

## CONFIDENTIAL MEMORANDUM

To: Kohar Kojayan, City of San Mateo

From: Benjamin C. Sigman, Economic & Planning Systems

Subject: Economic Considerations Concerning Community Benefit Contributions to be Negotiated with the Passage Project

Date: June 22, 2020

*The Economics of Land Use*



The City of San Mateo is negotiating a Development Agreement (DA) with the Passage at San Mateo, a significant mixed-use transit-oriented development. While the project is consistent with the City's Rail Corridor Plan, the applicant is seeking vested rights for 15 years. The City engaged Economic & Planning Systems (EPS) to provide economic analysis related to DA negotiation, specifically to develop quantitative metrics that value additional community benefits that might be offered by the project in exchange for the vested rights conferred by the DA.

This memorandum presents three analytical approaches to inform the magnitude of community benefit value that might be provided by the Passage project in return for vested rights. The three approaches consider (1) the project's fair share of transportation improvement costs, (2) public benefit burden levels, and (3) the value of risk reduction from vested rights. The memorandum presents each analytical approach and associated quantitative findings. **Figure 1** summarizes the key outputs from the analysis, which range from roughly \$2.2 million to \$3.3 million, and average about \$2.7 million. The estimates reflect data and analytical inputs from the Passage project applicant and the City of San Mateo. EPS also relies on 3<sup>rd</sup> party data, in-house data, and professional experience with local and regional real estate development to establish revenue and cost factors.

**Figure 1 Summary of Findings**

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Fair Share Transportation Improvements	\$2.2 Million
Public Benefit Burden Test	\$3.3 Million
Valuation of Vested Rights	\$2.6 Million
<i>Average</i>	<i>\$2.7 Million</i>

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## Fair Share of Transportation Improvements

The Passage applicant has indicated that in exchange for a DA the project may seek to contribute to traffic mitigation investments in the vicinity of the project, despite being legally exempted from such obligations.<sup>1</sup> As part of the DA negotiation, the City might request that the Passage project compensate the City for its fair share of the cost to implement a transportation improvement package that mitigates the project's effect on automobile congestion nearby.

The City has identified a series of transportation improvements that will help to stem traffic impacts generated by the Passage and other local projects. These improvements generally seek to improve vehicular flows on 19<sup>th</sup> Avenue and Fashion Island Boulevard. Eight unique investments comprise the proposed transportation improvement solution. The City estimates the cost of the proposed mitigation package at approximately \$9.6 million in 2020 dollars (i.e., before cost escalation), including all construction and construction management costs; planning, design, and permitting costs, construction easements and right of way acquisitions.

**Figure 2 Overview of Potential Transportation Improvements**



- 1. Two-Way Conversion (add WB lanes) – (\$3.7M)**
  - Convert 19<sup>th</sup> Avenue between Delaware Street and Grant Street from the existing one-way eastbound operation to two-way operations with one lane in each direction.
- 2. Delaware/19<sup>th</sup> + Grant/ 19<sup>th</sup> Int. and Signal Mod (\$630K)**
  - Intersection improvements at the Delaware Street and 19<sup>th</sup> Avenue intersection and the Grant Street and 19<sup>th</sup> Avenue intersection to accommodate the 19<sup>th</sup> Avenue two-way conversion.
  - Restripe eastbound 19<sup>th</sup> Avenue the Grant Street intersection to include one shared left-through lane and one shared through-right lane.
- 3. Add SB US101 On-Ramp Lane (\$500K)**
  - Widen the US 101 southbound on-ramp from Fashion Island Boulevard to include a second mixed-flow lane.
- 4. WB RT Lane on Fashion Island Boulevard (\$130K)**
  - Widen westbound Fashion Island Boulevard to include a right-turn pocket at the US 101 northbound on-ramp intersection
- 5. Lengthen EB-LT Pocket at Norfolk/Fashion Island Boulevard (\$1.03M)**
  - Lengthen the eastbound left-turn pocket at the Norfolk Street and Fashion Island Boulevard intersection.
- 6. Reversible Lane on Bridge (\$3.3M)**
  - Implement reversible lanes on the bridge between Norfolk Street and Harbor Seal Court. The AM peak period operations will be the same as existing conditions. The PM peak period operations will allow for two eastbound through lanes from west of Norfolk Street to just west of Harbor Seal Court where Fashion Island Boulevard opens up to two eastbound lanes. At the intersection of Norfolk Street and Fashion Island Boulevard, the eastbound approach will consist of one left-turn lane, one through lane and one shared through-right lane. The westbound approach will consist of one left-turn lane and one shared through-right lane.
- 7. Signal Coordination (Entire Corridor) (\$180K)**
  - Signal coordination at all signalized intersections on 19<sup>th</sup> Avenue/Fashion Island Boulevard between Delaware Street and Norfolk Street
- 8. Convert EB RT Lane to RT/TH Lane (\$170K)**
  - Restripe eastbound Fashion Island Boulevard at the US 101 southbound ramps intersection to include one through lane and one shared through-right lane.

