Urban Land Institute

Residential and Mixed-Use Real Estate Development Economics in San José

Presented to:

City of San Jose City Council

Study Session

April 26, 2018

Presentation Outline

1. Introduction to ULI San Francisco District Council
2. Real Estate Development Process
3. Key Real Estate Trends
4. Development Feasibility
5. San Jose Case Study
6. Question and Answer

Development today is more complicated – *physically and economically.*

- Typically mixed use with increased density
- More conversions from old uses
- Site challenges, including remediation and poor soils
- Community benefits more important, but often costly
- More complicated development economics

Santana Row

Entitlement process – *complex and challenging*

- More public involvement
- Concerns about height & density
- Need to fund development impacts
- Lack of infrastructure funding
- Often long process for environmental and design review
- Referendums and ballot measures

The Modera

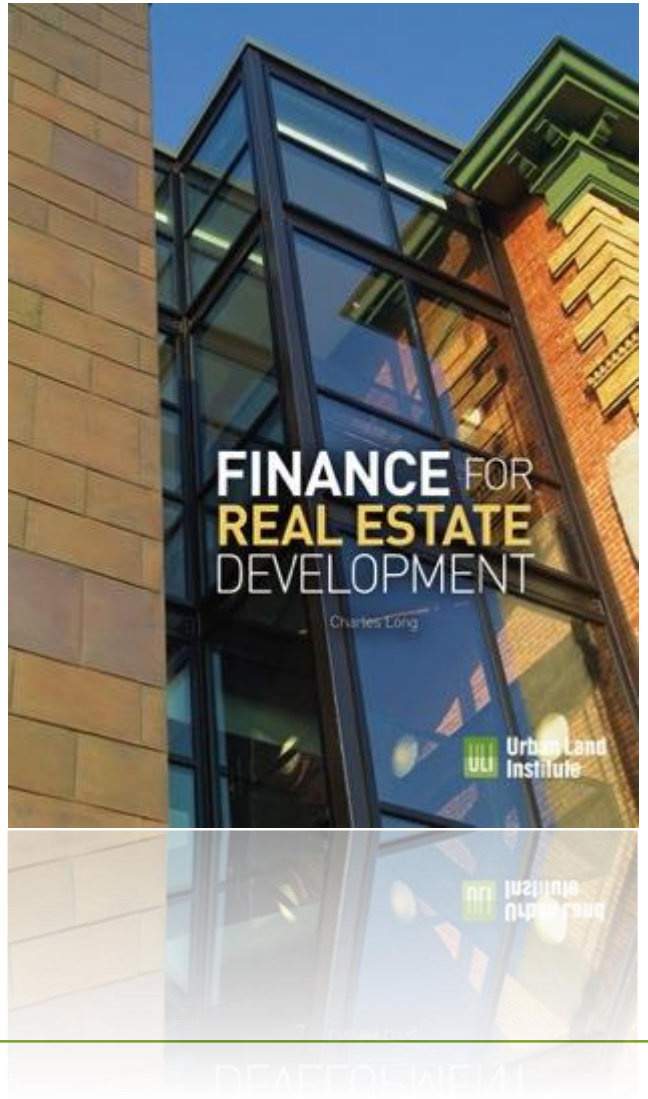
Urban Land Institute

Finance for Real Estate Development

Charles A. Long

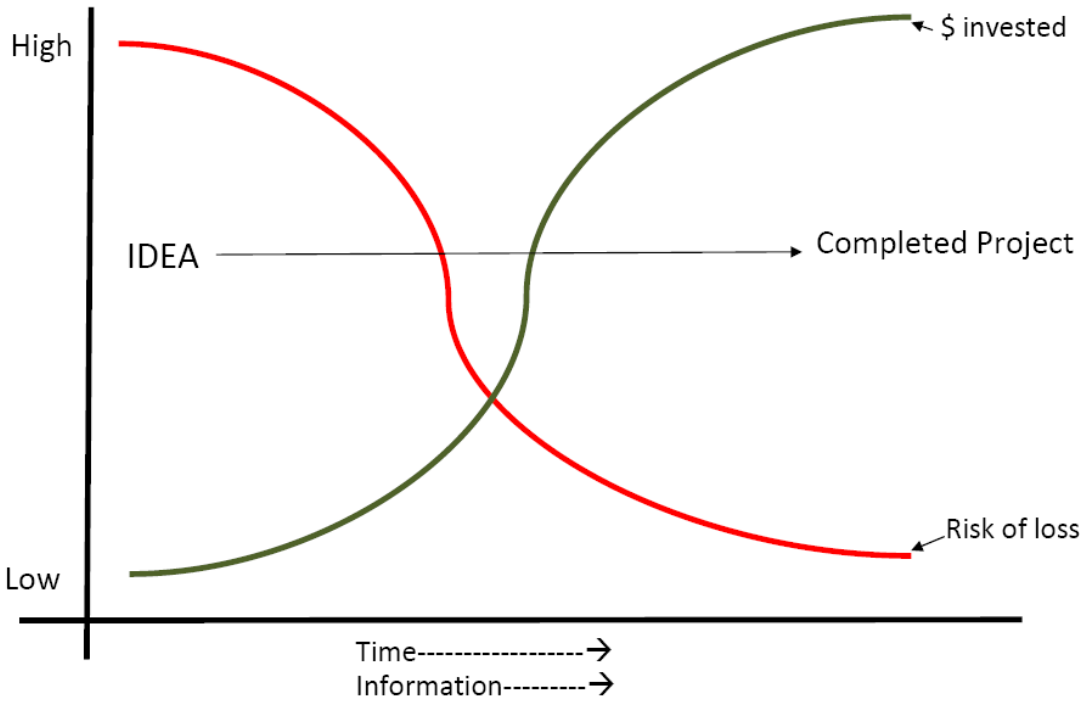
Published by ULI

April 2011

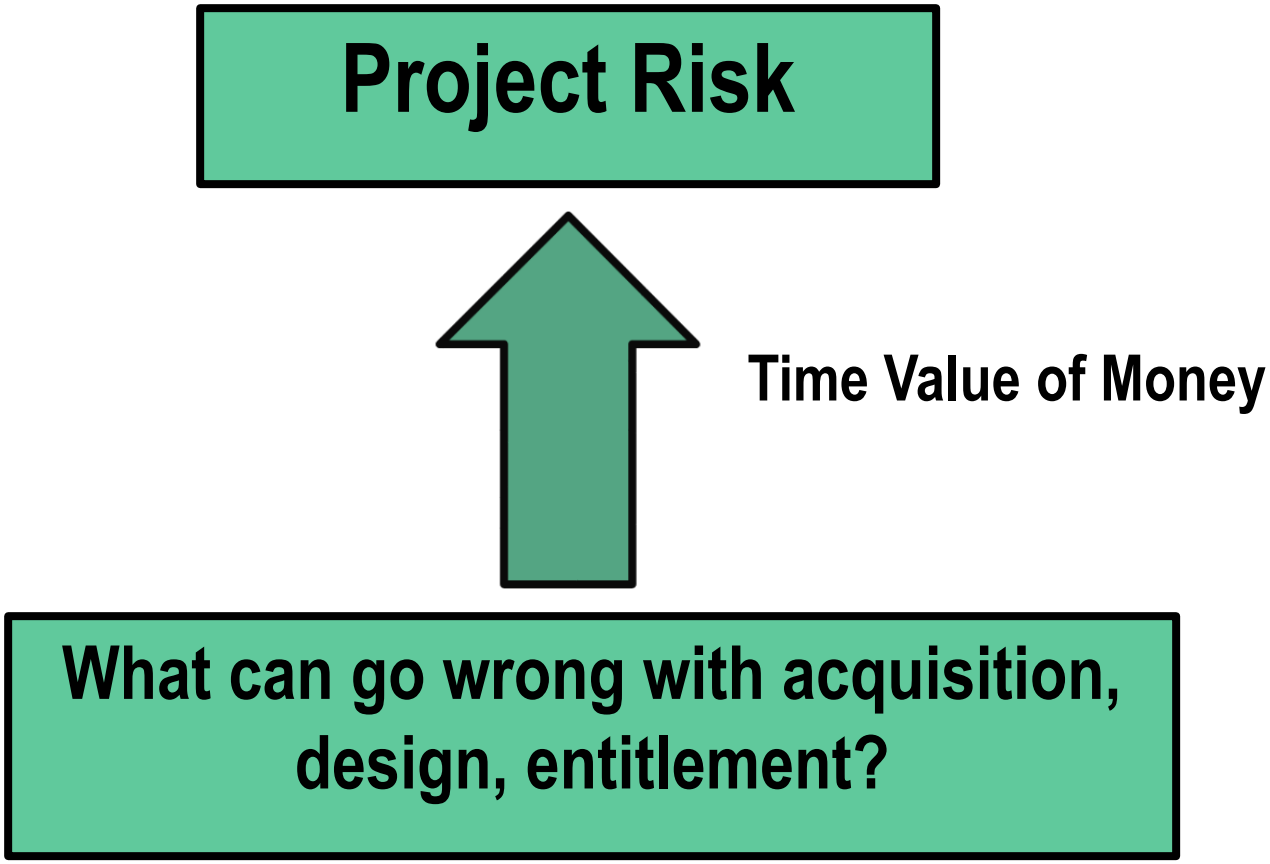


Development is…

…a separate, self-financing enterprise
that goes from small to large.



