City of Austin

MEMO

Neighborhood Housing and Community Development
P.O. Box 1088, Austin, TX 78767 -1088
(512) 974-3100 ◆ Fax (512) 974-3112 ◆ www.austintexas.gov/housing

Date: April 6, 2017

To: Mayor and City Council

From: Rosie Truelove, Interim Director
Neighborhood Housing and Community Development

Lauraine Rizer, Officer of Real Estate
Office of Real Estate Services

Subject: City Council Back-up for Austin Oaks Planned Unit Development (PUD)

Please find attached information to serve as additional back-up for the Austin Oaks Planned Unit Development (PUD). Responsive to several questions from Council, staff with Neighborhood Housing and Community Development Department (NHCD) and the Office of Real Estate Services solicited external expertise to evaluate information related to the Austin Oaks PUD, to assist in informing Council's decision on third reading of the PUD ordinance.

Please contact Regina Copic, NHCD's Real Estate and Development Manager, at 512.974.3180, for additional information.

MEMORANDUM

To: Rosie Truelove, Austin Neighborhood Housing and Community Development

Cc: Bert Lumbreras, Assistant City Manager
Lauraine Rizer, Office of Real Estate Services

From: Darin Smith

Subject: Review of Financial Analysis for Austin Oaks PUD Community Benefits; EPS Project #171048

Date: April 6, 2017

At the request of the City of Austin's Neighborhood Housing and Community Development (NHCD) and Office of Real Estate Services (ORES), Economic & Planning Systems (EPS) has reviewed calculations prepared by Austin staff regarding the value of additional entitlements being contemplated for the Austin Oaks PUD, as well as the cost of community benefits that may be requested in exchange for the enhanced entitlements. The City Council has deliberated multiple approaches to this entitlement, and most recently has focused on allowing the developer to construct an additional 40,000 square feet of office space in the mixed-use project in exchange for providing a certain number of apartments at prices affordable at 60 percent of Area Median Income.

EPS has been asked to provide this review because of our firm's experience conducting financial analysis for real estate projects and public policy deliberations throughout the United States, including numerous engagements for private developers as well as public clients exploring the feasibility of providing community benefits through new development. We also have extensive experience on Austin-area projects, including recent or current assignments for NHCD, ORES, and the City's Economic Development and Planning and Zoning Departments, as well as ongoing work on public-private development projects for Central Health and Travis County. Through these experiences, EPS can provide insights regarding developers' property valuation approaches that are central to the deliberation regarding the potential community benefits for the Austin Oaks PUD.

Our findings from this review are as follows:

The Economics of Land Use

Economic & Planning Systems, Inc.
One Kaiser Plaza, Suite 1410
Oakland, CA 94612-3604
510.841.9190 tel
510.740.2080 fax

Oakland
Sacramento
Denver
Los Angeles

www.epsys.com

- **The use of The Domain as a comparable project appears to be reasonable.**

  While The Domain is roughly 3 miles from the Austin Oaks property, they both are located in the same general area of the City, and roughly equidistant from the junction of the MoPac Expressway and Highway 183. Like The Domain, Austin Oaks plans to include a mix of retail, housing, and office space. EPS is not aware of any other recently constructed, mixed-use developments that are nearer to nor more comparable to the development that is proposed for Austin Oaks.

- **ORES has reasonably estimated that the 40,000 square feet of additional office space confers roughly $1.65 million in added value to the property owner.**

  The value of the enhanced entitlement is reflected in the "residual land value" that the property owner can generate from the allowable uses. The residual land value is the difference between what a building is worth when completed and the cost to construct the building, including an appropriate developer profit.

  Without having specific information regarding project design, soil conditions, and other factors that can influence development costs, ORES has used a widely recognized and authoritative industry source for estimating the development costs for new Class A office space as envisioned for Austin Oaks. In EPS's opinion, ORES has also used appropriate assumptions regarding development budget contingencies and profit margins for this type of development. The cost of land is not included in these development costs, because the added office space will be constructed on the same amount of land rather than requiring additional land acquisition. Based on the assumptions and approaches used by ORES, the cost of developing the additional 40,000 square feet of office space is estimated at roughly $10.04 million.

