

## **FINAL MEMORANDUM**

To: Bill Schrader, The Austin Group LLC  
From: Richard Berkson and Michael Nimon  
Subject: StoneFire Development Feasibility Review; EPS #131100  
Date: August 1, 2014

*The Economics of Land Use*



Stonefire Partners, LLC (the Developer) proposes to build a residential rental apartment building at 1974 University Avenue in the City of Berkeley (the Project). The Project is situated on approximately 0.5-acre site located in downtown Berkeley within half a mile of the University of California Berkeley campus. The Developer proposes a double-loaded corridor "L" shaped building with ground floor retail in an eight-story building. This analysis compares the proposed Project to several alternatives as follows:

- A "Base Project" with 72 market-rate rental units in a 5-story building. This design, consisting mostly of 1-bedroom units, reflects the maximum allowed under the City's existing zoning. The Base Project includes payment of affordable housing in-lieu fees.
- A "Base Project with BMRs" reflects the same building envelope and unit count as the Base Project, with eight inclusionary "Below Market Rate (BMR)" affordable units on-site replacing eight market rate units instead of the payment of in-lieu fees.
- A "Density Bonus Project" reflects an increase in the market-rate unit count of the Base Project with BMRs through an increase in building height from 5 to 7 stories. This alternative envisions larger unit sizes with mostly 2-bedroom units.

All alternatives are based on the "L" shape building design recommended by the Design Review Commission and include 76 parking spaces. EPS conducted a peer review of the developer's pro forma analysis of development alternatives on the site. The review provides an independent assessment of the impacts on financial returns due to the inclusion of affordable housing, density bonus units and concessions as allowed by State of California law.

EPS's review is based on an independent financial assessment and EPS revisions to the Developer's pro forma and assumptions, as further described in this memorandum. The review relies upon industry

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standards, EPS's experience with similar projects, and market conditions and trends in Berkeley and the Bay Area. EPS has reviewed the key market assumptions for reasonableness, but has not conducted a detailed market analysis. Actual financial outcomes will differ from the pro forma and EPS findings to the extent that future economic cycles, market, and development trends differ from current conditions. A summary of the pro forma alternatives is shown in **Table 1.**

## Summary of Findings

- 1. The Base Project generates a marginal return to the Developer.** This alternative generates a cash-on-cash return of 6.1 percent, on the cusp of being feasible. This threshold falls just within a reasonable range of 6.0 percent to 7.5 percent for projects of comparable development risk and complexity. This return range is based on discount rate and capitalization rate data as well as EPS experience with comparable projects.<sup>1</sup>
- 2. The Base Project with BMRs and the Density Bonus Project alternatives reduce the developer's return relative to the Base Project.** These two alternatives reflect provision of inclusionary housing on site. The Base Project with BMRs alternative has lower costs due to no inclusionary housing fees relative to the Base Project, but it also has lower revenues due to lower rental rates that can be generated by affordable units. The resulting cash-on-cash return of the Base Project with BMRs falls on the cusp of feasibility at 6.0 percent.

While the Density Bonus Project alternative has higher total revenues due to the addition of market rate units, the costs are substantially higher due to two additional floors that require more expensive construction. Furthermore, the building configuration in the Density Bonus Project alternative results in larger units, which generate lower rents on a per square foot basis. The resulting return of 5.4 percent in the Density Bonus alternative is outside the typical return range.

- 3. The addition of a retail component and an eighth story as density bonus concessions/incentives requested by the Developer provides a financially feasible project.** While addition of an eighth story increases total building development cost, inclusion of retail space offsets the cost increase and improves Project performance. The resulting returns of the Proposed Project are slightly higher but generally comparable to the Base Project and fall within the typical return range, consistent with the Developer's indicated yield threshold.

## Review of Key Assumptions and Methodology

### Revenues

As noted above, the average unit size increases from approximately 840 square feet in the Base Project and the Base Project with BMRs to approximately 890 square feet in the other two alternatives. While the average blended rent per square foot decreases with larger unit sizes on a per unit basis, the Proposed Project generates rents comparable to the Base Case project. This is because rent premiums associated with the eighth floor addition, retail rents on the ground floor, and larger unit sizes, enabled by the density concessions/incentives, offset the lower rents attributable to the inclusionary housing component in the Proposed Project.

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<sup>1</sup> IRR Monitor Viewpoint 2014 data for urban multi-family uses in the Oakland submarket.

