

## Memorandum

To	Lori Trevino, Redevelopment Manager City of El Cerrito	Pages	65
CC	Therese Trivedi, ABAG ; Migi Lee, CHS		
Subject	Deliverable 5 –Final Report		
From	Alexander Quinn, AECOM Laura Wiles, AECOM		
Date	November 28, 2012		

### ***Study Background and Purpose***

In 2011, AECOM initiated work on the *El Cerrito Development Feasibility Analysis* for the City of El Cerrito as it considered implementation of the Draft San Pablo Corridor Specific Plan. The feasibility analysis evaluated the viability of development in the corridor in the near-term and analyzed City development standards to determine those standards which drive development feasibility (e.g. parking, height, mixed-use standards, etc.) To complete the feasibility analysis, AECOM performed the following tasks:

- A market study analyzing current lease trends, vacancy rates, land prices, and sales prices in the Corridor and surrounding marketing area.
- A review of prevailing development inputs, including construction costs, financing, operating costs, and capitalization rates.
- A planning analysis to estimate development programs based on set-back, open space, parking, height and other building requirements.
- A feasibility study analyzing the development potential at various sites along the Corridor.
- A presentation to the City Council to communicate the key findings of our work.

Concurrent to this analysis, CHS Consulting has analyzed existing and future parking demand along the Corridor and developed a series of parking strategies to effectively manage parking demand in the future.

This memo identifies catalyst sites for development and builds on the findings from the feasibility study. A description of the methodology and assumptions used in the feasibility study is included as an appendix to this report. The methodological approach and assumptions used in this additional round of analysis is identical to those used in the feasibility study (see Appendix 1), except where clearly stated.



## Highest and Best Use

As suggested in the market study and in interviews with developers, and confirmed by the financial feasibility analysis, multi-family residential is the highest and best use along El Cerrito's San Pablo Corridor. While both Class A and professional offices were tested for some development scenarios, in all instances multi-family residential had a higher return on cost. There are a number of factors favoring multi-family residential return on cost. These include:

- *Lower capitalization rates compared to commercial space.* A capitalization rate is the annual profit expectation of any given investment (e.g. a 5 percent capitalization rate means an investor is willing to pay \$100 dollars for every \$5 dollars of annual income)<sup>1</sup>. Currently, investors are more willing to purchase residential projects than office projects. This is reflected in a 5 percent cap rate for residential projects compared to a 6.5 percent cap rate for office projects. One of the primary reasons office projects are viewed unfavorably at this time is their high vacancy rates, especially in locations outside of San Francisco and Silicon Valley. Double digit office vacancy rates in the East Bay indicate ample inventory to absorb additional office demand and stiff competition in attracting tenants. Investors consider new commercial space in the East Bay high risk, especially in locations with few proven examples of successful multitenant office projects. As a result, office space would only be perceived as potentially feasible in El Cerrito were an office constructed for a specific credit worthy tenant as a build-to-suit development.
- *Lower parking demand compared to commercial space.* The 1.04 parking spaces per unit for residential projects translates to approximately 1.3 spaces per thousand square feet, compared to 1.81 spaces per thousand square feet for commercial projects. As would be expected, the construction of additional parking spaces per square foot increases the cost of development and reduces the amount of buildable space.
- *Declining condominium prices.* Prices for condominiums in El Cerrito and western Contra Costa County overall have decreased dramatically since 2007. The average price per square foot of condominiums is currently well below the cost of new construction. In addition, the current investor appetite for condominiums is low and considered high risk, making residential condominium development infeasible in the near-term.

