of Project Hard Costs

Building Type/Structure	Unit	Cost
Condo (3-4 story)	psf	\$ 250.00
Office Class A, Vanilla shell, LEED Silver	psf	\$ 200.02
Retail ground floor + TI	psf	\$ 185.00
Surface parking	per space	\$ 5,000
Podium parking	per space	\$ 20,000
Underground parking level 1	per space	\$ 35,000
Underground parking level 2	per space	\$ 40,000

Source: Developer interviews (2012), ENR Construction Cost Index, Perkins + Will, Strategic Economics.

**Soft Costs**

Estimated soft costs include items such as permits, architectural fees, engineering fees, developer overhead, insurance, taxes, legal, accounting fees, and marketing costs. Permits and other development impact fees were calculated based on the current fee schedule for the City of Menlo Park and the local school districts, as shown in Table 7 below. The remainder of the soft costs was estimated based on standard industry ratios and conversations with local developers and architects, and calculated as a percentage of hard costs.

Table 7: Schedule of City and Local District Fees

Fee	Calculation
Recreation fee	0.008 x Number of Units x Land Value
Building construction street impact fee	0.0058 X Project Valuation
Construction inspection fees	\$500 + 3% X Site Improvement Costs
School district fee	
Residential	\$2.97 per Square Foot
Commercial	\$0.47 per Square Foot
BMR in lieu fees	
Commercial Office	\$14.50 per Square Foot
Retail	\$7.87 per Square Foot
Traffic Impact Fee	
Multifamily unit	\$1,704.34 per Square Foot
Office	\$4.10 per Square Foot
Retail	\$4.10 per Square Foot
Building check fee	
Multifamily residential - New, Type V construction	
Size basis 5,000 square feet	\$3,828 plus 0.205 each addtl sq ft
Size basis 8,333 square feet	\$4,511 plus 0.130 each addtl sq ft
Size basis 12,500 square feet	\$5,052 plus 0.404 each addtl sq ft
Office- Shell, Type I construction	
Size basis 5,000 square feet	\$3,638 plus 0.169 each addtl sq ft
Size basis 10,000 square feet	\$4,482 plus 0.083 each addtl sq ft
Size basis 25,000 square feet	\$5,730 plus 0.053 each addtl sq ft
Retail Sales- TI, Type V construction	
Size basis 1,000 square feet	\$912.50 plus 0.075 each addtl sq ft
Size basis 5,000 square feet	\$1,211.80 plus 0.056 each addtl sq ft
Retail Sales- TI, Type I construction	
Size basis 1,000 square feet	\$625.00 plus 0.051 each addtl sq ft
Size basis 5,000 square feet	\$830 plus \$0.039 each addtl sq ft
Specific Plan preparation fee <sup>1</sup>	\$0.80 per Square Foot

<sup>1</sup> In December 2011, the City Council authorized staff and the consultant team to analyze a fee that would account for the costs of preparing the Specific Plan and associated EIR. The fee cited here is a preliminary estimate for the purposes of providing an accurate feasibility analysis, but does not necessarily represent the exact fee that will subsequently be proposed and reviewed.

Source: City of Menlo Park Schedule of Fees, 1 July 2011; Sequoia Union High School District, 2012.

**Financing Costs**

Financing costs were estimated assuming that a construction loan would be obtained for 65 percent of the cost of development for a term of 24 months, with a 6.5 percent interest rate and a 1.5 percent loan fee. Given that the construction loan would be drawn down over the course of the project, the total financing cost was estimated assuming an average outstanding loan balance of 65 percent.

**Developer Profit**

The land residual method requires making an assumption about expected developer profit, since projects will not be built unless a developer feels that they have the potential to generate a return. The analysis assumes developer profit equal to 12 percent of other development costs, not including land, based on the industry standard for the Bay Area. While profit margin expectations change depending on a variety of factors including market conditions, expected timeframes to receive entitlements, and other factors, 12 percent is considered a conservative assumption for a threshold that would attract developers to Menlo Park.

**Project Value**

As mentioned earlier, the residual land value of a property is calculated by subtracting the estimated development costs (described above) from the estimated value of the property. The value of condominium units was estimated based on their expected sale prices. The value of office space and retail space were estimated using the income capitalization approach, wherein the value is estimated based on expected ongoing rental revenues from the space.