  To estimate the value of the added office space, ORES has projected market-oriented lease rates comparable to those achieved at The Domain, and vacancy rates and operating expenses comparable to the market standards according to published sources to estimate the Net Operating Income from the space. That Net Operating Income is then divided by a "capitalization rate" to estimate the long-term value of that space. Published capitalization rates typically reflect transactions on existing properties with stable tenant occupancies and a proven track record in their competitive market. When estimating the value of speculative office space not yet constructed and occupied, in EPS's experience it is typical to use a capitalization rate that is slightly higher (and thus yields lower values) than transaction-based and surveyed rates to reflect the added development, financing, and market risks of such a project. ORES' current assumptions appropriately reflect such an adjustment to the capitalization rate. The resulting value of the 40,000 square feet of additional office space is estimated at $11.69 million.

  This analysis indicates that the value of the additional 40,000 square feet of office space will exceed the cost to develop that space by roughly $1.65 million, and that the Austin Oaks property will be worth that much more for development than it would without the added office space. This figure is thus an appropriate metric against which to balance the cost of any additional community benefits being required of the Austin Oaks PUD.

It is worth noting that in a previous analysis presented to City Council, ORES used some different assumptions than have been used in the updated analysis. These included the assumption that the added office space would sum to 25,000 square feet rather than 40,000, and that the office space at Austin Oaks would be "Class B" rather than "Class A" space. EPS understands that these assumptions were compiled and calculations presented to reflect a "generic" Class B office space in the Austin Oaks location, and that ORES has since received more information regarding the design and market orientation of the project that have caused ORES to reconsider and adjust these assumptions and calculations. EPS believes ORES' updated assumptions are appropriate and yield a more reliable result.

- **NHCD has reasonably estimated the cost to the developer of providing affordable housing units at 60 percent of Area Median Income.**

The calculations provided by NHCD determine the annual difference in achievable rents between market-rate units and income-restricted affordable units, and then calculate the difference to the developer over the 40-year period of the affordability restriction. In this way, these calculations reflect the "opportunity cost" of what the developer might have received but for the affordability restriction – an appropriate approach in EPS's opinion.

In calculations previously presented to City Council in a letter dated March 20, 2017, NHCD first estimated the potential market-rate rents based on the rates achieved at The Domain. From this figure, NHCD subtracted the maximum rent affordable at 60 percent of Area Median Income to determine the difference in gross income per unit. Assuming that operating costs are the same whether the unit is affordable or market-rate – a reasonable assumption in EPS's opinion – this difference in gross income is also the difference in net operating income. For a 1-bedroom unit, NHCD has estimated this difference to be $10,839 per year in 2017 dollars, and for a 2-bedroom unit the difference is estimated at $17,916 per year.

At this point, NHCD could take any of three approaches that yield similar results regarding the long-term opportunity cost of the affordability restriction. The first approach, which was previously provided by NHCD to City Council, estimates the income difference in each of the 40 years of the affordability restriction and then calculates the Net Present Value of that difference in Year 2017 dollars. NHCD did not inflate the income difference over time, instead keeping the figures "constant" to reflect the value of the difference in today's spending power. NHCD then used a 4 percent discount rate for the Net Present Value calculation, meaning that the developer would value a $100 difference in spending power *next year* at roughly $96 *this year*. The discount rate reflects the "time value of money," or the fact that over time a reasonably shrewd investor could expect to receive a return on their investment commensurate with the risk of the investment. In this case, EPS considers the 4 percent discount rate to be reasonable because it echoes the current market standard for valuing stabilized first-class apartments in a strong market such as Austin; investors are paying purchase prices for quality apartment buildings on the expectation that the income they receive from that building in its first year will equal 4 percent of their purchase price. Using these assumptions, NHCD previously estimated that these opportunity cost figures would be $214,474 and $354,607 for the 1- and 2-bedroom units, respectively.

