Appendix 6

Memorandum
re Vallco Initiative/9212 Report

by
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March 24, 2016

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MEMORANDUM

TO: Elizabeth Seifel
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FROM: David Greensfelder

RE: **Vallco Initiative / 9212 Report**

DATE: March 24, 2016

In 2014, Greensfelder Commercial Real Estate LLC prepared a Retail Strategy Report (the "2014 Report") for the City of Cupertino. As part of the City's overall growth management system, Cupertino's General Plan establishes a development allocation system for commercial (retail), office, hotel room and residential growth. The 2014 Report was part of a larger planning effort to inform the future development allocations that would be made as part of a proposed general plan amendment process. The 2014 Report also addressed the suitability for [re]development of the Vallco Shopping Center in depth.

Greensfelder has been asked to evaluate the potential impact of an Initiative that would modify the General Plan by changing the allowable development allocations in the Vallco Shopping District, where Vallco Shopping Center is located, and altering other land use provisions in the General Plan. (Please refer to the Analysis of the Potential Impact of the Initiative on Vallco section of this memorandum for a summary description of the Initiative.) As part of this analysis, Greensfelder reviewed and updated key data and findings in the 2014 Report that are particularly relevant to the Vallco Shopping Center and the analysis of the Initiative.

This memorandum serves as a technical appendix to the Election Code 9212 Analysis of the Initiative and is organized into the following sections:

I. Executive Summary

II. Organizing Principles for Discussing Retail and Shopping Centers

III. Regional Mall and Department Store Trends

IV. Vallco-specific Findings

V. Analysis of the Potential Impact of the Initiative on Vallco

Executive Summary

This executive summary presents the major findings discussed in this memorandum and begins with an overview of key retail trends affecting both retail and shopping malls like Vallco:

- Mall retailers who do a better job of differentiating themselves from competitors are consolidating into fewer, high performing Class A regional malls, and an increasingly wide divide is developing between higher performing Class A malls and lower performing Class C malls of which Vallco is an excellent example.

  - Today's successful malls are predominantly comprised of "specialty" retailers that need to draw customers from a broad retail trade area.
  - Vallco operates in a retail trade area where there is an oversupply of mall space.
  - Mall leasing and operation is a highly competitive business.
  - The accelerating rate at which Class A malls are differentiating themselves from Class B and C malls is definitive evidence that Vallco's circumstance is not unique.
  - Department stores and big box retailers have consolidated within their respective categories.
  - Many retailers have experienced financial and operational challenges including Macy's, Sears and JC Penney, all of which were anchors at Vallco before their closure.

- Technology has changed shopping, particularly for commodity goods. Multiple retail "channels" now compete against traditional "bricks and mortar" retail.

  - An increasing number of retailers sell through multiple retail channels and try to create an "omnichannel" experience for the consumer.
  - This trend has resulted in the closure of some "bricks and mortar" retailers, while it has also provided some more nimble and responsive retailers with new opportunities to reach consumers.
  - These trends have particularly forced commodity retailers to operate in an ever-changing environment. This competitive environment combined with continued consolidation amongst commodity retailers means there will be fewer tenants available to fill space should Vallco be reimaged as a so-called power center.

- Retail must constantly reinvent itself to stay "fresh" and relevant to customers.

  - Mall operators and retailers alike must build rapport and excitement with their customers in order to create "want-based" as opposed to "need-based" specialty shopping experiences, and to retain a competitive edge.
  - Consumers are increasingly looking for well-designed and authentic destination retail environments where they not only can spend their free and recreational time, but where they can have a compelling "experience" while doing so.
  - The addition of residential and office space in a redeveloped Vallco provides greater opportunities to create a dynamic environment, and greater critical mass to support an active retail component.
  - An owner or developer with both expertise and deep financial capability is needed to execute a repositioning strategy at Vallco.

Specifically, current retail trends point to Valley Fair, Santana Row and Stanford Shopping Center continuing to dominate the retail market because all evidence points to the market having determined there is no need for another regional mall serving the Cupertino trade area.

The memorandum evaluates four potential development scenarios that could occur under the Adopted General Plan or the General Plan with Initiative. Each of these scenarios is evaluated based on the types of retail that might be supportable and attracted to Cupertino, the potential improvements that would be needed along with a high level estimate of required investment to accomplish anticipated development and its likelihood of success along with other considerations. The potential success of each of the listed scenarios is largely dependent on the market forces described in this memo.

Generally, the scenarios allowing Vallco to be redeveloped under the City's Adopted General Plan are the most likely scenarios, although the amount of successful retail is expected to be significantly less than presently exists at Vallco. The scenarios requiring Vallco to operate in its present format are generally not feasible. The specific findings for each scenario are presented below and additional findings are included in the Conclusion section of this memo. The summary conclusion from the evaluation of each scenario is shown below in italics:

- Adopted General Plan, which assumes full buildout of land uses throughout the City as allowed under the 2040 General Plan, including redevelopment of Vallco site.
  A mixed-use project with a smaller retail component has a much higher likelihood of success than preserving the existing Vallco mall in its present configuration.

- Adopted General Plan With Sand Hill Proposal, which is consistent with the first scenario with additional specificity based on what Sand Hill proposed in 2015.
  Allowing for a mix of land uses on the Vallco site has the greatest likelihood of success. The Sand Hill Proposal that includes 800 residential units and 2,000,000 square feet of office space has the potential to create a dynamic environment.

- General Plan With Initiative Assuming Vallco as Enhanced Mall, which assumes the mall can be preserved and rehabilitated to become a viable mall.
This scenario is not a feasible option from either a market or development perspective: Trying to preserve Vallco as it was decades ago will not attract new tenants or customers, especially customers who are drawn to vibrant, pedestrian-oriented retail environments. Rather, something substantively new and differentiated from competing projects must be created at Vallco in order to draw customer traffic. Without significant investment in redevelopment, Vallco is more likely to deteriorate as opposed to improve beyond its present 2016 level of occupancy (314,000 SF retail occupied).

- General Plan With Initiative Assuming Vallco With 2016 Occupancy, which assumes all three anchors remain closed and only a limited number of businesses remain occupied consistent with current conditions.
Vallco in its present configuration is unlikely to generate the incremental income required to justify investment in a significant renovation. The most likely outcome with the Initiative is that Vallco will remain in its current state, or it will continue to decline and face closure like many similar Class C malls across the United States.

Organizing Principles for Discussing Retail and Shopping Centers

A Brief History of Retail

By way of background, a brief history of how retail has evolved over the past century will provide context for this Report and its findings. In the early 20th century, cars were a rarity. Most towns and cities had downtown districts that served as the community's commercial hub and were characterized by a massing of retail that evolved to serve the community's needs. Towns often had their own homegrown department stores that sold a wide variety of goods. The best known examples of these include Emporium and May Co. on the West Coast, Dayton's and Marshall Field in the Midwest, and Filene's and Macy's in the Northeast. These were department stores in the truest sense, having separate departments under one roof for a variety of goods including clothing and shoes, electronics, housewares, books and records, pets, home goods, and the like.

When retail was clustered in a downtown or town square environment, there was not a need for today's ubiquitous suburban shopping center. In contrast, by the 1950's, the automobile became commonplace, and started a trend towards suburbanization. The need for shopping centers was born. Over a period of time, these malls replaced downtown shopping districts in the increasingly decentralized urban landscape.

As the advent of shopping malls began to erode the downtown shopping district's market share, discounters began to erode the traditional department store's market share. Walmart and Kmart started nationwide expansions. Even traditional department store companies began to enter this world, perhaps the most notable example being Dayton-Hudson's Target division. At the same time, the suburban regional mall would often be anchored by department store chains that expanded their market share by focusing on suburbs.

The next step in the evolution away from traditional department stores was the advent of retailers that became more efficient by specializing in a particular "department." Clustered together in what have come to be known as power centers, these "big box" and "category killer" stores were more convenient, focused narrowly on one category, but offered a wide variety of merchandise within that category, developed supply and distribution advantages extending from their narrower focus, and offered everyday low prices. They also started "killing off" the departments in the department stores. In-turn, department stores increased their focus on soft goods, thereby limiting the overall variety of merchandise and giving the consumer fewer reasons to visit.