**Condominiums**

Condominium sales prices and sizes were estimated based on the Strategic Economics market study memorandum report for the study area and updated for current market conditions. Average condominium values were set at \$700 per square foot for condominium flats. This is representative of the values achieved for recently constructed units in Menlo Park and comparable communities on the Peninsula (Table 8).

The City of Menlo Park currently requires that in residential developments of less than 20 units, 10 percent must be priced below-market rate. In developments with more than 20 units, 15 percent of units must be below-market rate (BMR). BMR units are to be priced for households at 110 percent of the area median income. It is the City’s preference that the units are provided on-site. Therefore, the analysis assumed that the developer would choose to build the units in the condominium or rental project rather than pay in-lieu fees. In situations where the inclusionary housing percentage calculation yields a fraction of a unit, Strategic Economics assumed a full additional unit. BMR units are assumed to be identical in size and quality to market-rate units. Based on an interview with the City of Menlo Park Housing Division, Strategic Economics estimated an average per unit price of \$370,000 for BMR units. Although the city’s existing zoning ordinance allows for an FAR bonus for BMR units, the additional FAR for BMR units was not included in this study, in order to keep assumptions about development intensity conservative.

*Table 8: Housing Value Assumptions*

Unit Type	Average Price/ Sq Ft	Avg. Unit Price
Condominium Flats	\$700	\$945,000

Source: Hanley Wood; Zillow; Strategic Economics, 2011

**Retail**

Based on Strategic Economics’ market research, rent for the newly built, ground-floor retail component of a mixed-use project at a prime retail location was estimated at \$4.25 per square foot per month (triple net)<sup>3</sup> in the study area. The average vacancy rate was assumed at 5.0 percent. Operating expenses not paid by the tenant were estimated at 10 percent of revenue. The value of the retail component was estimated assuming an 8.0 percent capitalization rate. Based on this calculation, the value of retail development was estimated to be \$542 per square foot in the study area (Table 9).

*Table 9: Operating and Valuation Assumptions for Ground-Floor Retail*

<b>Assumptions</b>	<b>Unit</b>	<b>Value</b>
Monthly Rent (NNN)	Per SF	\$4.25
Vacancy	Percent	5.0%
Non-Reimbursable Expenses	Percent	10.0%
Capitalization Rate	Percent	8.0%
Gross Annual Retail Income	Per SF	\$51.00
Less Retail Vacancy	Per SF	-\$2.55
Less Non-Reimbursable Exp	Per SF	-\$5.10
Net Operating Income	Per SF	\$43.35
Capitalized Value	Per SF	\$541.88

Source: Retail brokers, 2012; Marcus & Millichap Investment Outlook, 2011

**Office**

Office rents were estimated at \$5.00 a square foot (full service)<sup>4</sup> based on interviews with brokers and a survey of comparable new office buildings. The net income from office was estimated assuming 5.0 percent vacancy and operating expenses equal to 25 percent of gross income. The value of the units was estimated using an 8.0 percent capitalization rate. Based on this calculation, the value of office development was estimated to be \$525 per square foot (Table 10).

*Table 10: Operating and Valuation Assumptions for Office*

<b>Assumptions</b>	<b>Unit</b>	<b>Value</b>
Monthly Rent (NNN)	Per SF	\$ 5.00
Vacancy	Percent	5.0%
Non-Reimbursable Expenses	Percent	25.0%
Capitalization Rate	Percent	8.0%
Gross Annual Office Income	Per SF	\$ 60.00
Less Office Vacancy	Per SF	\$ (3.00)
Less Non-Reimbursable Exp	Per SF	\$ (15.00)
Net Operating Income	Per SF	\$ 42.00
Capitalized Value	Per SF	\$ 525.00

Source: Office brokers, 2012; Marcus & Millichap Investment Outlook, 2011

<sup>3</sup>Triple-net leases require the tenant to pay for net real estate taxes on the leased asset, net building insurance and net common area maintenance.

<sup>4</sup>Full service leases require the landlord to be responsible for the payment of taxes, maintenance, insurance and utilities.

## DISCUSSION OF FINDINGS

**Residential development with bonus FAR appears to be the most likely type of development in the plan area given current market conditions.** Projects with bonus FAR density on both the small and large parcels (FAR of 1.5 and 1.75, respectively) are feasible at current market conditions. Residential development projects at the base FAR of 1.25 on the large ECR SE parcel falls slightly short of being feasible given current land values. But with a very small increase in revenue, this building type does appear to be feasible.

