

DRAFT MEMORANDUM

To: Manira Sandhir, City of San Mateo
From: Thomas Gonzales, Darin Smith, and Ryan Martinez
Subject: Housing Element Sites Inventory Review; EPS #241028
Date: April 17, 2024

This memo summarizes a feasibility review conducted by Economic & Planning Systems, Inc. regarding potential housing sites identified in San Mateo's Housing Element. The California Department of Housing and Community Development (HCD) directed the City to address concerns regarding existing uses potentially hindering development on some sites in conjunction with adoption of the Housing Element.

EPS' review concludes that despite certain challenges posed by existing uses, San Mateo's Housing Element inventory reasonably identifies potential development sites. However, significant financial support will be necessary to achieve the RHNA goals for affordable housing.

Summary of Key Findings

- While existing commercial uses can constrain redevelopment, market trends suggest the inclusion of sites with existing uses in the Housing Element Sites Inventory is reasonable.
- Redevelopment of commercial sites for housing is a growing national trend also reflected in development trends within nearby cities.
- Strong housing demand and high land values for residential development have made redevelopment financially attractive and feasible for commercial property owners.
- Most existing commercial leases are expected to expire within the eight-year Housing Element planning period, reducing that barrier to future redevelopment opportunities.
- The City's methodology for site selection is generally sound, reflecting observed industry trends, property owner interests, and site-specific conditions likely to support redevelopment.
- Meeting the RHNA allocation for affordable housing in San Mateo would require significant financial subsidies greatly exceeding current City resources.

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Existing Uses Do Create Financial and Logistical Challenges

Many sites in the inventory currently have commercial uses. "Buying out" existing leases or consolidating surface parking into structures can significantly increase development costs.

Still, Real Estate Industry Trends Indicate Movement toward Redevelopment

Shopping center conversions and phased residential development on commercial surface parking lots are increasingly common real estate industry trends. Also, tenants are increasingly open to negotiating with developers for phased projects that improve long-term benefits for a retail property.

Local Development Economics Support Redevelopment

High housing demand has driven up land values for residential development, making it financially attractive for many commercial property owners to offer their sites for redevelopment even if they must absorb certain costs to terminate leases, consolidate parking, etc.

Regional Trends Indicate Commercial Redevelopment is Common

Utilizing data from CoStar, EPS found that 88% of large multifamily projects built in San Mateo County and nearby areas of Santa Clara County since 2014 were on land with previous commercial uses, indicating that such redevelopment is not only possible but in fact the norm in the general market area.

Lease Term Research Shows Opportunities within the RHNA Period

Although redevelopment of commercial uses is complex, EPS research suggests that most commercial leases in San Mateo have terms of five years or less, suggesting upcoming expiration and potential redevelopment opportunities during the Housing Element cycle (2023-2031).

Housing Sites Inventory Selection Criteria Appear Reasonable

Over 40% of the 7,015 total housing units in the City's RHNA allocation are projected to be developed in projects that are already in the development pipeline. Most of the remaining development capacity is on sites with documented redevelopment interest or potential. A smaller proportion of capacity (roughly 14% of total unit capacity) is on sites for which developers or owners have not yet expressed interest in redevelopment but with multiple physical or financial characteristics suggesting potential redevelopment.¹

Funding Needed to Support Development of City's RHNA Goals

EPS estimated that meeting the City's full RHNA allocation for affordable housing, a total of 3,975 units in total, will require financial subsidies of over \$2 billion, well beyond what current resources can likely support.

Attachment: Housing Element Sites Inventory Review Presentation

DRAFT

HOUSING ELEMENT SITES INVENTORY REVIEW

April 17, 2024

EPS #241028



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HCD INSTRUCTIONS

- HCD found the City's Housing Element in substantial compliance with state law
- Directed City to “find existing uses are not an impediment to additional residential development in the planning period” given the reliance on “nonvacant sites” to accommodate a substantial portion of the RHNA targets
- City needs to make these findings when adopting the Housing Element

KEY FINDINGS

- While existing uses are a constraint to redevelopment feasibility, market trends indicate that it is reasonable to include such sites in San Mateo's housing sites inventory
 - EPS identified that 88% of units in large multifamily projects built since 2014 in nearby cities occurred on land previously developed for commercial uses
 - Most commercial leases in San Mateo are expected to expire within the Housing Element cycle, which will relieve a constraint on redevelopment
 - Land values for residential development have been very high, enabling developers to overcome the cost and risk of redeveloping existing commercial sites
- The City's methodology for site selection is generally reasonable as it reflects observed trends in redevelopment and site-specific conditions
- To build the 3,975 units affordable to moderate and lower income households allocated under RHNA would require a financial subsidy over \$2 billion—likely more than is financeable with existing sources