Like with many businesses, department store chains began to consolidate in order to increase scale, decrease expenses, and maintain competitiveness … or simply to avoid going out of business altogether. By extension, the number and variety of regional mall anchor tenants contracted, and by the 1990's the contraction and consolidation trend of regional malls was in full swing. In some instances, even traditional department stores (Kohl's being one example) began to abandon malls and join the category killers in power centers. With fewer anchors, so-called "category killer" tenants finding each other in power centers, and the advent of the outer suburbs, fewer and fewer truly successful regional malls and even fewer downtown shopping districts remained.

Some department stores including Macy's, Sears, and JC Penney have evolved away from their all-things-under-one-roof model to more closely resemble commodity retailers. In other words, their product offerings are less distinguishable from what could be purchased in a variety of other places and through a variety of retail channels. Furthermore, with the exception of chains such as Nordstrom, Bloomingdale's, Neiman Marcus and the like, department stores have ceased to distinguish themselves for their service and environment.

With respect to so-called lifestyle and hybrid commodity-specialty projects, ULI's Professional Real Estate Development manual states: "Early lifestyle centers successfully combined desirable retail shops with appealing architecture and a variety of outdoor settings spawning the lifestyle center. ….These early centers were, in part driven by a trend in which small specialty retailers faced a shortage of high quality specialty retail space at the same moment that regional mall failures were accelerating. The dominant new commodity retail and shopping center formats had, in fact, left small store specialty retailers with few reliable anchors, and developers with no clearly defined shopping center template to replicate, spawning the ill-defined and somewhat chaotic lifestyle center concept."[1]

With the homogenization of department stores has come the demise of many regional malls, and the change in relative competitive positioning and performance of those that remain, which are now commonly classified as either Class "A," "B," and "C" malls. For purposes of this memo, we will use the following definitions, assembled from industry sources National Real Estate Investor and realtymogul.com:

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[1] ULI - Professional Real Estate Development The ULI Guide to the Business, 2012, By Richard Peiser, David Hamilton

A "Class A" mall is the dominant property in a major metropolitan market and the best performer in its retail trade area. (Malls typically draw from a retail trade area of up to 7 to 15 miles – in certain circumstances further - depending on the population density around it.) Often, Class A malls are newer or recently renovated properties, have the best locations, and are anchored by top anchor tenants. They contain top amenities, are professionally managed and demand the highest rent with little or no deferred maintenance issues. Their tenants have high sales per square foot (generally at least $400 per square foot), and they have low vacancy rates. A Class A mall will command the greatest investor interest, typically from institutional investors, owners, and operators.

A "Class B" mall is a non-dominant competitor in its retail trade area. A step down from Class A, these properties are generally older than Class A, tend to have lower retail sales per square foot (less than $400 per square foot), and may or may not be professionally managed. Rental income is typically lower than Class A. Although often well maintained, this type of mall typically has some deferred maintenance issues as the result of lower rental income, and likely is not up to current interior design standards. Many investors see this as a "value-add" investment opportunity (i.e. less expensive than a class "A" property) because through renovation and common area improvements, the property can be upgraded to Class A or Class B+.

A "Class C" mall is the weakest player and struggles to capture sales from its retail trade area due to competition from competing retail projects. A Class C mall typically has sales of less than $250 per square foot and is usually hobbled by a significant competitive disadvantage, such as inferior location, outdated physical layout, vacant anchor space, etc. These properties generally have the lowest rental rates in the retail trade area and need significant renovation including updating the building infrastructure and repositioning to get to steady cash flows for investors. Vallco is considered a Class C mall given its poor performance, challenging physical layout and poor historical retail performance.[2]

The San Francisco Bay Area has several high performing malls, including Valley Fair in San Jose and Stanford Shopping Center in Palo Alto, both of which are good examples of Class A malls on the Peninsula and in the South Bay. However, there are far more Class C malls like Vallco that have been unable to compete effectively. For example, nearby Westgate Shopping Center in San Jose was a Class C mall that was repositioned into a power center, and both San Antonio Center in Mountain View and Sunnyvale Town Center are Class C malls that are presently being repositioned. In the middle are Class B malls like Eastridge in San Jose and Stoneridge in Pleasanton. As retail has evolved to today's commodity versus specialty norm, some Class B and C malls will be revitalized or redeveloped while others will be repurposed into different projects altogether given the highly competitive retail environment within which malls currently operate.

[2] "Look Out Below," National Real Estate Investor, Kenneth Rogers, August 1, 2003. http://nreionline.com/retail/look-out-below
" What is Class A, Class B, or Class C property?", Jul 24, 2013, https://www.realtymogul.com/blog/what-is-class-a-class-b-or-class-c-property

Description of Commodity and Specialty Retail Classifications

As downtown shopping districts and regional malls declined, and big box, category killer retailers proliferated, and today's "commodity" versus "specialty" retail paradigm was born. This paradigm has transformed the retail landscape and is another key reason that Class C malls like Vallco have a tough time competing effectively.[3] This commodity versus specialty retail categorization was also described in the 2014 Report and is summarized below to explain how retail is currently organized, along with several other retail distinctions of relevance to this analysis.[4]

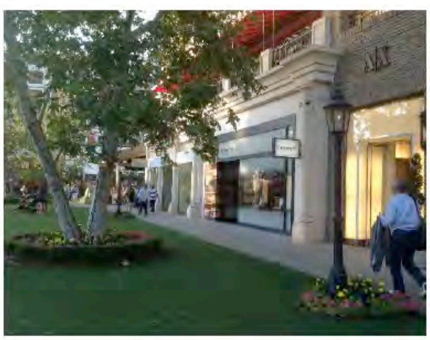
At its essence, today's shopping environment is about convenience and price versus experience. Commodity retail goods and services are those goods and services that are purchased and consumed on a regular basis from "primary" household funds, largely without emotional attachment by the consumer, and at retailers and retail shopping centers offering the consumer the combination of low price and convenience most suited to the consumer's needs at a particular moment. Examples of commodity retailers include local convenience stores, drug stores, grocery stores, discounters and warehouse stores. A "commodity shopping center" is the aggregation of a number of commodity retailers in one location, allowing for convenient cross-shopping.

[3] ULI - Professional Real Estate Development The ULI Guide to the Business, 2012, By Richard Peiser, David Hamilton

[4] Retail professionals use many terms to differentiate retail shopping choices and retailers, including terms such as "comparison goods," "convenience goods," "big-box," or "category killers," which refer to specific shopping preferences and the types of retail that align with them. The term "comparison goods" has traditionally been used to describe retail items that consumers do not purchase on a frequent basis (i.e. daily or weekly), and that are more likely to cause consumers to compare price, quality, and features than everyday items. Comparison goods might be either commodity goods or specialty goods. By contrast, a "convenience good" is something more likely purchased on a regular basis and is more likely a commodity as opposed to a specialty item. Good examples of convenience goods are those things that are regularly purchased at a grocery or a drug store. By definition, "convenience" or "comparison" goods could fit in either the commodity or specialty definitions described here. Shoppers are often willing to travel a greater distance to purchase comparison goods.

While habits may be developed over time (e.g. shopping at the same grocery store), consumers tend to view these retailers as interchangeable and do not to have a strong connection to a commodity retailer's brand or to a commodity shopping venue. For the most part, internet shopping is an option most consistent with purchasing commodity goods and services (see more in the discussion of omnichannel retail below).

