KEYSER MARSTON ASSOCIATES
ADVISORS IN PUBLIC/PRIVATE REAL ESTATE DEVELOPMENT

MEMORANDUM

ADVISORS IN:
REAL ESTATE
AFFORDABLE HOUSING
ECONOMIC DEVELOPMENT

SAN FRANCISCO
A. JERRY KEYSER
TIMOTHY C. KELLY
KATE EARLE FUNK
DEBBIE M. KERN
REED T. KAWAHARA
DAVID DOEZEMA

LOS ANGELES
KATHLEEN H. HEAD
JAMES A. RABE
GREGORY D. SOO-HOO
KEVIN E. ENGSTROM
JULIE L. ROMEY

SAN DIEGO
PAUL C. MARRA

To: Clay Holstine
City Manager

From: Tim Kelly

Date: March 22, 2016

Subject: Baylands: Economic Feasibility Considerations

The purpose of this memorandum is to discuss in general terms the financial and economic parameters that influence if and how a project of the proposed scale and complexity of the Brisbane Baylands might move forward, both on the part of the developer and the City. Given the early stage of the planning process, this discussion addresses "macro-level" economic and market issues and is primarily qualitative in nature. However, this memorandum utilizes quantitative information from the Baylands Developer Sponsored Plan (DSP) as a case study to illustrate these broad concepts and how they might apply to the future development of the Baylands. It should be noted that this discussion is not intended to provide a quantitative critique of the developer's pro forma.

Underlying Macroeconomic Factors

At the direction of City staff, this memorandum attempts to address two critical economic considerations that would apply to any prospective future development of the site:

1. Can fundamental factors be identified which influence the developer's perception of economic "feasibility" in considering whether to move forward and develop whatever land use program is approved for the site?

2. How can the City ensure that a project has a fiscally positive impact on the City's General Fund? In a separate report prepared by KMA, a preliminary assessment of fiscal impacts is presented for the DSP and other land use variants. The report includes measures on how the City can ensure that a project has a fiscally positive impact on the City's General Fund.

Fundamental factors which influence the developer's perception of economic "feasibility" for any approved land use plan.

Locational Characteristics

The Baylands site has a number of positive attributes for a developer as a potential development site. Baylands is one of largest remaining developable sites along the west shore of San Francisco Bay, has excellent regional access, close proximity to San Francisco and to San Francisco International Airport, transit access via Caltrain, and identity from US 101, all of which are valuable assets in today's economy. Real estate market opportunities for the Baylands continue to improve with the economy.

Feasibility Considerations

The developer will be measuring feasibility in terms of a return on its investment. Simply stated, under existing conventional market conditions, revenues must cover costs to motivate a developer to proceed with a project. For purposes of this memorandum, high level investment is grouped into three distinct components:

1. Horizontal development costs (remediation/landfill closure, grading, infrastructure, etc.)

2. Predevelopment costs (CEQA, planning, legal, engineering studies, and the like)

3. Land cost (net of revenues earned by current operations)

The net revenues must yield a profit. Primary revenues in a development plan can come from several sources, including:

1. Land sales

2. Vertical development profits (commercial and residential land use development projects, for example)

3. Bond proceeds from community facilities districts (CFD) for financing public improvements are commonly used in large scale projects to offset horizontal development costs and to fund public facilities

4. Public funding (Federal, State and local funding) to offset horizontal development costs

Ultimately, the timing of the development program will be market driven and influenced by a number of variables, including timing of delivery of the Project developable sites to market in the context of:

1. National and regional economies
2. Competitive environment
3. Regulatory environment
4. Cost to deliver buildable sites

Of course, other perspectives on potential feasibility of a development plan can exist depending on specific objectives. For example, some potential end users of the site, such as an institutional user, may not be motivated by return on investment as the basis for their interest in the property.

Case Study-DSP: Feasibility Considerations

To illustrate the implications of the basic concepts described above pertaining to feasibility, this memorandum utilizes the DSP as a case study. UPC submitted a preliminary feasibility analysis for the DSP, which focused on the costs incurred or to be incurred by UPC to create development sites and the relationship of costs to revenues plus potential sources of funding.