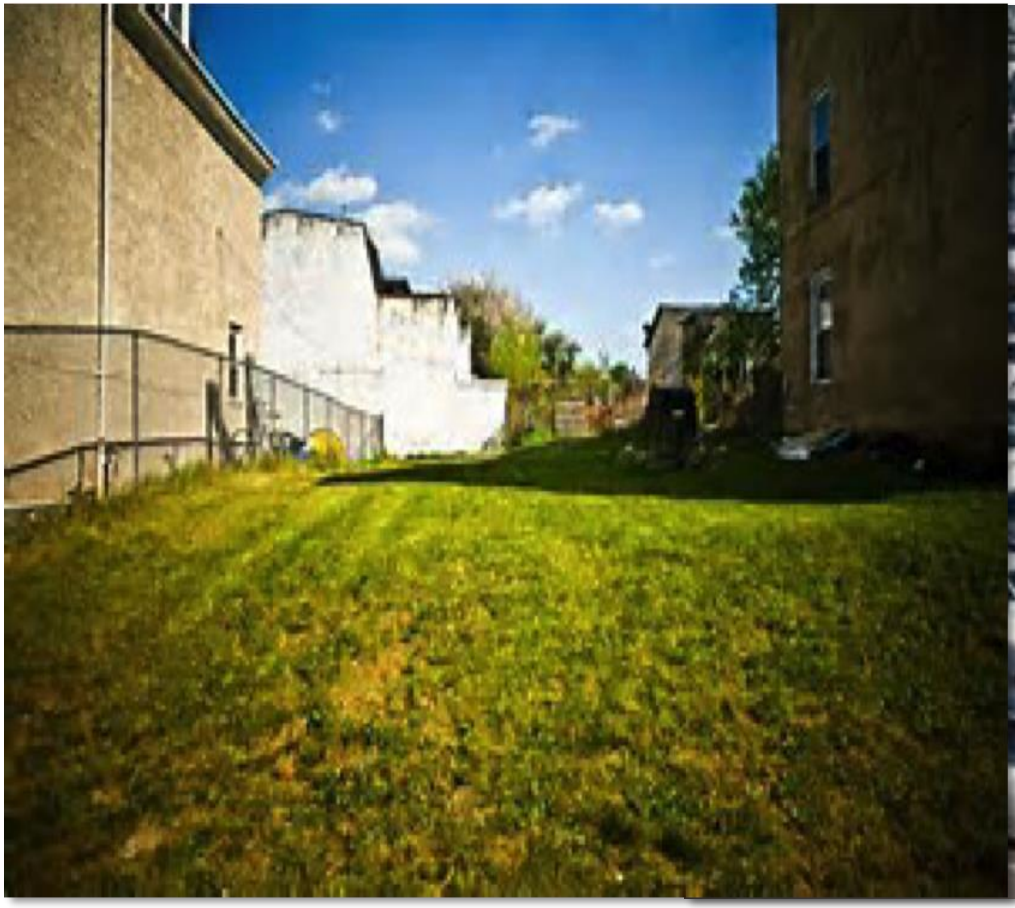
As pre-development is most risky phase, capital is most expensive.



Without site control and land use approvals, infill development cannot occur.

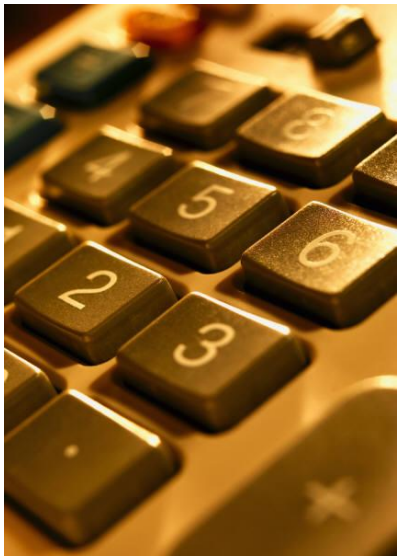
Site Acquisition Costs

Based on Existing Use and Future Value as Infill Development



Determination of Value

- Sales Price (Willing Buyer and Willing Seller)
- Negotiated Purchase Based on Appraised Value
  - Income Approach
  - Cost Approach
  - Sales Comparables
- Residual Land Value Analysis Based on New Development Potential



Cap Rates Used to Measure Value

Cap rate indicates investor perception of:

- Availability of capital
- Perceived financial strength
- Reliability of income and potential for price appreciation

Cap rate also indicates market strength

$$\text{Cap Rate} = \frac{\text{Net Operating Income (NOI)}}{\text{Project Value}}$$

$$\text{Project Value} = \frac{\text{NOI}}{\text{Cap Rate}}$$

High cap rate indicates market weakness/high cost of financing

Low cap rate indicates market strength/low cost of financing

Net Operating Income (NOI)

Revenue

Less: Vacancy

Less: Base Operating Expenses

Less: Property Taxes

Net Operating Income (NOI)

Value Calculations

NOI	Cap Rate	Value
$1,000,000	5%	?
$1,000,000	10%	?