[Estimated Total Mitigation Cost = \$9.6M]

Source: City of San Mateo

<sup>1</sup> Pursuant to SB 743, the Governor's Office of Planning and Research published updates to CEQA Guidelines which became effective in December 2018. The guidelines stated that LOS will no longer be considered to be an environmental impact under CEQA and considers VMT the most appropriate measure of transportation impact. VMT analysis finds that the project would not conflict or be inconsistent with CEQA Guidelines.

The fair share cost allocation considered here reflects the Passage project's contribution to traffic impacts generated by new development in the vicinity of 19<sup>th</sup> Avenue. EPS relies on calculations from the City of San Mateo, based on traffic counts collected by Hexagon Traffic Consultants. The analysis establishes baseline traffic conditions as of April 2018, and evaluates traffic growth associated with projects that have been approved by the City since that time, along with trips attributable to the Passage project. The fair share calculation reflects Passage-generated trips at impacted intersections as a percentage of all trips generated by the Passage project and recently approved projects at these intersections.

In addition to the Passage project, the City anticipates that eight approved projects will generate automobile trips that adversely affect mobility in the 19<sup>th</sup> Avenue/Fashion Boulevard corridor.

**Figure 3** identifies the eight projects that in combination with the Passage project create a pressing need for transportation improvements to mitigate traffic impacts. Together these projects exacerbate roadway congestion and deteriorate roadway mobility in the 19<sup>th</sup> Avenue/Fashion Boulevard corridor to an unacceptable level.<sup>2</sup>

**Figure 3 Additional Projects Contributing to Traffic in the 19<sup>th</sup> Avenue Corridor**

Project	Description	Status
Hillsdale Shopping Center Redevelopment	Retail expansion (increase of 20,000 SF)	Completed Construction
1650 Delaware Street (AAA)	Demolish commercial use and construct 73 residential units	In Construction
Station Park Green	599 residential units, 11,000 SF office, and 26,000 SF retail	In Construction
Bay Meadows Phase II	Single family and multifamily residential, office, and retail	In Construction
1 Waters Park Drive	Demolish office buildings and construct 190 residential units	Approved
Hampton Inn & Suites	Demolish hotel and construct 180 residential units	In Construction
Hillsdale Terrace	14,000 SF commercial and 74 condominiums	Approved
Franklin Templeton Campus Expansion	Office expansion (increase of 245,000 SF)	Completed Construction

Source: City of San Mateo

<sup>2</sup> Passage project development will generate increases in intersection delays in the 19<sup>th</sup> Avenue corridor based on General Plan criteria (Concar Passage Mixed-Use Development General Plan Conformance Transportation Analysis, Hexagon Transportation Consultants, 2020).

Based on City analysis of estimated traffic counts at impacted locations, the Passage generates 562 trips at affected intersections, out of the total 2,475 generated by the Passage and nearby approved projects combined.<sup>3</sup> At these levels of trip generation, the vehicle count data reveal that the Passage project is responsible for an estimated 22.7 percent of the increase in traffic generated by major new projects at intersections in the 19<sup>th</sup> Avenue/Fashion Boulevard corridor. Applying the Passage's proportion of new transportation impacts to the cost of the transportation mitigation projects yields a fair-share cost contribution of \$2.18 million.