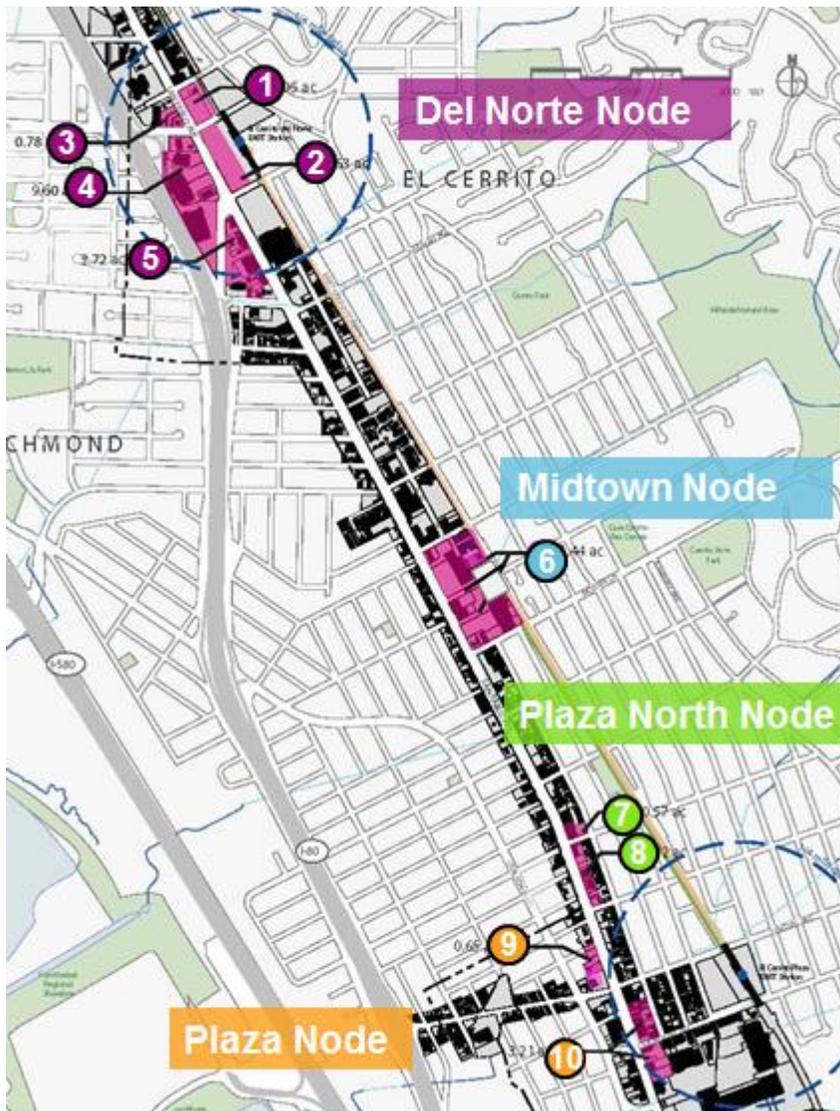
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<sup>1</sup> A low capitalization rate translates into lower perceived risk and stronger prospects of increasing profits of an investment. From a development perspective, low capitalization rates mean higher valuations of their project (i.e. a developer needs \$5 of net operating income for \$100 of investment with a 5 percent capitalization rate versus \$7 of operating income for the same \$100 of investment with a 7 percent capitalization rate).

## Description of Sites Analyzed

Along the San Pablo Corridor, AECOM analyzed development potential at 10 sites located at four nodes. Figure 1 below indicates the location of each node and each site along the corridor.

Figure 1: Location of Nodes and Sites



Source: AECOM, 2011.

Two to three development scenarios were analyzed at each site. Development scenarios could vary by use (residential vs. commercial), height, setback, and parking ratio. Figure 2 shows how each development scenario varied.

**Figure 2: Scenarios Tested, by Node and Site**

	Type of Retail	Height	Additional Setback	Parking Ratios	
				Commercial	Residential
<b>Del Norte</b>					
1	None	45	None	1.81	1.04
	Convenience	65	None	1.81	1.04
	Convenience	80	Yes, after 65'	1.81	1.04
2	Convenience	65	None	1.81	1.04
	Convenience	80	Yes, after 65'	1.81	1.04
3	Convenience	45	None	1.81	1.04
	Convenience	65	None	1.81	1.04
4	Big Box	45	None	2.70	1.04
	Big Box	65	None	2.70	1.04
	Big Box	80	Yes, after 65'	2.70	1.04
5	Convenience	45	None	1.81	1.04
	Convenience	65	None	1.81	1.04
<b>Midtown</b>					
6	Convenience	45	Yes	3.30	1.40
	Convenience	45	None	3.30	1.40
<b>Plaza North</b>					
7	Convenience	45	None	3.30	1.20
	Convenience	65	None	3.30	1.20
8	None	45	None	3.30	1.20
	None	65	None	3.30	1.20
<b>Plaza</b>					
9	Convenience	45	None	1.81	1.04
	Convenience	65	None	1.81	1.04
10	Convenience	45	None	1.81	1.04
	Convenience	65	None	1.81	1.04

Source: AECOM, 2011.

In addition to the programmatic variables described in Figure 2, there are also market-based variables with node-specific and site-specific impacts. There are three market-based variables:

- **BART-accessibility rent premiums.** The Del Norte and Plaza nodes are within a quarter mile of a BART station, and are assumed to have a 5 percent residential rent premium.