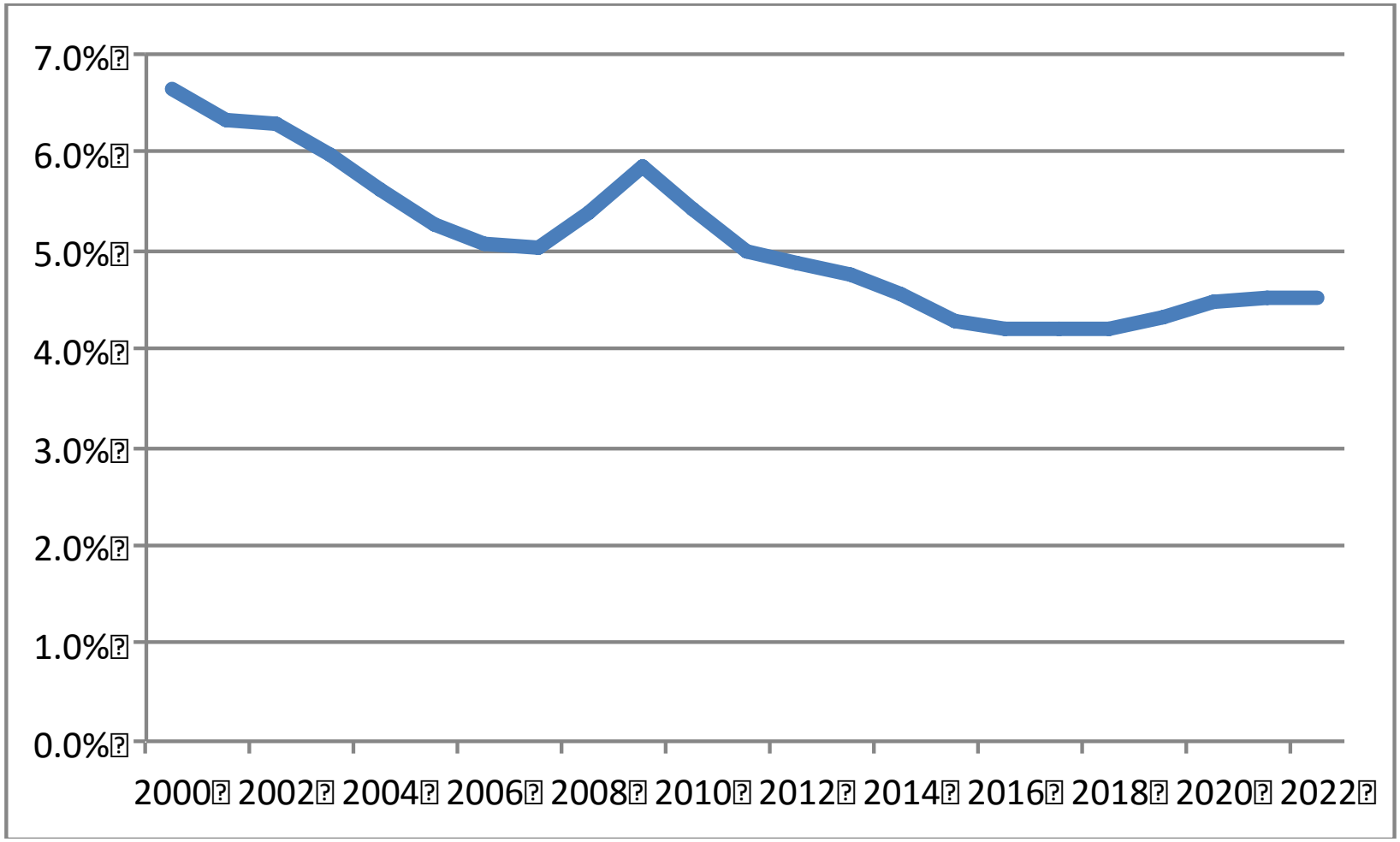
Value Calculations

NOI	Cap Rate	Value
$1,000,000	5%	$20,000,000
$1,000,000	10%	$10,000,000

Urban Land Institute

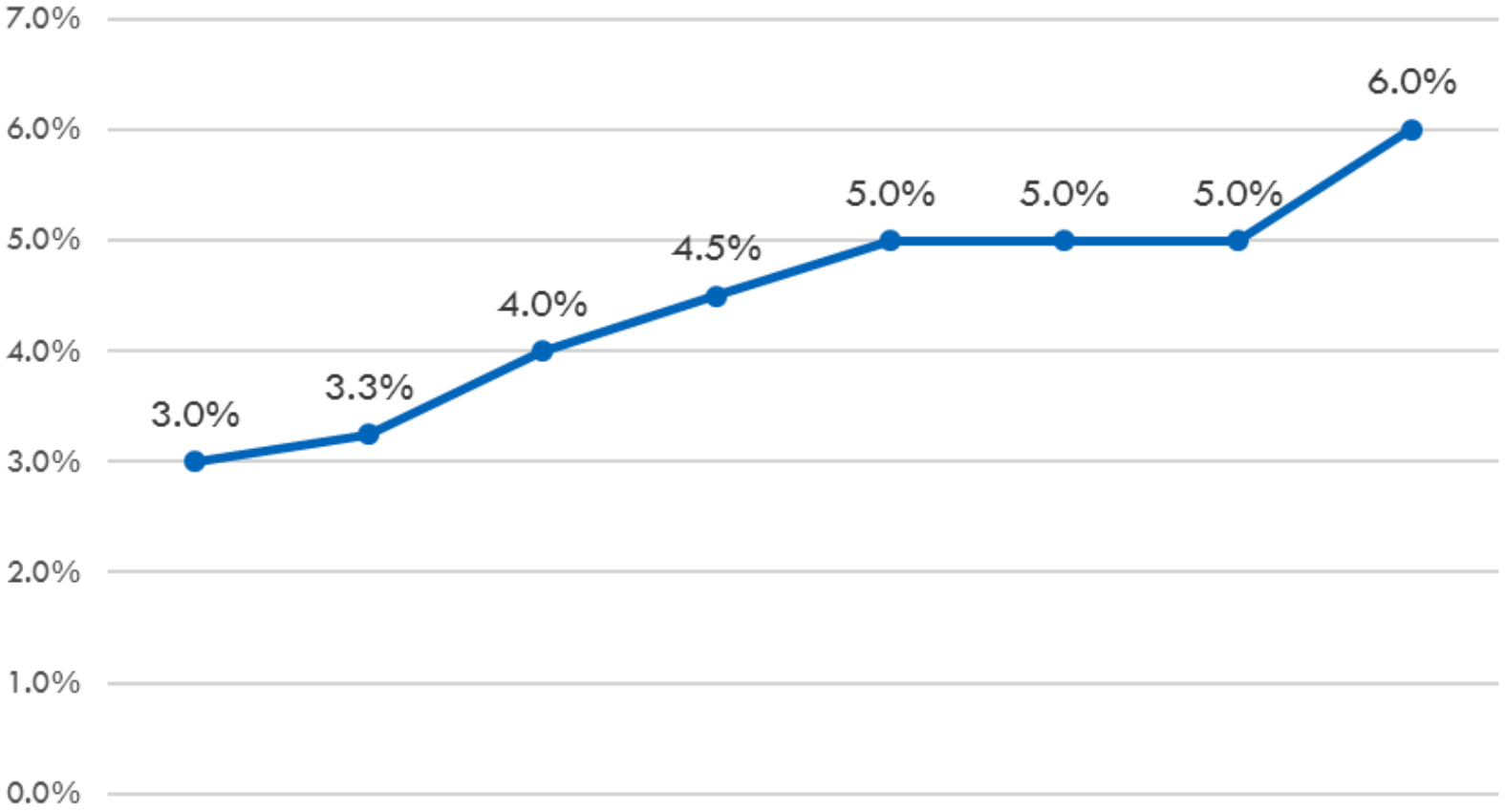
Key Real Estate Trends

Apartment Cap Rates at Historic Lows



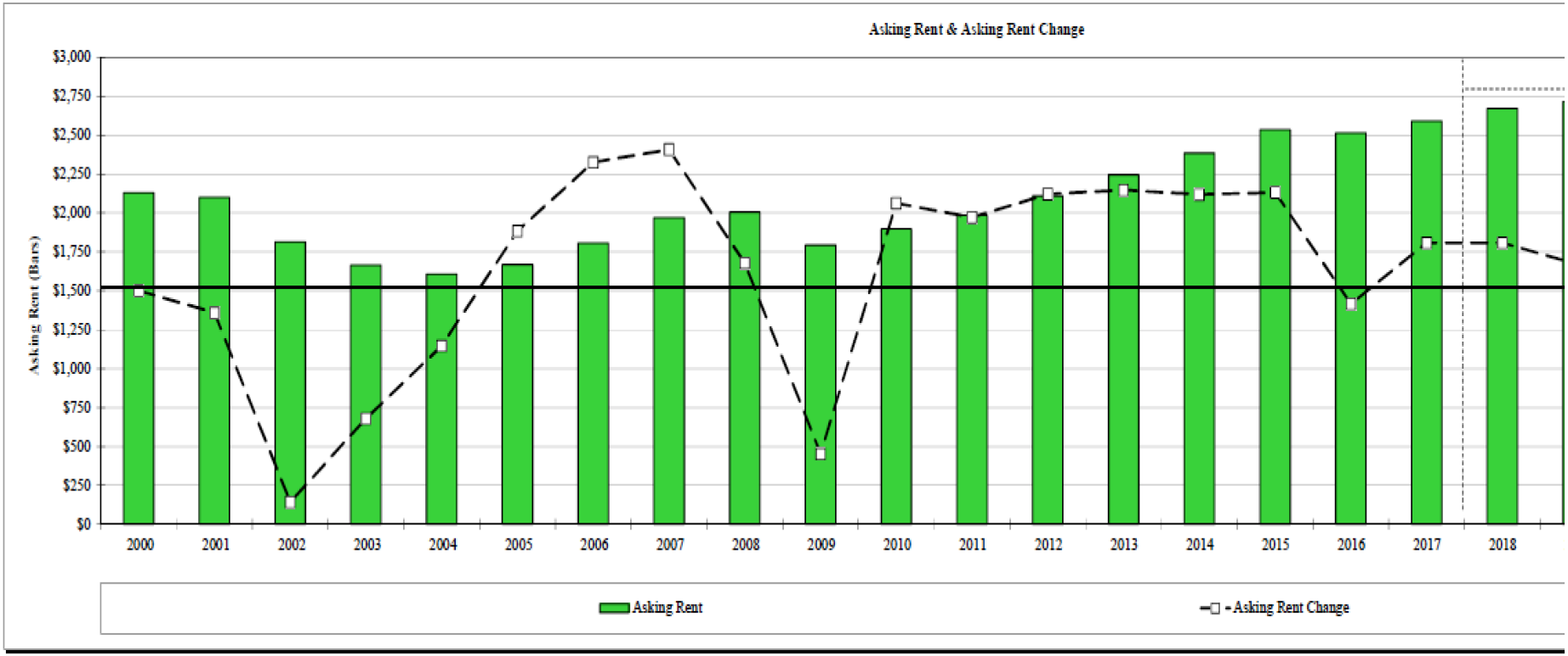
Source: CoStar for San Jose Market Area

Construction Costs Still Increasing



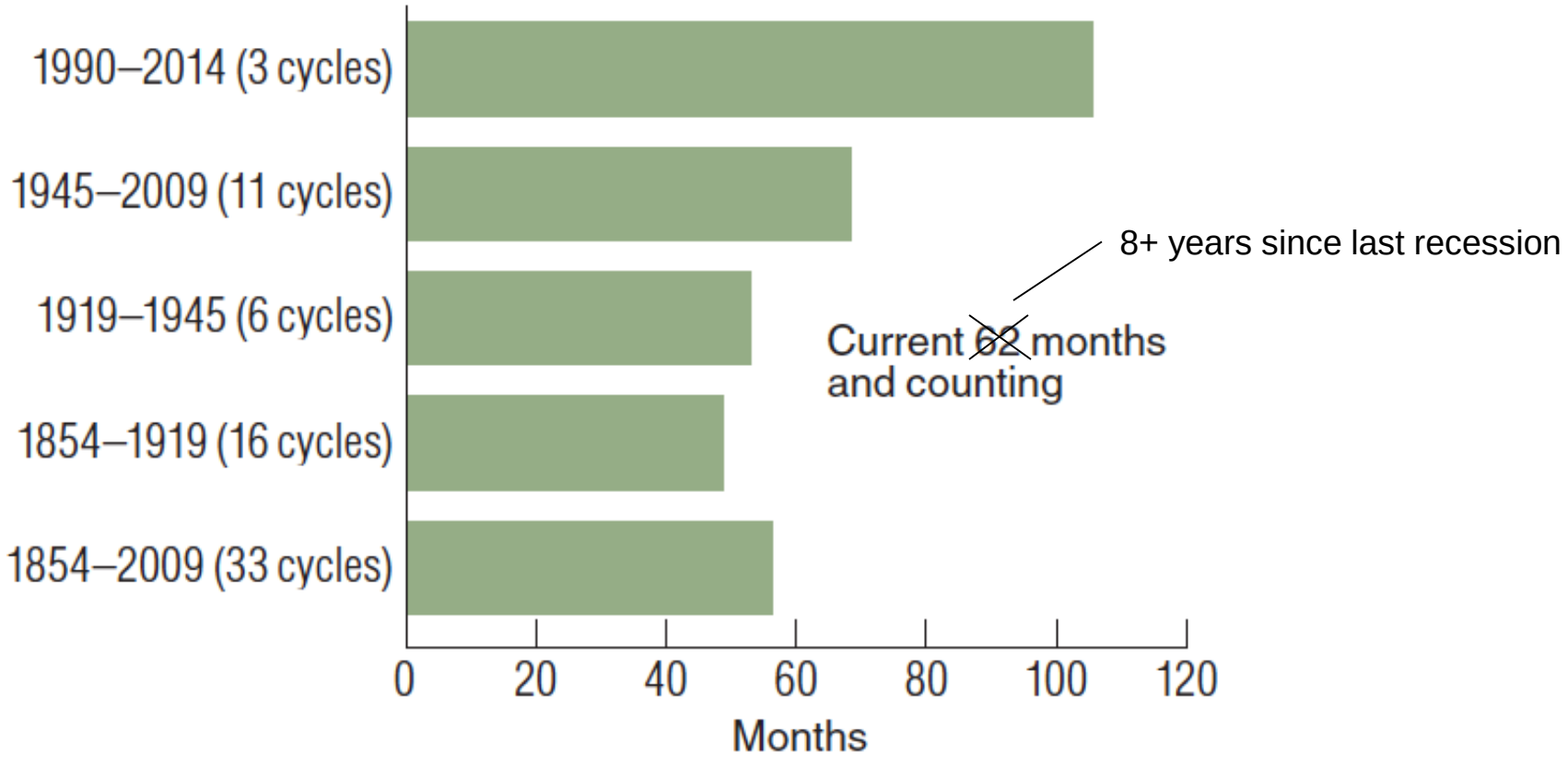
Source: San Francisco AICCIE, which combines numerous private cost indices to develop construction cost escalation factor

Rent Increases Have Stabilized



Current Economic Cycle Could End Soon

Exhibit 1-18 **Average Length of Economic Cycles, Trough to Trough**



Source: National Bureau of Economic Research.

