MEMORANDUM

To: Sandy Council, City of San Mateo

From: Darin Smith

Subject: Hillsdale Terraces Density Bonus and Concession Request; EPS #151052

Date: June 29, 2015

At your request, Economic & Planning Systems, Inc. (EPS) has reviewed materials submitted by Hillsdale Terraces, LLC ("the LLC") regarding their request for a density bonus and concessions from the City of San Mateo for their planned condominium project at 2700-2790 El Camino Real. The LLC is proposing to build a condominium project on land currently entitled for up to 49 units, and is seeking approval of a project including 74 units, of which eight would be "below market rate" (BMR) units affordable at "very-low income" (VLI) levels.

According to State law (Government Code 65915), the developer is entitled to a maximum density bonus of 35 percent additional units if the developer provides at least 11 percent of the units allowed under existing zoning at prices affordable to VLI households. This by-right bonus would allow the Hillsdale Terraces project to build up to 67 units on a parcel otherwise limited to 49 units, in exchange for 6 BMR VLI units within the project. The LLC is proposing to provide 8 VLI units, thus more than satisfying this initial State-mandated bonus criterion.

In addition, State law (Government Code 65915(d)(2)(B)) requires that Cities provide "concessions" for any project meeting or exceeding the State requirements for density bonus. The LLC is proposing to provide eight total VLI units, representing roughly 11 percent of the *total* units in the project (not just 11 percent of the units allowed under existing zoning limits). At this level of affordability, State law requires the City to provide three concessions to the developer. The LLC is requesting only two: 1) that the City of San Mateo allow a higher Floor-Area-Ratio (FAR) than allowed under existing zoning (2.5 rather than 2.0), and 2) that the City allow the developer to build a total of 74 units representing a 51 percent density bonus, rather than the 67 units that would be allowed by-right under the State law.

The City of San Mateo's Below Market Rate (Inclusionary) Program requires developments of eleven (11) or more residential units to provide a minimum of 10 percent below market rate (BMR) units which would result in a requirement of 5 BMR units for the proposed Project. In exchange for an increase to 74 units, the Project would provide a

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total of 8 BMR units resulting in an increase of 3 additional BMR units over the City's Inclusionary Program requirement. **Table 1** shows the number of BMR units and total number of units that would be provided if developed:

1) to meet the City's BMR Ordinance requirement, or
2) as allowed by the State Density Bonus provision, or
3) as proposed by the LLC.

Table 1 Alternative Density Bonus Allowances and Requested Project

BMR Requirement For 49 Base Units	Density Increase over Base Units	Very Low Income BMR Units	Total Units
City BMR (Inclusionary) Program 10% of Base Required	20%	5	59
State Density Bonus Law 11% of Base Required	35%	6	67
Project-Proposed Density Bonus No Maximum Requirement	51%	8	74

Consistent with State law, the City of San Mateo's Density Bonus Ordinance states that the City shall grant concessions to proposed developments unless "the concession or incentive is not required to provide for affordable housing costs" (San Mateo Municipal Code Section 27.16.060). The LLC has provided a financial analysis intended to demonstrate that the concessions requested are critical and material to the proposed project's ability to provide affordable units. EPS's task has been to review that analysis and confirm that its assumptions and calculations are reasonable and support the claim that the concessions are required for project feasibility. Based on the materials initially provided by the LLC to the City on March 31, 2015, and the LLC's responses to EPS's questions regarding additional assumptions and calculations, we have reached the following conclusions:

- **The LLC's analysis used reasonable assumptions and metrics regarding development economics, but we have amended some for clarity and consistency.**

  While extensive project details are not provided, the LLC's analysis assumes development costs that are consistent with EPS's expectations for multifamily development on the San Francisco Peninsula. The LLC initially did assume that development costs per square foot (excluding land costs) will decrease slightly as more units are added within the same total number of building square feet, which runs counter to EPS's expectations. Through communications between EPS and the LLC, we have agreed to assume that development costs will not vary but rather be the same among all scenarios, since the land costs and excavation costs (for underground parking) are the same in each case, and the potential efficiencies of a larger building (2.5 FAR vs. 2.0) may be offset by the slightly higher costs per square foot as unit sizes diminish. For planning and comparison purposes, we believe this approach is reasonable.