- **Neighborhood rent premiums.** The Plaza node is perceived as more desirable than the Del Norte node. There is a negative two percent residential rent deduction at the Del Norte node and a positive two percent residential rent increase at the Plaza node.
- **Site size construction costs.** There are economies of scale, or lack thereof, depending on site size. Sites able to accommodate less than 60 units incur 10 percent higher construction costs. Sites able to accommodate 500 units incur seven percent lower construction costs. Note that this is not a hard and fast rule but a general premise. Economics of scale can vary and are generally not established by a specific unit count. Rather, the analysis used these assumptions as part of testing different parcels sizes and development configurations.

Figure 3 below indicates the specific market-based costs and premiums associated with each site.

**Figure 3: Market-based Variables by Node and Site**

	BART- premium	Neighborhood premium	Site size
<b>Del Norte</b>			
1	+	-	
2	+	-	
3	+	-	-
4	+	-	+
5	+	-	
<b>Midtown</b>			
6			+
<b>Plaza North</b>			
7			-
8			
<b>Plaza</b>			
9	+	+	
10	+	+	

Source: AECOM, 2011.

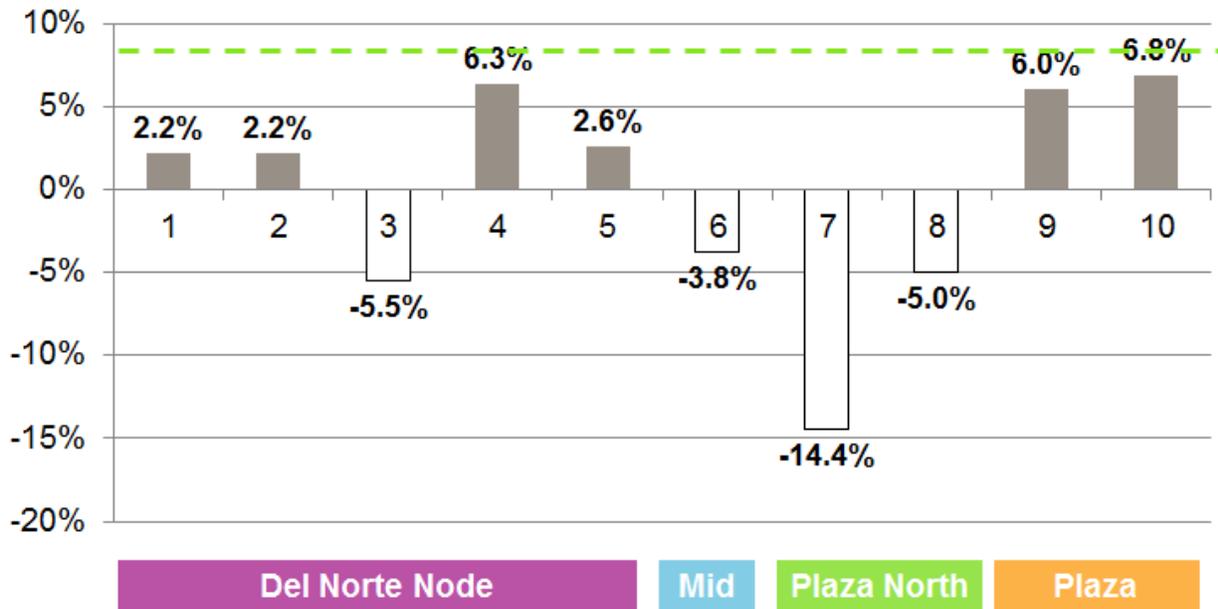


### Summary of Financial Feasibility

Based on the scenario parameters outlined in Figure 2 and the market variables outlined in Figure 3, AECOM used a static pro forma<sup>2</sup> to calculate the return on cost for each scenario. An analysis of the results of each scenario provides insight into the nodes that are most developable in the near-term, and how variations in height can impact development feasibility.

Figure 5 below summarizes the return on cost results, by presenting the highest return on cost for each scenario. For scenario-specific returns on cost, see Figure 5.

Figure 4: Summary of Most Feasible Scenario for Each Site



Source: AECOM, 2011.

<sup>2</sup> A static pro-forma analysis estimates future cash flows based on a stabilized point in time at which the project reaches normal occupancy. A static pro-forma is essentially a single-year snapshot of the project's financial performance. It determines the net residual value after accounting for typical costs of development.



Overall, sites at the Plaza are the most developable in the short-run, with returns on cost approaching seven percent. Sites at Del Norte are the next most developable, with returns on cost around two percent. Also note the return on costs estimated at Site 2 does not include the additional cost of replacing all or a portion of BART parking, which would be necessitated by any development on any BART parking lot. However, assuming an eight percent return on cost is necessary to seriously consider development<sup>3</sup>, none of the scenarios yield an immediately developable project.