Source: ULI Emerging Trends 2015

Urban Land Institute

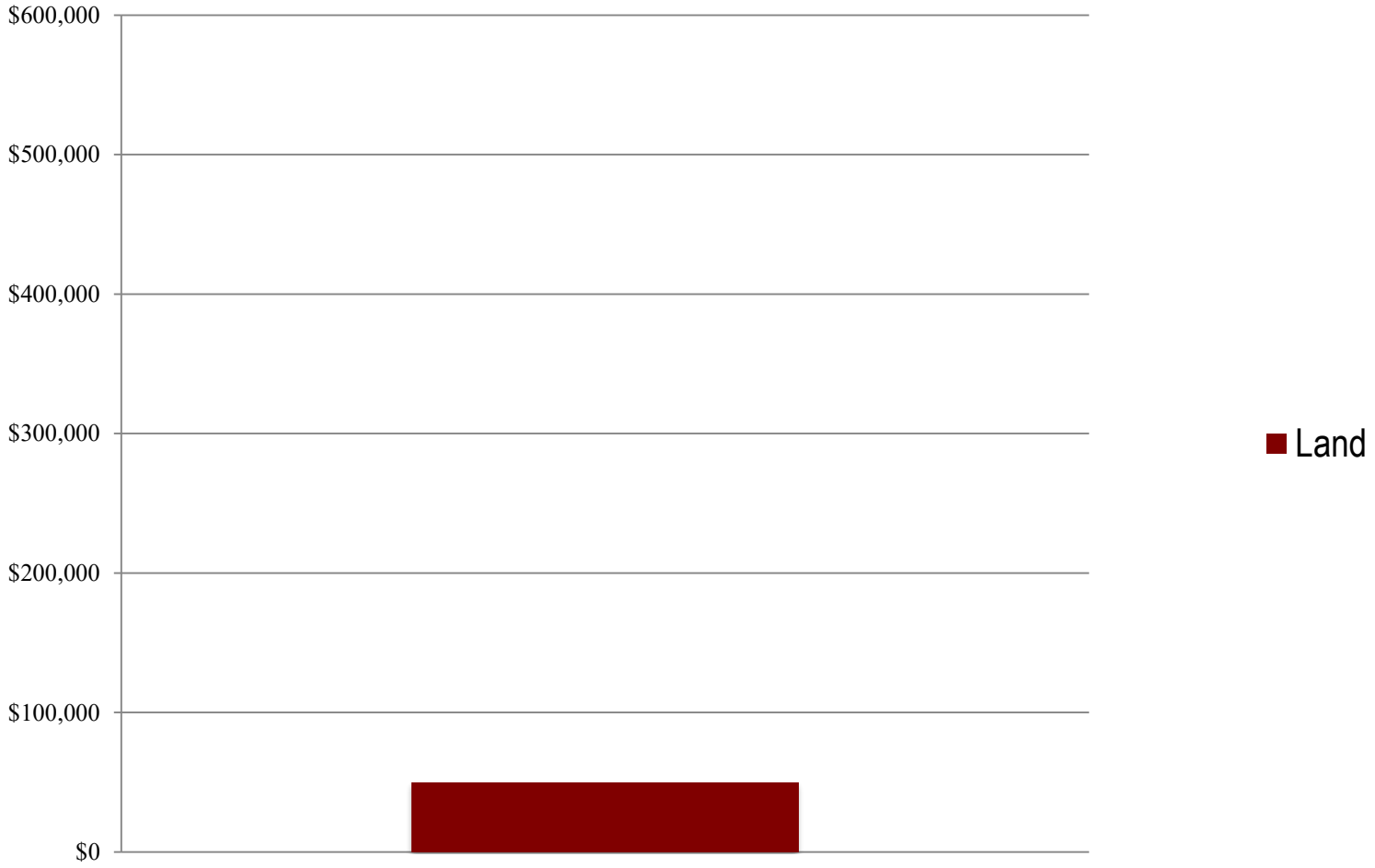
Summary of Trends

- Interest rates are at historic lows
- Cap rates are at historic lows
- Construction costs are still increasing and may increase more with pressures from Sonoma rebuild
- Rent growth has flattened
- Current economic cycle could end soon

