bae urban economics

Memorandum

To: Tom Smith, Kyle Perata, and Payal Bhagat, City of Menlo Park

From: Stephanie Hagar, Associate Principal

Date: January 4, 2021

Re: Evaluation of 111 Independence Drive Community Amenities Proposal

Purpose

This memorandum provides BAE's assessment of the value of the community amenities proposal for the proposed residential project at 111 Independence Drive in Menlo Park. The City-approved appraisal for the project site identified a required amenity value of $2,550,000, and the project applicant has submitted a community amenities proposal that consists of two below-market-rate (BMR) units and a 746 square foot café space. The applicant has provided an assessment of the value of the community amenities proposal that estimates a total value of $2,730,000, comprised of $870,000 in value due to the café space and $1,860,000 for the two BMR units ($930,000 per unit). This memorandum does not assess whether the proposed amenity is appropriate, falls within the current amenity list adopted by City Council resolution, or whether the same amenity has already been provided by another applicant. This memorandum evaluates the methodology and key assumptions that the applicant used to determine the value of the proposed community amenity and provides BAE's determination of the value.

Key Findings

This section presents key findings related to the value of the community amenities proposal that the project applicant has proposed as part of a request for bonus level development for a proposed project located at 111 Independence Drive in Menlo Park. Key findings from BAE's analysis of the value of the community amenities proposal include findings related to the method that the applicant used to estimate the value of the amenity as well as findings related to the resulting amenity value.

Methodology Findings

The applicant's valuation of the community amenity proposal used two different methods to estimate the value of the proposal: one method for the café and a separate method for the BMR units. These methods overestimate the value of the community amenity as delivered as a component of the overall project.

To estimate the value of the café, the applicant's valuation used a capitalized value approach. This approach estimates the market value of the café space based on the income that it produces for the property owner, or the amount that the café space would contribute to the overall sale price of the project if sold upon completion and stabilization. This valuation approach focuses on the value or benefit to the property owner, not the cost to the provide the amenity or the value or benefit to the community, and thus overstates the value of the amenity provided. Because the required community amenities are intended to address identified community needs that result from the effect of the increased development intensity on the surrounding community, the valuation approach should reflect the cost of providing the amenity and/or the value or benefit to the community, not the value to the developer. To that end, the analysis presented in this memorandum uses an incremental construction cost approach to value the café by evaluating the specific project costs associated with constructing the café space, net of all costs that the developer would incur regardless of whether the café is included in the project. Removing the costs that the developer would incur regardless avoids overestimating the actual cost of providing the amenity to the developer and results in a more reasonable valuation of the amenities. The incremental construction cost approach is appropriate in this situation because it captures the cost of including the proposed café in the project, thereby reflecting the value of the café as a contribution to community amenities, rather than the value that the café generates for the owner of the project.

To estimate the value of the BMR units, the applicant's valuation used a total development cost approach and then divided that total development cost by the number of residential units. This is similar to the applicant's valuation of the café space, in that the applicant provided an estimate of the market value to the property owner of the amenity in both instances, albeit using two different approaches to estimate market value, not the value or benefit to the community. As discussed above, this market value is focused on the value to the developer and tends to provide an overstated value conclusion. Because these are amenities for the community, a more balanced approach to valuation is appropriate to identify a fair and reasonable value of the amenity. Therefore, the methodology for valuing the BMR units should focus on the incremental cost to construct the components of the project that would constitute the amenity, net of all costs that the developer would incur regardless of whether these components are included in the project. The analysis presented in this memorandum uses an incremental construction cost approach to assign a value to the BMR units that is analogous to the approach used to assign a value to the café space. Unlike the total development cost approach, the incremental construction cost approach avoids overestimating the actual cost to the developer to construct the two BMR units by excluding costs that the developer would incur even if these units were not included in the project.

Amenity Value Findings

Table 1 below provides a summary of the value of the applicant's community amenities proposal as provided by the applicant and as evaluated in this memorandum. As shown, BAE found the value of the proposed amenity to be equal to $1,661,728 or $888,272 lower than the required $2.55 million value.