Specialty retail goods and services, by contrast, are those goods and services that are purchased on an optional basis by consumers using "discretionary funds" (i.e. funds not designated for basics like rent, food, and transportation), and selected and often consumed during "free" or "discretionary" time (i.e. when not working or tending to daily responsibilities). Successful specialty shopping venues deliver a unique and attractive combination of tenant mix and environment (i.e. a sense of place), often reflecting the character of consumers in the market or trade area in which they operate. Equally as important, these specialty-shopping areas lend themselves to extended consumer stays. An emotional "feeling" or "pleasure" derived from the overall shopping "experience" is an important part of the consumer's point of reference. Successful specialty shopping venues, regardless of format, deliver a unique combination of "product" (i.e. shops) and "place" (i.e. physical and conceptual environment), unique and attractive to the consumer within the market or trade area in question.




Shopping malls typically contain a curated mix of retailers with far more specialty than commodity retailers in a "destination retail" environment that brings together "anchor" department stores, complementary smaller retailers, eating establishments and entertainment in a compelling and appealing environment. Well designed and tenanted shopping malls and lifestyle centers are retail venues that draw consumers from longer travel distances than projects devoted primarily to commodity retailers, and customers typically visit these projects for several hours.

Omnichannel Retail

Retail is now conducted through many channels (e.g. traditional stores, catalogs, on-line, via mobile devices, television, etc.), a phenomenon often referred to as multi-channel retail. Omnichannel retail refers to a consistent and seamless consumer experience across multiple retail channels. This significant shift in how we shop has had a dramatic impact on the competitive retail environment for both shopping malls and department stores.

Omnichannel consumers frequently use more than one channel simultaneously. For example, a consumer might do research using a price check "app" or look up product reviews on the internet while looking at a product in a traditional retail store, sometimes referred to as "showrooming." Likewise, omnichannel retailers will track customers across the various channels they utilize (catalog and on-line shopping, or on-line and mobile shopping for example), and employ social media to increase sales opportunities and more precisely target marketing campaigns to consumers most likely to buy a particular product.

Omnichannel strategies work differently for commodity as opposed to specialty retailers. For example, multiple retail channels might be used by a consumer to research and assist in purchasing a particular commodity like a television, or to push out or target a promotion. By contrast, a specialty retailer might use onnichannel strategies to drive customer traffic to a "bricks-and-mortar" store, restaurant, or shopping district. Applicable to both commodity and specialty retailers, the availability and use of multiple retail channels allow consumers to be better informed. A byproduct of a well-educated consumer is that retailers and their salespeople must know much more about their products and competitors in order to serve their customers.

A November, 2012 "Shopping Centers Today" article notes the significant changes that have occurred with retail distribution channels. Previously, these channels operated separately (i.e. something ordered from a catalog or online would be delivered to a customer's house), but they are now merging so that real estate is part of the picture (i.e. something ordered may be picked up the same or the next day at a local outlet).

Regional Mall and Department Store Trends

All of the retail trends described above are directly impacting Vallco and will continue to exert themselves on the mall business throughout the United States. In summary, three key trends are of significant importance to understanding how the Initiative may affect Vallco:

1. Class A malls continue to flourish while Class B and C malls are languishing at an accelerating rate throughout the United States.

2. Consolidation amongst retailers, most notably department stores, continues, resulting in more instability among the retail tenant base for malls.

3. Consumers are increasingly looking for well-designed and authentic destination retail environments where they can not only spend their free and recreational time, but where they can "experience" something unique and appealing on an emotional level.

New York Times reporter Nelson Schwartz has reported on the current economic challenges that malls face across the nation, referencing research performed by Green Street Advisors that documents recent closures of ten malls, with sixty more on the brink of doing so.[5] He points out that these challenges will likely continue: "With income inequality continuing to widen, high-end malls are thriving, even as solid retail chains like Sears, Kmart and J. C. Penney falter, taking the middle- and working-class malls they anchored with them."

The trend is exemplified by the declining occupancy rates at shopping malls nationwide: 80 percent of malls have a vacancy rate of 10 percent or less today as compared with 94 percent just ten years earlier. One could fairly speculate that Class B and C malls are experiencing the highest vacancy rates as compared to Class A malls. He goes on to say that "nearly 15 percent of malls are 10 to 40 percent vacant, up from 5 percent in 2006. And 3.4 percent — representing more than 30 million square feet — are more than 40 percent empty, a threshold that signals the beginning of what Green Street calls "the death spiral." This is precisely the trend that has led to Vallco's demise.

The closure of the three department stores at Vallco can be seen in the broader context of department store closures nationwide: Macy's is closing 36 department stores in 2016 in addition to the 14 stores closed in 2015, and JC Penney's announced the closure of 7 department stores in 2016 in addition to the 40 closed in 2015.[6]

Schwartz also integrates the impact of consolidation among retailers. He says: "Instead, the fundamental problem for malls is a glut of stores in many parts of the country, the result of a long boom in building retail space of all kind." He quotes Christopher Zahas, a real estate economist and urban planner in Portland, Oregon: "We are extremely over-retailed. Filling a million square feet is a tall order." Schwartz correctly points out that while online shopping gets lots of attention, it accounts for only 10 percent of retail sales, however, those 10 percent of sales disproportionately impact commodity retailers.

A November 2014 McKinsey research paper titled "The Future of the Shopping Mall," author Roberto Fantoni says: "…the mall as it's been conceived for the last half century is at a critical inflection point. A storm of global trends are coming together at the same time to cause malls to change the role they play in people's lives. No longer are they primarily about shopping. Now, when consumers visit malls, they are looking for experiences that go well beyond traditional shopping." He cites increasing urbanization, more people living in a smaller area, and increasing interest in mixed-use projects as a response to sustainability concerns as primary catalysts for this trend. This author also agrees with Fantoni's assertion that "…maintain[ing] a strong association between consumption and pleasure is driving the need for more engaging shopping experiences" and that "the rise of digital technologies are fundamentally reshaping consumer expectations and

[5] "The Economics (and Nostalgia) of Dead Malls" (New York Times, January 3, 2015),
[6] http://www.usatoday.com/story/money/2016/01/06/macys-announces-layoffs-restructuring-after-disappointing-2015/78373358/
http://www.businessinsider.com/list-of-sears-and-kmart-stores-closing-2016-2
https://consumerist.com/2016/01/13/jcpenney-closing-7-stores-by-mid-april/

shifting the function of stores toward useful and entertaining customer experiences."

The McKinsey study identifies three trends in mall investment:

1. A trend away from commodity towards specialty environments where there is a "broadened value proposition for consumers…that attempt to recast the mall as a new downtown, including concerts, arts centers, spas, fitness clubs, and farmers markets…a place to spend quality time with friends and family."

2. An increasing use of technology that expands the consumer's experience to include both before and after a visit to a mall. These efforts might include anything from marketing to using technology to "decrease customer pain points" like finding parking.

3. A willingness to explore new formats for malls including open air malls, mixed-use projects, and a more open, natural design for enclosed spaces. The paper cites non-store space of 30-40 percent or even 50 percent of total space in a project.

The bottom line is that capital must receive a compelling return in order to be attracted. Fantoni states: "Mixed used developments offer consumers an attractive, integrated community in which to live, work and shop. They also serve to generate additional traffic for the malls while maximizing returns on invested capital." Projects must "define a clear value proposition for both consumers and retailers," increase efficiency of an existing project, and focus on areas with clear potential for growth. In sum, "To avoid becoming what one chief executive calls a "historical anachronism – a sixty-year aberration that no longer meets the public's needs," mall operators must expand their horizons of what a mall can be."

In an editorial written for Shopping Centers Today, Yaromir Steiner, a well-respected shopping center designer, states that "…understanding the dynamics surrounding Class B and C malls requires an appreciation for the key differences between need-based and want-based retail environments. Need-based environments provide essential goods, promise value and general serve local trade areas. Want-based environments are very different. Designed and built to service large regional trade areas, want-based assets include primarily experiential and aspirational retail tenants." Steiner points out that some formerly high sales per square foot malls have evolved into Class B and Class C malls with little upside as "want-based competition or unfavorable development patterns forced a regional location to a more sub-regional profile" and better positioned and curated malls have drawn shoppers away.