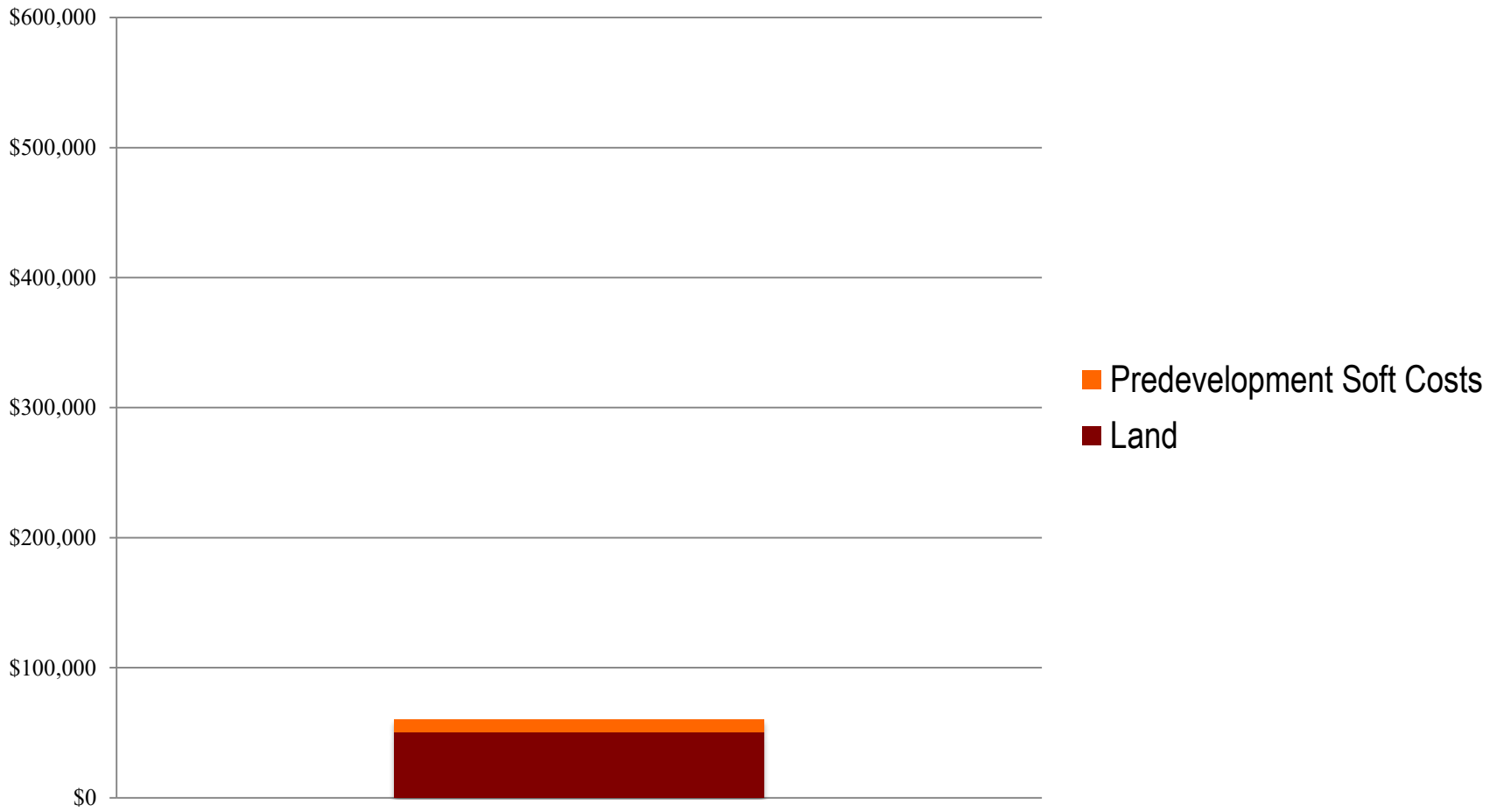
Urban Land Institute

Development Feasibility

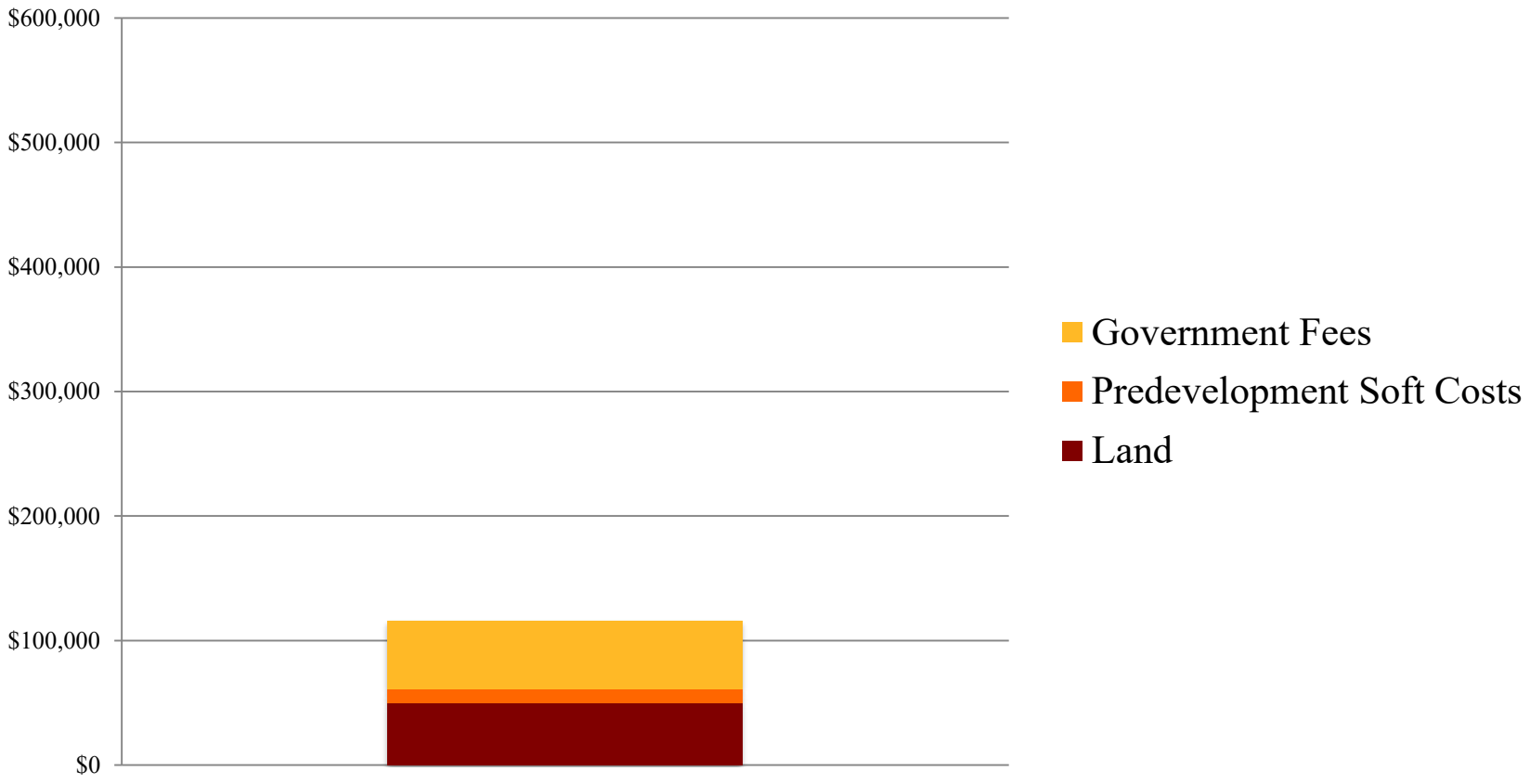
Development Feasibility Framework



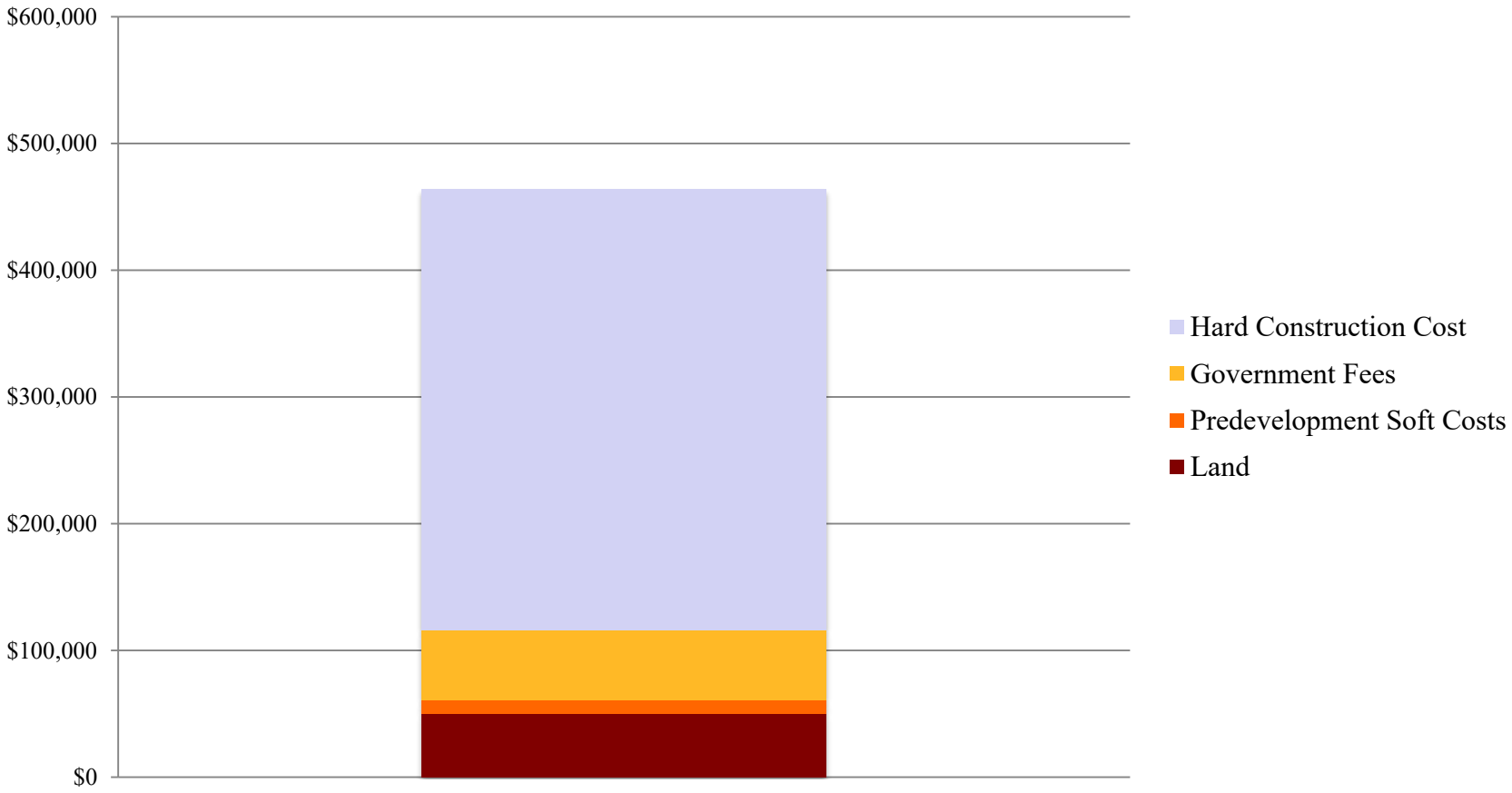
Development Feasibility Framework



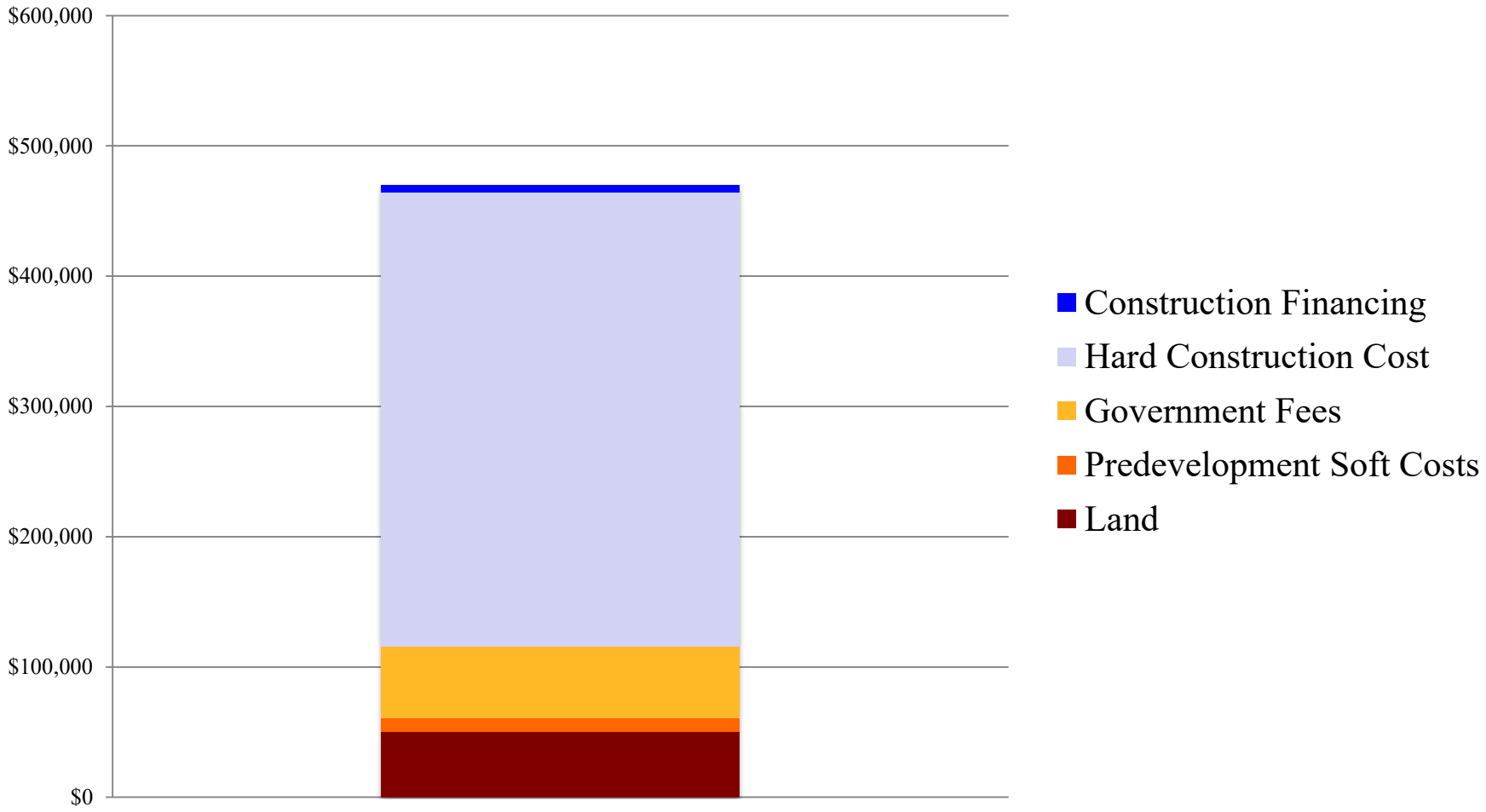
Development Feasibility Framework



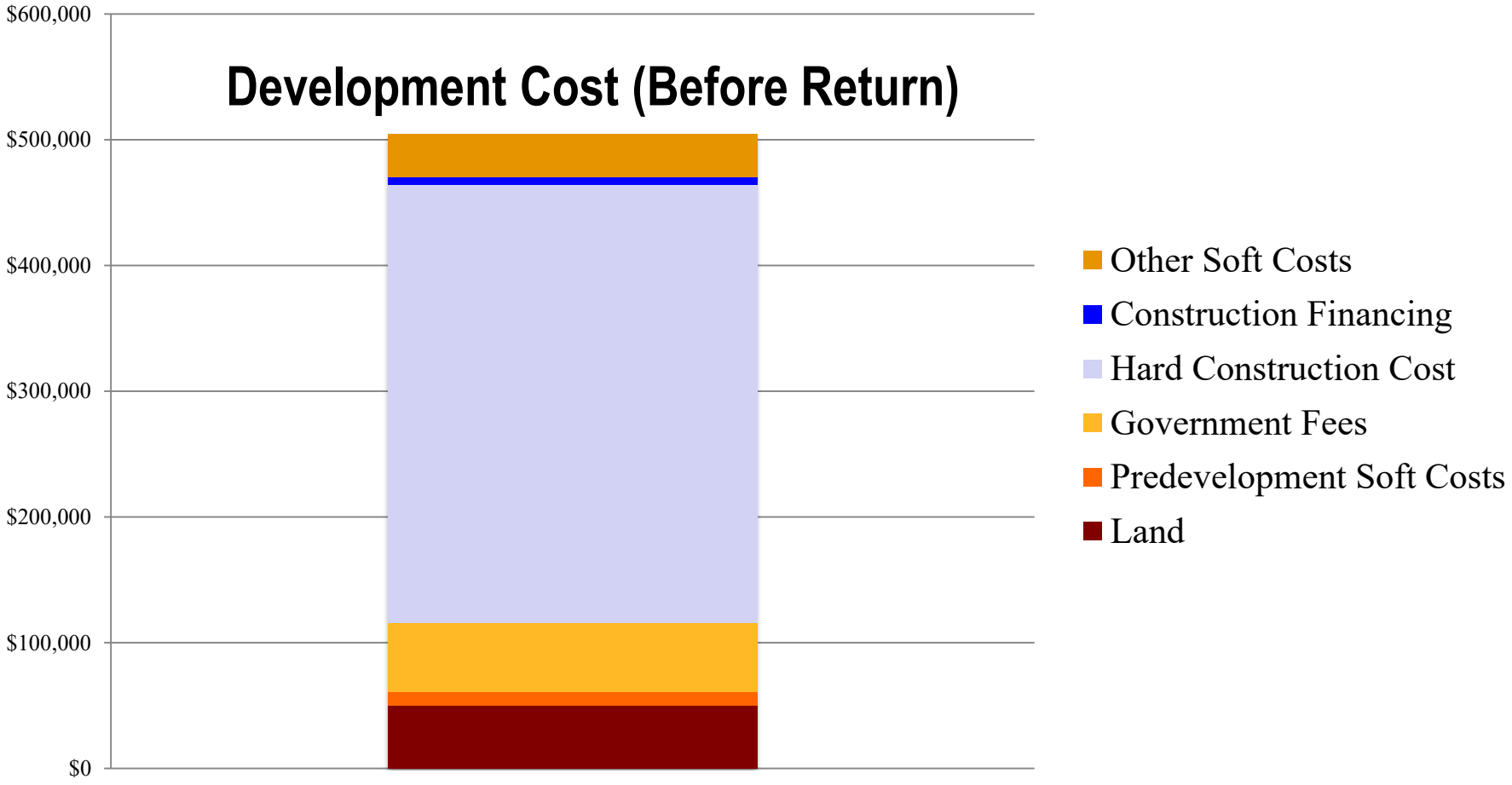
Development Feasibility Framework



Development Feasibility Framework



Development Feasibility Framework



Development is "feasible"

IF PROJECT VALUE
is sufficient to pay:

- **Development Costs**
  - Cost of Debt
  - Cost of Equity Capital
- **Developer Return or Profit**

Typical Measurements of Return

• Pre-tax Internal Rate of Return (IRR)
  – Leveraged
  – Unleveraged
• Net Present Value
  – Present value of cash flow
	• **Return on cost (ROC)**
	• **Yield on cost (YOC)**
	• Return on equity (ROE)
	• Return on investment (ROI)
	• Cash-on-cash return
	• Return on sales (ROS)
	• Net Margin

Important to clarify how project return is being calculated!

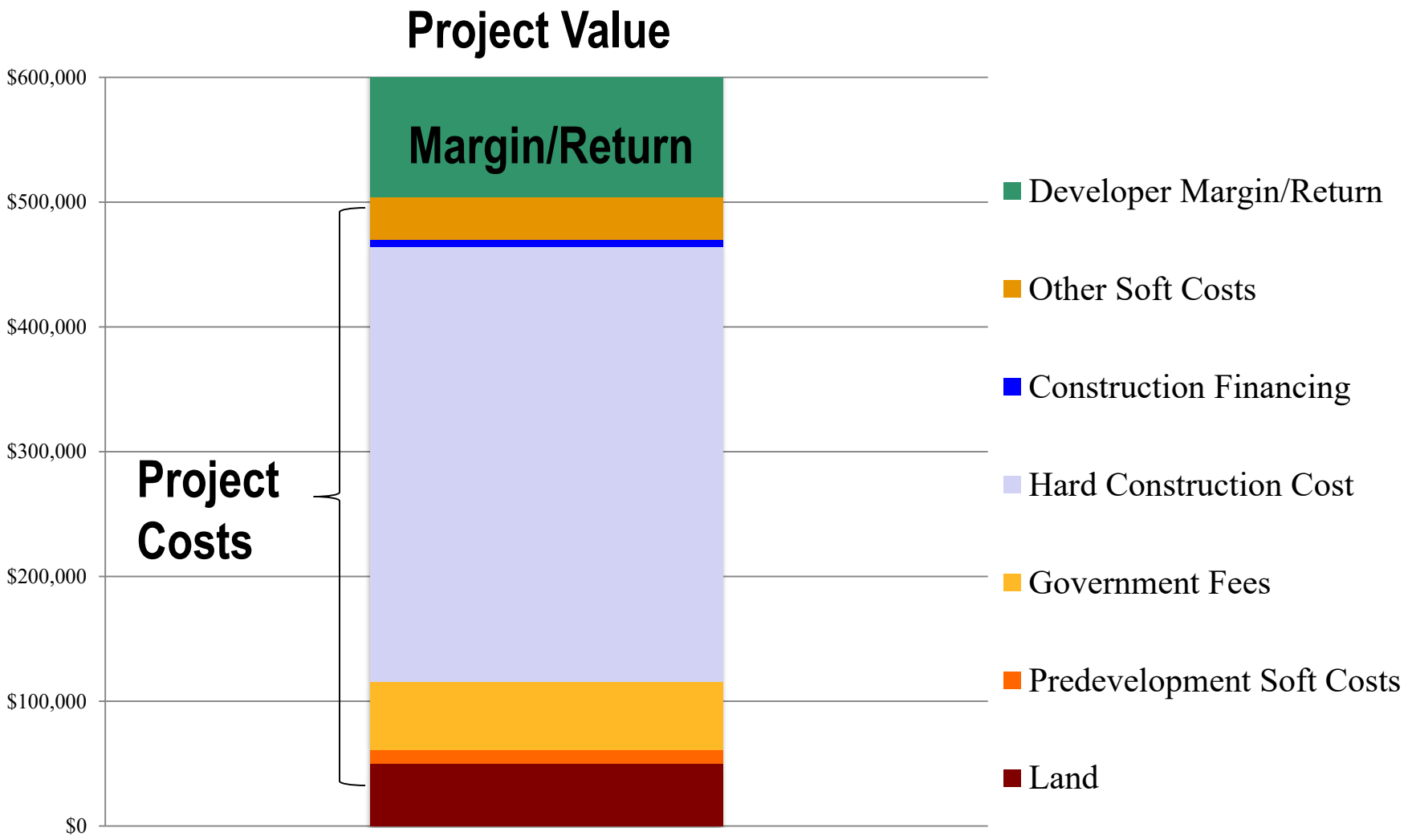
Return on Cost

Return on Cost = Return *divided by* Development cost

<u>For rental property</u>

Return on Cost (or Yield on Cost) = NOI *divided* by Development cost

Development Feasibility Framework



Return on Cost For Apartments

Return on Cost (or Yield on Cost)