Table 1: Summary of Community Amenity Proposal Valuation for Proposed Menlo Uptown Project

	Dedication of Two Additional BMR Units	**Café Space**	**Total**	**Shortfall (Compared to $2.55 million required)**
Applicant Valuation	$1,860,000 *Methodology: Market value estimate based on total development cost*	$870,000 *Methodology: Market value estimate based on capitalized value*	$2,730,000	**N/A**
BAE Evaluation	$1,122,850 *Methodology: Incremental Construction Cost*	$538,878 *Methodology: Incremental Construction Cost*	$1,661,728	**($888,272)**

Project Description

The proposed project at 111 Independence Drive in Menlo Park consists of 105 multifamily rental units along with a 746 square foot café space on the ground floor of the residential building. The project site is located within the Bayfront Area of Menlo Park and the project applicant is seeking approvals to construct the project at the bonus level of development pursuant to the City's community amenities program for the Residential Mixed-Use Bonus (R-MU-B) zoning district. The R-MU-B zoning district allows a project to develop at a greater level of intensity with an increase in density, floor area ratio, and/or height in exchange for providing community amenities, which are intended to address identified community needs that result from the effect of the increased development intensity on the surrounding community. Community amenities also enable the surrounding community to benefit from the substantial increase in project value that is attributable to the increase in density, floor area, and/or height. Full project details are available on the City of Menlo Park website (https://www.menlopark.org/1571/111-Independence-Drive).

Community Amenities Proposal

Because the project would be built at the bonus level of development, the project applicant is required to provide community amenities in exchange for the additional development potential that is allowable under the bonus level of development. In the case of the subject project, an appraisal commissioned by the City (available on the City website at the link shown above) determined that the value of the community amenity must equal $2,550,000.

The project applicant has provided a community amenities proposal that consists of (a) two one-bedroom BMR units that would be affordable to low-income households, and (b) a 746 square foot café space. In addition to the two one-bedroom BMR units that would count toward the applicant's community amenity contribution, the project would include an additional 14 BMR units that are required to meet the City's BMR Housing Program requirements for the project, which would not count toward the community amenity requirement for the project. In accordance with the City's BMR Housing Program, all BMR units in the project would be required to remain affordable for 55 years.

Valuation of Community Amenities Proposal

The project applicant has provided an assessment of the value of the community amenity proposal described above. This section describes the applicant's methodology for assigning a value to each component of the proposal, presents BAE's methodology for assigning a value to each component, and provides BAE's determination of the value of each component.

The valuation approach submitted by the applicant essentially provides estimates of the market value to the owner of the components of the project that would count toward the community amenity requirement. The market value of a project or a component of a project can be estimated based on 1) the total development cost for the project, 2) the sale price of recently-sold, comparable properties, and/or 3) the capitalized value of the property. The capitalized value of an investment property is equal to the net operating income that the property produces on an annual basis (i.e., rental income less vacancy and operating expenses) divided by the capitalization rate (cap rate). The cap rate is a common metric used to estimate the value of a property based on the rental income it produces, and varies based on property type, location, and other property-specific characteristics. The valuation submitted by the project applicant used a total development cost approach to value the two BMR units and a capitalized value approach to value the café space. Both of these methods estimate the market value of the proposed amenities, which the developer would then own, hold, and receive at sale. In other words, the market value reflects the benefit to the property owner due to their inclusion of the café and BMR units in the project, not the value or benefit to the community. As discussed above, the focus of the community amenities requirement is not on the value of the amenities to the developer, but on the value or benefit to the community which experiences the effects attributable to the increase in density, floor area, or height at the bonus level of development. Because the market value of the project approach to value the amenities – whether estimated based on total construction cost, capitalized value, or another method – is developer focused, it tends to overstate the value conclusion. Therefore, a more reasonable and balanced valuation approach is required to ensure the community obtains the benefit or value anticipated in exchange for the effects of increased density, floor area, or height.