The 2014 Report also identified a number of trends that help explain Vallco's underperformance:

- Echoing Schwartz, the excess supply of retail space has shifted retail dollars to new centers without creating additional demand, leading to the decline of older centers. As long ago as

2002, it was reported that of the more than 2000 enclosed malls in the U.S., approximately 15 to 20 percent of all malls were headed for closure. [7]

- Regional shopping centers with uncertain and shifting identities lacked the ability to appeal to increasingly value-conscious consumers who had alternative channels such as factory outlet stores, catalogs, internet sales, and big-box stores. In addition, a "do-it-yourself" mentality drove customers from traditional retailers to warehouse stores.

- By creatively rethinking public space and urbanism, decaying malls are able to be transformed into "genuine places in the older areas of our spreading suburban environment" resulting in broader appeal to today's consumers.

These observations support the theory that today's retail landscape is a dichotomy of price and convenience-oriented commodity retailers, and specialty retailers congregated in appealing environments. Not coincidentally, shoppers are choosing alternatives to enclosed regional malls in part because those malls lack an identifiable sense of place.

- Retail alternatives, or specialty projects where consumers enjoy spending their discretionary time and income, have become a major focus. Formats that add entertainment and cultural uses, or unconventional uses such as mixed-use centers, educational facilities, medical clinics, or a variety of other uses are increasingly common and sought after. Fitzgerald and Leigh agree that downtown shopping may be poised for a recovery, noting "shoppers who used to buy in malls are now more willing to shop on 'Main Streets.'"

In October 2012, Co-Star published a series of three articles on demalling America. As has already been noted, the articles point out that as anchor tenants merge and contract, dominant regional malls are faring better than secondary malls and do a better job attracting tenants. This trend is particularly important in light of many retailers trending towards smaller stores, exacerbating vacancy rates in weaker projects, and providing opportunities to augment tenant mix in stronger ones. A dominant mall's success in a retail trade area is often at the expense of outmoded centers such as Vallco. The article asserts that 10 percent of the approximately 1,000 regional malls in the

[8] J. Thomas Black, Libby Howland, and Stuart L. Rogel, Downtown Retail Development: Conditions for Success and Project Profiles (Washington, D.C.: The Urban Land Institute, 1983).
Kevin Mattson, "Antidotes to Sprawl," in Sprawl and Public Space: Redressing the Mall, ed. David J. Smiley (Washington, D.C.: National Endowment for the Arts; New York, N.Y.: Distributed by Princeton Architectural Press, 2002).
Nora Ganim Barnes, "The Restructuring of the Retail Business in the US: The Fall of the Shopping Mall," Business Forum 27, no. 1 (Winter 2005).
Mark Robbins, "Redressing the Mall," in Sprawl and Public Space: Redressing the Mall, ed. David J. Smiley (Washington, D.C.: National Endowment for the Arts; New York, N.Y.: Distributed by Princeton Architectural Press, 2002).
Joan Fitzgerald and Nancey Green Leigh, Economic Revitalization: Cases and Strategies for City and Suburb (Thousand Oaks, CA: Sage Publications, 2002).

US will fail by 2022 and repeats the quip: "Shopping centers aren't overbuilt, they're merely under-demolished."

Malls are typically well located, and are designed for a shorter lifespan than other types of real estate such as housing and office. (Retail is routinely remodeled, as customers are attracted to "new and shiny.") Malls need to provide a dynamic mix of shopping, dining and entertainment experiences in a "want-based" environment. With this consumer desire in mind, many malls as well as new retail projects are being redesigned as town squares or open-air pedestrian "streets."

Malls and stores that are not refreshed on a regular basis tend to perform far worse than those with significant upgrades and reinvestment. Distressed malls often reflect the challenges associated with low rents and occupancies, as they cannot generate sufficient income to support the significant reinvestment and financing costs associated with a major renovation. While painful on a case-by-case basis, the culling of weaker properties from the market is a healthy process.

CoStar states that a fundamental decision needs to be made about whether to reposition a mall or to demolish and start over. Regardless, a major repositioning represents key opportunities for visionary planning, political leadership, and the owner. There are positive externalities such as a well-executed project helping lure desired employers and their highly desirable workers that should be considered as well. Execution is difficult: In order to obtain financing, tenants need to be lined up in advance, and the authors point out that successful mall repositioning involves a combination of deleveraging, demalling, and deep pockets. These observations were echoed by several stakeholders whose interviews are summarized in the 2014 Report.

The accelerating differential between the best and marginal malls clearly demonstrates that Vallco is not a unique circumstance. Vallco has suffered because of directly competitive Class A malls in superior locations, namely Stanford Shopping Center and Valley Fair. These malls have best-in-class anchor department store tenants, an up to date selection of in-line shops (as differentiated from Vallco whose shop tenants are virtually nonexistent), and a much more pleasant, pedestrian-oriented physical environment in contrast to Vallco's poorly laid out mall core and parking, and lack of a direct and pleasant pedestrian connection across Wolfe Road.

In addition to Valley Fair and Stanford Shopping Center having continued to upgrade their common areas and amenities so they are appealing places for consumers to shop and "experience" their free time, Santana Row[8] has introduced an open-air, "Main Street" environment in Vallco's primary trade area. All three of these projects have created a high standard for "want-based" shopping environments. (An update to the 2014 Report's description of Valley Fair, Santana Row, and Stanford Shopping Center is included in Attachment "B" to this memo.)

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[8] Although it does not have the characteristics of a traditional shopping mall, Santana Row competes with surrounding shopping malls (as it would with Vallco), as it offers a unique mix of retail, restaurant and entertainment in a well-curated pedestrian oriented environment.

Vallco suffers from all of the circumstances, both within and beyond its control, that conspire to relegate once vibrant malls like Vallco to Class C status. It also must be emphasized that Vallco is not unique; many malls across the United States and within the San Francisco Bay Area have experienced exactly the same phenomenon, as documented above.

Vallco-specific Findings

The 2014 Report contained a significant amount of research and analysis of Vallco that is summarized below and updated (*in italics*) to reflect current observations of particular relevance to the analysis of the Initiative. The mall was originally constructed between 1974 and 1979. Increased competition soon came from other regional malls such as Stanford Shopping Center, and in particular Valley Fair, which opened in 1986. These direct competitors began to take market share from Vallco.
The market and ownership challenges faced by Vallco cannot be understated. While Vallco was a high performing destination when it opened, it quickly faced a formidable challenge from Valley Fair, which is located in close proximity and at a high traffic intersection of two major freeways. In addition, Vallco is located in Stanford Shopping Center's trade area.

Vallco's circumstances are not unique as there is an oversupply of mall space in the United States. Key to the repositioning process is creating a brand that sets Vallco apart from competing projects and communicating that brand to the community and prospective tenants alike.
As documented earlier, Vallco was anchored by faltering department stores that did not allow Vallco to differentiate itself from its competitors. Combined with other leasing challenges, including numerous ownership changes as the result of its poor economic performance, Vallco's ability to compete effectively in the competitive regional mall industry was reduced. This led to Vallco having no compelling qualities with which to distinguish itself from other retail offerings serving Cupertino and surrounding communities. Specifically, Cupertino residents have ready access to Valley Fair, Santana Row, and Stanford Shopping Center, all Class A projects. For this reason, the consolidation among tenants (especially anchors), and Vallco's various owners not investing in upgrading facilities and retaining key tenants, Vallco has sunk to Class C status.

An owner or developer with the expertise and financial capability to execute a repositioning strategy is required for a successful outcome. The City's ability to contribute financially and/or to use its governmental powers to facilitate redevelopment will have a material impact on the success and timing of any redevelopment.
Vallco's various owners have been either unable or unwilling to make the financial investment required to renovate Vallco so that it could have a physical plant capable of competing with Valley Fair and Stanford Shopping Center. Neither have they made the financial investments needed to "buy" key tenants to jumpstart leasing efforts, a reflection in part of Vallco's long-term poor economic performance and frequent ownership changes during a period in which repositioning efforts may have had more potential than in today's environment.