While convenient for calculation purposes, the assumption that the difference between market-rate and affordable rents will remain constant is unlikely to be true, as inflation should increase both these rent figures over time. For this reason, the developer has suggested that inflation should be included in the calculation of the opportunity cost of the units' affordability. NHCD attempted to reflect this by inflating the difference in achievable rents (market-rate vs. affordable) by 3 percent annually for the 40-year term. As a result, the annual rent difference and opportunity cost grew significantly from those derived under the first approach, as reported to Council in NHCD's letter dated March 20, 2017. However, EPS believes NHCD erred by inflating the annual income differences but using the same 4 percent discount rate as under the first approach. This would mean that the developer would value $103 in nominal dollars received next year (or $100 in today's buying power) at $99 today – effectively only discounting the "real" value of those dollars by 1 percent. In EPS's experience, this discount rate underestimates the "time value of money," as any reasonably shrewd investor could achieve a 1 percent return on investment for virtually no risk or effort – certainly well below the market risks and management efforts involved in any real estate property, even in a strong and stable market like Austin. Instead, EPS recommends that the discount rate used on an inflated cash flow be increased by the assumed rate of inflation – in this case, from 4 to 7 percent – to reflect the difference in real spending power as well as the opportunity cost and risk associated with delayed revenues. With 3 percent inflation of annual rent differences and a 7 percent discount rate on those annual differences over 40 years, the net present value of the opportunity cost is $218,709 and $351,501 for the 1- and 2-bedroom units, respectively – very close to the results under the first approach.

The third approach would be to simply capitalize the first year's annual difference in Net Operating Income using an appropriate capitalization rate. Again assuming that the capitalization rate prior to new construction would be 1.0 percentage points higher than it is for existing stabilized properties – as used for the office valuation noted above – a 5.0 percent capitalization rate would yield an opportunity cost of $216,720 and $358,320 for the 1- and 2-bedroom units, respectively– again, very similar to the figures derived under the first and second approaches described above.

Based on these alternative calculations, each of which EPS considers to be reasonable, the opportunity costs for a 1-bedroom unit at 60 percent of Area Median Income is estimated at roughly $215,000, and for a 2-bedroom unit the figure would be roughly $355,000.

Darin Smith

Managing Principal

Education

Master of City Planning, University of Pennsylvania, 1997.

Bachelor of Arts in Psychology, University of Pennsylvania, 1993.

Previous Employment

Real Estate and Urban Planning Consultant, ZHA, Inc., Annapolis MD (1997-2000)

Retail Site Selection Consultant, Pep Boys, Inc., Philadelphia, PA (1996-1997)

Honors + Awards

Congress for the New Urbanism “Award of Excellence” 2001 – Robert Mueller Municipal Airport Reuse Plan, Austin, TX

FTA/FHWA/APA “Transportation Planning Excellence Award” 2004 – Valley Metro Rail Station Development Opportunities and Strategies, Phoenix, AZ

California APA “Award of Merit for Planning Implementation” 2002 – Sonoma County Housing Element, Sonoma County, CA

California AIA and APA “Ahwahnee Award of Honor” 2002 – Hayward Cannery Area Design Plan

Speaker – Best Practices in Transit-Oriented Development, Rail~Volution National Conference, 2007, 2008, 2010, and 2012

Panelist – Urban Land Institute “Transit-Oriented Development Marketplace,” 2007, 2008 and 2009

Panelist – California APA Conference “Local Solutions for Affordable Housing,” 2015

About

Darin Smith is a real estate economist with broad experience providing strategic advice to public and private clients on the economic and financial dimensions of land use and real estate development. He has particular expertise in complex, urban reuse and redevelopment projects, and in the negotiation of public/private development and financing agreements. Mr. Smith has also helped numerous clients to optimize opportunities for transit-oriented development, as well as creating strategies and policies to promote the creation of affordable housing and the revitalization of downtown areas.

Selected Real Estate Development and Management Project Experience

VTA Joint Development Strategies and Negotiations, San Jose, CA
For VTA, EPS evaluated development and revenue generation prospects for the agency’s overall real estate holdings, made market-based recommendations for specific development and land acquisition opportunities, and provided assistance in evaluating development proposals for specific projects.

BART Real Estate Portfolio, Bay Area, CA
For BART, EPS evaluated the market, regulatory, physical and political conditions affecting development opportunities at 49 stations, and prepared a strategy for property retention or disposition to enhance BART’s ridership and revenues.

BART Joint Development Projects, Bay Area, CA
For the Bay Area Rapid Transit District, EPS provided market and feasibility analysis, land value estimations, review of developer qualifications and proposals, and negotiation support for business terms for numerous public/private deals.