Without any BART-related rent premiums, the prospects for development at Midtown and Plaza North do not fare as well, indicating negative returns under current development conditions. It is important to note that sites at the Plaza North node may be well positioned in the medium- and long-term. While sites at this node may not benefit from any BART-related or neighborhood premiums at the moment, an improved San Pablo corridor with stronger connections to the Plaza and BART may increase rents at this node in the future.

It is also important to note the impact of site size at the Del Norte node. Site 3 is hindered by its small size and faces higher construction costs, while Site 4 enjoys higher returns on cost due to the lower construction costs associated with such a large project.<sup>4</sup> As a point of reference, were there no cost impacts based on site size, the return on cost of a 65' development at site 3 would be 2.34 percent and the return on cost of a 65' development at site 4 would be 0.19 percent.

Overall, results from the return on cost analysis indicate that increasing heights increases return on cost by approximately two percent. Additionally, 80' heights are clearly not feasible on any site, largely because the building code requires steel frame construction at heights in excess of 65'. The conversion from wood-frame to steel-frame increases construction costs 25 percent.

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<sup>3</sup> This number can vary according to the perception of risk by developers; there are examples of developers undertaking projects with a six and a half percent return on cost in very low-risk environments and example of developers requiring at least a ten percent return on cost in a very high-risk environment. Additionally, if a landowner is considering contributing some land for development, a lower return on cost may be necessary to spur development.

<sup>4</sup> New Bay Area Air Quality Management District regulations may limit residential uses in close proximity to major freeways and highways. As such, Site 4 may have larger redevelopment challenges than presented in this analysis.



Figure 5: Return on Cost, by Scenario

Site	Height	Additional Setback	Parking Ratio		Return on Cost
			Commercial	Residential	
<b>Del Norte</b>					
1	45	None	1.81	1.04	2.2%
1	65	None	1.81	1.04	2.1%
1	80	Yes, after 65'	1.81	1.04	-17.4%
2	65	None	1.81	1.04	2.2%
2	80	Yes, after 65'	1.81	1.04	-17.0%
3	45	None	1.81	1.04	-7.7%
3	65	None	1.81	1.04	-5.5%
4	45	None	2.70	1.04	3.9%
4	65	None	2.70	1.04	6.3%
4	80	Yes, after 65'	2.70	1.04	-14.6%
5	45	None	1.81	1.04	0.5%
5	65	None	1.81	1.04	2.6%
<b>Midtown</b>					
6	45	Yes	3.30	1.40	-3.9%
6	45	None	3.30	1.40	-3.8%
<b>Plaza North</b>					
7	45	None	3.30	1.20	-16.3%
7	65	None	3.30	1.20	-14.4%
8	45	None	3.30	1.20	-6.6%
8	65	None	3.30	1.20	-5.0%
<b>Plaza</b>					
9	45	None	1.81	1.04	3.5%
9	65	None	1.81	1.04	6.0%
10	45	None	1.81	1.04	4.9%
10	65	None	1.81	1.04	6.8%

Source: AECOM 2011.

### Identification of Catalytic Sites

Based on the results of the return on cost analysis, sites with strong potential to act as catalysts for development by demonstrating the viability of development along the Corridor are sites 1, 2, 4, 5, 9 and 10. However, there may be considerations that challenge development at these sites. In particular, site 2 is hindered by existing BART parking replacement requirements and site 4 is potentially constrained by recent air quality legislation restricting residential development near freeways. Additionally, site 10 involves multiple parcels currently held by multiple landowners, thus coordinating development across the site may have some organizational challenges.



