ATTACHMENT D

Strategic Economics Financial Feasibility of Alternatives

November 2020

DRAFT MEMORANDUM

To: Clare Campbell, City of Palo Alto

From: Sujata Srivastava, Strategic Economics

Date: November 17, 2020

Subject: Financial Feasibility of NVCAP Alternatives

Introduction

This memo summarizes the key financial feasibility findings as they relate to the preliminary land use alternatives for the North Ventura Coordinated Area Plan. The conclusions presented in this report are based on a financial feasibility analysis that was completed in January 2020. Since the onset of the COVID-19 pandemic, rental apartment vacancy rates have increased and rents have declined, but the need for housing is likely to continue growing. Reducing the cost of construction for residential development continues to be important for improving the feasibility of new construction; the overall conclusions from early in 2020 are unchanged. Alternative 3 allows for more efficient housing types and a greater mix of land uses, and is therefore the most viable alternative of the three proposed alternatives, and the most likely to deliver community benefits.

Approach to the Analysis

Strategic Economics worked closely with the Consultant Team to develop the approach and methodology for the financial feasibility analysis. The following summarizes the steps undertaken in the analysis and the key data sources.

Step 1. Develop Residential Prototypes

The initial step of the analysis was to create a series of residential prototypes. These are intended to represent ownership and rental development that is likely to occur in the City of Palo Alto in the next three to five years. Strategic Economics worked with the Consultant Team to develop assumptions about the building types, parcel size, density, ground-floor retail, and other factors. The prototypes include townhouses with above-ground podium parking, multifamily condos (medium and higher density), multifamily rental apartments (medium and higher density), and mixed-use multifamily rental apartments with ground-floor retail.

Step 2. Collect Key Inputs and Build Pro Forma

The financial feasibility of each prototype is measured using a static pro forma model that calculates profitability. The key inputs in the financial feasibility analysis are the revenues (rents/ sales prices), development costs, and land costs. Strategic Economics collected and summarized data on these inputs using the following data sources:

- **Costar**, a commercial real estate database that tracks rental multifamily properties and property transactions.
- **Interviews** with local developers and brokers.
- **Redfin** and **Polaris Pacific**, real estate firms that collect data on residential sales prices.
- **Review of pro formas** from other projects and clients.

Step 3. Calculate Financial Feasibility

Once all the assumptions and inputs are added, the pro forma model sums up all development costs, including land costs, hard costs (construction costs), soft costs, and financing costs. The pro forma also adds up the project's total value. The project's total value is the sum of the estimated value of the units (i.e. the average per unit sale price for ownership units or the capitalized value of rental units multiplied by the number of units in the project).

The project's profitability, or rate of return, is then calculated by dividing the project's net revenue (i.e. total value minus total development costs), by total development costs. To understand the feasibility of development, the results are compared to developers' typical expectation of return. If the developer's return for a project is within the range of the expected return, the development project is highly likely to be developed. If the return is lower than the market expectation, it is less likely to be built.

Financial Feasibility of Alternatives

ALTERNATIVE 1

- Townhouse development (up to 30 feet) is the most likely development type to move forward in this alternative, because it can accommodate the required parking in an above-ground parking podium. Townhouse construction is less expensive than multifamily housing, which would need to accommodate the parking underground. Assuming that townhomes are more likely to be for-sale products, they can be expected to contribute approximately 15 percent of units for below-market-rate (BMR) housing, per the City's existing policy.

- Three-story (35 feet) and four-story (50 feet) multifamily condos and apartments are unlikely to be developed in this alternative due to the cost of underground parking to accommodate the parking requirement of one space per bedroom, relative to the number of units that can be achieved on the sites under the proposed height limits.

- Feasibility is more challenging for mixed-use multifamily housing because of the increased cost of building the retail space and providing the required parking, which is not usually offset by the modest retail rents that can be achieved from ground-floor retail spaces.

- Residential developers are less likely to dedicate parkland rather than paying park fees. This is because the maximum density enabled in this alternative is low, and they would need to maximize the development potential on their sites in order to make projects more financially feasible to develop. The existing park fees are more likely to encourage compact multifamily development.

- The lack of new office development in Alternative 1 – combined with the challenging feasibility of multifamily residential development – limits the potential for additional community benefits contributions in the NVCAP area.