Similarly, the LLC assumes market-rate housing prices that are similar to if slightly lower than reported condominium sale prices in local ZIP Code 94403 in early 2015, the time of EPS's initial analysis. The LLC analysis assumes market-rate units will sell for $590 to $600 per square foot, with the higher figure applied to the project with smaller units, which is consistent with EPS's expectations and experience. While the 20 surveyed condominium sales in the ZIP Code averaged $620 to $630 per square foot (see **Table 2**), with San Mateo home values at an all-time high in recent times, EPS believes it is reasonable to assume prices slightly below current rates for project underwriting purposes for a project that is at least a year or two from unit sales and occupancy. At roughly $600 per square foot, the prices assumed are similar to the City's median home prices per square foot during the 2006-2007 housing "bubble" peak, after which they fell to below $500 per square foot from 2009 through 2013, only reaching $600 again in early 2014 (source: Trulia.com).

In recognition of the general trend in which smaller units achieve somewhat higher values than larger units on a per-square-foot basis, EPS has modulated the market-rate unit value assumptions modestly—now ranging between $590 and $615 per square foot in our analysis, a difference of about 4 percent from the scenarios with the smallest to the largest average market-rate unit sizes (930 to 1,363 square feet).

The LLC assumes BMR unit sale prices that were provided by the City of San Mateo and that are consistent with the City's expectations by unit size and income level. For certain scenarios (described below), EPS has utilized more of the City's pricing information than was included in the LLC's analysis, as EPS is exploring more affordability options.

The LLC analysis did not specify the cost of acquiring the land for this project. However, land costs are generally high in San Mateo and other Peninsula communities, and affect the feasibility of development significantly. EPS researched the parcels underlying the proposed project at 2700-2790 El Camino Real, and determined they were each acquired within the past few years for a total sum of $6.1 million (not including potential closing and legal costs). EPS has used this figure as an input for our feasibility analysis.

Finally, the LLC calculated and compared their two scenarios' feasibility based on an estimated Internal Rate of Return (IRR) for each alternative. While IRR calculations can be useful in some circumstances, EPS believes it is more straightforward and appropriate in this instance to calculate a "Return on Costs," meaning the net project proceeds (all unit sales revenues less all unit development and land acquisition costs) divided by the total project costs (development and land acquisition). This metric avoids concerns that the IRR can be significantly affected by the assumed timing of various project activities, such as the pace of development or sales of units. Obviously, the higher the return, the more attractive the investment would be, but based on our experience, EPS believes a "Return on Costs" of 10 percent or higher represents a potentially feasible project, while returns below that level would not be attractive investments given the various entitlement, construction, and market risks taken on by the financiers.[1]

[1] A 10 percent return on costs for a project with 30 percent equity would represent about a 33 percent return on the equity investment overall. However, if this return takes three or four years to fully materialize after initial equity investments are made, the annualized return on equity would be nearer 10 percent—appropriately higher than the 5 or 6 percent annual return one might expect for

- **The LLC's initial analysis has been improved by adding some more scenarios reflecting more choices the developer may pursue.**

  The LLC's initial analysis aimed to show the difference in project feasibility between two scenarios, one with the State-mandated density bonus (67 total units) offering 8 VLI units, and another with 74 total units, also including 8 BMR units. Each of these scenarios assumed that the City would grant an FAR bonus (from 2.0 to 2.5), so the building square footage was the same in each scenario. Therefore, they differed only in the number of units within that same square footage, with the 74-unit scenario having a few more and slightly smaller units than the 67-unit scenario.

  In EPS's opinion, these two scenarios did not explore the feasibility of the full range of development options for the subject site. In our opinion, it is important to understand the basic economics of developing under the base zoning (without a density bonus) as well as with the density bonus and various concessions. Only through exploration of this range of options is it possible to address the central question: are the requested concessions required to provide for affordable housing costs?

  To answer this question, EPS believes an appropriate standard should be: "but for" the concession(s), would the developer make a different choice that would lead to fewer affordable housing units? Thus, the answer focuses on the developer's financial returns, assuming that the developer will elect to pursue the available project that yields the largest return on her investment. EPS has expanded the analysis to compare the financial feasibility of 11 alternative development scenarios, as follows:

  1) 5 LOW Units: Development of 49 units, as allowed under current zoning, with 5 BMR units (10 percent) for sale at "low" income levels per the City's inclusionary housing policy

  1a) 5 LOW Units, Density Bonus: Development of 59 total units with 5 BMR units, as the State density bonus law grants the developer a 20 percent density bonus for meeting the City's basic requirement of 10 percent "low" income units

  1b) 5 LOW Units, Density Bonus, One Concession: Development of 59 total units with 5 BMR units and concession of 2.5 FAR rather than 2.0, as the State density bonus law grants the developer both a 20 percent density bonus and rights to one concession for meeting the City's basic requirement of 10 percent "low" income units

  2) 8 MOD Units: Development of 49 units, as allowed under current zoning, with 8 BMR units (15 percent) for sale at "moderate" income levels per the City's inclusionary housing policy

  2a) 8 MOD Units, Density Bonus: Development of 54 total units with 8 BMR units, as the State density bonus law grants the developer a 10 percent density bonus (but no City concessions) for meeting the City's basic requirement of 15 percent "moderate" income units

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purchasing an existing and stabilized residential development, but reflecting the added risk associated with the entitlement, development, and marketing of a new building in dynamic market conditions.

