



MEMORANDUM

To: Leslie Mendez, City of Berkeley

From: Sujata Srivastava and Sam Moskol, Strategic Economics

Date: August 28, 2018

Subject: Peer Review of Community Benefits Package for 2190 Shattuck Avenue

INTRODUCTION

The City of Berkeley retained Strategic Economics to conduct a peer review of the community benefits proposal for the 2190 Shattuck mixed-use development project. According to the City of Berkeley's Municipal Code, developments that exceed 75 feet in height are required to provide "significant community benefits." The value of the community benefits should bear a "reasonable relationship" to the project's value, while not resulting in infeasibility. As part of their community benefits package, the applicant is expected to provide a Project Labor Agreement. In addition, the applicant must opt to either: (1) provide additional affordable housing units or fees beyond existing requirements and provide at least one other category of public benefit that may be related to arts and culture, open space, historic restoration, or other benefits; or (2) pay a per square foot fee determined by an independent consultant.

The applicant's community benefits proposal includes a project labor agreement for construction. The proposal also includes an on-site, public art installation, as well as a community room which could provide subsidized space for area non-profits. The applicant's financial analysis (conducted by EPS) found that an additional per-square-foot community benefits fee was economically infeasible.

This memorandum report summarizes the peer review of the key financial assumptions of the community benefits package, focusing on the project pro forma developed by EPS in June 2018. The peer review is intended to help decision-makers determine whether the proposed community benefits package is reasonable, given the development economics of the project and current expectations of return.

COMMUNITY BENEFITS PACKAGE

Figure 1 is a summary of the proposed community benefits package. This section reviews the estimates of the value of the project labor agreement and of providing the community space.

FIGURE 1. 2190 SHATTUCK AVE. COMMUNITY BENEFITS PACKAGE TOTAL VALUE

	City Fees that Create Community Benefit	Project Labor Agreement	Additional Benefits
Affordable Housing In-Lieu Fee	\$10,138,000		
School District Fees	\$701,533		
Arts In-Lieu Fee	\$720,000		
Streets/ Open Space Improvement Fees	\$409,214		
Transit Passes for Residents	\$663,080		
Project Labor Agreement		\$5,547,020	
Integrated On-Site Art Component			\$720,000
Community Space			\$780,000
Total: \$19,678,847	\$12,631,827	\$5,547,020	\$1,500,000

Source: Economic & Planning Systems, 2018; Strategic Economics, 2018.

Project Labor Agreement

The community benefits package includes a project labor agreement (PLA) for construction. Total construction costs are estimated to be approximately \$111 million, which includes both the cost to build the high-rise, as well as the tenant improvements for the ground-floor retail tenant. The value of the construction PLA is estimated at five percent of total construction costs, or \$5.5 million, consistent with City Council guidance on this issue. The applicant's estimate of the value of the PLA is conservative; Alameda County Building Trades Council estimated that the value of a PLA for a high-rise development was between 10 and 12 percent of construction costs in 2016.

Community Space

EPS measured the value of the community space by estimating the foregone retail revenues from leasing the space to a retail tenant, and then dividing the annual revenues by a capitalization rate to calculate the capitalized value. The EPS analysis assumes that the space could command full-service rents of \$5.70 per square foot. Based on these rental rates, the total annual revenue is \$47,000 per year, and the total capitalized value is estimated at \$780,000. However, this calculation does not incorporate any operating expenses which would be expected for a full-service lease. The lease rate estimate is also inconsistent with the rental rate assumptions applied in the pro forma for the retail rents, which are \$3.00 per square foot triple net. Applying the lower retail rent assumption generates an estimated value of \$411,000 for the community space, as shown in Figure 2 below.

FIGURE 2. COMMUNITY SPACE VALUE CALCULATION

	EPS Estimate	Strategic Economics Estimate
Rent per Sq Ft	\$5.70 (FS)	\$3.00 (NNN)
Sq Ft	685	685
Revenue Per Month	\$3,905	\$2,055
Revenue Per Year	\$46,854	\$24,660
Capitalized Value (a)	\$780,900	\$411,000

Notes:

(a) Operating expenses are not included in the EPS calculation despite using a full service lease assumption. Factoring in expenses, or changing the rental rate estimate, would lower the overall capitalized value of the community space.

Source: Economics & Planning Systems, 2018; Strategic Economics, 2018.

PRO FORMA REVIEW

In order to determine if the project could feasibly contribute additional community benefits, Strategic Economics reviewed several key assumptions in the financial pro forma submitted by the applicant, including rents, construction costs, and developer return.

Rents and Capitalized Value

To calculate the value generated by the project, the EPS pro forma assumes that the “base case” midrise project would command average rents of \$5.95, and the proposed high-rise project would command average rents of \$6.16. These assumptions were based on an estimate of average rental rates achieved at comparable Downtown Berkeley properties, plus a ten percent “value premium” associated with a newly built product. In addition, the high-rise project includes an anticipated view premium for units on the higher floors.