Thereafter, while its competitors renovated, expanded, and re-tenanted to meet market demands, Vallco languished with incomplete development, defaults from prior ownerships, prolonged and

unrealized redevelopment plans, management changes, and other setbacks. One widely and commonly-cited reason for Vallco's decline was a mismatch between Vallco's mid-range stores and Cupertino and the surrounding area's growing affluence and changing ethnic makeup.
Vallco's anchor tenants: Sears, JC Penney, and Macy's (previously Emporium that was acquired by Macy's) are precisely the sorts of retailers that did not fare well as regional malls differentiated themselves from their competitors. Valley Fair's anchor tenants (Macy's, Nordstrom, and planned Bloomingdales) only serve to accentuate Valley Fair's superior retail positioning.

Regional mall operation, leasing and management is a competitive business: Vallco was unable to compete with the much larger and more sophisticated operators of Stanford and Valley Fair. As a direct result, the mall is largely vacant, save for AMC Theater, The Bay Club, the skating rink, bowling center, a few restaurants, and small tenants.
Westfield (Valley Fair) and Simon (Stanford) both own multiple properties. Space at both Valley Fair and Stanford is at a premium, and the demand for space allows Westfield and Simon to do package deals with tenants with specific leasing conditions that could put Vallco at a competitive disadvantage. For example, some leases may require tenants to exclusively occupy high-demand malls, dictate a specific location within those malls or place "radius restrictions" that prohibit tenants from opening stores at competing properties within a certain number of miles of their store. Vallco has no doubt had trouble leasing to various tenants in this competitive environment.

The lack of clothing and apparel-related stores is due in part to the lack of fashion-driven, destination retail centers in Cupertino. Vallco suffered from competition with Valley Fair and other projects, leading to high vacancy and shoppers on apparel-driven trips turning to destinations outside Cupertino.
Cupertino currently lacks specialty retail, and fashion, in particular. With the department stores at Vallco now being closed, and new offerings at competing Valley Fair, Santana Row, and Stanford Shopping Centers, this dearth of fashion has gotten worse.

Several adjacent projects are planned or under construction. The adjacent Rose Bowl project is under construction, and the owner expects to receive competitive rents for the 60,000 square feet of retail space. Main Street is entitled and being marketed for lease, but grading has only just begun. The Apple Campus 2 is approved, with construction expected to start soon.
These projects are presently either complete or under construction, and the opportunities or competition they represent, as the case may be, will inform how Vallco is ultimately designed so as to be most successful.

Governing documents control what can be changed on the property, including parking, building requirements, and certain uses. Ground leases and various tenant leases have provisions further restricting changes and certain uses.
With the three department stores and the mall itself now under a single ownership, the restrictions contained in Vallco's governing documents are not as significant as before, but some remaining tenants still have certain control rights in their leases. Certain approvals needed to redevelop the property will need to be negotiated. Details of these leases follows:

- **AMC Theaters**: AMC executed a lease on 5/5/05 for 15 years with three 5-year options and one 4½-year option. The lease includes the following provisions:

- A protected area requiring AMC's approval for changes of any parking areas west of Wolfe Road including the then newly built parking deck, and all pedestrian access to and from the parking areas, but allowing the landlord rights to certain future building areas (lease § 26).
- A requirement that the landlord continuously operate the property as a shopping center.
- Restrictions on the sale of movie concession food or beverage within 50 feet of AMC's premises, in common areas, or in parking areas, on so-called noxious uses typically restricted in shopping center governing documents (but allowing Lucky Strike bowling alley), and on a health club.
- Co-tenancy requirements (and rent concessions for failure for them to be met).

- **Lucky Strike**: The bowling alley executed a lease on 12/11/06 for 38,000 square feet of space for a term of 15 years from 1/1/07 to 12/31/22 with three 5-year options to renew.

- **The Bay Club**: The Bay Club's lease dated 3/15/11 has a term of 15-years 4-months plus options to renew for three 5-year periods. The lease establishes part of the common areas as protected areas requiring Bay Club's approval for modifications, and an exclusive for a health club on Sears' lands.

- **Sprint**: Sprint has two leases for cell towers, each commencing in 2002 with a 15-year initial term plus two 5-year options to renew.

Analysis of the Potential Impact of the Initiative on Vallco

This memorandum analyzes the potential impact of the Initiative on Vallco by comparing what would be allowed under the City's currently adopted General Plan with what could occur if the Initiative were to be approved by Cupertino's voters. It begins with a brief description of the Initiative and then analyzes potential development scenarios with and without the Initiative.

The Initiative would modify the General Plan and would affect future development at the Vallco Shopping District and in other areas of Cupertino in the following ways.

➢ At the Vallco Shopping District, the Initiative would limit uses to retail, entertainment, and hotel, prohibiting any new residential or office development.

  - While none of the units allocated to Vallco (389 units) would be allowed to be built, about 60 percent (243 units) would be reallocated to other residential areas in Cupertino.
  - In contrast, the 2,000,000 square feet of office space presently allowed at Vallco would be eliminated from the General Plan altogether, which would significantly reduce potential new office development in Cupertino.
  - The Initiative would also reduce height limits for any new development on the site to a maximum of 45 feet, below the height of some of the existing buildings at Vallco.

- In other areas of Cupertino, the Initiative would generally modify the General Plan to:

  - Set maximum building heights for Neighborhoods at 45 feet, which increases the maximum General Plan height for these areas;
  - Set maximum building heights for Special Areas as identified in the current General Plan.
  - Add new policies regarding development setbacks, "step-backs," "building planes," and rooftop height extensions citywide.
  - Limit the maximum lot coverage for projects over 50,000 square feet.
  - Reduce the number of new residences allowed by 146 units.
  - Add specific land use policies applicable to North De Anza Boulevard, Stevens Creek Boulevard, and Homestead Road in North Vallco Park.

- Voter approval would be required for any further changes to the development allocations for Vallco and to the other policies and provisions enacted by the Initiative.

- Voter approval would not be required for the City Council to make changes to the development allocations for other areas of the City, or for any General Plan provisions not enacted or amended by the Initiative.

This memorandum evaluates what could occur at Vallco under the following potential development scenarios, as further described in the 9212 Report for this Initiative:

- Adopted General Plan, which assumes full buildout of land uses throughout the City as allowed under the 2040 General Plan, including redevelopment of Vallco site,

- Adopted General Plan With 2015 Sand Hill Proposal, which is consistent with the first scenario with additional specificity based on what Sand Hill is currently proposing,

- General Plan With Initiative Assuming Vallco as a Viable Mall, which assumes the mall can be preserved and rehabilitated to become a viable mall.

- General Plan With Initiative Assuming Vallco With 2016 Occupancy, which assumes all three anchors remain closed and only a limited number of businesses remain occupied consistent with current conditions.

In order to understand the Initiative's potential impact, each of these potential scenarios are evaluated with respect to the following:

- **Supportable Retail**: Types of retail that might be supportable and attracted to Cupertino, given Cupertino's retail trade area and retail environment, with emphasis on anchor tenants.

- **Needed Improvements**: Potential physical and other improvements that would be needed to accomplish each scenario.

- **Required Investment**: To the extent possible, a high level estimate of required investment.

- **Market Strategies**: Strategies to accomplish each scenario, and associated costs if known.

- **Likelihood of Success**: An opinion about the relative financial feasibility, and probability of success of each scenario.

Adopted General Plan: Full buildout throughout the City under the 2040 General Plan, including redevelopment of Vallco site as allowed under the adopted General Plan (i.e. 389 residential units allowed at Vallco; other units could be reallocated as per Alt. C in the 2014 EIR). This alternative does not include the additional community and fiscal benefits proposed by Sand Hill for the Hills at Vallco Project.