**The base and bonus FARs proposed in the Draft Specific Plan allow residential developers the flexibility to provide a range of unit sizes to accommodate a diverse market.** The market niche for residential development in Menlo Park is currently for higher-end, larger two- and three-bedroom condominium and townhouse units. However, the proposed densities in the Draft Specific Plan allow developers flexibility to build these traditional types of units or to introduce projects that contain more compact units for young professionals and smaller households.

**Increasing densities from the base FAR to the maximum FAR would enhance the financial feasibility of residential projects on both El Camino Real parcels.**

According to the analysis, a building with a bonus density of 1.5 on the small parcel yields a residual land value of \$148 per square foot, compared to \$116 per square foot for a building with a base density of 1.1. Similarly, on the large ECR SE parcel, the bonus density residential building generates a land value of \$121 compared to \$98 at the base density (Figures 1 and 2).

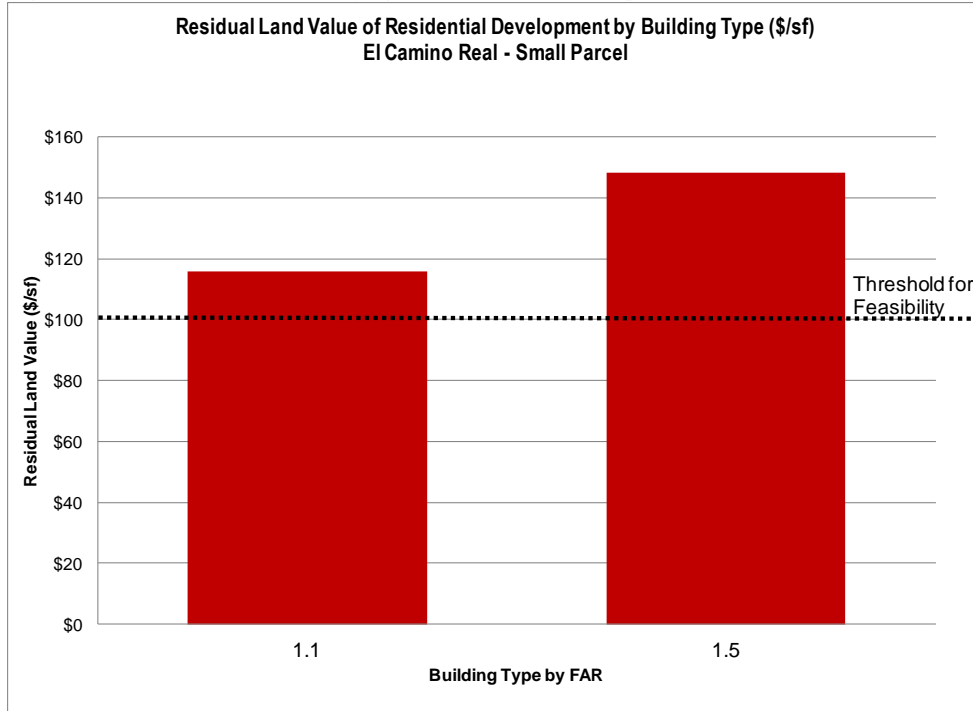
**This added value to increased density suggests that there is potential for the city to pursue strategies to negotiate public benefits with developers that seek to maximize density for residential projects.** However, because of the added costs associated with meeting the Draft Specific Plan's design requirements, such as underground parking, and variability of financial performance from project to project, the value is likely to vary. In addition, a public benefit strategy that results in additional time and uncertainty could both reduce the amount of value that could be shared, and limit the Plan's ability to address inherent project objectives, such as the provision of additional housing and the activation of the station area and downtown. This strategy is not as likely for office developments, which do not currently generate sufficient revenues for most developers even with the maximum proposed FAR.

**There are various strategies for cities to receive public benefits from private development.** The most commonly used methods are development impact fees, which require a nexus study to be legally implemented, and negotiated developer agreements. There are fewer city programs that tie density bonuses to the provision of public benefits. One of the few examples is from San Diego, where the local redevelopment agency - Centre City Development Corporation (CCDC) – has implemented a voluntary FAR Bonus Payment Program that allows developers to purchase additional FAR for projects in the Downtown Community Plan Area. Under the program, an additional 1.0 to 2.0 of FAR (above a base FAR of 5.5 to 8.0) can be purchased. The FAR Bonus Payment program is administered by the CCDC, and all payments go into a fund that is primarily used for the acquisition of land and construction of public parks, but can also be used for other infrastructure improvements in the Downtown Community Plan Area. The fee, which is set at \$15 per square foot, was based on a combination of independent financial analysis and negotiations with the local development community. CCDC staff report that the use of a below-market rate fee allows the program to be applied uniformly across land uses and building types. Yearly increases in the cost of FAR are tied to the consumer price index, and the City is free to reevaluate the cost of additional FAR at any time. It is important to note that this program has not replaced development impact fees or developer agreements, but rather is complementary to those other funding sources for community facilities,