= NOI *divided* by
Development cost

Currently between 5% to 5.5% in Bay Area

Cap Rates for Apartments

Currently between 4% to 4.5% in Bay Area

Developer Margin or Return is difference or "spread" between Return on Cost and Cap Rate

Currently between 20% to 25%

San Jose Case Study

Existing Property and Land Use

- Approximately 2 acre site
- 0.2 Commercial Floor Area Ratio (FAR)
- About 20,000 SF of existing retail

Potential Residential Development

- 200 Units at 90 DU/acre

Proposed Building Characteristics

- About 170,000 leasable SF (NRSF)
- 7 stories
- Podium construction
- About 300 parking spaces
- Ground floor retail (street frontage)

2 Pierce Avenue

What cap rate for existing retail?

NOI	Cap Rate	Value
About $460,000	??	??

What is value of existing retail?

NOI	Cap Rate	Value
About $460,000	6.5%	$7,000,000

- Would seller be willing to sell building for this amount?
- How much more would have to be paid given that developer may option property for 2+ years?

Project Characteristics

Characteristics	
Total Units	200
Market Rate	200 (or 180)
Below Market Rate	0 (or 20 with on-site BMR)
Average Apartment Size	850 SF
Market Rate Rent/SF	About $3.85/sf
Market Rate Rent /Month	About $3,300
Parking	About 300 spaces
Residential Net Rentable Area	174,000 SF
Retail Leasable Area	Up to 8,000 SF