The Base Project with BMRs, the Density Bonus Project, and the Proposed Project alternatives reflect accommodation of the affordability requirement on site. Per unit monthly rents for affordable units are estimated to range from \$1.50 to \$2.00 per square foot, depending on unit size. These rents reflect a very-low income affordability cohort of households that make below 50 percent of the area median income.

Overall, the market-rate rents fall within a reasonable rent range relative to other rental projects in Berkeley. The rents reflect the Project's location premium in downtown Berkeley and proximity to many amenities, such as the arts district, dining, university campus, and public transit.

### **Vacancy and Operating Expenses**

This analysis reflects a vacancy rate of 3.5 percent. This is a typical level of stabilized vacancy in strong residential markets, such as downtown Berkeley. The assumption reflects frictional vacancy associated with the turnover rate from both the residential and commercial Project components.

The Developer assumes that annual operating expenses will be \$15,000 per unit. These expenses reflect a blend of market rate and affordable units and typically include property management, administration, maintenance, utilities, insurance, and taxes. For affordable units, management and administration expenses also include services required for monitoring, compliance and other costs associated with fulfilling the affordability requirements. Assumed operating costs fall within a typical range of between 30 and 40 percent of gross effective income.

### **Development Costs**

The cost for new construction generally has been increasing over the past several years due to improvements in the economy, revival of new development activity, and growth in demand for construction services and materials. The developer estimates direct construction cost of approximately \$210 per square foot for the blend between Type III and Type V construction envisioned for a 5-story building under the Base Project and the Base Project with BMRs alternatives. A building height change to seven stories in the Density Bonus Project alternative requires Type I construction with the cost increasing to over \$280 per square foot. The Proposed Project's development costs are lower, at about \$270 per square foot, however total costs are the highest of the alternatives due to its larger size. Addition of the eighth story increases the building area, which provides economies of scale on a per square foot basis.

Development costs include land and entitlement, indirect costs, and project contingency. These costs do not vary significantly between alternatives evaluated in this analysis. Indirect costs include architecture and engineering, professional services, taxes, bonds, and insurance, closing costs, developer fee, financing cost<sup>2</sup>, and development fees. These costs comprise between 26 and 33 percent of the direct costs between the Base Project with BMRs, Density Bonus, and Proposed Project alternatives and fall within a typical range. Soft costs in the Base Project are higher relative to the other alternatives because of the affordable housing fee payment envisioned to offset a lack of the inclusionary housing provision on site.

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<sup>2</sup> Based on 4 percent of direct construction cost

Development costs also include a Project contingency assumed at about 5 percent of direct and indirect costs across all scenarios.

### **Financial Returns**

Expected returns on development investment vary based on a range of factors such as risk, capital and real estate market conditions, building uses, and other trends. All evaluated alternatives generate cash-on-cash yields ranging between 5.4 and 6.3 percent. The Proposed Project and the Base Project generate the highest return whereas the Density Bonus Project alternative generates the lowest return. These yields are based on net operating income as a share of total cost.

Projects of comparable development risk and complexity typically require a return threshold ranging between 6.0 percent and 7.5 percent depending on location, construction type and other factors. This range is based on the discount rate and capitalization rate data reported for Class A apartments in the Oakland submarket as well as EPS experience with comparable projects.

**Table 1**  
**Pro Forma Summary of Development Scenarios\***  
**StoneFire Feasibility Review; EPS #131100**

Item	Base Case	Base Project w BMRs	Density Bonus	Proposed Project
PROJECT DESCRIPTION	5-story	5-story (with 11% VL Income Units)	7-story; [without concessions (1)]	8-story; [with concessions (1)]
Average Unit Size (net sq.ft.; rounded)	840	840	890	890
DEVELOPMENT PROGRAM				
Units				
Market Rate	72	64	90	90
Inclusionary	0	8	8	8
Total	72	72	98	98
Retail/Commercial Sq. Ft.	0	0	0	8,700
Underground Parking Spaces	76	76	76	76
REVENUES				
Gross Effective Income (annual)	\$3,162,011	\$3,021,883	\$4,156,727	\$4,753,161
(less) Vacancy/Operating Expenses	(\$1,190,670)	(\$1,185,766)	(\$1,615,485)	(\$1,636,361)
ANNUAL NOI	\$1,971,341	\$1,836,117	\$2,541,242	\$3,116,800
ANNUAL NOI (per unit)	\$27,380	\$25,502	\$25,931	\$31,804
DEVELOPMENT COSTS				
DEVELOPMENT COST (per unit)	\$32,188,230	\$30,676,230	\$46,644,683	\$49,323,410
	\$447,059	\$426,059	\$475,966	\$503,300
Cash-On-Cash Yield	6.1%	6.0%	5.4%	6.3%

(1) Concessions include ground floor retail space and larger unit sizes resulting in addition of an 8th story.