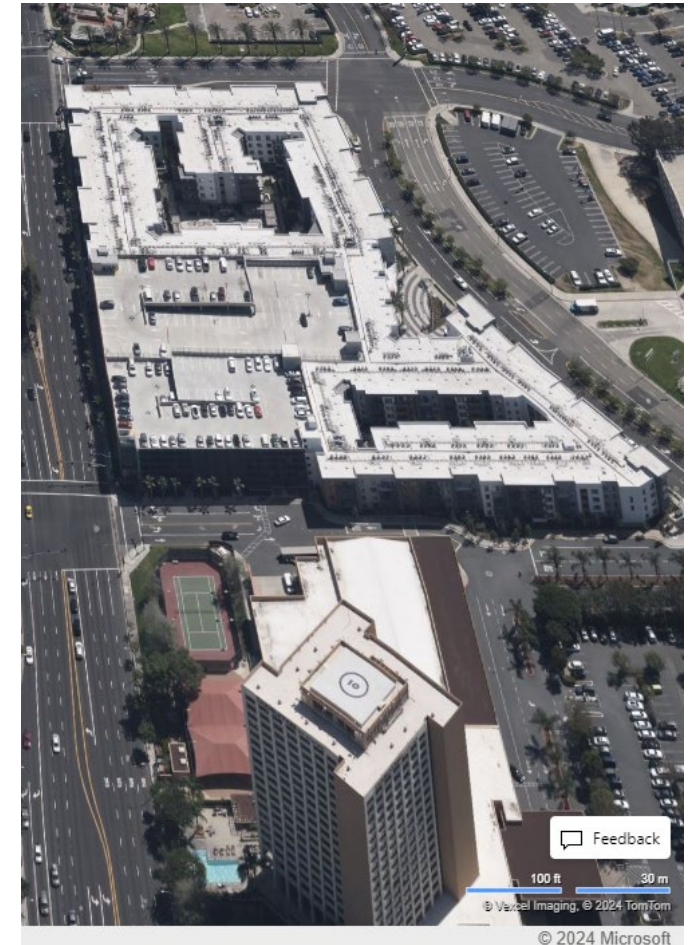
EVALUATION OF EXISTING USES AS SITE CONSTRAINTS

EXISTING USES DO CONSTRAIN REDEVELOPMENT FEASIBILITY

- Many of the properties in the City's Housing Element Site Inventory include existing commercial uses. The cost of "buying out" existing commercial leaseholders can substantially increase the cost of purchasing commercial land redevelopment project.
- Estimating this cost can be challenging and difficult to generalize due to limited available data and the complexity of commercial leasing activity—each site and set of leases and tenants will present different costs and issues.
- Overall, it is expected that active/profitable uses at a site add significant risk for redevelopment in terms of timing and cost; in some cases, a tenant that does not want to interrupt its business activity can prevent them from redeveloping until the end of the lease term.
- Some landlords may have recapture clauses that reduce these risks and costs, but these are rare (or rarely enforceable) for leases with experienced national/regional tenants. Even for phased redevelopment (e.g., on parking lots), loan and tenant agreement terms typically make changes to the property difficult to negotiate.

BUT REASONABLE TO EXPECT SOME EXISTING USES TO REDEVELOP

- Redevelopment of shopping centers and other commercial uses (both wholesale and phased) has been a growing industry trend for at least a decade ¹
 - Developers have looked to add residential uses to shopping centers to create mixed-use nodes and activity centers that better meet changing consumer demand for retail
 - Developers looking to improve site utilization have built residential uses on top of former surface parking lots at shopping centers, office parks, and hotel sites
- Tenants are increasingly interested in negotiating and partnering with owners, especially on phased projects that may have long-term benefits of drawing more customers and activity to a property or shopping center ²



Example site in Orange, CA with housing built on the former surface parking lot of a hotel development, which has been consolidated into a multistory parking garage.

¹ [Turning Malls into Neighborhoods](#), *Urban Land*, February 27, 2023

² ['Ransom Payment' No More: Mall Anchors Losing Their Leverage As Owners Ramp Up Redevelopment](#), *Bisnow*, October 8, 2023

LOCAL DEVELOPMENT ECONOMICS JUSTIFY REDEVELOPMENT

- Strong demand for housing has increased the land price that residential developers can pay, making it easier to assume the cost and risk of buying a site with existing commercial uses
- From available CoStar sales data, EPS found that developers in San Mateo paid between \$19 and \$31.6 million per acre for residential developments in 2021 and 2022, up from \$9.5 to \$17 million per acre in 2016–2020
 - In many cases, these land values are enough to finance the purchase of an existing office or retail site
 - It can also justify the consolidation of surface parking into a parking garage
- Housing Element makes reasonable claims that
 - “Rather than the existing uses discontinuing from lack of interest, market trends reveal that developers have bought out long-term businesses to allow redevelopment into housing or utilized phased development or partial site redevelopment to allow the existing use(s) to remain while new housing was developed.” (p H-C-16)