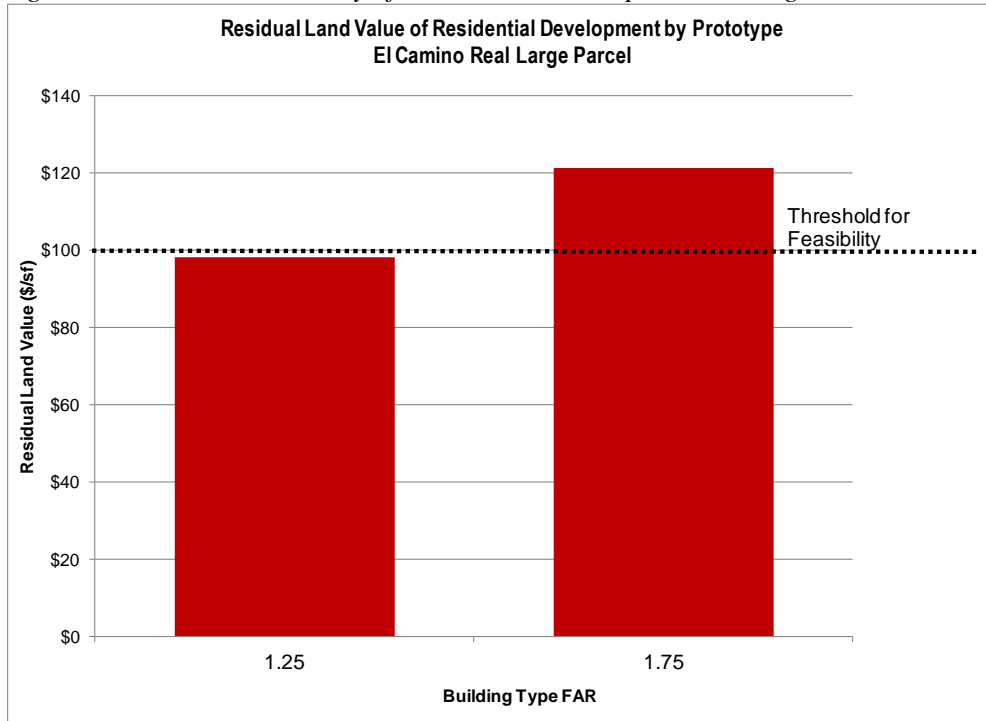
amenities, and infrastructure. Since its inception in 2007, the program has been used in four projects, generating \$1.7 million in revenues for CCDC, with an average payment of approximately \$425,000 per project. CCDC staff emphasized that there will be a need to reevaluate the program on a regular basis to ensure that the fees are consistent with market realities. With the dismantling of the redevelopment agency, the program will be transferred to the City of San Diego, and is expected to remain active.

Figure 1: Financial Feasibility of Residential Development on Small El Camino Real Parcel



Source: Perkins + Will, 2012; Strategic Economics, 2012.

Figure 2: Financial Feasibility of Residential Development on Large El Camino Real Parcel

