

DRAFT MEMORANDUM

To: Ryan Wassum
From: Darin Smith and Ashley Boots
Subject: 200 Airport Community Benefits Review; EPS #191036
Date: May 14, 2019

The Economics of Land Use



Economic & Planning Systems, Inc. (EPS) has been retained by the City of South San Francisco (City) to review the community benefits proposal from Fairfield Residential, the developers of property at 200-214 Airport Boulevard. As provided under section 20.280.005(A) of the City's Municipal Code, developers may request additional housing density in exchange for providing a variety of community benefits.

Fairfield is proposing to develop a project with 94 rental housing units, 3,630 square feet of retail space, and 110 parking spaces on the 0.55-acre site. This project would thus yield a density of 171 units per acre. As the site is adjacent to the Caltrain Plaza, zoned Downtown Transit Core (DTC) and within the Downtown Station Area Specific Plan (DSASP), densities up to 180 units per acre would be permitted in exchange for community benefits.

The community benefits proposed by the developer include:

- 1) Nine affordable housing units, priced at "Moderate" income levels
- 2) The retail space (3,630 square feet)
- 3) Participation in the future South San Francisco Industrial Area Community Facilities District
- 4) Up to \$50,000 in design services for enhancements to the Caltrain Plaza
- 5) Ongoing maintenance of Caltrain Plaza hardscape
- 6) Public art costing roughly \$75,000

The developer has estimated the value of these benefits, and EPS has been asked to review those calculations. EPS has also evaluated the overall project financials under the base zoning and with the requested bonus density, to assess whether the community benefits represent a reasonable benefit relative to the financial benefit of the added density. Our findings are as follows:

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Affordable Housing

Because the project’s application was deemed complete in October 2018, it is exempt from the City’s Inclusionary Housing Ordinance effective November 1, 2018. As such, EPS considers it appropriate that the nine affordable units offered should be considered part of the community benefits package.

The developer has indicated that the nine affordable units will be comprised of two studios, four one-bedrooms, and three two-bedroom units. EPS understands from City staff that the affordable units will be priced at “Moderate Income” reflecting 110 percent of the County’s Area Median Income by household size. **Table 1** below shows the median income and resulting monthly rents allowable for different unit sizes, based on standards established by the California Department of Housing and Community Development (HCD). Also, the table shows an estimate of current market-rate rents for apartments in South San Francisco, based on the listed prices for the recently built Cadence apartments that City staff indicates represent a comparable project in terms of location and amenities.

Table 1 Estimated Rents by Income Level

Unit Size	Area Median Income (AMI)	Affordable Units at 110% AMI		Market Rate Rent ²	Affordable as % of Market
		Annual Income	Monthly Rent ¹		
Studio (1 person)	\$82,900	\$91,190	\$2,117	\$3,054	69%
1-BR (2 people)	\$94,700	\$104,170	\$2,430	\$3,607	67%
2-BR (3 people)	\$106,550	\$117,205	\$2,718	\$4,460	61%

1) Assumes 30% of income spent on rent, less utility allowance set by County

2) Reflects average rents listed for Cadence apartments in South San Francisco, which opened in 2019 in the vicinity of the proposed Fairfield project

Sources: California HCD; www.cadencessf.com; EPS

As shown, even though the affordable units will be priced at “Moderate Income” for households earning slightly above the County’s median income, the rents are estimated to be only 61 to 69 percent of market-rate rents, with some variation based on the size of the unit. This comparison demonstrates that newly constructed market-rate housing is truly affordable only to households earning very high incomes.

When estimating the value of a unit, it is typical to deduct vacancy losses and operating expenses from the gross rents, and then to apply a market-based “capitalization rate” to the resulting cash flow or “Net Operating Income.” Using this approach and contemporary market-based assumptions, **Table 2** below estimates the value of the affordable units as well as the market-rate units.