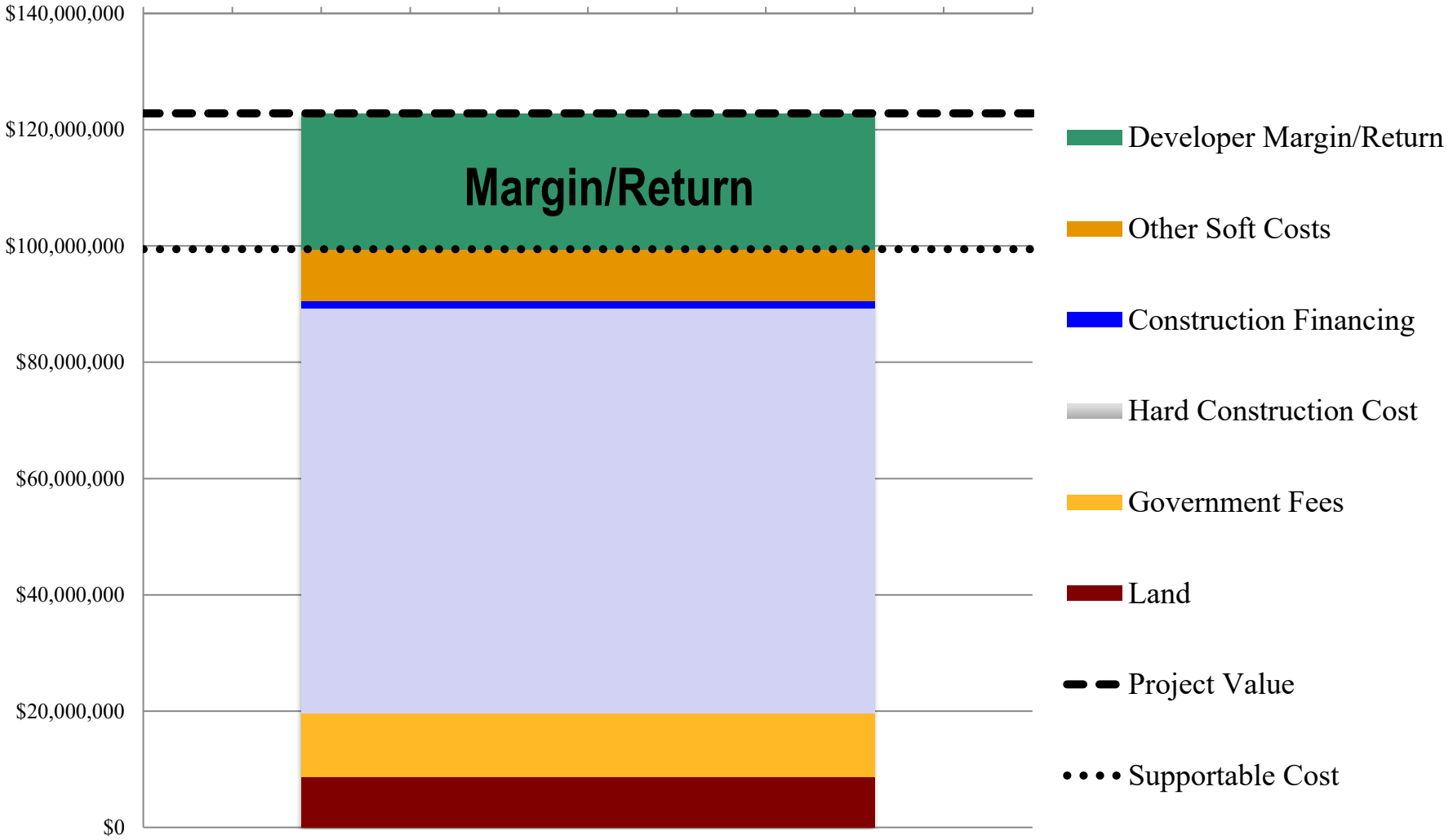
Base Case

100% Market Rate (with Housing Fee)

Net Operating Income	**$5,220,000**
Return on Cost Target	5.25%
Total Supportable Development Cost	**$99,400,000**
Less: Total Costs Without Land	$90,700,000
Residual Land Value (RLV)	**$ 8,700,000**

Yahtzee: Residual Land Value above $7,000,000 commercial value.

Base Case


$140,000,000
$120,000,000
$100,000,000
$80,000,000
$60,000,000
$40,000,000
$20,000,000
$0
Margin/Return
Developer Margin/Return
Other Soft Costs
Construction Financing
Hard Construction Cost
Government Fees
Land
Project Value
Supportable Cost

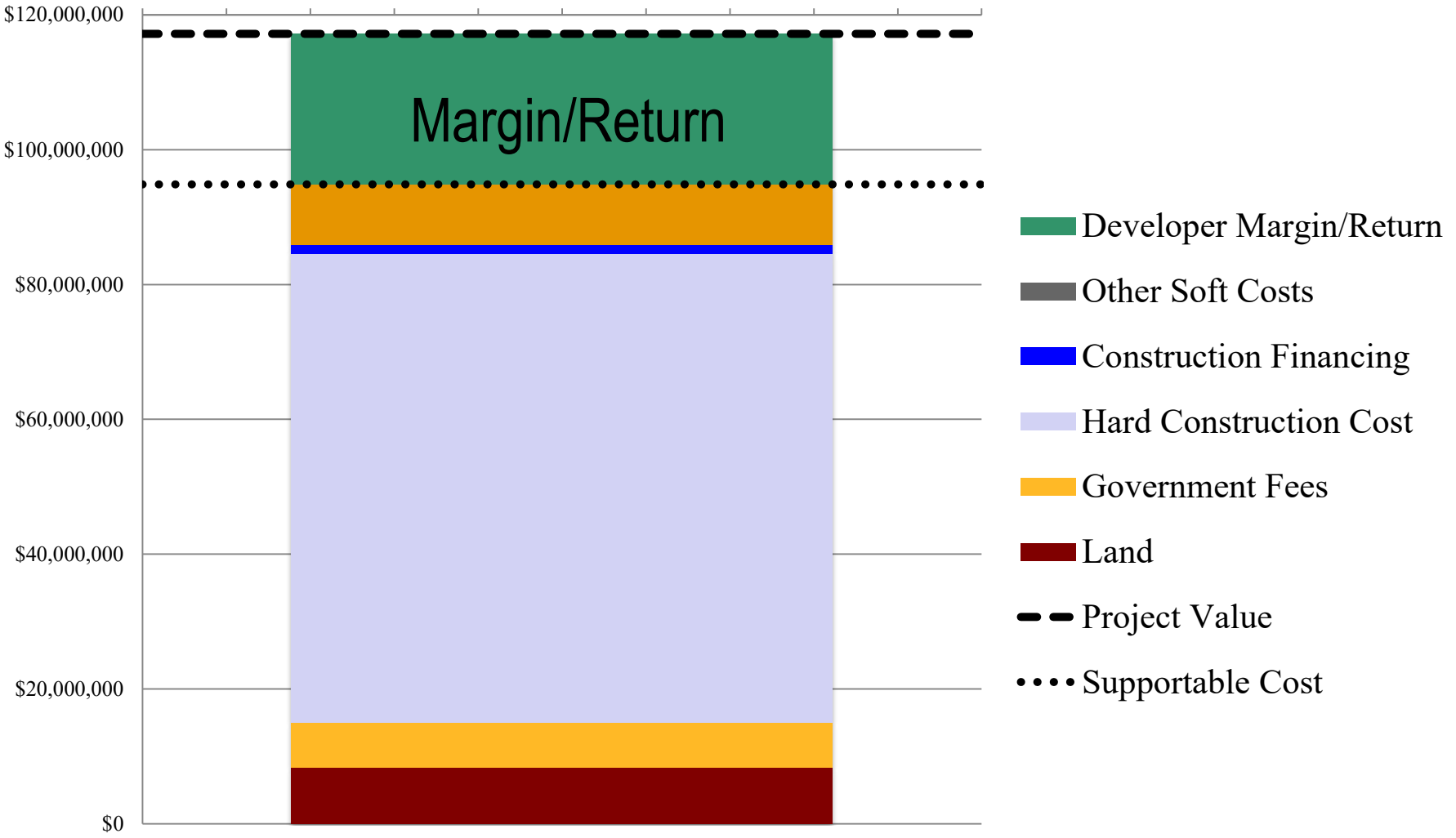
Sensitivity Analysis 1

15% On-Site BMR

Net Operating Income	**$4,980,000**
Return on Cost Target	5.25%
Total Supportable Development Cost	**$94,900,000**
Less: Total Costs Without Land	$86,500,000
Residual Land Value (RLV)	**$ 8,400,000**

Yahtzee: Residual Land Value above $7,000,000 commercial value.

15% On-Site BMR



Sensitivity Analysis 2

City Fee Up 10%

Net Operating Income	**$5,220,000**
Return on Cost Target	5.25%
Total Supportable Development Cost	**$99,400,000**
Less: Total Costs Without Land	$92,700,000
Residual Land Value (RLV)	**$ 6,700,000**

No Deal. *Residual Land Value below value of commercial building.*

Sensitivity Analysis 3

Construction Cost Up 10%

Net Operating Income	**$5,200,000**
Return on Cost Target	5.25%
Total Supportable Development Cost	**$99,400,000**
Less: Total Costs Without Land	$98,200,000
Residual Land Value (RLV)	**$ 1,200,000**

No Deal! *Residual Land Value below value of commercial building.*

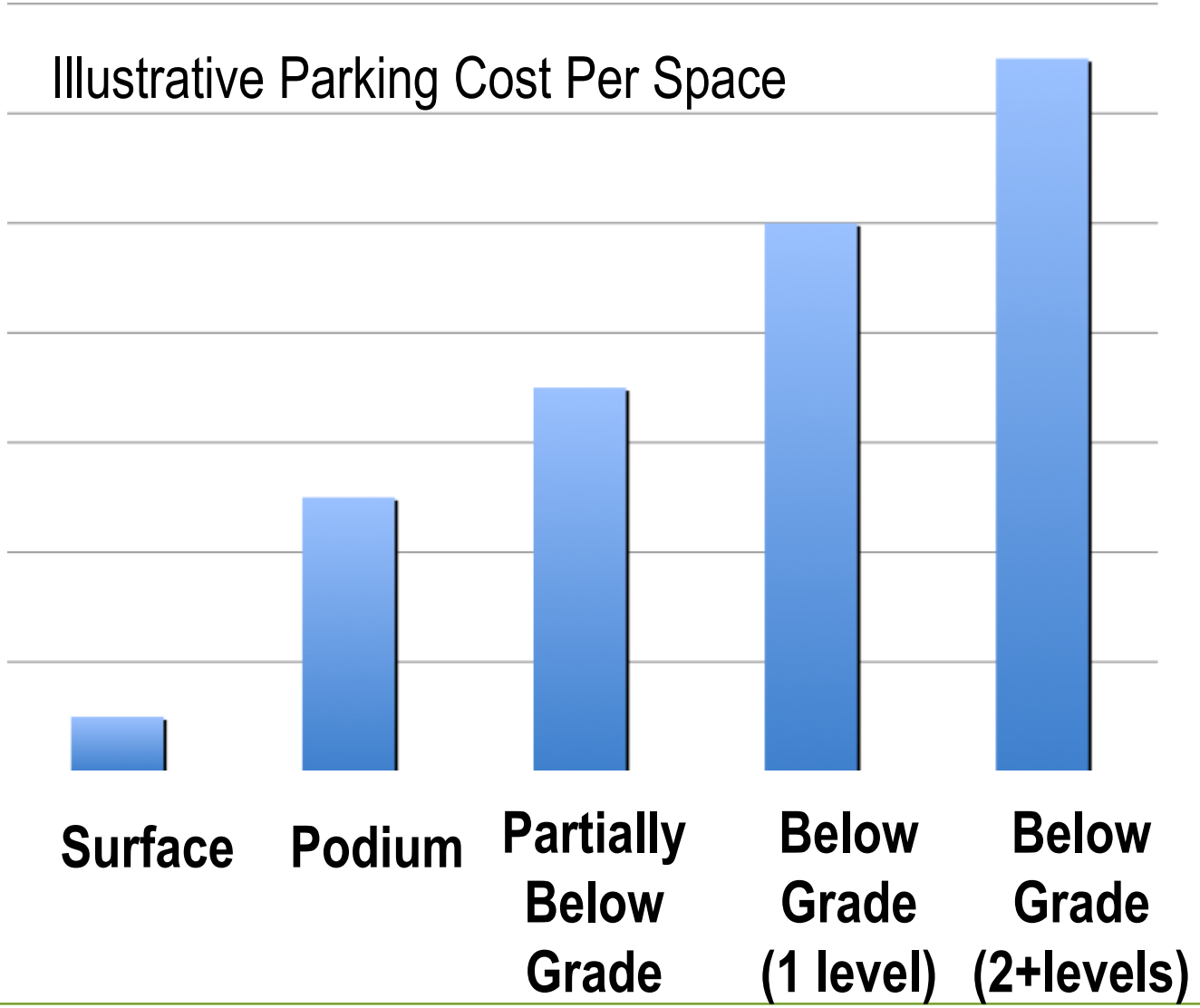
Sensitivity Analysis 4

All of the Above

Net Operating Income	**$4,980,000**
Return on Cost Target	5.25%
Total Supportable Development Cost	**$94,900,000**
Less: Total Costs Without Land	$95,800,000
Residual Land Value (RLV)	**-$900,000**

No Deal! *Residual Land Value is negative.*

How about reducing required parking?