Rather than the total development cost and cap rate method for determining market value, BAE evaluated the community amenities proposal based on the incremental cost to the developer associated with constructing the components of the project that would comprise the community amenities, after factoring out development costs that the developer would incur regardless of whether the project includes these components. Removing the costs that the developer would incur regardless avoids overestimating the actual cost to developer (and thus overestimating the value of the amenities). The incremental construction cost approach values the proposal based on the estimated added cost associated with including the community amenities, not in terms of the value that the developer would gain from including these components in the project, but the cost to provide the amenities to benefit the community. The incremental construction cost approach is therefore the most appropriate method for valuing these components of the project as community amenities as it reflects the value/benefit to the community.

Valuation of BMR Units

The project applicant's community amenities valuation estimated the value of the two one-bedroom BMR units based on a total development cost approach that assigned a value to each BMR unit based on total project development costs, divided by the number of units in the project. BAE's analysis instead valued the two BMR units based on the estimated incremental cost associated with constructing the two units that would not be incurred if the units were not included in the project.

Project Applicant Valuation of BMR Units. The applicant's valuation of the two BMR units is based on an estimate of the total per-unit development cost for the proposed project, plus an estimate of the per-unit land value for the project site. The applicant's total development cost estimate for the project includes approximately $61.8 million in hard costs, $12.4 million in soft costs, and $11.1 million in developer fee and profit, totaling $85.2 million before accounting for land. The project applicant estimates a land value of $12.8 million for the project site. Therefore, the developer's total valuation of the project equals $98.0 million, or $933,639 per unit ($98,032,084 total estimated project valuation ÷ 105 units in project). Based on this estimate, the applicant's valuation assesses the value of the two BMR units at $1.86 million ($930,000 per unit x 2 BMR units). These calculations are shown in Table 2 below.

Table 2: Applicant Valuation of BMR Units Provided as a Community Amenity

	Total	Per Unit
Hard Cost Estimate	$61,754,409	$588,137
Soft Costs (20% of Hard Costs)	$12,350,882	$117,627
Developer Fee & Profit (15% of Total Costs)	$11,115,794	$105,865
Total Development Costs (Excl. Land Value	$85,221,084	$811,629
Estimated Land Value	$12,811,000	$122,010
Total Estimated Value	$98,032,084	$933,639
Rounded Value		$930,000
Per-Unit Value x 2 BMR Units		**$1,860,000**
Units in Project		105

Sources: SP Menlo LLC, 2020; BAE, 2020.

The applicant's total development cost approach includes in the cost of the BMR units many costs that the developer would incur regardless of whether the two BMR units were included in the project, and therefore overestimates the incremental cost associated with providing these two units. Many of the costs associated with developing the project, such as construction costs for tenant amenity space and site work, would be incurred regardless and are not affected by the inclusion of the two additional BMR units, and therefore are not part of the incremental cost associated with providing the two BMR units as a community amenity.

BAE Valuation of BMR Units. BAE assessed the community amenities value of the two BMR units based on the estimated incremental cost to construct these units, net of all costs that the project applicant would incur regardless of whether these units are included in the project. To estimate the incremental cost to construct the units, BAE used a project construction budget provided by the applicant as an attachment to the applicant's community amenities valuation report. BAE evaluated the applicant's project construction budget and determined that the cost assumptions are reasonable since the project would require Type IIIA construction due to the height of the proposed building. The construction budget divides the total construction hard costs between residential space, tenant amenity space, and the parking garage. To estimate the incremental cost to provide the two BMR units, this analysis evaluated the cost of residential space and the garage but omitted the cost of tenant amenity space. Tenant amenities in the proposed project would include a fitness center, pool, and dog washing station, among other items. These tenant amenities are provided to attract tenants to the project and would be provided regardless of the additional two BMR units. The cost of constructing these tenant amenities is not contingent on the addition of the two BMR units and would be included in the project even if these two additional BMR units were not included in the project. BAE then adjusted the hard cost estimates for residential space and the garage to remove line items that would not be directly impacted by the construction of the two BMR units. This analysis assumes that costs for items such as demolition, sitework, landscaping, the foundation, and the roof would essentially be unchanged by the inclusion of the two additional BMR units and associated parking in the project, compared to a scenario in which the project has two fewer units. These calculations result in estimated hard costs totaling $402,768 per BMR unit and $65,086 per parking space. This analysis applies a 20 percent soft cost assumption to these hard cost estimates, consistent with the developer's estimate, to determine total construction costs per residential unit and per parking space.