## Sensitivity Analysis

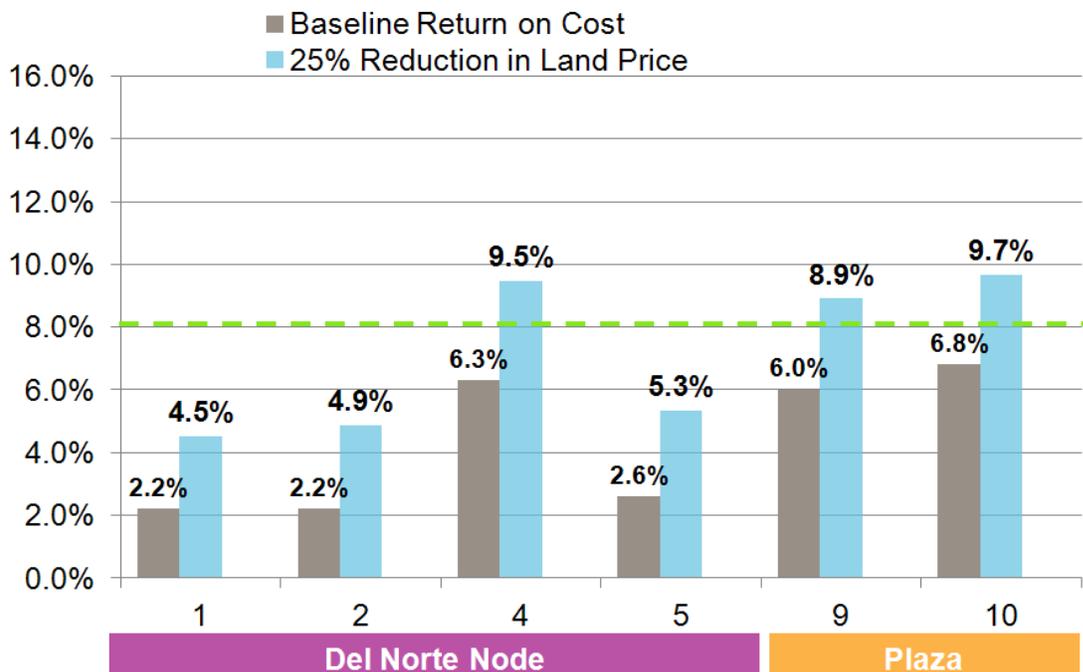
AECOM conducted a sensitivity analysis of changes in land price, residential rental revenue, and parking demand at the sites that are already experiencing positive returns on cost. This analysis allows for a more refined understanding of the programmatic and market-based variables that might impact development potential at sites along the Corridor.

### Land Cost

While the financial feasibility analysis assumed a constant land cost throughout the Corridor (\$40 per square foot), it is likely that land costs would vary depending on any existing structures on the property, the property's location along the Corridor, and the motivation of the property owner.

As shown in Figure 6 below, a 25% reduction in land cost equates to a roughly two to three percent increase in return on cost.

Figure 6: Impact of Land Cost on Return on Cost



Source: AECOM, 2011.