- **Rental rates.** Strategic Economics reviewed current rents for newly built Downtown Berkeley apartment projects. The list of projects, as well as the data source, were identical to those selected in the applicant’s pro forma. As shown in Figure 3, the average weighted rents for these properties was \$5.10 per square foot, slightly lower than the applicant’s estimate of \$5.41 per square foot. This lower average rate could potentially be a function of the seasonality of rental rates in Berkeley, differences in the types of units that were available for rent in August compared to June, or other factors.
- **Rent premium.** The EPS pro forma analysis incorporates a 10 percent premium for new products. While the available data does not show a clear relationship between the age of buildings and average rents, developer interviews confirm that there is a 5 to 10 percent rent premium for apartments in buildings near the Downtown BART station. The project’s location above the Downtown Berkeley BART station justifies including a premium over the average rental rates in Berkeley overall. Incorporating a value premium for higher floors is also a standard practice for estimating revenues in high-rise residential development projects. Using recent August rental rates and applying the same rent premiums, Strategic Economics calculated an average rental rate of \$5.61 per square foot for the mid-rise project and \$5.81 per square foot for the high-rise. By comparison, the EPS pro forma incorporates more optimistic assumptions of rental rates, as shown in Figure 4.
- **Capitalized value.** The value of the residential units is estimated using a capitalized value approach, in which the net operating income (rents minus operating expenses) is divided by the capitalization rate (cap rate). The EPS pro forma assumes a cap rate of 4.10 percent for

the high-rise project, and 4.20 percent for the mid-rise project. CBRE's Cap Rate Survey report for the second half of 2017 found that multifamily properties in the Oakland metro area (which includes Berkeley) was between 4.25 percent and 4.75 percent (Figure 5). The applicant's use of a lower cap rate in the pro forma results in a higher estimate of project value.

FIGURE 3. DOWNTOWN BERKELEY APARTMENT RENTAL RATES, AUGUST 2018

Building Name	Year Built	Vacancy Rate (%)	Avg Effective Rent Per Sq Ft	Avg Effective Rent/Unit	Avg Unit Size (Sq Ft)	Number of Units
The Dwight	2015	1.00	\$5.57	\$3,776	667	99
Addison Arts Apartments	2016	0.00	\$5.26	\$3,543	673	69
Varsity Berkeley	2015	3.85	\$5.11	\$4,165	816	78
Parker Apartments	2016	1.29	\$5.05	\$3,584	709	155
Stonefire Berkeley	2017	9.18	\$4.79	\$4,269	891	98
Berkeley Central	2012	11.89	\$4.62	\$4,203	909	143
The Overture	2016	6.98	\$4.34	\$2,926	692	43
New Californian	2010	4.73	\$4.24	\$2,977	701	148
Telegraph Gardens	2013	0.00	\$3.52	\$3,342	950	38
Touriel Apartments	2004	2.86	\$5.99	\$2,976	497	35
Berkeleyan	1998	1.79	\$5.96	\$3,618	607	56
Bachenheimer	2004	3.57	\$5.69	\$3,776	663	56
Gaia Apartments	2000	3.30	\$5.42	\$3,569	659	91
Fine Arts Apartments	2004	7.00	\$5.27	\$3,089	586	100
Renaissance Villas	1998	17.65	\$4.77	\$3,244	680	34
Stadium Place	2006	5.41	\$5.63	\$3,572	635	74
K Street Flats	2006	14.77	\$5.39	\$3,807	706	176
ARTech	2003	14.81	\$5.32	\$3,783	711	27
Hillside Village	2005	5.32	\$5.25	\$4,137	786	94
Allston Place	2002	10.00	\$5.22	\$2,767	530	60
Average/ Weighted Average		6.39	\$5.10	\$3,623	716	84

Source: Strategic Economics, 2018; Costar, 2018.

FIGURE 4. COMPARISON OF RENTAL RATE ASSUMPTIONS

	Average Rent per Sq Ft, Comparable Buildings	Average Rent per Sq Ft, Mid-Rise with 10% Premium	Average Rent per Sq Ft, High-Rise With View Premium
Applicant, June 2018	\$5.41	\$5.95	\$6.16
Strategic Economics, August 2018	\$5.10	\$5.61	\$5.81

Source: Costar, August 2018; Economic & Planning Systems, June 2018; Strategic Economics, 2018.

FIGURE 5. CAP RATES FOR CLASS A MULTIFAMILY PROPERTY IN OAKLAND METRO AREA

Source	Cap Rate
CBRE Cap Rate Survey, 2 nd Half 2017	4.25-4.75%
Applicant, June 2018	4.10% - 4.20%

Source: Economic & Planning Systems, 2018; CBRE Cap Rate Survey, 2nd Half 2017, Strategic Economics, 2018.

Development Cost Assumptions

The main categories of development costs reviewed in this analysis include land costs, construction costs, and city fees. According to the applicant, the construction cost for the building is \$524 per square foot. Construction costs can vary a great deal from project to project, depending on the specifics of the building program, design, site characteristics, and other factors. Developers of other high-rise multi-family projects in the Bay Area estimate that current hard costs are between \$500 and \$600 per square foot (Figure 6). The EPS cost assumptions are on the lower side of this range.