Table 3 below shows the resulting adjusted cost per residential unit and per parking space in the project and applies these costs to the two BMR units, assuming one parking space per BMR unit. As shown, this analysis results in an estimated value of $1,122,850 for the two BMR units, or $561,425 per BMR unit.

Table 3: BAE Valuation of BMR Units Provided as a Community Amenity

		Residential	Parking Garage
Total Hard Cost for Project (a)		$45,566,340	$8,833,289
Less: Hard Costs Line Items not included in Incremental BMR Unit Const. Cost (a) (b)		($3,275,728)	($1,738,887)
Total Hard Costs for Line Items included in Incremental BMR Unit Const. Cost		$42,290,612	$7,094,402
per Unit / Parking Space		*$402,768*	*$65,086*
	2 BMR Units	**Parking for 2 BMR Units**	**Total Cost, 2 BMR Units**
Total Hard Construction Costs	$805,535	$130,173	$935,708
Soft Costs	$161,107	$26,035	$187,142
Total Café Construction Costs	**$966,643**	**$156,207**	**$1,122,850**
Assumptions			
Total Units in Project	105		
BMR Units Provided as a Community Amenity	2		
Total Parking Spaces in Project	109		
BMR Unit Parking Spaces	2		
Soft Costs as a % of Hard Costs	20%		

Notes:
(a) Hard cost estimates are based on the construction budget provided by the project applicant.
(b) Analysis assumes that hard costs items shown in the budget as demo, earthwork, and sitework; landscaping & irrigation; foundation; and roofing & WP are not included in the incremental project cost attributable to the construction of the two BMR units that would serve as a community amenity or the two parking spaces that would serve these units.

Sources: Project construction budget as attached to Joseph J. Blake and Associates, Inc. Review of Appraisal Report, October 15, 2020; BAE, 2020.

Valuation of Café Space

The applicant's valuation of the café space as a community amenity is based on the capitalized value of the space upon completion of the project. This is a different approach than the total development cost approach that the applicant's valuation used to estimate the value the BMR units, though both the capitalized value and total development cost approach can be used to estimate the market value of the project components. Similar to the applicant's valuation of the BMR units, the applicant's valuation of the café provides an estimate of the market value of the café space from the perspective of the value to the developer or a potential future buyer. This value is retained by the property owner in the form of a real estate asset and tends to reach the highest valuation conclusion, not the value to the community.

Because the intent of the community amenities program is to address community needs, the amenity should instead be valued based on the cost to provide the project components that would serve as an amenity. BAE's methodology for estimating the value or the café space uses the same incremental construction cost methodology that BAE used to evaluate the BMR units. This approach avoids overestimating the actual cost to the developer and more accurately captures the cost of the amenity, or only the cost of the café space which is the amenity. This approach provides a more accurate estimate of the value of the amenity to community, not to the developer, to ensure the community obtains the exchange anticipated with the bonus level of development.