There are many variables and caveats in projecting both revenues and costs for a project with the scale and complexity of Baylands. Such a financial analysis is highly complex and includes many speculative assumptions. Therefore, in addressing the fundamental feasibility issues, it is our view that an appropriate approach for this case study is to address the following question: can revenues from land sales for sites with land use entitlements (i.e. approved specific plan and CEQA) cover the horizontal development cost (excluding land and predevelopment costs)? While the developer can choose to develop commercial and residential projects instead of selling land, the "vertical" development still needs to support a land value and, in our view, the land value needs to support the cost to create developable sites.

To allow for this simplified case study to be prepared, there are a number of key assumptions that need to be made. They are:

Horizontal Development Costs: Costs for remediation/landfill closure, grading, Infrastructure (utilities and roads), and the like are referred to as horizontal development costs. The cost estimates have been generated by the Project sponsor's technical team. In regard to detail on the horizontal development costs, information provided was aggregated for the Project and several large phases. As a

result, it is not known to what extent these costs are 'fixed' irrespective of land use type, development intensity and/or location. It is also not known which costs are 'variable', dependent on land use type, development intensity, and/or location. This case study assumes for simplicity that costs are fixed.

Based on information submitted by UPC and its technical team, the horizontal development costs are estimated to be $1.1 billion through buildout. For purposes of this simplified case study based on UPC inputs, significant horizontal development costs are front-loaded and need to be funded with the initial development phases. This simplified case study further assumes that all horizontal development costs will be borne by the applicant.

Scale of Development: Another factor in evaluating feasibility is the scale of development. UPC indicates that site conditions require significant horizontal development costs to be front-loaded and, since the dollar amount of the investment is so large, the scale of development must be on a scale large enough to absorb the costs. The result is that existing conditions of Baylands require large pieces of land be developed at one time; a series of small individual parcels cannot do that, as KMA understands the information provided by UPC.

Additional key inputs and assumptions in preparing the DSP case study include:

1. This case study represents a snap shot in time based on current market conditions. Continued feasibility analysis in combination with the strengthening economy and the diminishing supply of large sites in the marketplace, particularly when entitlements are in place, can affect the conclusions of this planning level analysis.

2. This case study only considers horizontal development costs. It does not attempt to capture land costs, predevelopment costs, or developer profit expectation. Achieving a threshold in which revenues from land sales cover horizontal development costs might be an acceptable minimum return to commence development only if the overall development program enables the property owner to recover all costs and earn a profit. Without the ultimate expectation that revenues will cover all costs and yield a profit, timing of development would be delayed until market conditions support moving forward.

3. Costs and values are stated in today's dollars; future increases in costs and values are not projected. All values and costs are a rough approximation and on an "order of magnitude" basis.

4. Site development conditions after the remediation/land fill closure and other required regulatory obligations will allow for development of both commercial and residential (if approved) land uses.

5. Analysis is not an appraisal of land values in the Project, either for the Project land area as a whole or for individual development parcels. KMA has relied upon publicly available information on land values supported in the marketplace by various land uses.

6. Independent market analysis of commercial and residential land uses is not part of this effort.

Analysis

In completing the case study, the following factors were considered:

1. **Entitled development acreage:** The primary income producing asset in the DSP to recover costs and generate a profit is entitled development acreage. The overall land area in the Project is approximately 684 acres. Of this area, approximately 384 acres are estimated to be dedicated for such uses as open space (170 acres), solar farm (25 acres), and roads. The result is roughly 300 net entitled development acres. The revenues from these 300 acres are the primary source of income in this analysis.

2. **Horizontal development costs:** These costs need to be expended to open up the Project for development. The horizontal development costs are projected by UPC to be approximately $1.1 billion through build out of the Project. The $1.1 billion does not include costs of predevelopment, financing, and land. The figure does not include a developer profit. The $1.1 billion cost converts into approximately $3.67 million per entitled developable acre ($1.1 billion divided by 300 net acres), or $84 per square foot of land area.