FIGURE 1: ALTERNATIVE 1 SUMMARY OF FEASIBILITY OF RESIDENTIAL DEVELOPMENT

Prototype	Townhome (Ownership) 30 feet	Multifamily Condos 35 feet	Multifamily Rental 35 feet	Multifamily Condos 50-70 feet	Multifamily Rental 50-70 feet	Mixed-Use Multifamily Rental 50-70 feet
Description	2-story townhomes with podium parking	3-story condos with underground parking	3-story apartments with underground parking	4 to 6-story condos with underground parking	4 to 6-story apartments with underground parking	4 to 6-story apartments with ground-floor retail and underground parking
Total Units	**18**	**56**	**78**	**119**	**170**	**192**
Number of Market Rate Units	15	48	78	101	170	192
Number of BMR Units Required	3	8	0	18	0	0
Average Unit Size (in square feet)	1,600	1,000	780	1,000	700	700
Number of Parking Spaces	36	112	117	238	255	308
Parking Ratio	2.0	2.0	1.5	2.0	1.5	1.6
Market Rate Sales Price / Monthly Rent	$1,440K	$1,150K	$4,290	$1,150K	$3,850	$3,850
Development Cost per Unit	$1,054K	$947K	$707K	$942K	$660K	$658K
Feasibility/ Likelihood of Development	**Somewhat likely**	**Unlikely**	**Unlikely**	**Unlikely**	**Unlikely**	**Unlikely**
Potential Community Benefits Contributions	**Modest**	**None**	**None**	**None**	**None**	**None**

Source: Strategic Economics, January 2020.

ALTERNATIVE 2

- The results of Alternative 2 are similar to Alternative 1 because there are few differences in the types of residential development envisioned. The slightly higher parking requirement of 1.5 spaces per bedroom would be equivalent to at least 2 spaces per unit for the larger ownership prototypes (townhouses and condominiums), and approximately 1.5 spaces per unit for rental apartments, which are likely to be studios and one-bedrooms.

- There is no financial incentive for private developer to demolish the existing office space in the 340 Portage building and convert to multifamily residential, especially if there is also a significant parkland dedication. Currently, the estimated value of the existing office space is approximately $1,400 per square foot (assuming that rents are about $7 per square foot on a triple net basis). The estimated value of a new market-rate rental apartment building would be lower at $1,125 per square foot. A new office development project would be more lucrative than a new rental residential project, generating nearly double the net value per square foot, as shown in the table below.

FIGURE 2: COMPARISON OF NET VALUE OF RENTAL HOUSING AND OFFICE DEVELOPMENT PROJECTS

Land Use/ Building Type	35 foot rental apartment with underground parking	2-story office building with structured parking
Development Cost (per net sq. ft.)	$906	$988
Market Value (per net sq. ft.)	$1,125	$1,387
Net Value per sq. ft.	$218	$399

Source: Strategic Economics, 2020.

- It is not likely that small professional office would support the provision of additional community benefits – small companies and nonprofits are not typically able to afford the rents that are required to support new development.

- Overall, Alternative 2 provides very limited potential for community benefits contributions due to the challenging economics for multifamily housing with higher parking requirements, and the marginal feasibility of small professional office space.

FIGURE 3: ALTERNATIVE 2 SUMMARY OF FEASIBILITY OF RESIDENTIAL DEVELOPMENT

Prototype	Townhome (Ownership) 30 feet	Multifamily Condos 35 feet	Multifamily Rental 35 feet	Multifamily Condos 50-70 feet	Multifamily Rental 50-70 feet	Mixed-Use Multifamily Rental 50-70 feet
Description	2-story townhomes with podium parking	3-story condos with underground parking	3-story apartments with underground parking	4 to 6-story condos with underground parking	4 to 6-story apartments with underground parking	4 to 6-story apartments with ground-floor retail and underground parking
Total Units	**18**	**56**	**78**	**119**	**170**	**192**
Number of Market Rate Units	15	48	78	101	170	192
Number of BMR Units Required	3	8	0	18	0	0
Average Unit Size (in square feet)	1,600	1,000	780	1,000	700	700
Number of Parking Spaces	36	112	117	238	255	308
Parking Ratio	2.0	2.0	1.5	2.0	1.5	1.6
Market Rate Sales Price / Monthly Rent	$1,440K	$1,150K	$4,290	$1,150K	$3,850	$3,850
Development Cost per Unit	$1,054K	$947K	$707K	$942K	$660K	$658K
Feasibility /Likelihood of Development	**Somewhat likely**	**Unlikely**	**Unlikely**	**Unlikely**	**Unlikely**	**Unlikely**
Potential Community Benefits Contributions	**Modest**	**None**	**None**	**None**	**None**	**None**

Source: Strategic Economics, January 2020.

ALTERNATIVE 3

- All of the residential prototypes are likely to be financially feasible in this scenario because of the lower parking requirement of one space per unit. The lower ratio is particularly helpful for ownership products, which are more likely to be two-bedroom or three-bedroom units. At this parking ratio with the building heights proposed, the parking could potentially be accommodated on an above-ground podium rather than underground, which would considerably lower construction costs and improve feasibility.