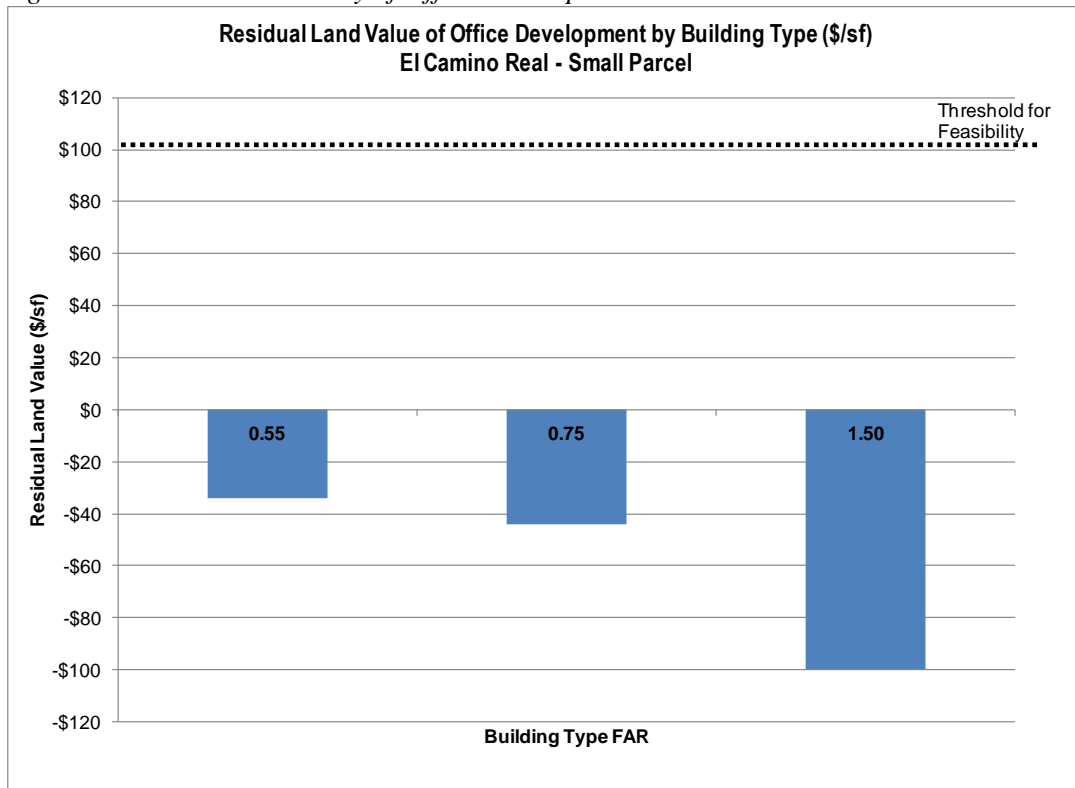


Source: Perkins + Will, 2012; Strategic Economics, 2012.

**Office buildings are not feasible in the current market on either of the prototypical parcels.** The proposed base and proposed bonus FAR office buildings do not generate enough revenue to offset the development costs (Figure 3).

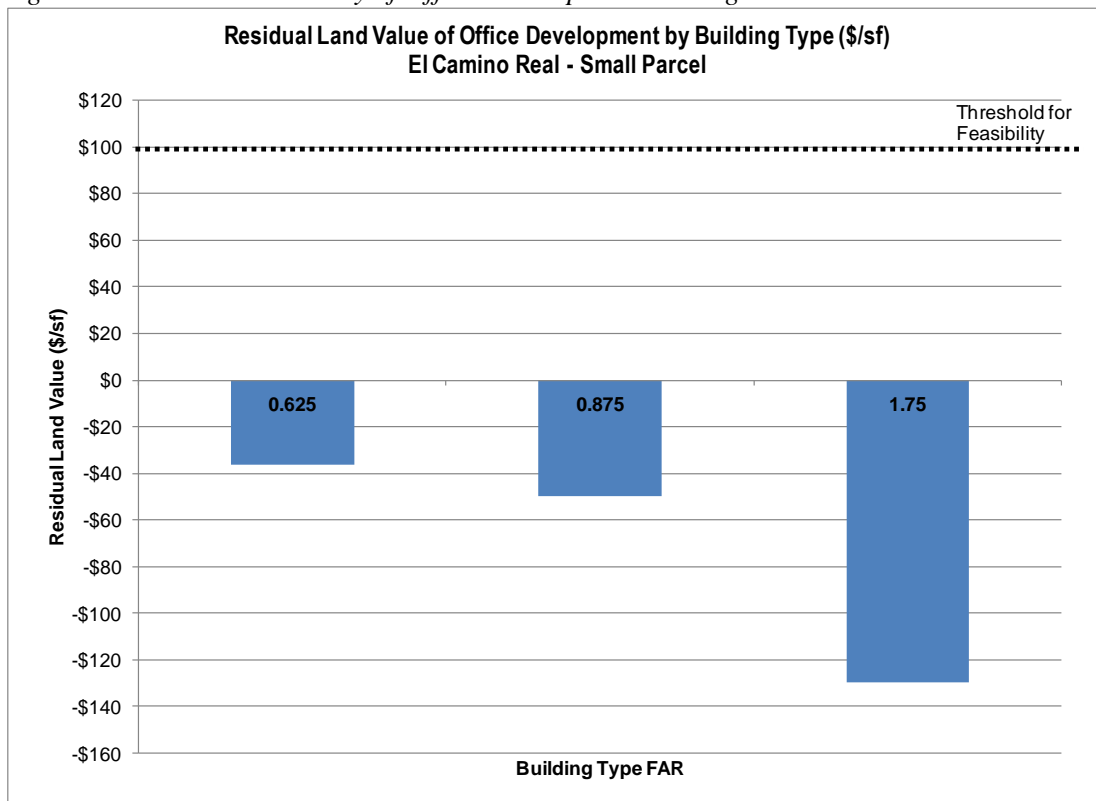
**Office buildings with higher FARs than the proposed maximum are also infeasible based on current market conditions** (Figures 3 and 4). This is in large part due to the fact that the office market has not fully recovered to command the high rents that would be required for these projects to be financially feasible.