3) 6 VLI Units, Density Bonus: Development of 67 units, taking advantage of the State-mandated 35 percent density bonus in exchange for providing 6 BMR units (11 percent of the base zoning allowance) for sale at "VLI" income levels

3a) 6 VLI Units, Density Bonus, One Concession: Development of 67 units, taking advantage of the State-mandated 35 percent density bonus in exchange for providing 6 BMR units (11 percent of the base zoning allowance) for sale at "VLI" income levels, but also seeking one concession from the City to increase allowable building size from a 2.0 FAR to a 2.5 FAR

3b) 6 VLI Units, Density Bonus, Two Concessions: Development of 74 units, taking advantage of the State-mandated 35 percent density bonus in exchange for providing 6 BMR units (11 percent of the base zoning allowance) for sale at "VLI" income levels, but also seeking two concessions from the City to a) increase allowable building size from a 2.0 FAR to a 2.5 FAR, and b) allow 7 more total units within the same square footage envelope

4) 8 VLI Units, Density Bonus, No Concessions: Development of 67 units, taking advantage of the State-mandated 35 percent density bonus in exchange for providing 8 BMR units (16 percent of the base zoning allowance) for sale at "VLI" income levels, but seeking no concessions from the City

4a) 8 VLI Units, Density Bonus, One Concession: Development of 67 units, taking advantage of the State-mandated 35 percent density bonus in exchange for providing 8 BMR units (16 percent of the base zoning allowance) for sale at "VLI" income levels, but also one concession from the City to increase allowable building size from a 2.0 to a 2.5 FAR

4b) 8 VLI Units, Density Bonus, Two Concessions: The LLC's proposal to develop 74 units, taking advantage of the State-mandated 35 percent density bonus in exchange for providing 8 BMR units (16 percent of the base zoning allowance) for sale at "VLI" income levels, but also seeking two concessions from the City to a) increase allowable building size from a 2.0 FAR to a 2.5 FAR, and b) allow 7 more total units within the same square footage envelope. In this scenario, the development would be entitled to a third concession under State density bonus law, but the developer has requested only two concessions despite the added BMR units.

- **The scenario analysis demonstrates that the proposed project (Scenario 4b) provides the highest number of affordable units at the lowest income levels, and appears feasible with the concessions but does not yield the highest possible return to the developer.**

  As the scenarios demonstrate, the developer has numerous options available for this project, with respect to affordability and density. The financial analysis on **Table 3** indicates that the developer has a strong incentive to take advantage of the density bonus mandated by State law. By simply complying with San Mateo's inclusionary housing requirements, the project is entitled to 10 to 20 percent more market-rate units, the profitability of which greatly enhance the project's return on costs (see Scenarios 1 vs. 1a and 2 vs. 2a). Also, the analysis indicates that meeting the City's requirements with 5 "low" income units is more advantageous than providing 8 "moderate" income units, both with and without the added value of the State-mandated density bonus (see Scenarios 1 vs. 2 and 1a vs. 2a).

It is further indicated that the developer's proposal to provide VLI units can be of greater financial benefit than providing low or moderate income units, due to the significantly greater density bonus and added potential for concessions. Indeed, this is the premise behind the State density bonus law and its concession requirements—providing effective incentives to produce housing affordable to the lowest possible income levels. Comparing Scenarios 3 and 3b, the density bonus for 6 VLI units does not appear to be sufficient by itself in achieving the feasibility threshold, but the value of the added concessions does achieve that feasibility.

Notably, there are several scenarios in which the developer could achieve higher returns on cost than the scenario they propose, 4b. For instance, their returns may be higher if they offered only the 6 VLI units required to get the maximum density bonus plus two concessions granted under State law, rather than the 8 VLI units they have offered (see Scenario 4b vs. 3b). They may even be able to achieve higher returns by simply meeting the City's inclusionary requirement with 5 "low" income units (thus qualifying for a 20 percent density bonus and one concession) than under their proposed scenario (see Scenario 4b vs. 1b).