- Ownership products (townhouses and condos) could feasibly contribute 15 percent of units at restricted prices for moderate-income households, conforming to the existing policy.

- Rental development are more likely to be able to contribute in-lieu fees (current policy) rather than providing units on-site, consistent with the existing policy.

- Because the lower parking requirement allows for a more efficient use of space, it is more likely that residential developments in Alternative 3 could contribute a small percentage of land for open space/parks.

- Permitting new office development on key opportunity sites, without restrictions on the size or type of office, provides a stronger economic incentive for redevelopment of those properties. As shown in Figure 2 above, office development generates a higher net value than residential uses. For this reason, allowing more office also increases the potential for the provision of community benefits on the sites and in the overall NVCAP area. This includes parkland dedication, creek improvements, commercial linkage fee revenues or land dedication for BMR housing, nonprofit/community spaces, and public realm improvements.

FIGURE 4: ALTERNATIVE 3 SUMMARY OF FEASIBILITY OF RESIDENTIAL DEVELOPMENT

Prototype	Townhome 30 feet	Multifamily Condos 35 feet	Multifamily Rental 35 feet	Multifamily Condos 50-70 feet	Multifamily Rental 50-70 feet	Mixed-Use Multifamily Rental 50-70 feet
Description	Two-story townhomes, Smaller-Scale Project	3-story condos with underground parking	3-story apartments with underground parking	4 to 6-story condos with underground parking	4 to 6-story apartments with underground parking	4 to 6-story apartments with ground-floor retail and underground parking
Total Units	**18**	**56**	**78**	**119**	**170**	**192**
Number of Market Rate Units	15	48	66	101	144	163
Number of BMR Units Required	3	8	0	18	0	0
Average Unit Size (in square feet)	1,600	1,000	780	1,000	700	700
Number of Parking Spaces	18	56	78	119	170	206
Parking Ratio	1.0	1.0	1.0	1.0	1.0	1.1
Market Rate Sales Price / Monthly Rent	$1,440K	$1,150K	$4,290	$1,150K	$3,850	$3,850
Development Cost per Unit	$1,003K	$819K	$643K	$814K	$596K	$589K
Feasibility/ Likelihood of Development	**Highly Likely**	**Highly Likely**	**Highly Likely**	**Highly Likely**	**Highly Likely**	**Highly Likely**
Potential Community Benefits Contributions	**High**	**High**	**Moderate**	**High**	**Moderate**	**Moderate**

Source: Strategic Economics, January 2020.

EFFECTS OF COVID-19 ON HOUSING AND COMMERCIAL DEVELOPMENT

It is important to note that the feasibility analysis summarized in this report was conducted in January 2020 prior to the onset of the COVID-19 pandemic and does not account for the severe economic impact of the pandemic. There are some indications that the for-sale housing market, especially for single-family homes, has remained strong in the Bay Area. According to Costar data, the average rental rates in Palo Alto have declined by eight percent from the end of 2019 to November 2020. Vacancy rates have also increased from four percent at the end of 2019 to eight percent currently. Some of the reduced demand for market-rate rental housing could be attributed to Stanford University's decision to limit the number of students on campus during the academic year. While the demand for rental apartments shows some weakness, construction costs continue to rise. Architects and developers report that the cost of lumber has increased by approximately 20 percent in the last year in response to the recent boom in home improvements and renovations.

The commercial office market has also been impacted by the pandemic, as most Bay Area firms are unable to operate at full capacity at the office. Available data does not show a significant change in rental rates or vacancy rates because most firms are still on long term leases which have not yet been renegotiated or expired. Many employers are still waiting to make a decision about taking on new commitments for space. A number of large Silicon Valley corporations have announced that they will allow remote working for at least the next six months. Given the uncertainty of the course of the pandemic, real estate developers and brokers are divided on how much the pandemic will alter overall demand after conditions improve enough for Shelter-in-Place restrictions to be removed.

There is insufficient data to confidently predict the timing of the recovery from COVID-19, and the long-term outcomes on the demand for market-rate housing or commercial development. The need for housing is likely to continue, especially for workforce and lower-income households. However, it is not clear whether construction and land costs will continue to rise, and whether the demand for market-rate rental housing and office will return to the same levels that existed prior to the pandemic. The feasibility analysis shows that strategies to reduce the cost of construction for multifamily housing (such as parking reductions) and to create incentives for redevelopment will improve the likelihood of new housing development; this will continue to be the case if the demand for market-rate housing takes time to recover.