Mueller Airport and Other Public Property Reuse Negotiations, Austin, TX
For the City of Austin, EPS provided market and feasibility analysis for the reuse plan for the former Austin airport and other City-owned properties, and assisted in the solicitation and negotiation of master development agreements, including the creation of innovative financing strategies.

San Mateo Corporation Yard Redevelopment, San Mateo, CA
For the City of San Mateo, EPS provided market and feasibility analysis for developing a public property, and then assisted with the evaluation of developer proposals for affordable housing.

Denver RTD Ground Lease Negotiations, Denver, CO
For the Regional Transit District, EPS evaluated a developer’s proposals to renew, amend, or buy-out a ground lease for an existing downtown office tower.

Selected Economic and Financial Impact Analysis Project Experience

Central Health Medical Campus Redevelopment, Austin, TX
For the Central Health district, EPS is part of a multidisciplinary team evaluating market opportunities, financial feasibility, and projected revenues from alternative reuse scenarios for a closing hospital campus.

SELECTED ECONOMIC AND FINANCIAL IMPACT ANALYSIS PROJECT EXPERIENCE (CONTINUED)

TIGER Grant Benefit-Cost Analysis, Santa Clara County

For Santa Clara County and VTA, EPS has provided Benefit-Cost Analyses in support of grant applications for federal transportation funding.

High Speed Rail Economic Impact Analysis, Palo Alto, CA

For the City of Palo Alto, EPS projected the economic impacts on property values and business activity that would result from operation of the planned high-speed rail line through the City.

Coyote Valley Specific Plan, San Jose, CA

For the City of San Jose, EPS prepared market and feasibility analysis, fiscal impact analyses, and financing strategies for public facilities, public services, and community benefits for a large master plan area.

SELECTED PUBLIC FINANCE PROJECT EXPERIENCE

West San Carlos and South Bascom Urban Villages, San Jose, CA

For City of San Jose, EPS evaluated a variety of traditional and innovative “value-capture” financing tools for placemaking infrastructure in two Urban Village plans.

Transbay Center District Financing Plan, San Francisco, CA

For the City of San Francisco, EPS created a “value capture” financing strategy to generate funding for planned infrastructure from new station area development.

Transit Benefit Assessment District Feasibility, Bay Area, CA

For BART, EPS is evaluating opportunities to create benefit assessment districts to fund infrastructure and service improvements around transit stations.

Lawrence Station Area Financing Plan, Sunnyvale, CA

For the City of Sunnyvale, EPS prepared market analysis, development programming, and a financing plan for infrastructure and public facilities around a Caltrain station.

Freeway Cap Park Financing Plans, Los Angeles, CA

EPS is currently exploring options to fund the Park 101 and Hollywood Central Park freeway cap projects in Los Angeles, evaluating tools ranging from EIFDs and other tax-increment based approaches and development value-capture approaches through federal funding and philanthropic contributions.

SELECTED AFFORDABLE HOUSING EXPERTISE

Affordable Housing Feasibility Studies and Strategies

For numerous private developers and public cities and transit agencies, EPS has analyzed the feasibility of various approaches to affordable housing, including broad inclusionary requirements and incentive programs, as well as narrower, project-specific solutions. EPS has also led negotiations for affordable housing programs as part of our practice in public/private development solicitation and implementation.

Affordable Housing Nexus Fee Studies

For Mountain View, Sunnyvale, San Mateo, Pleasanton, Santa Rosa, Walnut Creek, and Sonoma County, EPS has prepared nexus studies documenting the link between the development and occupancy of new market-rate housing and the demand for affordable housing, and recommending fees to mitigate these impacts.

Nonresidential Linkage Fee Studies

For Sunnyvale, Pleasanton, Walnut Creek, Rohnert Park, Sonoma County, Goleta, and Alameda, EPS has determined the housing needs created by new retail, office, and industrial development, recommended fee programs to mitigate those impacts, and in some cases drafted linkage fee ordinances that have been adopted.

Affordable Housing Inclusionary Zoning Programs and In-Lieu Fees

For the Cities of Laguna Beach, Gilroy, Larkspur, San Bruno, Goleta, and Newport Beach and the County of Sonoma, EPS has prepared ordinances requiring developers to provide affordable units within their market-rate developments or, under certain circumstances, to pay fees in-lieu of providing affordable units.