### **Public Benefit Burden Test**

To provide another lens on the potential of the Passage project to generate additional community benefits in return for a DA, EPS considers the overall public benefit cost burden associated with the project proposal, relative to industry norms. This analytical exercise uses a well-accepted industry metric to test the cost of infrastructure, public facilities, and affordable housing contributions relative to the Passage project's estimated market value. In EPS's experience over nearly 40 years of real estate consulting in the Bay Area, excessive public cost burdens, typically above roughly 15 percent of a project's market value, challenge the financial feasibility of new development. This analysis evaluates whether the Passage can take on additional community benefit costs before hitting the 15 percent upper-bound metric.

The Public Benefit Burden Test is a relatively simple comparison of public benefit costs to the total market value of the project, in constant dollars. In this analysis, public facility cost and fee data provided by the applicant and vetted by City, along with affordable housing subsidy estimates prepared by EPS, are compared to EPS-researched estimates of the project's market value. While useful for considering the economic potential for the Passage project to generate additional community benefits for the City, this financial feasibility test does not acknowledge extraordinary costs or unique market conditions that specific projects may face.

### **Public Benefit Costs**

The key contributions that the Passage project makes to public facilities and programs include construction efforts and funding:

- Construction costs for development of building shells for a transportation hub ("depot lounge"), a day care facility, and a community theater, based on the applicant's contractor estimates from October 2019.
- Construction cost for development of off-site public infrastructure including improvements to public streets, utilities, landscaping, signals, and pedestrian and bicycle infrastructure, based on the applicant's contractor estimates from October 2019.
- Development impact fees for parks, art, sewer infrastructure, transportation, and schools, based on the 2020 fee schedules.
- Below-market-rate housing subsidy requirements, based on EPS subsidy analysis.

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<sup>3</sup> Includes AM or PM counts at 10 intersections.

In aggregate, these public benefits will cost approximately \$95 million in constant 2020 dollars. The construction of on-site and off-site public elements account for about \$15 million, impact fees cost the project about \$30 million, and subsidies for affordable housing are roughly \$50 million. **Figure 5** summarizes these cost estimates and additional supporting calculations are provided in the **Appendix** to this memorandum.

### **Project Valuation**

For the purpose of the Public Benefit Burden Test, the analysis establishes market value based on sale transactions observed in the local and regional real estate market. EPS considered multifamily and retail real estate sales in the City of San Mateo and in San Mateo County based on data available from CoStar Group.<sup>4</sup>

- **Multifamily Residential Values**

Transaction research identified two major multifamily residential projects built after 2010 that have sold since 2015. 888 North San Mateo Drive is a 160-unit class A multifamily project that sold in 2018 for \$105 million (\$655,000 per unit). Mode Apartments at 2089 Pacific Boulevard is a 111-unit multifamily project that sold in 2015 for \$74 million (\$663,000 per unit). Both projects include 10 percent of their units at below-market-rate rents. Accounting for the inclusionary housing component of these project, EPS estimates the value of new market rate units in the City of San Mateo at roughly \$725,000 per unit. This valuation is near the midpoint in the range of major market rate multifamily project transactions in San Mateo County since 2015, which span from about \$690,000 per unit (a 2016 sale) to \$815,000 per unit (a 2019 sale).

- **Retail Values**

Retail real estate value is extremely sensitive to a number of locational factors, including access, visibility, and adjacent retail uses. The size of the building or floor space, and the magnitude of the property's host retail center also are essential to value. Significant variation in retail real estate value is apparent in the transaction data collected from San Mateo County since 2015. Observed per-square-foot sale prices ranged from about \$530 to \$2,230. The unweighted average per-square-foot price across eight transactions identified was about \$1,190. These were sales of smaller spaces (about 7,000 square feet on average). Considering that the Passage has significantly more retail, about 38,000 square feet, and anchor tenants are likely to generate lower per-square-foot rents, EPS assumes that pricing will be in the middle of the observed value spectrum, about \$750 per square foot. After factoring in that approximately 1/3<sup>rd</sup> of retail space will be rent free in perpetuity (i.e., performance space and day care), EPS assumes a weighted retail sale value of \$500 per square foot across the 38,000 square feet of Passage retail space.