3. **Land value per entitled acre supported by scale of development necessary to fund horizontal development costs:** Site conditions require large scale developments. Even if divided into phases, the primary land uses most likely to support development costs will be campus office or residential. Based on current market conditions, land values are anticipated to be:

    - Campus office = +/- $4 M per acre
    - Residential = +/- $4.5 M per acre: both low density (for sale) and high density

Other commercial land uses, such as hotel and retail, can complement the primary land uses; but it is not expected that either hotel or retail will be the primary land use for a large scale development. The reason is that these land uses are in competitive real estate environments that either do not support large acreage developments and/or do not support land values to fund the major horizontal development costs. To illustrate, the hotel development environment is competitive and there are multiple sites in the marketplace, including the Sierra Point hotel site. The DSP includes a limited amount of hotel rooms, with approximately 369 keys, and would require a small site, in the range of 5 to 10 acres. For a retail shopping center requiring a large scale development site, the market for such a major development appears to be very competitive (subject to confirmation by a market study) and impacted by several factors, including: new shopping centers (Candlestick for example) and the impact of the internet on retail bricks and mortar projects. The retail component in the DSP is 566,000 square feet and includes first floors in buildings in which primary land uses are commercial or residential. In summary, neither hotel development or a major retail shopping center development are expected to be the primary land use can that can fund the initial phases major horizontal development costs.

Case Study Conclusions:

- Horizontal development costs allocated over 300 entitled acres averages $3.67 million per acre, or $84 per square foot of land area.

- Campus office land value approximates the rough estimate of the cost to create a developable site. Campus office opportunities at the Baylands are increasing as major developable parcels are removed from the market. Examples of decreasing supply of sites would be: at Mission Bay, the major parcels are now committed; and on the Peninsula, developers are now redeveloping former industrial sites, such as in South San Francisco, where redevelopment of older industrial buildings with major office development is occurring on Oyster Point Boulevard and additional redevelopment plans are in place.

- Residential land values approximate the rough estimate of the cost to create a developable site. However, residential land values are affected by several factors including the intrinsic value of the location, increasing construction costs, and affordable housing requirements. These factors would need to be further evaluated to refine the residential land value supported.

- Revenues from land sales for campus office and residential large scale development would cover horizontal development costs; however, land sale

revenues at today's values would not cover all costs, i.e. land, predevelopment and horizontal costs.

- Achieving a threshold in which revenues from land sales cover horizontal development costs might be an acceptable minimum return to commence development only if the overall development program enables the property owner to recover all costs and earn a profit. Without the ultimate expectation that revenues will cover all costs and yield a profit, timing of proceeding would be delayed until market conditions support proceeding.

Future Planning Considerations

The DSP case study above illustrates a number of factors the city might want to take into account, to the extent that economic feasibility is a consideration in the decision making process for the Baylands.

Development footprint/intensity: Assuming that the horizontal development costs are relatively fixed, a significant reduction in net developable acres would spread these costs over fewer revenue producing acres. This would require the remaining income producing acres to support a high land value to cover costs. For example, if the net developable acreage is reduced to 250 acres, then the cost is approximately $4.4 million per developable acre. If the net developable acreage is 200 acres, then the cost is approximately $5.5 million per developable acre. If the net developable acreage is 150 acres, then the cost is approximately $7.33 million per developable acre.

If the development footprint is reduced, can the value be maintained by increasing the density/intensity on a reduced developable footprint? For example, would the value of the DSP be maintained if the entire DSP land use program was developed on 150 acres instead of 300 acres? Increased density on a reduced amount of developable acres does not necessarily translate into higher land sale revenues. For example, taller, high rise structures will result in higher construction costs. Additionally, market acceptance of large scale development programs may have a faster rate of absorption with lower density than a program with taller structures, higher construction costs, and higher land value. For residential, two to three story projects as well as four to six story projects are expected to be economically feasible; commercial, four to six stories on average are anticipated. Even if the property were planned and zoned for taller commercial structures, there is no demonstrated demand under current market conditions for a more intense, large scale development program in a location such as this.

Land Use Mix: As noted in the case study analysis, under current market conditions the range of land uses with values that support significant front loaded horizontal development costs is relatively limited. Given the site's unique characteristics such as size and location, there may be potential users for whom the site's "value" is not based on its potential to support market-driven development. For purposes of this memorandum, it is not possible to identify or evaluate who these end users or what these uses might be.

Horizontal Development Costs: As discussed above in the case study, horizontal development costs are a key driver in determining feasibility. As such, significant reductions in horizontal development costs could influence what might be considered a feasible development program. For, example if the horizontal development costs could be reduced from $1.1 billion to $600 million based on reduced development density, value engineering or other factors, and spread over the assumed 300 acre DSP developable footprint, the cost per acre is approximately $2 million.