Figure 3: Financial Feasibility of Office Development on Small El Camino Real Parcel



Source: Perkins + Will, 2012; Strategic Economics, 2012.

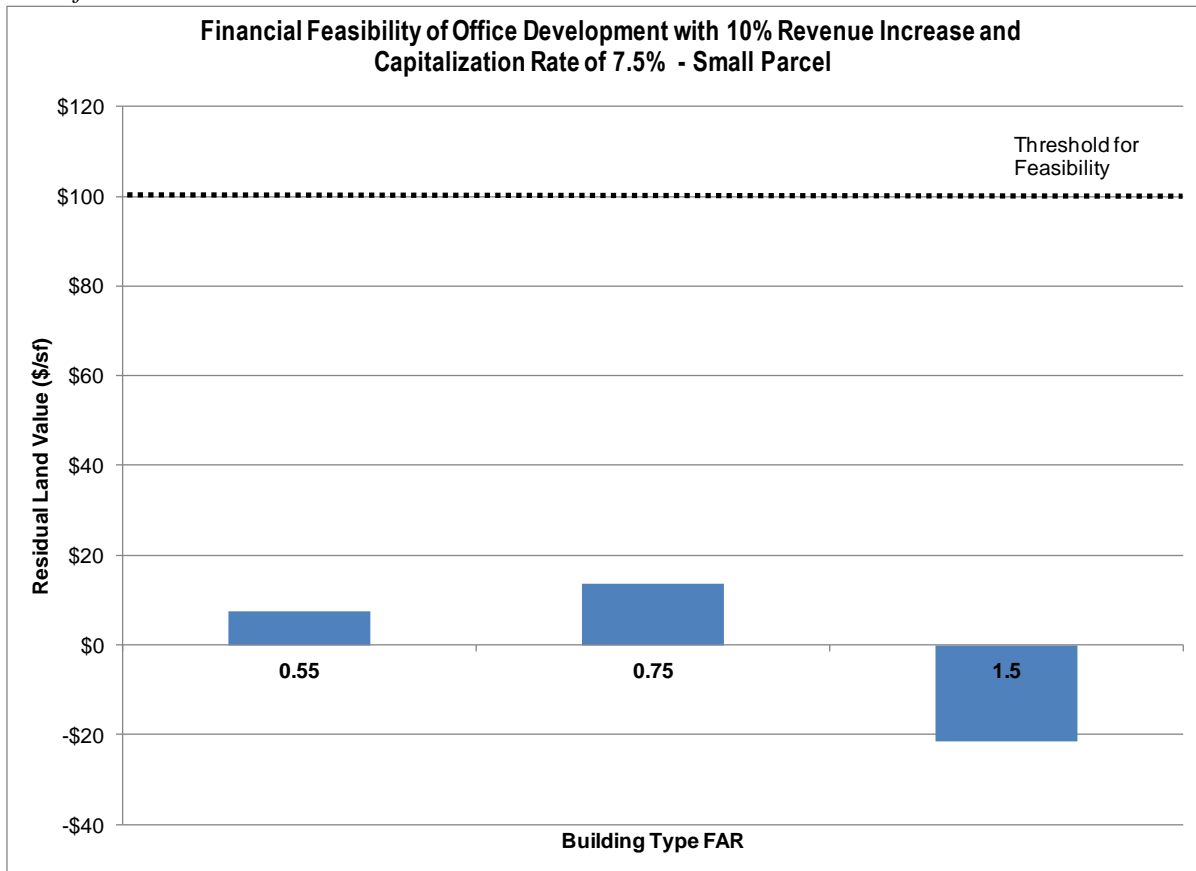
Figure 4: Financial Feasibility of Office Development on Large El Camino Real Parcel



Source: Perkins + Will, 2012; Strategic Economics, 2012.