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<sup>4</sup> CoStar Group is the leading provider of real estate data and analytics in the United States.

## Public Benefit Burden Calculation

The Public Benefit Burden Test considers aggregate public benefit contributions relative to total project market value. As discussed above, benefits include on-site and off-site public improvements, development impact fees, and affordable housing subsidies. Valuation reflects an assessment of the project's potential sale value in the market today, assuming it is fully built out and operations have stabilized (i.e., full lease up). Even before considering any additional cost burden that may be imposed in exchange for the DA, the burden analysis finds that the Passage project's public benefit burden is already very close to the 15 percent threshold, estimating the cost burden at about 14.5 percent of project value.

Based on the 15 percent test, there may be some additional potential for the Passage project to provide public benefits, assuming no extraordinary cost factors are limiting the project's economic potential. An additional \$3.3 million in public benefit costs would bring the burden up to exactly 15 percent of project value. **Figure 5** presents a summary of the public benefit burden calculation, including a summary of cost and value elements associated with the project. The **Appendix** to this memorandum provides additional supporting detail concerning cost estimates.

**Figure 4 Public Benefit Burden Test Data and Calculation**

Item	Estimate	Note
<b><u>Public Benefit Value Estimates</u></b>		
Transportation Hub (Depot Lounge)	\$2,500,000	Applicant estimate of building cost
Day Care Facility	\$4,000,000	Applicant estimate of building cost
Community Theater	\$2,000,000	Applicant estimate of building cost
Off-Site Improvements <sup>1</sup>	\$6,300,000	Applicant estimate of infrastructure cost
Parks Impact Fee	\$19,000,000	City-confirmed applicant fee estimate
Art Program	\$2,500,000	City-confirmed applicant fee estimate
Trunk Sewer	\$2,600,000	City-confirmed applicant fee estimate
Transportation	\$1,700,000	City fee estimate
School Impact Fee	\$3,200,000	City-confirmed applicant fee estimate
Moderate Income BMR Housing Subsidy	\$5,166,000	EPS estimate
Very Low Income BMR Housing Subsidy <sup>2</sup>	\$46,419,000	EPS estimate
<b>Total Infrastructure, Facility and Fees</b>	<b>\$95,385,000</b>	
<b><u>Project Built Value Estimates</u></b>		
Market Rate Unit Count	852	Project program
Average Per-Unit Value	\$725,000	EPS estimate based on Sales
Value of Market Rate Units	\$617,700,000	
Moderate Income Unit Count	36	Project program
Average Per-Unit Value	\$484,000	EPS estimate based on City Rent Limits
Value of Moderate Income Units	\$17,424,000	
Very Low Income Unit Count	73	Project program
Average Per-Unit Value	\$53,000	EPS estimate based on City Rent Limits
Value of Very Low Income Units	\$3,869,000	
Commercial (Square Feet)	38,000	Project program
Average Per-Square-Foot Value	\$500	EPS estimate based on Sales <sup>3</sup>
Value of Commercial Space	\$19,000,000	
<b>Total Project Built Value</b>	<b>\$657,993,000</b>	
<b>Public Benefits as a % of Total Value</b>	<b>14.5%</b>	
<b><u>Additional Community Benefits</u></b>		
<b>@15% Burden Level</b>	<b>\$3,313,950</b>	

<sup>1</sup> Improvements to public streets, utilities, landscaping, signals, and pedestrian and bicycle infrastructure.

<sup>2</sup> The subsidy for very-low-income housing could be reduced by Low Income Housing Tax Credits, not considered here.

<sup>3</sup> The commercial rent shown is weighted to reflect that approximately 1/3rd of the commercial program will be tenanted with zero or minimal rent to not-for-profit and/or public benefit entities (e.g., YMCA and Peninsula Ballet Theatre).