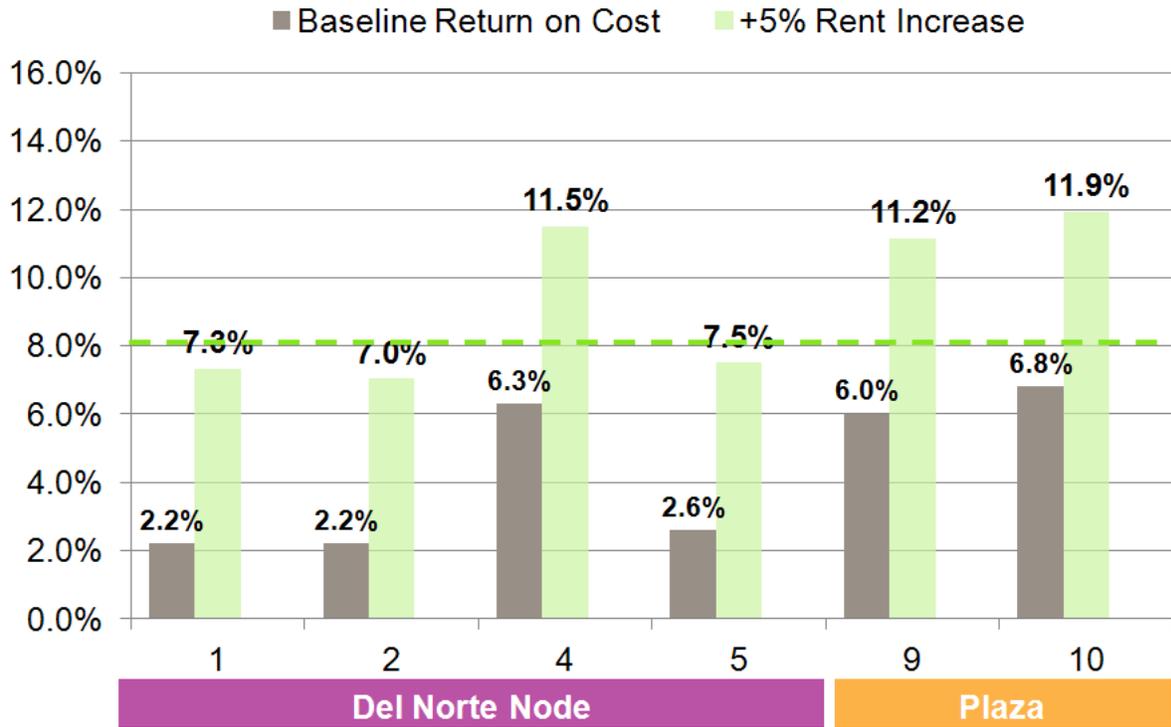
### Residential Rent Increase

Despite the current national economic recession, the Bay Area multi-family residential market indicates robust growth due to lowering vacancy rates, rising rents, and projected growth in demand as more households are expected to rent rather than own their homes. The difficulty in accessing financing for home purchases means many households are delaying home purchases, and choosing to rent for longer periods of time. Additionally, home owners whose homes have been foreclosed are returning to the rental market.



As shown in Figure 7 below, an increase in residential rents can have a very significant impact on the development potential of sites throughout the Corridor, increasing return on cost approximately five percent.

**Figure 7: Impact of Increase in Residential Rents**



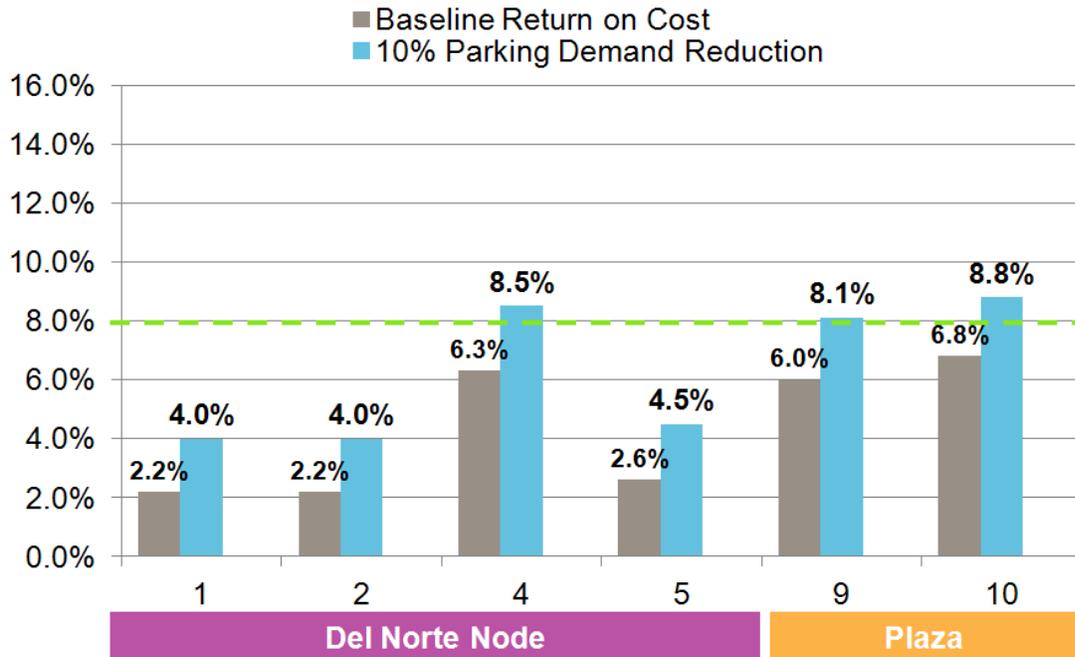
Source: AECOM, 2011.

### Parking Demand

The successful implementation of the parking strategies presented by CHS Consulting will further reduce parking demand along the San Pablo Corridor. Additionally, continued hyperinflation of fossil fuels may also influence the car ownership trends and driving habits of prospective residents and customers in El Cerrito. As developers recognize the declining demand for parking, and respond by constructing less parking, the financial feasibility of projects will improve.

As shown in Figure 8 below, a decrease in parking demand increases return on cost approximately two percent.

**Figure 8: Impact of Decrease in Parking Demand**



Source: AECOM, 2011.

This increase in return on cost is driven by two factors. First, there is a lower cost of construction since developers do not have to construct parking spaces and second, developers have more area on each site in which to construct residential units, since less area is devoted to parking. For example, on site 10, before the 10 percent parking demand reduction a developer could potentially build 195 units and after the 10 percent parking demand reduction a developer could potentially build 217 units.

## Key Recommendations

### *Consider a 68' to 70' height limit*

Given the jump in construction costs once heights exceed size stories, development at 80' is unlikely. However, limiting heights to 65' needlessly restricts development. Allowing 68' or 70' heights leaves open the opportunity for developers to incorporate articulation along roofs, or increase the ceiling height of ground floor or top floor units.