Table 2 Comparative Value of Affordable and Market-Rate Units

Item	Studio	1-BR	2-BR
Affordable Units			
Monthly Rent	\$2,117	\$2,430	\$2,718
Annual Rent	\$25,401	\$29,163	\$32,618
less 5% Vacancy Losses	(\$1,270)	(\$1,458)	(\$1,631)
less Operating Expenses	(\$12,800)	(\$12,800)	(\$12,800)
Net Operating Income	\$11,331	\$14,905	\$18,187
Capitalization Rate	4.25%	4.25%	4.25%
Unit Value	\$266,611	\$350,702	\$427,921
Market-Rate Units			
Monthly Rent	\$3,054	\$3,607	\$4,460
Annual Rent	\$36,648	\$43,284	\$53,520
less 5% Vacancy Losses	(\$1,832)	(\$2,164)	(\$2,676)
less Operating Expenses	(\$12,800)	(\$12,800)	(\$12,800)
Net Operating Income	\$22,016	\$28,320	\$38,044
Capitalization Rate	4.25%	4.25%	4.25%
Unit Value	\$518,014	\$666,348	\$895,153
Implied Subsidy/Affordable Unit	\$251,404	\$315,646	\$467,232

Sources: California HCD; Fairfield Residential; EPS

Comparing these affordable unit values to the values of the same units if offered at market-rate rents, it is clear that the affordable units are worth far less due to their restricted rents. The "Implied Subsidy/Affordable Unit" represents the "opportunity cost" to the developer of providing the affordable units. The same units, if priced at market rates, would each be worth hundreds of thousands more dollars than they are based on their restricted rents.

Table 3 applies these implied subsidies to the number of affordable units offered by the developer to estimate the "value" of this community benefit.

Table 3 Estimated “Community Benefit Value” of Affordable Units

Item	Studio	1-BR	2-BR	Total
Units	2	4	3	9
Implied Subsidy/Unit	\$251,404	\$315,646	\$467,232	
Aggregate Value	\$502,807	\$1,262,584	\$1,401,697	\$3,167,088

Source: EPS

As shown, EPS estimates the “community benefit value” of these affordable units at \$3.17 million. This figure is substantial, at roughly \$350,000 per affordable unit.

Retail Space Value

The developer has suggested that the inclusion of 3,630 square feet of ground floor retail space in the project represents a community benefit. The developer has asserted that the community benefit value of the retail space is equal to its development cost. Their formula is as follows:

$$(3,630 \text{ square feet of retail}) \times (\$675 \text{ cost/square foot}) = \$2,450,250$$

The developer’s calculation does not account for the fact that the retail space will be generating rental revenue. According to CoStar Group data, retail space within ½-mile of the project site is currently generating “triple net” rents of \$27.46 per square foot. One of the comparable transactions provided by CoStar is a ground floor space in a recently built mixed use building, achieving \$27.00 rents per square foot. “Triple net” rents mean that the tenants are paying for nearly all operating costs for the building in addition to the stated rent rate, so EPS estimates the value of the retail space as follows:

$$((\$27/\text{SF rents}) - (5\% \text{ operating costs})) / (8.5\% \text{ capitalization rate}^1) = \$302/\text{SF value}$$

The value of this retail space does not cover the costs of construction, resulting in a need for subsidy and an implied “community benefit.” EPS estimates this community benefit value as follows:

$$((\$675/\text{SF costs}) - (\$302/\text{SF value})) \times (3,630 \text{ SF}) = \mathbf{\$1,353,990}$$

¹ For commercial development in the Bay Area, the capitalization rate is generally several percentage points higher than for residential development. EPS has conservatively assumed a relatively high capitalization rate to limit the estimated value of this commercial space, as numerous examples have demonstrated that ground floor retail space in mixed-use buildings may not be as marketable to tenants as stand-alone retail space in established commercial districts.

Other Community Benefits

The developer has proposed to participate in a not-yet-formed Community Facilities District, up to a maximum annual rate of \$0.25 per gross building square foot (including parking). Payments to this CFD would be used for improvements that benefit a broader district, and thus may be regarded as community benefits. The developer has assumed this additional payment would be incurred by the development and would reduce the project's Net Operating Income. Applying a 4.25 percent capitalization rate to this annual expense indicates that the project's value would be reduced by a total of \$848,635. EPS believes these calculations are reasonable estimates of the value of this community benefit.

Similarly, the developer has indicated that they would contribute \$50,000 to the design of the Caltrain Plaza, and another \$75,000 to public art (a "DNA window" on the project's east elevation). These figures are straightforward, and EPS has no reason to question their correctness.

Summary of Community Benefits Value

Based on the calculations described herein, **Table 4** shows the difference between the developer's and EPS's estimation of the value of the proposed community benefits.