EPS concludes that both of the requested concessions are required to provide for the proposed affordable housing costs.

Even with lower BMR unit counts or higher income levels, there is no scenario evaluated that meets the expected feasibility threshold (10 percent return on costs) without either of the concessions requested from the City. With a single concession (the FAR increase from 2.0 to 2.5), the developer's optimal outcome appears to be Scenario 1b, but that would yield only 5 low income units rather than 8 VLI units as proposed.[2]

With 8 VLI units, the developer is entitled by State law to a second concession and even a third, which the developer has not requested at this time. The financial analysis indicates that these 8 VLI units cannot be provided through the maximum 35 percent density bonus alone, or even with a single concession of an increased FAR. However, with both the FAR increase and 7 additional market-rate units, the developer can provide and the City can receive 33 to 60 percent more affordable units (8 vs. 5 or 6) than would otherwise be feasible. Therefore, EPS concludes that both concessions are required to provide for the proposed affordable housing costs.

[2] EPS has not evaluated any scenario in which only an additional 7 units would be requested, rather than in concert with the FAR increase. If the FAR remained at 2.0 and the project could still yield only 64,581 square feet of sellable residential space, the average unit in the building would be less than 875 square feet – very small for a contemporary condo project on the Peninsula in EPS's experience.

Table 2
Condominium Sales in ZIP Code 94403 between March-May 2015
San Mateo Density Bonus; EPS #151052

Address	Price Sold	Sq. Ft.	Price/SF
1700 De Anza Blvd, #204C	$788,000	1,060	$743
823 Laurel Ave.	$876,000	1,400	$626
55 W. 20th Ave, #107	$645,000	1,213	$532
4106 George Ave., #4	$530,000	812	$653
10 Scenic Way, #117	$730,000	1,152	$634
35 28th Ave., #201	$655,000	1,176	$557
1518 Day Ave., #156	$590,000	1,008	$585
66 Laurie Meadows Dr., #4	$485,000	840	$577
3090 Los Prados St., #11	$515,000	900	$572
114 24th Ave., #8	$548,000	841	$652
1700 De Anza Blvd, #303	$826,000	1,060	$779
3369 La Selva St., #G	$470,000	723	$650
2828 Edison St., #4	$619,000	1,024	$604
1700 De Anza Blvd, #105C	$740,000	1,060	$698
1919 Alameda De Las Pulgas, #79	$580,000	892	$650
1919 Alameda De Las Pulgas, #9	$503,000	692	$727
1919 Alameda De Las Pulgas, #3	$665,000	1,024	$649
3045 Los Prados St., #110	$475,000	956	$497
262 W. 20th Ave.	$810,000	1,434	$565
4108 George Ave., #5	$590,000	1,128	$523
Average			$634
Weighted Average			$620

Source: Trulia.com as of 6/16/15

Table 3
Financial Analysis of Development and Affordability Scenarios
San Mateo Density Bonus; EPS #151052