### *Choose minimum parking requirements that can reflect changing parking demand*

Demand for parking will decline as the Corridor becomes more urban in character, new residents reduce car ownership, and the existing parking supply is managed more effectively. It is important that minimum parking requirements don't unnecessarily hinder the ability of developers to respond to these changes. As demonstrated previously, a 10 percent reduction in parking demand can significantly impact



the return on cost of a development project. Allow developers to realize this potential by choosing parking minimums that can accommodate a reduction in parking demand.

*Allow project densities to be driven by physical constraints and market forces*

Many factors impact the density of projects, such as set back requirements, open space requirements, parking requirements, and ground floor uses. Rather than choosing the “perfect” density for the Corridor, focus on creating the design guidelines and parking strategies that create a livable neighborhood for all residents. Given that some upper limit of project densities will be required for CEQA purposes, consider density maximums as high as 100 units per acre in order to allow urban planners and developers flexibility.

*Be strategic about retail ground floor requirements*

The factors impacting the success of retail space vary throughout the Corridor. High-traffic areas with ample parking, good freeway access, and an affluent neighborhood demographic are more likely to attract credit tenants able to pay high rents. Areas with some of these characteristics, but not all, are likely to attract small-scale retailers, if any at all. Rather than a broad-brush approach to retail along the Corridor, with requirements that all ground floor space have commercial uses, consider more targeted retail requirements focused on existing retail nodes such as the Plaza and Del Norte. Lifting ground floor retail requirements will allow developers greater flexibility when designing projects and reduce the likelihood that ground floor space sits unoccupied for long stretches of time.



## **Appendix 1: Methodology and Assumptions**

### **Development Programs**

To explore the financial feasibility of different prototypes, AECOM performed a static cash flow analysis on a variety of development programs along the San Pablo Corridor. These development programs vary based on parcel size, intended use, building height, and parking ratio, as these variables are seen as the most relevant to project feasibility. Each variable is described below. A full list of the assumptions used in the pro forma analysis can be found in Appendix A of the feasibility study.

#### *Parcel Size*

AECOM tested a total of 10 different site sizes. A map showing the location of these sites is included in Figure 1 at the beginning of this report. These sites were chosen in consultation with the City of El Cerrito, and are meant to represent the diversity of development opportunities along the Corridor. Some of these sites are owned wholly or in part by a nonprofit corporation or BART, while others are privately owned.

The site size was determined based on assessors map data measured using GIS software. Thirty foot rear setbacks were applied on all sites and additional 15' side and front setbacks were applied on areas above 65'. A conservative attempt was made to provide sufficient open space to meet forthcoming LEED Green Code requirements. After adjusting for setbacks and open space, roughly 70 to 75 percent of the total site was available for development.

The smallest site size was approximately 30,000 square feet in total and the largest was approximately 543,000 square feet. In most cases, the site was comprised of multiple parcels, each configured differently. Only three of the sites evaluated were rectangular with the remainder having unique dimensions.

#### *Intended Use*

The primary land use tested was a mixed use development program, with apartments over ground floor retail. Developers indicated that this development program would be the most feasible, and this result was borne out in the results of this analysis. However, while apartments were more feasible than commercial uses they were not able to achieve high enough returns on cost to justify development. Given the lack of development potential for rental developments, for-sale development was not tested.

Above ground floor office uses were tested in three different development programs: once a Class A build-to-suit office, and twice professional offices. As the Corridor contains both traditional big box stores and also smaller convenience retail establishments, both big box retail uses and convenience-oriented retail uses were tested.

#### *Building Height*

Based on the maximum allowable heights in the Draft Specific Plan, the development programs test building heights of 45', 65', and 80'. Only three of the development programs tested the 80' height, due to a roughly 25 percent increase in construction costs at 65', as development shifts from stick frame wood construction over a concrete podium to a structural steel frame.



### *Parking Ratios*

The parking ratios tested were developed from multiple sources. Interviews with developers provided a sense of how much parking would typically be constructed along the Corridor under current and potential future economic conditions and development standards, while CHS provided consultation regarding how much parking demand may fall given a suite of parking demand management policies. The development programs test a residential parking ratio of 1.04 spaces per unit at the Del Norte and Plaza nodes, and 1.20 and 1.40 spaces per unit at the Plaza North and Midtown nodes, respectively. The commercial parking ratios tested range from 1.81 to 3.30 spaces per 1,000, depending on proximity to BART and the type of commercial use.