Table 4 Comparison of Community Benefit Value Estimates

Item	Developer Estimate	EPS Estimate
Affordable Housing	\$4,981,500	\$3,167,088
Retail Space	\$2,450,250	\$1,353,990
CFD Payments ¹	\$848,635	\$848,635
Public Art	\$75,000	\$75,000
<u>Caltrain Plaza</u>	<u>\$50,000</u>	<u>\$50,000</u>
Total Benefit Value	\$8,405,385	\$5,494,713
Requested Bonus Units	39	39
Benefit Value/Bonus Unit	\$215,523	\$140,890

1) CFD value reflects CFD payments with a 4.25% cap rate, consistent with assumption for unit valuation. Fairfield had used a different figure, using a 4.00% cap rate, for their initial CFD benefit value.

Sources: Fairfield Residential; EPS

As shown, EPS's estimate of the value of the proposed community benefits falls well below the value estimated by Fairfield Residential. Still, we estimate that the developer is offering community benefits that sum to over \$140,000 per bonus unit sought, which is a substantial figure, particularly as it comes in addition to standard fees for parks and other community facilities and improvements.

Feasibility Assessment

EPS was also asked by City staff to assess whether the City might be able to demand more community benefits while still providing adequate incentive to the developer to move forward with the project as currently envisioned. To reach such a conclusion, EPS has endeavored to model the economics of the project overall, with and without the requested density bonus. On **Table 5** on the following page, EPS has estimated the value of the project as proposed by the developer, including the various community benefits in exchange for increasing the project size from 55 to 94 total units. In this case, EPS has used some figures provided by the developer which EPS finds credible based on the design proposal for the project, as well as market data and other recent development pro formas for Peninsula projects. Other assumptions were derived by EPS alone, again based on local market information. As shown, EPS estimates that at current market-rate rents, the proposed project would be worth roughly \$65.3 million when completed. Its construction cost, including land, buildings, and parking, are estimated at \$54.5 million, and the developer is offering community benefits which EPS has estimated to have a value of \$5.5 million. In sum, the project costs (including community benefits) are estimated at \$60.0 million, so the project's value exceeds its cost by \$5.3 million or roughly 9 percent.

By contrast, **Table 6** shows EPS's estimate of the project economics if built at the base zoning, and thus providing 55 units. In this case, EPS has assumed – and Fairfield has confirmed – that the average unit size would increase because the project would still be the same height and a similar bulk but have fewer units. The land acquisition costs would be spread among fewer units and thus would increase per unit, while the parking and construction costs would be somewhat lower per square foot because the parking is less complicated (no “stackers” are required) and the larger units are somewhat less expensive to construct on a per-square-foot basis. Market-rate rents are also somewhat lower per square foot for larger units, so the average market-rate rent is lower than was shown on **Table 5**, while operating costs per unit will likely be higher due to lower economies of scale and also the fact that the units are larger. In this scenario, the developer and City staff have both indicated that the only community benefit that would be expected is participation in the Community Facilities District at \$0.25 per gross building square foot but for a smaller building, resulting in a capitalized cost of \$686,471. With this figure included, EPS estimates that a 55-unit project under the base zoning would be worth roughly \$42.1 million, while its costs would be \$38.5 million, resulting in a profit margin of \$3.6 million or 9 percent.

Based on this analysis, EPS estimates that the proposed project with added density may yield a similar profit margin to that achievable under the base zoning (9 percent of costs in both cases). However, this profit margin falls below what EPS typically expects for projects of this type, which generally range from 12 to 15 percent at a minimum. The developer may be willing to pursue this marginally feasible project because a) future market-rate rent escalation will enhance their returns, and/or b) they may achieve operational efficiencies in their adjacent project at 150 Airport that enhance that project's returns – the projects are expected to share operating staff, though this benefit may only occur as long as the developer retains and operates both properties).

More broadly, we conclude that any request by the City to substantially increase the value of the community benefits may lead the developer to pursue the base zoning scenario instead, because the return on their investment would be proportionately greater. Whether the proposed project represents the optimal mix of community benefits reflecting the City's policy priorities is a matter that can be debated, but EPS concludes that the \$5.5 million economic cost of those offered benefits cannot be significantly increased without jeopardizing the feasibility of the bonus density project.