Scenario	1	1a	1b	2	2a	3	3a	3b	4	4a	4b
Affordable Units and Income Level	5 Low	5 Low	5 Low	8 Mod	8 Mod	6 VLI	6 VLI	6 VLI	8 VLI	8 VLI	8 VLI
Zoning Density	Base Zoning	20% Bonus	20% Bonus	Base Zoning	10% Bonus	35% Bonus	35% Bonus	35% Bonus	35% Bonus	35% Bonus	35% Bonus
Concessions	None	None	2.5 FAR	None	None	None	2.5 FAR	2.5 FAR + 7 Units	None	2.5 FAR	2.5 FAR + 7 Units
Total Units	49	59	59	49	54	67	67	74	67	67	74
Total Residential Square Footage	64,581	64,581	80,726	64,581	64,581	64,581	80,726	80,726	64,581	80,726	80,726
BMR Units	5	5	5	8	8	6	6	6	8	8	8
1 BR Units	1	1	1	2	2	1	1	1	2	2	2
Sq.Ft./Unit	850	850	850	850	850	850	850	850	850	850	850
Value/Unit	$199,000	$199,000	$199,000	$267,000	$267,000	$123,000	$123,000	$123,000	$123,000	$123,000	$123,000
Cost/Unit	$380,000	$380,000	$380,000	$380,000	$380,000	$380,000	$380,000	$380,000	$380,000	$380,000	$380,000
Net Value/(Cost) per Unit	($181,000)	($181,000)	($181,000)	($113,000)	($113,000)	($257,000)	($257,000)	($257,000)	($257,000)	($257,000)	($257,000)
2 BR Units	3	3	3	5	5	4	4	4	5	5	5
Sq.Ft./Unit	1,100	1,100	1,100	1,100	1,100	1,100	1,100	1,100	1,100	1,100	1,100
Value/Unit	$231,000	$231,000	$231,000	$307,000	$307,000	$145,000	$145,000	$145,000	$145,000	$145,000	$145,000
Cost/Unit	$490,000	$490,000	$490,000	$490,000	$490,000	$490,000	$490,000	$490,000	$490,000	$490,000	$490,000
Net Value/(Cost) per Unit	($259,000)	($259,000)	($259,000)	($183,000)	($183,000)	($345,000)	($345,000)	($345,000)	($345,000)	($345,000)	($345,000)
3 BR Units	1	1	1	1	1	1	1	1	1	1	1
Sq.Ft./Unit	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600
Value/Unit	$262,000	$262,000	$262,000	$347,000	$347,000	$167,000	$167,000	$167,000	$167,000	$167,000	$167,000
Cost/Unit	$600,000	$600,000	$600,000	$600,000	$600,000	$600,000	$600,000	$600,000	$600,000	$600,000	$600,000
Net Value/(Cost) per Unit	($338,000)	($338,000)	($338,000)	($253,000)	($253,000)	($433,000)	($433,000)	($433,000)	($433,000)	($433,000)	($433,000)
Total BMR Program											
BMR Unit Values	$1,154,000	$1,154,000	$1,154,000	$2,416,000	$2,416,000	$870,000	$870,000	$870,000	$1,138,000	$1,138,000	$1,138,000
BMR Unit Costs	$2,450,000	$2,450,000	$2,450,000	$3,810,000	$3,810,000	$2,940,000	$2,940,000	$2,940,000	$3,810,000	$3,810,000	$3,810,000
Total BMR Net Value/(Cost)	($1,296,000)	($1,296,000)	($1,296,000)	($1,394,000)	($1,394,000)	($2,070,000)	($2,070,000)	($2,070,000)	($2,672,000)	($2,672,000)	($2,672,000)
Market-Rate Units											
Number of Units	44	54	54	41	46	61	61	68	59	59	66
Avg. Sq.Ft./Unit	1,337	1,089	1,388	1,361	1,213	946	1,211	1,086	945	1,219	1,090
Avg. Value/Sq.Ft.	$595	$605	$590	$595	$600	$615	$600	$605	$615	$600	$605
Avg. Value/Unit	$795,553	$659,123	$819,182	$809,502	$727,576	$582,040	$726,649	$657,279	$581,444	$731,451	$659,322
Total Value	$35,004,326	$35,592,634	$44,235,840	$33,189,576	$33,468,480	$35,504,442	$44,325,600	$44,694,980	$34,305,192	$43,155,600	$43,515,230
Avg. Cost/Sq.Ft.	$425	$425	$425	$425	$425	$425	$425	$425	$425	$425	$425
Avg. Cost/Unit	$568,252	$463,020	$590,089	$578,216	$515,366	$402,223	$514,710	$461,725	$401,811	$518,111	$463,160
Total Cost	$25,003,090	$25,003,090	$31,864,800	$23,706,840	$23,706,840	$24,535,590	$31,397,300	$31,397,300	$23,706,840	$30,568,550	$30,568,550
Total Market-Rate Net Value/(Cost)	$10,001,236	$10,589,544	$12,371,040	$9,482,736	$9,761,640	$10,968,852	$12,928,300	$13,297,680	$10,598,352	$12,587,050	$12,946,680
Total Unit Value (Market-Rate + BMR)	$36,158,326	$36,746,634	$45,389,840	$35,605,576	$35,884,480	$36,374,442	$45,195,600	$45,564,980	$35,443,192	$44,293,600	$44,653,230
less Total Development Costs	$27,453,090	$27,453,090	$34,314,800	$27,516,840	$27,516,840	$27,475,590	$34,337,300	$34,337,300	$27,516,840	$34,378,550	$34,378,550
less Land Acquisition	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000	$6,100,000
Net Project Proceeds	$2,605,236	$3,193,544	$4,975,040	$1,988,736	$2,267,640	$2,798,852	$4,758,300	$5,127,680	$1,826,352	$3,815,050	$4,174,680
Return on Cost (% of Costs)	7.8%	9.5%	12.3%	5.9%	6.7%	8.3%	11.8%	12.7%	5.4%	9.4%	10.3%

Sources: Hillsdale Terraces, LLC; San Mateo County Assessor; City of San Mateo; Economic & Planning Systems, Inc.