Applicant Valuation of Café Space. The applicant's valuation of the café space is based on an estimated capitalized value of the café component of the project, i.e. what does the café space add to the overall value of the project to the developer or to a buyer, not what is the value to the community. The applicant estimates that the café will generate $5.00 per square foot per month in gross rental income, or $42,780 per year. After accounting for a 5.0 percent vacancy allowance and 4.0 operating expense deduction, the applicant estimates that the space will generate $39,015 per year in net operating income. Using the applicant's assumed cap rate of 4.5 percent, the café space would be valued at $867,008 ($39,015 in net operating income ÷ a 4.5 percent cap rate), which the applicant rounded to $870,000. This methodology essentially estimates the amount that the café space would contribute to the overall sale price of the proposed project if a hypothetical buyer were to purchase the project after completion and stabilization. BAE is not recommending that the City value the café space based on this methodology, and therefore did not conduct a detailed evaluation of the individual assumptions that the developer used to determine a value based on this approach.

BAE Valuation of Café Space. Similar to BAE's evaluation of the BMR unit value, BAE's valuation of the café space is based on the incremental cost associated with constructing the café space. BAE's analysis of the incremental costs to construct the café space is based on the same project construction budget from the applicant that BAE used to estimate the value of the BMR units, with similar adjustments to show only those costs associated with constructing the café space. The project construction budget for amenities space includes the cost of resident-serving amenities as well as the café space, which in total comprise 10,130 square feet of the project as shown in the budget. BAE adjusted the hard cost estimate for the amenities space to remove line items that would not be impacted by the construction of the café space itself to estimate the hard cost per square foot for only those hard cost line items that would be included in the incremental construction cost for the café space, equal to $427 per square foot. This per square foot cost was then applied to the 746 square foot café space to generate a total hard cost estimate for the café space totaling $318,893. After incorporating a 20 percent soft cost assumption, consistent with the applicant's soft cost assumption as cited above, this analysis provides a total construction cost estimate for the café totaling $382,671. The analysis assumes two parking spaces to serve the café space at the same cost per space as the parking spaces that would serve the BMR units ($65,086 hard cost per space plus 20 percent soft costs) and adds this cost to the cost of constructing the café space. This analysis uses the resulting total construction cost estimate as the value of the café as a community amenity.

Table 4: BAE Valuation of Café Space as a Community Amenity

	Amenities Space	Parking Garage
Total Hard Cost for Project (a)	$7,354,780	$8,833,289
Less: Hard Costs Line Items not Included in Incremental Café Construction Cost (a) (b)	($3,024,510)	($1,738,887)
Total Hard Costs for Line Items Included to Café Construction Cost	$4,330,270	$7,094,402
per Amenties Square Foot / Parking Space	*$427*	*$65,086*

	Café Space	Café Parking	Total Café Cost
Total Hard Construction Costs	$318,893	$130,173	$449,065
Soft Costs	$63,779	$26,035	$89,813
Total Café Construction Costs	**$382,671**	**$156,207**	**$538,878**

Assumptions	
Total Amenities Square Footage in Project (a)	10,130
Café Square Footage	746
Total Parking Spaces in Project	109
Café Parking Spaces	2
Soft Costs as a % of Hard Costs	20%

Notes:
(a) Hard cost and total project square footage estimates are based on the construction budget provided by the project applicant.
(b) Analysis assumes that hard costs items shown in the budget as demo, earthwork, and sitework; landscaping & irrigation; foundation; roofing & WP; furnishings; and special construction are not included in the incremental project cost attributable to the construction of the café.

Sources: Project construction budget as attached to Joseph J. Blake and Associates, Inc. Review of Appraisal Report, October 15, 2020; BAE, 2020.

Summary of Determination of Community Amenity Value

Table 5 below provides a summary of BAE's determination of the value of the community amenity proposal for the proposed project. The value shown includes the value of the two BMR units and café space based on BAE's methodology as described above. As shown, this analysis estimates that the value of the proposed community amenity package totals $1,661,728, which is $888,272 less than the required amenity value of $2.55 million.

Table 5: BAE Valuation of Community Amenity Proposal

Value of Providing Two Additional BMR Units	$1,122,850
Value of Café Space	$538,878
Total Value of Community Amenity Proposal	**$1,661,728**
Required Amenity Value	$2,550,000
Excess / (Shortfall) Community Amenity Value	**($888,272)**

Source: BAE, 2020.