Table 5 Estimated Feasibility and Returns for Proposed Density Bonus Project

DEVELOPMENT PROGRAM ASSUMPTIONS		per Unit	Total
Acreage			0.55
Total Residential Units		1	94
Market-Rate			85
Affordable			9
Gross Building Area (Square Feet)		1,184	111,306
Livable Area (Square Feet)		820	77,094
Retail Area (Square Feet)			3,630
Total Leasable Area			80,724
Parking Spaces (Residential)		1.2	109
Parking Spaces (Retail)			9
Parking Space - Total			118
BUILDING VALUE			
Gross Potential Rent (GPR)	\$4.54 per SF/Month	\$3,712	\$348,907
less Losses to Vacancy	5.0% of GPR	-\$186	-\$17,445
Gross Revenue/Month		\$3,526	\$331,462
Gross Revenue/Year	12 Months	\$42,314	\$3,977,540
less Operating Expenses (incl. Taxes)	-\$12,800 per Unit	-\$12,800	-\$1,203,200
Net Operating Income		\$29,514	\$2,774,340
Total Capitalized Value	4.25% Capitalization Rate	\$694,453	\$65,278,580
Per Sq. Ft. (Net)			\$809
PROJECT COSTS			
Development Costs			
Land	\$321 per land SF	\$81,915	\$7,700,000
Parking Costs	\$41,841 per Space	\$52,524	\$4,937,240
<u>Remaining Development Costs</u>	\$518 per Net SF	<u>\$445,228</u>	<u>\$41,851,460</u>
<i>Total Development Cost</i>		<i>\$579,667</i>	<i>\$54,488,700</i>
Community Benefit Costs			
Affordable Housing (implied subsidy)		\$33,692	\$3,167,088
Retail Space		\$14,404	\$1,353,990
CFD Payments		\$9,028	\$848,635
Public Art		\$798	\$75,000
<u>Caltrain Plaza</u>		<u>\$532</u>	<u>\$50,000</u>
<i>Total Benefit Costs</i>		<i>\$58,454</i>	<i>\$5,494,713</i>
Total Project Cost		\$638,121	\$59,983,413
Per Sq. Ft. (Net)			\$743
DEVELOPER RETURNS			
Total Profit			\$5,295,168
% of Project Costs			9%

Table 6 Estimated Feasibility and Returns for Base Density Project

DEVELOPMENT PROGRAM ASSUMPTIONS		per Unit	Total
Acreage			0.55
Total Residential Units			55
Market-Rate			55
Affordable			0
Gross Building Area (Square Feet)		1,350	74,250
Livable Area (Square Feet)		977	53,720
Common Area (Square Feet)			1,000
Total Leasable Area			54,720
Parking Spaces (Residential)		1.2	66
Parking Spaces (Retail)			0
Parking Space - Total			66
BUILDING VALUE			
Gross Potential Rent (GPR)	\$4.25 per SF/Month	\$4,150	\$228,240
less Losses to Vacancy	5.0% of GPR	-\$207	-\$11,412
Gross Revenue/Month		\$3,942	\$216,828
Gross Revenue/Year	12 Months	\$47,308	\$2,601,936
less Operating Expenses (incl. Taxes)	-\$14,800 per Unit	-\$14,800	-\$814,000
Net Operating Income		\$32,508	\$1,787,936
Total Capitalized Value	4.25% Capitalization Rate	\$764,892	\$42,069,082
Per Sq. Ft. (Net)			\$769
PROJECT COSTS			
Development Costs			
Land	\$321 per land SF	\$140,000	\$7,700,000
Parking Costs	\$35,000 per Space	\$42,000	\$2,310,000
<u>Remaining Development Costs</u>	\$508 per Net SF	<u>\$505,496</u>	<u>\$27,802,260</u>
<i>Total Development Cost</i>		<i>\$687,496</i>	<i>\$37,812,260</i>
Community Benefit Costs			
Affordable Housing		\$0	\$0
Retail Space		\$0	\$0
CFD Payments		\$12,481	\$686,471
Public Art		\$0	\$0
<u>Caltrain Plaza</u>		<u>\$0</u>	<u>\$0</u>
<i>Total Benefit Costs</i>		<i>\$12,481</i>	<i>\$686,471</i>
Total Project Cost		\$699,977	\$38,498,731
Per Sq. Ft. (Net)			\$704
DEVELOPER RETURNS			
Total Profit			\$3,570,352
% of Project Costs			9%