Source: CoStar

DEVELOPMENT TRENDS SUPPORT ASSERTION

EPS used data from CoStar and Google to research the previous uses at large multifamily housing projects built since 2014 within San Mateo County and nearby cities in Santa Clara County:

- The 42 largest (200+ units) projects either completed or under construction include approximately **15,795** total units
- Of these units, **13,937 (88%)** have been built on land previously developed for office, retail, industrial, and/or associated parking uses
- Another **829 units (5%)** have been built on land previously developed for residential uses
 - The City of San Mateo has allocated fewer than 100 units to sites with existing residential uses (less than 2% of its total housing site inventory)
- **1,029 units (6.5%)** have been built on land that was either vacant or dedicated to public parking (e.g., BART and Caltrain parking lots)

LEASE TREND RESEARCH SHOWS OPPORTUNITIES

EPS analyzed leases and subleases signed in the last five years (since Apr. 2019) for which lease term data from CoStar is available:

- Most commercial leases were signed for a term of five years or less:
 - Out of 248 total leases, about 158 (64%) were for five years or less
- The largest commercial leases had longer terms:
 - Of the 25 largest commercial leases* (more than 10,000 square feet), 12 (48%) were for a term of 5 years or less
- EPS identified over 1.44 million square feet of rentable space with leases set to expire in the next five years (by Apr. 2029)
- These data suggest that most existing commercial leases will expire during the current Housing Element cycle (2023–2031), potentially making their sites available for redevelopment

REVIEW OF HOUSING SITES INVENTORY METHODOLOGY

SUMMARY OF SITE SELECTION CRITERIA FACTORS

Any site meeting any one of the following five criteria:

1. Property owner or developer interest in redevelopment
2. Site that is developer owned
3. Site with previous proposal for redevelopment
4. Vacant site
5. Sites with surface parking lot use only or similar unimproved condition

Or, meeting at least three of the following five criteria:

6. Existing use similar to commonly redeveloped sites (retail or shopping center, banks, office, gas station or automotive use, grocery stores, lower density residential)
7. Structure is more than 30 years old (or 20 years if commercial use)
8. Current structure is one-story only
9. Property has Improvement to Land Value ratio of <1.0 (or <2.5 if commercial use)
10. Property has 50% or less lot coverage

SELECTION CRITERIA ARE GENERALLY REASONABLE

- While not necessarily indicating imminent redevelopment, Criteria 1–5 reflect sites with proven interest in or low barriers to redevelopment during the 2023–31 Housing Element Planning period (RHNA Cycle)
- Criteria 6–10 provide a less clear expectation of redevelopment interest, but they do reflect redevelopment potential, and were used to select a relatively small number of sites:
 - Taken together, these sites account for a relatively approx. 14% of all site capacity (1,449 units) within the inventory
 - EPS estimated that less than 35% of this site capacity (approx. 500 units) would be lost if a higher threshold (at least 4 of the 5 criteria) was required for site selection

Sites Inventory Categories	Site Capacity by Income Level			
	Very Low & Low	Moderate	Above Moderate	Total
<i>RHNA Needs</i>	<i>2,800</i>	<i>1,175</i>	<i>3,040</i>	<i>7,015</i>
ADUs	264	132	44	440
Pipeline Projects	625	51	2,412	3,088
Sites based on Criteria 1-5	1,685	829	2,795	5,309
Sites based on Criteria 6-10 only	555	266	629	1,449
Inventory Grand Total	3,129	1,278	5,880	10,286
<i>Buffer Over RHNA</i>	<i>329</i>	<i>103</i>	<i>2,840</i>	<i>3,271</i>