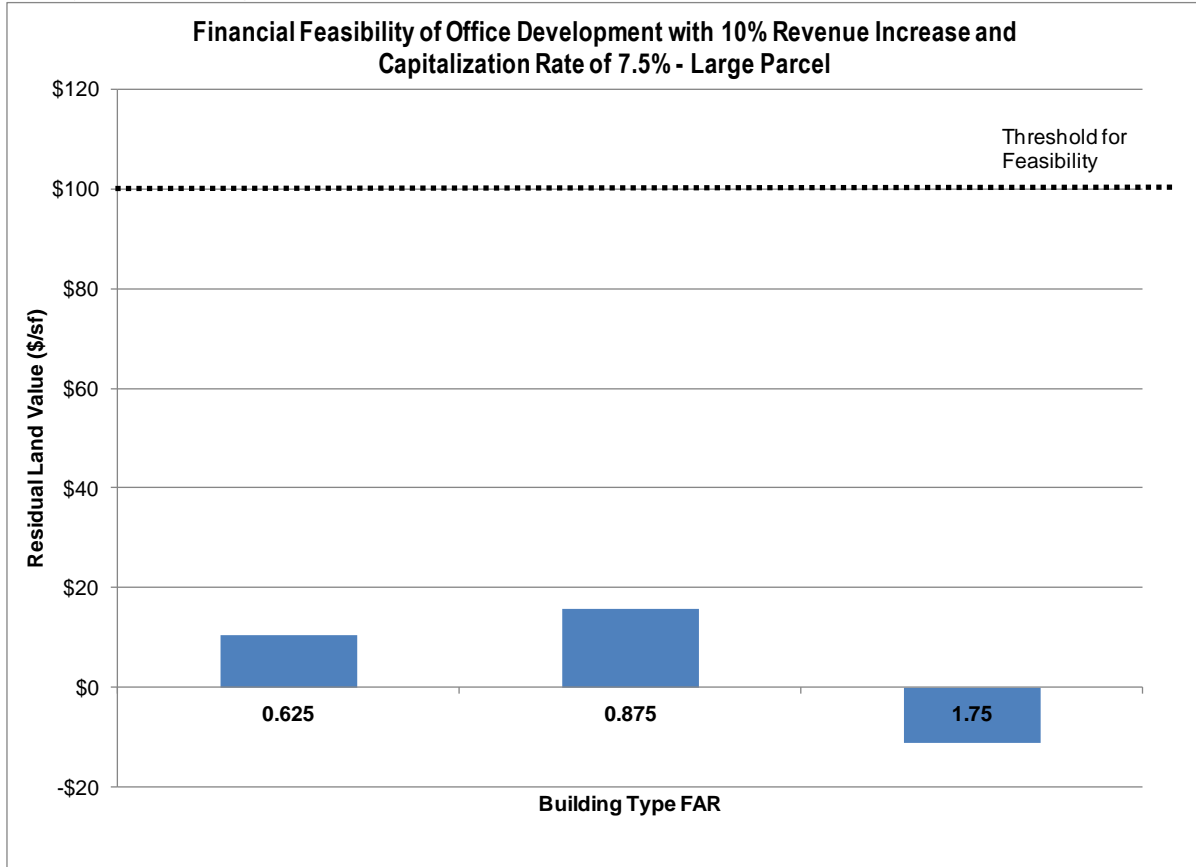
**In the short- to mid-term, once the office market is restored, the analysis shows that the proposed base and maximum FAR office buildings would still be infeasible.** To test the effect of a healthier office market on feasibility, Strategic Economics evaluated the financial feasibility of mixed-use office buildings with a rent increase of 10 percent and a more favorable capitalization rate of 7.5 percent. With these assumptions in place, the proposed base and maximum FAR buildings still do not pencil out (Figures 5 and 6). Office building types with FARs utilizing the full potential of the parcels (FARs of 1.5 on the small parcel and 1.75 on the large parcel) are also estimated to be infeasible under these conditions (Figure 6). It should be noted that long-term property ownership, construction costs, parcel size/configuration, and other factors may make it more feasible for some properties to be developed into office use.

*Figure 5: Financial Feasibility of Office Development with 10% Revenue Increase and Capitalization Rate of 7.5% on Small El Camino Real Parcel*



Source: Perkins + Will, 2012; Strategic Economics, 2012.