- **Supportable Retail**: As documented in this memorandum, it is unrealistic that Vallco will remain a regional shopping center under any scenario because "solid retail chains like Sears, K Mart, and JC Penney are faltering," and high-end retailers like Nordstrom, Bloomingdales, and Neiman Marcus are consolidating into a smaller number of remaining Class A malls that are able to draw from a wide geographic area. The retail options left for Vallco can be categorized as follows:

    a. Have a significantly smaller retail footprint with specialty retailers curated for Cupertino and the surrounding retail trade area with the caveat that the trade area will be much smaller than that commanded by a regional mall,

    b. Focus on attracting commodity or daily needs retailers (i.e. big box commodity stores, or food/drug retailers with some shop space) whose store spacing requirements would include Cupertino, or

    c. Some combination of "a" and "b" where an even smaller specialty component would exist in a distinctly different district than the commodity component.

- **Needed Improvements**: The supportable retail scenarios described above lend themselves to an open-air environment. In the case of this scenario, a so-called lifestyle center or a "Main Street" or "Downtown" environment would be required. In the case of a commodity or daily needs shopping center, convenience attributes such as easy access (both ingress and egress), visibility, and ample convenient parking would be called for as competing projects posses these attributes, and retailers will be cautious not to be at a disadvantage with respect to attributes enjoyed by a competitor. Regardless of the scenario selected, demolition of a significant portion (if not all) of the existing mall would likely be required.

- **Required Investment**: Required investment will be equal to that required for development of any new project. Costs would be similar to those incurred at the Village at San Antonio Center in Mountain View, or other similar projects, and will vary, potentially significantly, depending upon the extent of vertically integrated mixed-use structures and structured parking incorporated into the project design. In addition, a developer would need to incur the significant costs of acquiring Vallco, demolishing the existing buildings, buying out existing tenants, preparing plans and processing land use approvals, "carrying" this upfront investment for a substantial amount of time until a new project is approved, and financing the construction and development of a new project.

- **Market Strategies**: Vallco has long since been a "tainted" mall that does not have a brand: a clear statement of what makes it unique and compelling as compared with alternative shopping environments. A clearly articulated branding statement will need to be made. Furthermore, a clearly articulated plan demonstrating a clear path for redevelopment including obtaining required governmental approvals and a realistic timeline for accomplishing this will be required in order to generate attention from prospective retail tenants. The inclusion of office, residential and hotel uses at Vallco will provide more "round the clock" activity and a local retail consumer base to help support its retail offerings, although onsite demand will need to be significantly supplemented from the surrounding retail trade area. Aggressive economic deals will need to be made with the first tenants committing to the new project, most likely in the form of rent concessions and tenant improvement allowances. Brokerage commissions and legal expense will be significant up front costs.

- **Likelihood of Success**: If a developer is able to articulate a clear branding statement, has the financial capability and staying power to execute redevelopment and can attract tenants through potentially aggressive lease concessions, then a project of a realistic size and scope should be achievable. Again, this project is likely to be much smaller than what presently exists at Vallco Shopping Center.

Adopted General Plan with Sand Hill Proposal: Full buildout throughout the City under the 2040 General Plan, with the Hills at Vallco project redeveloped as proposed in September 2015 (as further specified in Dec. 2015) at the site of the Vallco Shopping Center. This plan calls for 800 residential units, some reallocated from other areas.

- **Supportable Retail**: Same as described above under Adopted General Plan scenario.

- **Needed Improvements**: Same as described above under Adopted General Plan scenario.

- **Required Investment**: Same as Adopted General Plan scenario with the caveat that vertically integrated mixed use projects can be significantly more complicated and expensive to build than single use or horizontally integrated mixed use projects.

- **Market Strategies**: Same as Adopted General Plan scenario. On-site residential units will help generate "round the clock" activity and will likely add some incremental on-site sales.[9]

[9] If you consider that each household in Cupertino has approximately 2.87 persons per household (Strategic Economics, January, 2016), 800 dwelling units would be expected to house 2,296 persons. Compare this number to the 16 million customer visits at Valley Fair, many of which are repeat customers from the

- **Likelihood of Success**: Same as described above under Adopted General Plan scenario.

General Plan with Initiative Assuming Vallco as Enhanced Mall: Full buildout throughout the City under the 2040 General Plan *as amended by the Initiative,* with a re-tenanted 1.2 million SF enclosed shopping center. The existing 1.2 million square feet of retail-dining-entertainment at Vallco would need to be maintained as both a "minimum" and a "maximum," thereby reducing flexibility and the ability to adapt to changing market conditions. There will be no residential units, and no office space added to the project.

- **Supportable Retail**: As stated earlier, it is unrealistic that Vallco will be successful as a regional mall under any scenario. Stipulating that Vallco will have a minimum size approximately equal to that of Valley Fair is unrealistic given the historical experience of Vallco and the current competitive retail environment in which it operates. Although Vallco once thrived in the '80's and early '90's, its decline started in the mid-90's as the result of competing projects with superior location attributes, anchor tenants better suited to withstand two decades of retailer consolidation, and greater investment in creating a more attractive shopping environment. Also, as noted earlier, while 800 residential units will not attract retailers on their own, a mix of uses including residential and office will add vitality to a project – vitality that would be precluded under the Initiative.

- **Needed Improvements**: The entire mall would need to be gutted and upgraded to a level of finish that would compete favorably with competing projects. It is unlikely that the pedestrian bridge and the JC Penney portion of the project could successfully be renovated, and alternative arrangements would likely need to be made for those facilities. Parking facilities would also need to be redesigned and rebuilt where they do not function well.

- **Required Investment**: In absolute dollars, the required investment would not likely be as high as under the Adopted General Plan because less development is contemplated at Vallco. However, the return on investment could reasonably be assumed to be much lower than the Adopted General Plan scenario given the challenges and costs associated with repositioning the Mall. Given these challenges, this scenario may not generate high enough returns to attract sufficient private capital to fund the extensive renovation and repositioning that the mall would require to be successful. Several owners in the past have attempted to make Vallco successful at significant financial cost, which has resulted in a history of ownership changes, foreclosures and deferred maintenance.

- **Market Strategies**: A marketing strategy would initially need to focus on finding suitable anchor tenants. It has already been established that mid-market anchor retailers like Sears or JC Penney do not have the drawing power required of a regional mall in today's world;

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surrounding retail trade area. In other words, while the on-site residential population will add a certain amount of vitality and round-the-clock activity, the on-site residential population in and of itself does not create the demand required to attract retailers that seeks to draw sales from a much broader retail trade area.

their brands do not help to differentiate the malls they anchor. It is unlikely that high-end anchor tenants like Nordstrom, Bloomingdales, Neiman Marcus, and the like would be interested in locating at Vallco if for no other reason than expected cannibalization of sales at their next closest stores. Some malls have backfilled anchor tenant spaces with Walmart, Costco, or Target. These anchors are generally not compelling anchors for mall tenants looking for new environments in which to open. Without anchor tenants, it is unlikely that main mall tenants would be attracted even to an upgraded Vallco. Many malls have used entertainment anchors as part of their repositioning strategy, however, Vallco presently has three major entertainment uses: movies, bowling and an ice rink. If these current entertainment uses were compelling for mall tenants, Vallco's occupancy level would be much higher.

- **Likelihood of Success**: Doing something over the same way and expecting a different result is an unlikely outcome. It certainly would not be a predictor of success for a redeveloped Vallco. Retail must constantly reinvent itself to stay "fresh" and relevant to customers. Trying to preserve Vallco as it was decades ago would not result in attracting new tenants or customers, both of which are critical to project success. Rather, something substantively new and differentiated from other competing projects should be created at Vallco in order to draw customer traffic.

General Plan with Initiative Assuming Vallco with 2016 Occupancy: Full buildout throughout the City under the 2040 General Plan *as amended by the Initiative,* with no re-tenanting of Vallco, and no site improvements. This scenario recognizes that, without significant investment and redevelopment, Vallco is unlikely to improve beyond its present 2016 level of occupancy (314,000 SF retail occupied). This scenario also assumes, as required by the Initiative that there will be no residential units, and no office at Vallco.