SITE SELECTION CRITERIA DETAILED ANALYSIS

Criteria	Provides reasonable expectation that property may be redevelop during the Planning Period (RHNA cycle)?
1. Property owner or developer interest in redevelopment	Yes, active interest from a developer or owner provides reasonable expectation.
2. Site that is developer owned	Yes, confirming a known owner that specializes in development also provides reasonable expectation. However, there are many challenges with identifying true owners of property and categorizing owners as developers vs non-developers.
3. Site with previous proposal for redevelopment	Yes, a history of redevelopment proposals provides some reasonable expectation. However, relying on outdated proposals that are not reflective of current zoning or market trends may be a poor indicator of redevelopment potential.
4. Vacant site	Yes, a vacant property condition provides reasonable expectation.
5. Sites with surface parking lot use only or similar unimproved condition	Yes, an unimproved property condition provides reasonable expectation.
6. Existing use similar to commonly redeveloped sites (retail/shopping center, banks, office, gas station, etc.)	Yes, this provides a reasonable expectation as these are uses the City has seen at proposed redevelopment projects in the past.
7. Structure is more than 30 years old (or 20 years if commercial use)	This is in some cases correlated with properties that may be redeveloped. However, assessor data on age of structure does not account for renovated structures that have extended their life and thus does not necessarily provide a strong expectation.
8. Current structure is one-story only	Yes, this provides a reasonable expectation as one-story structures are among the most common type of commercial property that is redeveloped.
9. Property has Improvement to Land Value ratio of <1.0 (or <2.5 if commercial use)	Assessor data regarding values is impacted by Prop 13 and typically does not reflect true market value of land or improvements.
10. Property has 50% or less lot coverage	Yes, lot coverage of less than 50% is correlated with underutilization (often large surface parking areas) that provide a reasonable expectation.

ESTIMATE OF RHNA HOUSING PRODUCTION SUBSIDY

FUNDING NEEDED TO SUPPORT DEVELOPMENT OF CITY'S RHNA GOALS

RHNA HOUSING GOALS ARE DESIGNATED BY INCOME

San Mateo's Goals include:

	Very Low Income (<50% of AMI)	Low Income (50%-80% of AMI)	Moderate Income (80%-120% of AMI)	Above Moderate (>120% of AMI)	Total
San Mateo Units	1,777	1,023	1,175	3,040	7,015
San Mateo County Units	12,196	7,023	7,937	20,531	47,687
Bay Area Units	114,442	65,892	72,712	188,130	441,176
San Mateo Percent	25.3%	14.6%	16.7%	43.3%	100.0%
San Mateo County Percent	25.6%	14.7%	16.6%	43.1%	100.0%
Bay Area Percent	25.9%	14.9%	16.5%	42.6%	100.0%

AFFORDABLE UNITS REQUIRE FINANCING SUBSIDY

- Housing units priced for Above Moderate Income households can reasonably be financed through market-based pricing
- Housing for lower income groups will have to be restricted to below-market rates, which are typically insufficient to fully finance the cost of construction
- EPS calculated a rough estimate¹ of the subsidy needed to finance a unit of housing at each income level, as well as the cumulative total needed to meet the 2023–31 RHNA goals
- The subsidy needed to build all 3,795 below-market-rate units was estimated at \$2.0 billion as detailed in the table on the following slide

¹ EPS developed a static (i.e., point-in-time) pro forma model to simulate the “financing gap” associated with the City’s affordable portion of its RHNA allocation. The model estimates the supportable development value of income-restricted units based on assumptions concerning maximum incomes, affordable lease rates, operating costs, and capitalization rates, and compares the unit valuation with its estimated cost of construction. The difference between construction costs and achievable rent-based unit value represents the subsidy required to produce these units

The estimate assumes that all housing is rental housing and is built with a mix of unit sizes informed by a review of CoStar data on multifamily rental projects built in San Mateo during the previous Housing Element cycle.

SUBSIDY GAP ESTIMATE TO MEET RHNA NEEDS

Item	Very Low Income	Low Income	Moderate Income	Total
6th Cycle RHNA Allocation [1]	1,777	1,023	1,175	3,975
Per-Unit Supportable Development Value [2]	\$280,041	\$599,645	\$947,805	\$559,684
Per-Unit Construction Cost [3]	<u>\$1,066,296</u>	<u>\$1,066,296</u>	<u>\$1,066,296</u>	<u>\$1,066,296</u>
Per-Unit Financing Gap	(\$786,255)	(\$466,651)	(\$118,491)	(\$506,612)
Total Financing Gap	(\$1,397,174,319)	(\$477,383,871)	(\$139,226,391)	(\$2,013,784,581)

[1] Excludes 3,040 Above-Moderate units for a total RHNA allocation of 7,015.

[2] Assumes that households pay no more than 30% of published maximum household income limits including utility cost, using income data published by the California Department of Housing and Community Development (CA HCD) and utility allowance data from the San Mateo County Housing Authority. Total value reflects per unit operating cost assumptions of \$9,000 per unit and a 4.25% cap rate, based on EPS market research,

[3] Assumes 50-unit per acre apartment construction with a mix of unit sizes averaging 990 square feet. EPS compared costs against affordable housing cost data from recent project applications in San Mateo County submitted to the California Tax Credit Allocation Committee (CTCAC).

Source: Economic & Planning Systems, Inc., CA HCD, San Mateo County Housing Authority, CTCAC