## Valuation of Vested Rights

While a development applicant may seek a DA for a variety of reasons, including to add density, achieve code variances, or to pursue public funding, vested rights alone can generate significant value for a developer. Vested rights prevent a City from requiring new project contributions or changing development program parameters throughout the duration of the DA. Particularly for multi-phased projects that will be developed over many years, developers and their investors benefit from the certainty that local jurisdictions will not modify project requirements over time. Multiple case studies (e.g., Stanford Campus in Redwood City and Sierra Point Campus in Brisbane) exhibit that the value of vested rights alone can be enough to support community benefit contributions. The current term sheet for the Passage project DA anticipates a 15-year DAs.

The value of vesting the entitlement can be measured in terms of reduced risk. The reduction is calculated through a downward adjustment to the project's threshold required internal rate of return (IRR). The risk reduction achieved by the Passage through a DA likely is modest, with the State of California's Housing Accountability Act recently strengthened to help to protect new housing projects from opposition by anti-growth activists. However, the applicant is interested in a DA to achieve an extra layer of security in the entitlement, an important signal to potential investors that the project's approvals are secure.

This analysis of the value of vested rights considers the Passage project's potential cash flow, including costs and returns over a seven-year period. Based on EPS cost assumptions, the analysis assumes all-in cost for the project will be approximately \$670 million, spent evenly over the development period. While the applicant has not indicated the project will be sold in the near term, this analysis assumes that project stabilization (full lease up) is achieved in year seven, at which point the project is sold. In a baseline (without DA) scenario, sale proceeds generate an internal rate of return (IRR) of 14.0 percent.<sup>5</sup> The analysis compares the baseline to a "with DA" scenario in which the vested rights reduce project risk, and compress the project's required rate of return by 15 basis points (0.15 percentage points) to 13.85 percent. EPS assumes that this reduction in return (a roughly 1 percent reduction in the IRR) is commensurate with the reduction in project risk conferred by the vested rights provision of the DA.

Given the EPS cost and return assumptions, the vested rights valuation analysis finds that reduced project risk and the lower IRR threshold result in a potential for an increase in project equity of approximately \$2.6 million, about 0.5 percent of the original project investment. That is, with a reduced financial return requirement attributable to the DA, project investors are indifferent between the original project cash flow (without the DA) and cashflow with an added upfront payment of \$2.6 million that buys entitlement assurances through the anticipated development and stabilization period for the project. If the upfront community benefit payment is delayed in time, project investors' willingness to pay will be higher.

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<sup>5</sup> This is a simplified analysis. Project cash flows reflects projected revenues and costs over time but do not contemplate phasing, market absorption, or a number of other factors that can significantly affect financial performance.



**Figure 5 Valuation of Vested Rights Cash Flow Analysis**

Year	0	1	2	3	4	5	6	7
Cash Flow with IRR requirement of 14.00% (Higher Risk without Development Agreement)								
Net Cash (Millions)	(\$96)	(\$94)	(\$91)	(\$88)	(\$85)	(\$76)	(\$85)	\$1,094
IRR	14.00%							
Cash Flow with IRR requirement of 13.85% (Lower Risk with Development Agreement)								
Net Cash (Millions)	(\$96)	(\$94)	(\$91)	(\$88)	(\$85)	(\$76)	(\$85)	\$1,087
IRR	13.85%							
Value of Risk Reduction from Development Agreement								
Change in IRR (Percentage Points)	-0.15%							
Change in Year-7 Reversion Value	(\$6.5) million							
Change in NPV Reversion Value	(\$2.6) million							
NPV as Percentage of Initial Investment	0.5%							
Cash Flow with Community Benefit Contribution and Development Agreement								
Net Cash (Millions)	\$ (99)	\$ (94)	\$ (91)	\$ (88)	\$ (85)	\$ (76)	\$ (85)	\$ 1,094
IRR	13.85%							