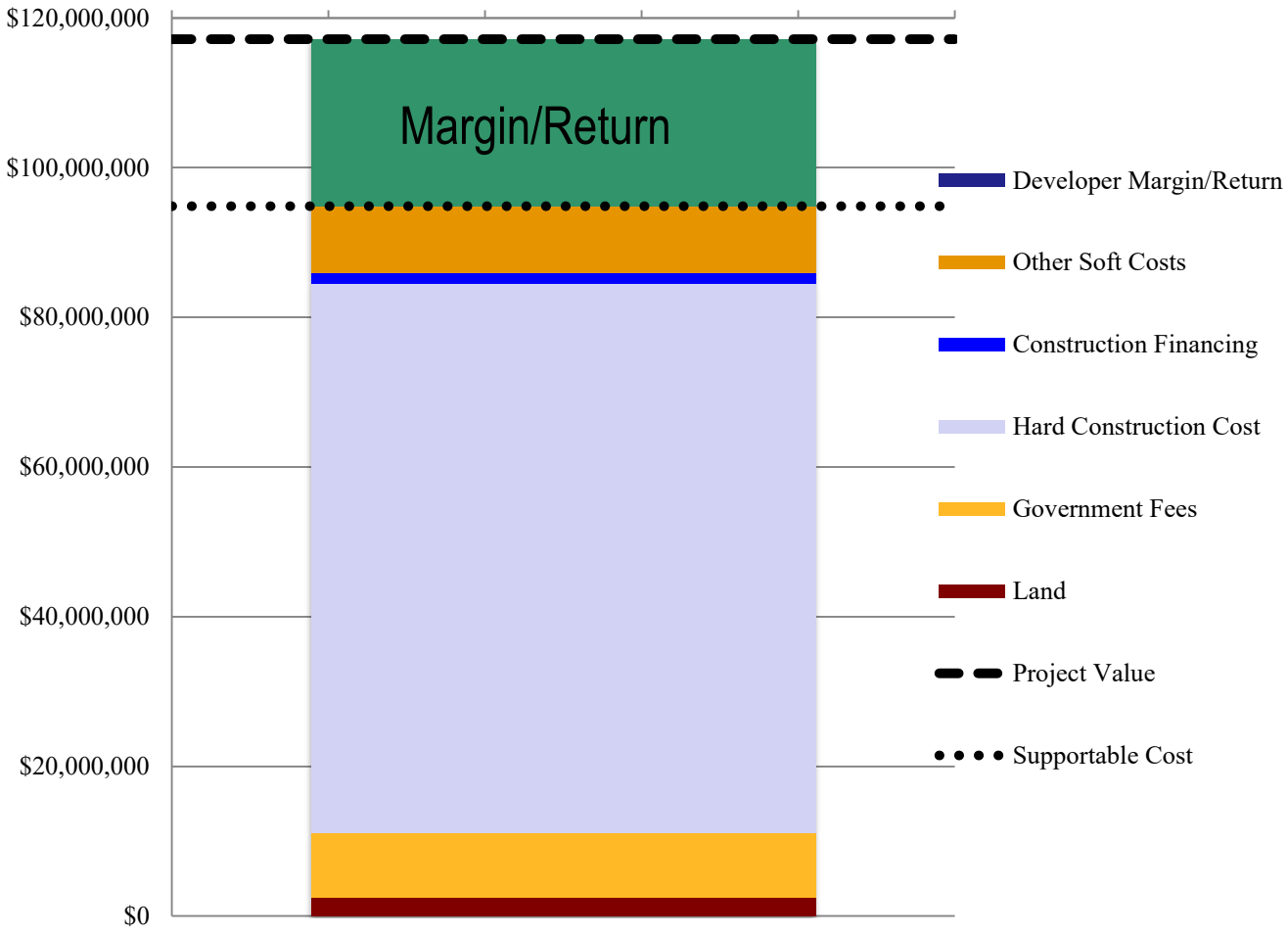
Sensitivity Analysis 4

All of the Above With 20% Parking Reduction

Net Operating Income	**$4,980,000**
Return on Cost Target	5.25%
Total Supportable Development Cost	**$94,900,000**
Less: Total Costs Without Land	$92,400,000
Residual Land Value (RLV)	**$ 2,500,000**

No Deal! *Residual Land Value still below value of commercial building.*

All of the Above With Parking Reduction



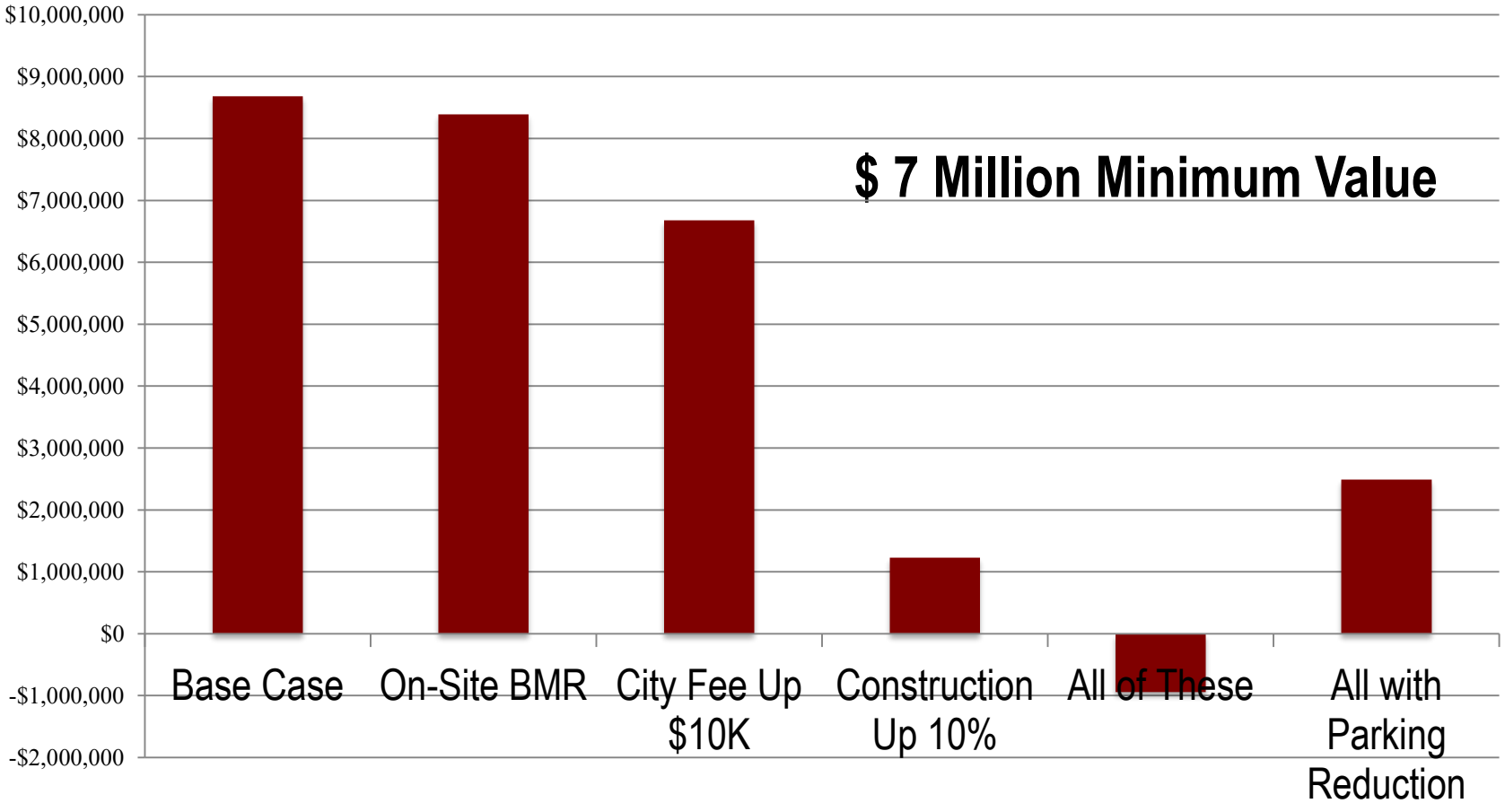
Sensitivity Analysis

Base Case: 100% Market Rate (with Housing Fee)

Sensitivity Cases:

- 15% On-site BMR (6% Very Low and 9%Moderate)
- City fee increases by $10,000
- Construction costs are 10% higher
- All of the above
- All of the above with 20% parking reduction

Summary of Residual Land Value Results



Question and Answer

Presenters from ULI San Francisco District Council

Andrew (Drew) Hudacek
Board Member
ULI San Francisco District Council
Chief Investment Officer
Sares Regis of Northern California

Elizabeth (Libby) Seifel
Board Member
ULI San Francisco District Council
President
Seifel Consulting Inc.