Figure 6: Financial Feasibility of Office Development with 10% Revenue Increase and Capitalization Rate of 7.5% on Large El Camino Real Parcel



Source: Perkins + Will, 2012; Strategic Economics, 2012.

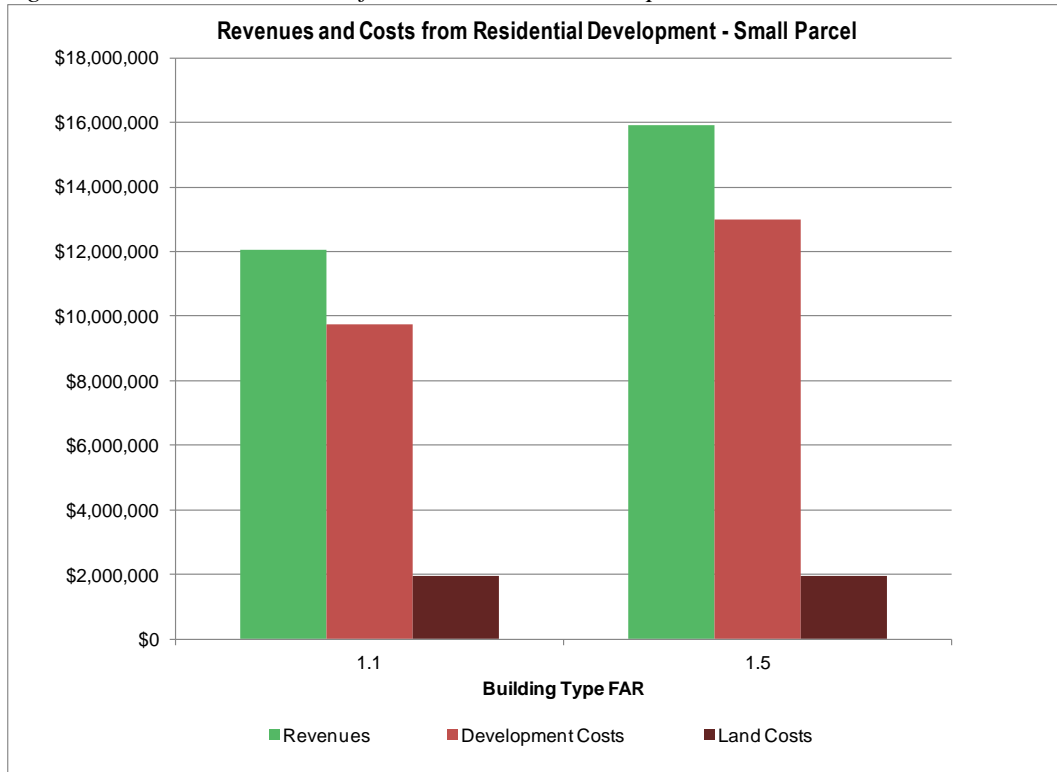
**Ground floor retail on El Camino Real is feasible to build as long as the retail location is strong enough to support top-of-the-market rents.**

The retail component of a mixed-use residential or office building can be a revenue generator, as long as the retail store front can be leased to a high-value tenant willing to pay the rents needed to offset the cost of building the space and associated parking. It is likely that developers will choose to build retail on the ground-floor in locations that are attractive to high-performing retailers. It is not likely that the entire El Camino Real corridor can support mixed-use development with ground-floor retail.

**Development costs escalate along with revenues as densities increase.**

Though higher density projects can generate more revenues, they are also more costly to build due largely to the higher cost of underground parking relative to podium or surface parking (Figures 7 and 8). This holds true for both residential and office projects.

Figure 7: Revenues and Costs from Residential Development on Small El Camino Real Parcel



Source: Perkins + Will, 2012; Strategic Economics, 2012.

Figure 8: Revenues and Costs from Residential Development on Large El Camino Real Parcel



Source: Perkins + Will, 2012; Strategic Economics, 2012.

## REFERENCES

The following sources were used in the analysis:

- Marcus & Millichap Investment Outlook 2011
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- Howard E. Dallmar, Cornish and Carey
- Curtis Leigh, Hunter Properties
- James Gaglione, Terranomics
- Brad Wiblin, BRIDGE

## **APPENDIX A: SITE ACCOMMODATION STUDIES**



## **APPENDIX B: DETAILED PRO FORMAS**