## Appendix Tables

**Appendix Table 1      Off-Site Public Improvement Cost Estimate Detail**

<b>Off-Site Public Infrastructure<sup>1</sup></b>	<b>Cost Estimate<sup>1</sup></b>
Demolition, earthwork, traffic control	\$420,000
AC Paving, restripe	\$350,000
Allowance for additional street repair	\$350,000
Concrete curbs, gutters, sidewalks	\$945,000
Landscape and irrigation	\$770,000
Underground wet utilities	\$1,540,000
Underground dry utilities	\$910,000
Allowance for new traffic signal	\$490,000
Allowance for bike and pedestrian improvements	<u>\$525,000</u>
<b>Total</b>	<b>\$6,300,000</b>

<sup>1</sup> Improvements to public streets, utilities, landscaping, signals, and pedestrian and bicycle infrastructure.

<sup>2</sup> Estimates include soft costs and contingency. Estimates reflect union contractor bids from our October 2019.

**Appendix Table 2      Moderate-Income Housing Subsidy Calculations**

<b>Units and Rent Potential</b>					
<b>Unit Type</b>	<b>Count</b>	<b>Housing Cost Limit<sup>1</sup></b>	<b>Utilities Allowance<sup>2</sup></b>	<b>Rent Potential</b>	
Studio	8	\$2,466	-\$75	\$2,391	
1-Bed	18	\$2,823	-\$85	\$2,738	
2-Bed	10	\$3,169	-\$107	<u>\$3,062</u>	
Weighted Average				\$2,751	
Annual Revenue				\$31,360	
Annual Operating Expenses				\$12,000	
Net Operating Income				\$19,360	
<b>Capitalized Market Value Per Unit (a)</b>				<b>\$484,003</b>	
<b>Development Cost Per Unit</b>					
<b>Land</b>		12.5% of Total		\$78,437	
<b>Hard Cost</b>					
Site Work and Building		\$415 Per SF		\$334,248	
Parking		\$75,000 Per Stall		<u>\$105,000</u>	
Hard Cost				\$439,248	
<b>Soft Cost</b>		25% of Hard Costs		\$109,812	
<b>Total Development Cost Per Unit (b)</b>				<b>\$627,497</b>	
<b>BMR Subsidy Requirement ( = a - b )</b>				<b>-\$143,494</b>	

<sup>1</sup> Community Development Department, June 2020

<sup>2</sup> U.S. Department of Housing and Urban Development, "Utility Allowance Schedule: Housing Authority of San Mateo County," November 2019. Assumes landlord pays for water and trash collection.

**Appendix Table 3      Very-Low-Income Housing Subsidy Calculations**

<b>Units and Rent Potential</b>				
<b>Unit Type</b>	<b>Count</b>	<b>Housing Cost Limit<sup>1</sup></b>	<b>Utilities Allowance<sup>2</sup></b>	<b>Rent Potential</b>
Studio	12	\$1,125	-\$75	\$1,050
1-Bed	25	\$1,276	-\$85	\$1,191
2-Bed	36	\$1,439	-\$107	<u>\$1,332</u>
Weighted Average Monthly Rent				\$1,237
<b>Annual Cash Flow and Value for a Very-Low-Income Unit</b>				
Annual Revenue				\$14,106
Annual Operating Expenses				12000
Net Operating Income				\$2,106
<b>Capitalized Market Value Per Unit (a)</b>				<b>\$52,647</b>
<b>Development Cost Per Unit</b>				
<b>Land</b>		12.5% of Total		\$86,066
<b>Hard Cost</b>				
Site Work and Building		\$415 Per SF		\$376,968
Parking		\$75,000 Per Stall		<u>\$105,000</u>
Hard Cost				\$481,968
<b>Soft Cost</b>		25% of Hard Costs		\$120,492
<b>Total Development Cost Per Unit (b)</b>				<b>\$688,525</b>
<b>BMR Subsidy Requirment ( = a - b )</b>				<b>-\$635,879</b>

<sup>1</sup> Community Development Department, June 2020

<sup>2</sup> U.S. Department of Housing and Urban Development, "Utility Allowance Schedule: Housing Authority of San Mateo County," November 2019. Assumes landlord pays for water and trash collection.