- **Supportable Retail**: If no site improvements are made, then "nothing new" would drive either retailer or consumer interest. Furthermore, the project would remain mostly vacant, a strong deterrent to customers visiting the center. In this scenario, new tenants likely would not be attracted to Vallco and the remaining tenants, primarily entertainment, restaurant and fitness uses, would represent the Mall's primary draw.

- **Needed Improvements**: No major improvements are assumed, in part due to the fact that there would be little surplus rental revenue from tenants to enable the owner to invest in needed improvements.

- **Required Investment**: While capital investment would be minimal, the owner would continue to have significant ongoing operating expenses in addition to carrying costs on the acquisition. In addition, the owner will likely have to bear the cost of lease concessions to keep current tenants on site.

- **Market Strategies**: There is no plausible marketing strategy for a do-nothing scenario.

- **Likelihood of Success**: There is no plausible likelihood of success for a do-nothing scenario, and Vallco will likely continue to deteriorate to the point of closure.

Conclusion

This memo has identified three key trends that explain both the environment in which all malls operate, including Vallco, and the reasons some are successful while others are not:

1. Class A malls continue to flourish while Class B and C malls are languishing at an accelerating rate throughout the United States.

2. Consolidation amongst retailers, including department stores, continues, resulting in instability among the retail tenant base for malls.

3. Consumers are increasingly looking for well-designed and authentic destination retail environments where they can not only spend their free and recreational time, but where they can "experience" something unique and appealing on an emotional level.

Store spacing has been referenced multiple times. Malls are generally tenanted by specialty retailers who draw from a wide trade area. The more unique the offering, the wider a consumer draw that can be expected. Both Valley Fair and Stanford Shopping Center offer unique shopping environments with tenants, particularly anchors, that exist only in those locations.
For example, a daily needs retailer such as a grocery or drug store may draw from as little as a one-mile radius. Conversely, a luxury retailer like Neiman Marcus might decide it only needs 3 stores to adequately cover a metropolitan area the size of the San Francisco Bay Area. Valley Fair and Stanford leasing plans and trade areas may be found in Appendix B.

Department stores are no longer department stores as most of the "departments" left a long time ago and became "big box" retailers. Today's department stores can be more accurately described as large fashion retailers without any particular brand other than their own house labels. The dramatic consolidation of department stores has led to an environment with fewer available anchors to backfill vacant spots in malls. In some situations, non-traditional anchors such as Walmart, Costco, and branded anchors like F21 are filling these gaps, however, these retailers do not have the star drawing power of traditional department stores. Multi-channel retailing and the internet in particular offer consumers a compelling choice in the price/convenience equation. This phenomenon combined with consolidation of the big box retailers that sell commodities means big box stores are not likely candidates to backfill Vallco's anchor spaces.
The major projects competing for customers from Vallco's primary trade area have reinvested heavily, bringing in new and interesting tenants, and creating an appealing environment and amenities not found elsewhere. Examples include Valley Fair's Luxury Collection and Dining Terrace, and Santana Row's open air, Main Street environment. The cost of such improvements is significant.

Rent and the cost of construction are directly linked. Existing "second hand" space can be both attractive and competitive as compared with new construction, however, existing spaces may not have key physical attributes, such as access, proximity to adequate parking, visibility, loading facilities, and windows, which a retailer is likely to require. Thus, occupying secondhand space in an older project such as Vallco is not an option for many retailers, as they do not believe that they will be able to compete effectively from a sub-marginal facility or generate the top line sales necessary to justify investment in a new store. Complicating matters, Vallco does not generate much rental income from which to pay for its operating costs or debt service. If forced to stay in its present configuration, there is no reason to believe Vallco would be able to generate the additional income required to fund a significant renovation that might make it more attractive to retailers.

Encouraging mixed-use projects is part of a larger nationwide trend of encouraging increased density and activity. With respect to retail, this trend is not without its own set of issues as it is much more difficult and expensive to accommodate a mix of uses as opposed to a single retail use. [10] If economically viable, the community, owners, and tenants alike can benefit from the synergies created by a mix of uses in the same project, increased resilience to an economic downturn due to a diversity of uses, shared parking, increased scale of development as compared to a single use projects, and some incremental consumer demand on-site.

Finally, a complete conversation about Vallco cannot occur without referencing the understandable sentimental attachment the community has to Vallco in its heyday. However, the retail landscape has evolved in ways that were unimaginable when Dorothy Hamill was practicing at Vallco's skating rink in the 1970's. Redevelopment of obsolete assets is a fact of life, whether the asset is economically or functionally obsolete. In Vallco's case, it is both.

Could Vallco be resurrected? Not in its original form, but quite possibly in another form that could be a centerpiece of the Cupertino community and serve today's consumer's needs. Any resurrection needs to be sufficiently profitable to attract investment in a competitive economic environment. A strict adherence to the past can result in a distressed shopping center continuing on a downward spiral, unable to compete in a rapidly changing retail environment, and to continued blight.

The initiative that is the subject of this memo should be carefully evaluated for unintended consequences. Similar land use initiatives in other cities have significantly impaired the ability of

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[10] Cupertino is a suburban, auto-oriented environment that is just starting to experience the market and economic changes that make increased densities viable. It can be difficult to attract quality retailers because of the compromises a retailer might need to make as compared with more traditional settings. In addition, incorporating all the design and facility elements needed to successfully operate retail space as part of a mixed use project (e.g. parking, vertical transportation systems, loading including accommodating truck turning movements, trash and recycling areas, utilities, mechanical and venting systems, etc.) is challenging from a cost perspective. For example, when designing space that does not compete with existing projects' critical convenience attributes (visibility, parking, and access), overcoming tenant objections can be difficult. Often it is easier and more cost effective to design horizontally integrated mixed-use projects where the intent is to include a retail component alongside residential and non-residential uses.

owners to redevelop a property, mostly due to the significant costs associated with planning and executing a redevelopment project combined with the uncertainty of obtaining the required approvals to move a new project forward. In other words, such initiatives have skewed the cost benefit equation away from making these projects attractive for investment.

Four scenarios describing Vallco's future have been evaluated in this memo. These scenarios and a summary of the conclusion for each (*in italics*) are as follows:

- Adopted General Plan, which assumes full buildout of land uses throughout the City as allowed under the 2040 General Plan, including redevelopment of Vallco site,
  A mixed-use project with a smaller retail component has a much higher likelihood of success than preserving the existing Vallco mall in its present configuration.

- Adopted General Plan With Sand Hill Proposal, which is consistent with the first scenario with additional specificity based on what Sand Hill proposed in 2015,
  Allowing for a mix of land uses on the Vallco site has the greatest likelihood of success. The Sand Hill Proposal that includes 800 residential units and 2,000,000 square feet of office space has the potential to create a dynamic environment.

- General Plan With Initiative Assuming Vallco as Enhanced Mall, which assumes the mall can be preserved and rehabilitated to become a viable mall.
  This scenario is not a feasible option from either a market or development perspective. Trying to preserve Vallco as it was decades ago will not attract new tenants or customers, especially customers who are drawn to vibrant, pedestrian-oriented retail environments. Something substantively new and differentiated from competing projects must be created at Vallco in order to draw customer traffic. Valley Fair (and Santana Row), and Stanford Shopping Center continue as the successful Class A malls serving Cupertino's trade area, market forces having determined there is no need for an additional Class A regional shopping center serving the Cupertino trade area.

- General Plan With Initiative Assuming Vallco With 2016 Occupancy, which assumes all three anchors remain closed and only a limited number of businesses remain occupied consistent with current conditions.
  Vallco in its present configuration is unlikely to generate the incremental income required to justify investment in a significant renovation. The most likely outcome with the Initiative is that Vallco will remain in its current state, or it will continue to decline and face closure like many similar Class C malls across the United States.

These trends do not mean that a retail component will not be successful at the Vallco site. Rather, these trends point to the Vallco site needing to be redeveloped into a project that more closely reflects the realities of today's consumer and real estate market. The scenarios allowing the redevelopment of the Vallco site into a mixed-use project with a smaller retail component are far more likely to succeed than the scenarios that require the existing mall to be left in place, which have little chance of succeeding.