FIGURE 6. HARD COST ESTIMATES FOR TYPE 1 HIGH-RISE CONSTRUCTION

	Construction Cost Per Sq Ft
Applicant, June 2018	\$524
Developer Interviews	\$500-\$600

Source: Economics & Planning Systems, 2018; Developer Interviews, 2018.

Similarly, the assumptions of land costs (around \$84,000 per unit) are also in line with the input gathered from area developers and recent transactions. For example, the 1951 Shattuck site which is also entitled for high-rise development two blocks from 2190 Shattuck, reportedly was listed for a similar land price per unit of \$86,000 (Figure 7).

FIGURE 7. ENTITLED LAND COST ESTIMATES FOR DOWNTOWN BERKELEY HIGH-RISE DEVELOPMENT

	Transaction Year	Price	Units	Price Per Unit
2190 Shattuck	2015	\$23,000,000	274	\$83,942
1951 Shattuck (a)	2017	\$13,400,000	156	\$85,897

Notes:

(a) The list price for 1951 Shattuck was \$13.4 million. The actual sales price is not available.

Source: Economic & Planning Systems, 2018; Berkeleyside, 2018; Strategic Economics, 2018.

Strategic Economics also reviewed the applicant’s estimate of city fees, excluding utility fees and some permit fees. As shown in Figure 8 below, the calculations are consistent with Strategic Economics’ research, with the exception of the SOSIP residential fee, which was found to be slightly lower than the applicant’s estimate.

FIGURE 8. CITY OF BERKELEY FEES

	EPS Fee Per Unit	SE Fee Per Unit
BUSD Developer Fee	\$2,560	\$2,560
Building Permit Fees	\$10,729	\$10,729
Plan Check Fees	\$4,697	\$4,697
Affordable Housing Mitigation Fee	\$37,000	\$37,000
SOSIP (Residential) Fee	\$1,722	\$1,641
SOSIP (Commercial) Fee	-\$229	-\$229
Sewer Connection Fee	\$2,012	\$2,012
1% Arts Fee	\$2,628	\$2,628
Total	\$61,119	\$61,038

Source: Economic & Planning Systems, 2018; Berkeley Permit Fee Estimator, 2018; Berkeley Building and Safety Division Fees, 2018; Berkeley Fact Sheet: One-Percent for Public Art on Private Development, 2016; Berkeley Unified School District Fees FAQ, 2017; Berkeley Affordable Housing Mitigation Fee Ordinance, 2018; Berkeley Downtown Area Plan Streets and Open Space Improvement Plan Fee Nexus Study, 2011, Strategic Economics, 2018.

Return Assumptions

Strategic Economics evaluated the applicant's assumptions of developer return using the yield on cost (YOC) metric. YOC is calculated by dividing the net operating income at year of stabilization by total development costs (including construction costs, indirect costs, and land costs but excluding financing costs). It is a useful metric for feasibility because it allows for a comparison of rates of return among similar projects, without skewing the results based on the specific financing arrangements (such as the particular combination of debt and equity) that can be highly variable from project to project.

The applicant's pro forma assumes a yield on cost of 4.77 percent for the proposed high-rise project. According to interviews with developers, the current expectation for YOC for a high-rise multi-family project is typically 6.0 percent, although some investors may be able to accept a return of 5.25 percent. Developers noted that development projects in Berkeley face significant entitlement challenges, which can result in higher expectations of return from investors. As a general rule of thumb, a healthy YOC is usually between one and 1.5 basis points above the cap rate. As shown in Figure 9 below, the applicant's pro forma provides a lower return than would be typically considered financially feasible.

FIGURE 9. YIELD ON COST

	Expected Return on Investment	Capitalization Rate	Expected Yield on Cost
Applicant Pro Forma with Community Benefits	10%	4.10%-4.20%	4.77%
Developer Interviews and Research	15%	4.25%-4.75%	5.25%-6.0%

Source: Economic & Planning Systems, 2018; Developer Interviews, 2018; Strategic Economics, 2018.

POTENTIAL FOR ADDITIONAL FEE CONTRIBUTIONS

As described above, the applicant's proposed project provides a lower return than would typically be expected for a complex, high-rise development project in Berkeley. It should be noted that the applicant's calculation of return assumes higher than average values and lower than average construction costs, resulting in an optimistic estimate of return.

There are several factors that could allow the proposed project to perform better than other multi-family development projects in the market area, including the prime location in the heart of Downtown Berkeley, the high demand for housing in Berkeley, and the premiums associated with proximity to the BART station and the views offered on higher floors.

While the rental housing market remains very strong, if more conservative estimates of revenue and costs are applied, the project's return would be lower, resulting in a project that is less financially viable than what is proposed by the applicant.

For these reasons, Strategic Economics concludes that it is not reasonable to expect that the proposed development could contribute additional community benefits fees.