**Table 1**  
**Detailed Pro Forma of Development Scenarios**  
**StoneFire Feasibility Review; EPS #131100**

Item	Base Project	Base Project w BMRs	Density Bonus	Proposed Project
PROJECT DESCRIPTION	5-story	5-story (with 11% VL Income Units)	7-story; [without concessions]	8-story; [with concessions]
Average Unit Size (net sq.ft.; rounded)	840	840	890	890
<b>DEVELOPMENT PROGRAM</b>				
<u>Units</u>				
Market Rate	72	64	90	90
Inclusionary	<u>0</u>	<u>8</u>	<u>8</u>	<u>8</u>
Total	72	72	98	98
Retail/Commercial Sq.Ft.	0	0	0	8,700
Underground Parking Spaces	76	76	76	76
<b>REVENUES</b>				
<u>Gross Effective Income (annual)</u>				
Market Rate	\$2,935,451	\$2,650,467	\$3,771,631	\$3,950,465
Inclusionary	\$0	\$144,856	\$144,856	\$144,856
Commercial Space	\$0	\$0	\$0	\$417,600
Garage	\$159,600	\$159,600	\$159,600	\$159,600
Other (1)	<u>\$66,960</u>	<u>\$66,960</u>	<u>\$80,640</u>	<u>\$80,640</u>
Total	\$3,162,011	\$3,021,883	\$4,156,727	\$4,753,161
(less) Vacancy (2)	(\$110,670)	(\$105,766)	(\$145,485)	(\$166,361)
(less) Operating Expenses (3)	<u>(\$1,080,000)</u>	<u>(\$1,080,000)</u>	<u>(\$1,470,000)</u>	<u>(\$1,470,000)</u>
ANNUAL NOI	\$1,971,341	\$1,836,117	\$2,541,242	\$3,116,800
<b>DEVELOPMENT COSTS</b>				
<u>Direct Costs</u>				
Sitework	\$1,556,954	\$1,556,954	\$1,556,954	\$1,556,954
Construction	\$12,584,000	\$12,584,000	\$24,813,000	\$25,928,897
General Conditions	\$1,944,000	\$1,944,000	\$2,646,000	\$2,757,240
GC Contingency	\$907,350	\$907,350	\$907,350	\$1,233,971
Office/Lounge/Workout/Solar	<u>\$300,000</u>	<u>\$300,000</u>	<u>\$300,000</u>	<u>\$300,000</u>
Total	\$17,292,304	\$17,292,304	\$30,223,304	\$31,777,062
<u>Indirect Costs</u>				
Architecture & Engineering	\$350,000	\$350,000	\$425,000	\$425,000
Professional Services	\$900,000	\$900,000	\$1,295,000	\$1,345,000
Tenant Improvement Allowance	\$0	\$0	\$0	\$652,500
Taxes/Bonds/Insurance	\$350,000	\$350,000	\$403,125	\$403,125
Closing Costs	\$225,000	\$225,000	\$225,000	\$225,000
Developer Fee	\$1,367,000	\$1,367,000	\$1,581,488	\$1,741,488
Financing Cost (4)	\$691,692	\$691,692	\$1,208,932	\$1,271,082
Municipal/Utility Fees	<u>\$3,262,750</u>	<u>\$1,822,750</u>	<u>\$2,811,373</u>	<u>\$2,884,133</u>
Total	\$7,146,442	\$5,706,442	\$7,949,918	\$8,947,329
Soft costs as % of hard costs	41%	33%	26%	28%
<u>Land and Entitlement</u>	\$6,562,800	\$6,562,800	\$6,562,800	\$6,562,800
<u>Contingency (5)</u>	\$1,186,684	\$1,114,684	\$1,908,661	\$2,036,220
TOTAL DEVELOPMENT COST	\$32,188,230	\$30,676,230	\$46,644,683	\$49,323,410
<b>Cash-On-Cash Yield</b>	<b>6.1%</b>	<b>6.0%</b>	<b>5.4%</b>	<b>6.3%</b>

(1) Includes various premiums, late fees, and other income (estimated at \$15/month/unit).

(2) Assumed at 3.5% in all scenarios.

(3) Assumed at \$15,000 per unit.

(4) Based on 4% of direct costs.

(5) Based on 5.0% of total costs for the 7-story and 8-story building and on 4.85% of total costs for the 5-story building scenarios.