### **Feasibility Analysis Assumptions**

#### *Static Pro Forma*

The analysis performed uses static pro formas. A static pro-forma analysis estimates future cash flows based on a stabilized point in time at which the project reaches normal occupancy. A static pro-forma is essentially a single-year snapshot of the project's financial performance. It determines the net residual value after accounting for typical costs of development.

#### *Revenues*

Revenue assumptions for all land uses are based on existing market conditions along the San Pablo Corridor and its environs. They are not average estimates of prevailing lease rates and sale prices in the Corridor, but recognize that new development generally commands higher rents. New products can offer more modern amenities and unit floor plans that separate it from surrounding competition.

The development programs test a baseline estimate of approximately \$2.16 per square foot rental residential, based on comparable projects constructed in El Cerrito, Albany, Berkeley and Emeryville. Convenience-oriented retail space was estimated at \$1.70 per square foot, representing an improvement over the \$1.50 per square foot rents observed in May of this year but not nearly approaching the peak \$2.50 per square foot rents observed prior to the current recession in the fourth quarter of 2008.

In addition, the analysis recognizes residential rents along the San Pablo corridor may vary based on proximity to BART and the desirability of neighborhoods. This was consistent with comments from developers, who viewed different parts of the Corridor as more or less developable based in part on expected rents.

After developing a baseline rent estimate for the Midtown area of the Corridor, additional premiums were developed to reflect the premium residential renters are willing to pay for BART accessibility. These premiums were applied to development programs around BART stations. To reflect the varying desirability of the different neighborhoods along the Corridor, the development programs incorporate an upward adjustment of rent potential around the Plaza neighborhood and downward adjustment of rent potential around the Del Norte BART station. After a review of current rents, the following revenue assumptions were developed.



#### Multifamily:

- Studios: \$1,200 / month
- One bedroom: \$1,525 / month
- Two bedrooms: \$1,750 / month
- 7 percent upward adjustment for BART accessibility
- 3 percent upward adjustment for Plaza development programs
- 2 percent downward adjustment for Del Norte development programs

#### Commercial:

- Convenience Retail: \$1.70 / Sq.Ft. NNN
- Big Box Retail: \$1.30 / Sq. Ft. NNN
- Class A Build-to-suit Office: \$3.25 / Sq. Ft. Full Service
- Professional Offices: \$2.25 Sq. Ft Full Service

#### *Costs*

Construction costs were based on information provided by Davis Langdon, a cost estimating firm. Construction costs on a per square foot basis increase as height increases when going from 65' to 75', due to the need to transition from wood-based construction to steel-based construction. This shift is reflected in a 25% upward adjustment of the hard costs of construction.

There is a relationship between not only cost and height, but also costs and site size. For large sites able to accommodate more than 500 units, referred at times as “mega” sites in the pro formas, there is a seven percent reduction in hard costs to account for additional economies of scale. For small sites only able to accommodate 60 units or less, referred to as “mini” sites in the pro formas, there is a 10 percent increase in hard costs. This is based on discussions with developers regarding the economies of scale of construction.

#### *Land Value*

The assumed land value is \$40 per square foot, based on recent transactions along the Corridor. Land values can vary significantly by site based on the economic use of the property and its actual or perceived economic value. For the purposes of this analysis, AECOM assigns a nominal amount which recognizes the cost of acquiring land in El Cerrito. Public and nonprofit property owners may choose to sell parcels at a lower cost than \$40 per square foot in order to incentivize the amount and type of development they would like to see.

#### *Parking Configuration*

All parking is assumed to be on-site and above ground. Where appropriate, a number of parking configurations were tested as a part of each development program. For larger sites, development programs tested a “wrap” style parking configuration. This parking configuration involves above ground, structured parking. The estimated cost of this parking configuration is approximately \$22,500 per parking space, before accounting for soft costs (i.e. architecture and engineering, contingency, etc). AECOM attempted to design the cheapest parking solution for each development program evaluated (i.e. surface, then tuck under, then podium parking).



While smaller sites cannot accommodate a wrap parking configuration, they can accommodate tuck under podium parking. For all sites, development programs tested a parking configuration in which 30 to 50 percent of the ground floor building area is tuck under parking and the remainder parking needs are accommodated through surface parking. As a point of reference, all development programs also tested surface parking.

*Developer Feasibility Thresholds*

The development programs tested use a “return on cost” to measure development potential. The return on cost is calculated by dividing the total cost of a project by its expected net capitalized revenue.

Typically, developers need at least an eight percent return on cost to undertake a project in the Bay Area, though this can vary depending on the economic climate and the risk threshold of the developer.