In conclusion, as previously stated in the 2014 Report: "The suitability of a retail project for any given community is a comment on how market forces have evolved over time. Focus on planning retail projects that are best suited to serve the local community's needs as opposed to replicating facilities found elsewhere or resurrecting facilities from another era."

Attachment "A"

Historic and Current Retail Conditions in Cupertino and Surrounding Areas

The following findings were made in the 2014 Report about Cupertino and the surrounding area. To the extent applicable, updates have been added in *italic letters* at the end of each finding.

Situational and Demographic Findings

The 2014 Report noted a number of attributes identified in the 2014 BAE Market Study. Like in 2014, these attributes provide important context for this memo:

- ABAG's One Bay Area Plan indicates that Cupertino will gain almost 5,000 households and over 7,000 jobs between 2010 and 2040.
  No change.

- Cupertino differs markedly from the County and region with respect to racial and ethnic breakdown. The City's Asian population comprised 63.1 percent of total population in 2010. By contrast, just under 35 percent of daytime workers are of Asian descent.
  The City's ethnicity has not changed markedly.

- Reflecting high education levels and professional occupations, Cupertino households earn a significantly higher median household income ($123,700) than Santa Clara County ($87,200), and the Bay Area ($75,800).
  No change.

- On a per capita basis, Cupertino's annual retail sales for 2011 are $10,483, compared to $13,404 for Santa Clara County, and $12,493 for California.
  If anything, Cupertino's annual retail sales have eroded slightly with the recent closure of Vallco's anchors, and Santa Clara County's have increased slightly with the opening of new retail projects like Hunter Storm's development on the former Hitachi property.

- Office demand continues to be strong, limited primarily by supply constraints and Apple's demand for office space.
  If anything, demand for Class A office space has only increased as the high-tech industry has continued to expand in Santa Clara County. The opportunity for Cupertino can easily be seen in the number of office campuses that recently have been or presently are being assembled in neighboring cities. Apple's North San Jose assemblage is just one example.

The City is well served by road infrastructure; however, there exist few regional mass transit options.
A rapid bus route along Stevens Creek Blvd. has been proposed by VTA, and, once implemented, will bring a new and much needed public transit option to what has traditionally been an auto-oriented community.

The City's resident and workforce populations are distinct beyond the income and ethnicity differences noted above. For example, Apple is competing with Google, Facebook, LinkedIn and others for talent. To the extent that these workers are younger (as is often the case), there is a greater demand for a more urban environment.
Competition for knowledge workers has only increased since the 2014 Report was written. Controversies such as private busses taking San Francisco residents to and from jobs in Silicon Valley only serve to highlight the extent to which millennials prefer to live in urban as opposed to suburban environments.

Cupertino's central location within the Trade Area as well as access to freeways and major arterials creates the opportunity to introduce new retailers to the City, and perhaps even to capture sales presently leaking out of the City to other parts of the Trade Area.
The lack of a coherent retail economic development strategy (i.e. a Cupertino "retail branding statement"), political uncertainly about key redevelopment opportunities, and well tenanted and managed shopping alternatives all undermine capitalizing on this opportunity.

Cupertino has more jobs than employed residents, leading to a net inflow of workers (31 percent of people employed in Cupertino live in San Jose, 16 percent live in Cupertino, and 34 percent elsewhere in Santa Clara County). This daily inflow creates a significant opportunity for well-located properties in Cupertino to be positioned as destination-oriented retail development.
There are established traffic patterns favoring Cupertino given the established and growing office sector (the Apple 2 campus being the most obvious growth example). Taking advantage of these established traffic patterns could be part of a retail economic development strategy.

Daytime workers generate demand for purchases near their workplace, especially meals eaten during the workday. Additional daytime or to/from work shopping opportunities are created when shopping alternatives are near to or on the path of travel to/from workplaces.
To the extent that office campuses are not "closed" in that they offer dining and daily needs shopping venues on-site, demand for daily needs and food and beverage should continue to grow along with the growing base of office space.

General Retail Findings

There are significant barriers to entry such as lack of available land to build new retail projects in Cupertino.
The Apple II campus has been approved by the City and is presently under construction. The Main Street project is also moving forward. There remains a lack of large parcels suitable for new commercial development; most development will need to be redevelopment of existing but economically obsolete product.

Vallco will be the City's single greatest opportunity to draw retail dollars to Cupertino. While the present retail allocation for Cupertino is projected to be adequate to meet the retail needs of today's residents and projected population growth, developing an overall retail strategy as a stated economic development goal will inform that allocation and enhance the City's ability to create retail facilities capable of meeting the City's future needs and meeting any stated goal of recapture

leaking sales.
The City has begun to address a retail economic development strategy, however, clearly articulated goals have not yet been made. The absence of such a strategy has created a vacuum in which considerable speculation about the worth and value of Vallco has occurred. This speculation is not consistent with the goal of implementing a retail strategy for the City.

Cupertino has a bifurcated retail sector: Daily needs and some commodity categories perform well while other categories perform poorly or not at all. Overall, the City leaks sales to Cupertino's larger shopping Trade Area. That less than eight percent of potential sales from trade area customers were occurring outside of the Trade Area indicates that the overall retail trade area is well balanced with respect to retail.
The City's commodity retail options (daily needs retailers in particular), with the exception of food and beverage, remain more plentiful than specialty retail options. Sales and sales leakage patterns have not changed materially in the part two years.

This leakage is probably more as a result of being bested by more aggressive economic development and better-executed development elsewhere than by any fundamental flaw such as the City's location in the Trade Area, transportation issues, or demographics.
Neighboring cities continue to forward economic development initiatives, so Cupertino remains in an even more competitive environment for attracting specialty retail than at the time the 2014 Report was drafted.

A retail offering tailored to better meet the needs of citizens (both those presently living in Cupertino and likely future residents, i.e. knowledge workers) will be instrumental if the City hopes to recapture some of the sales leakage.
Real estate circles have repeatedly identified two trends contributing to "B" and "C" regional malls losing market share to "A" malls, closing, and being redeveloped: (A) Retail anchors and in-line retailers focused on other than the high-end market, and the malls that are primarily comprised of these retailers continue to lose market share while malls with high-end/luxury retailers are gaining market share. (B) Enclosed malls that "turn their back" on the street by not having stores facing outwards, and instead having blocks-long blank walls facing outwards are not appealing to today's customers who increasing value a more urban experience.

A broad array of retail shopping options are available in nearby communities and are easily accessible to Cupertino residents.
The number of options available to Cupertino residents has not changed materially, however, higher-end specialty destinations Valley Fair and Stanford Shopping Centers have undergone upgrades since the 2014 Report was drafted.

The leakage analysis shows that city boundaries do not represent a constraint on Cupertino residents shopping elsewhere or non-residents shopping in Cupertino.
No change. This point is an important one: Political boundaries (in this case the limits of incorporation of the City of Cupertino) do not represent a boundary on where residents will travel to shop. Distance, traffic congestion, and time of travel are all greater factors when making shopping decisions than which municipality might receive the benefit of sales tax revenue.

With respect to specific categories:

- The general merchandise category, which includes businesses that sell everyday items, is performing well in part because of three mall department stores and one discount department store whose sales are included. It should be noted that two Trader Joe's and two Safeway stores are located just outside the City limits, but that a new Safeway will be opening within the City shortly.
  Two of the three department stores at Vallco have closed, and the third is expected to close imminently. As could be expected, the general merchandise category is performing slightly worse than at the time of the 2014 Report, however, performance has been tempered due to increased sales due to an improving economy and the shopping center on Homestead with the relocated Safeway now being open.

- There are also no major electronics or appliance stores such as Best Buy or Fry's in Cupertino, although Sears (in the general merchandise store category) carries a large variety of appliances and may capture a larger share of resident expenditures that would otherwise occur in stores dedicated to electronics and appliances.
  Sears is now closed, however, many of the items sold by Sears are commodities that can be obtained easily in or in close proximity to Cupertino.

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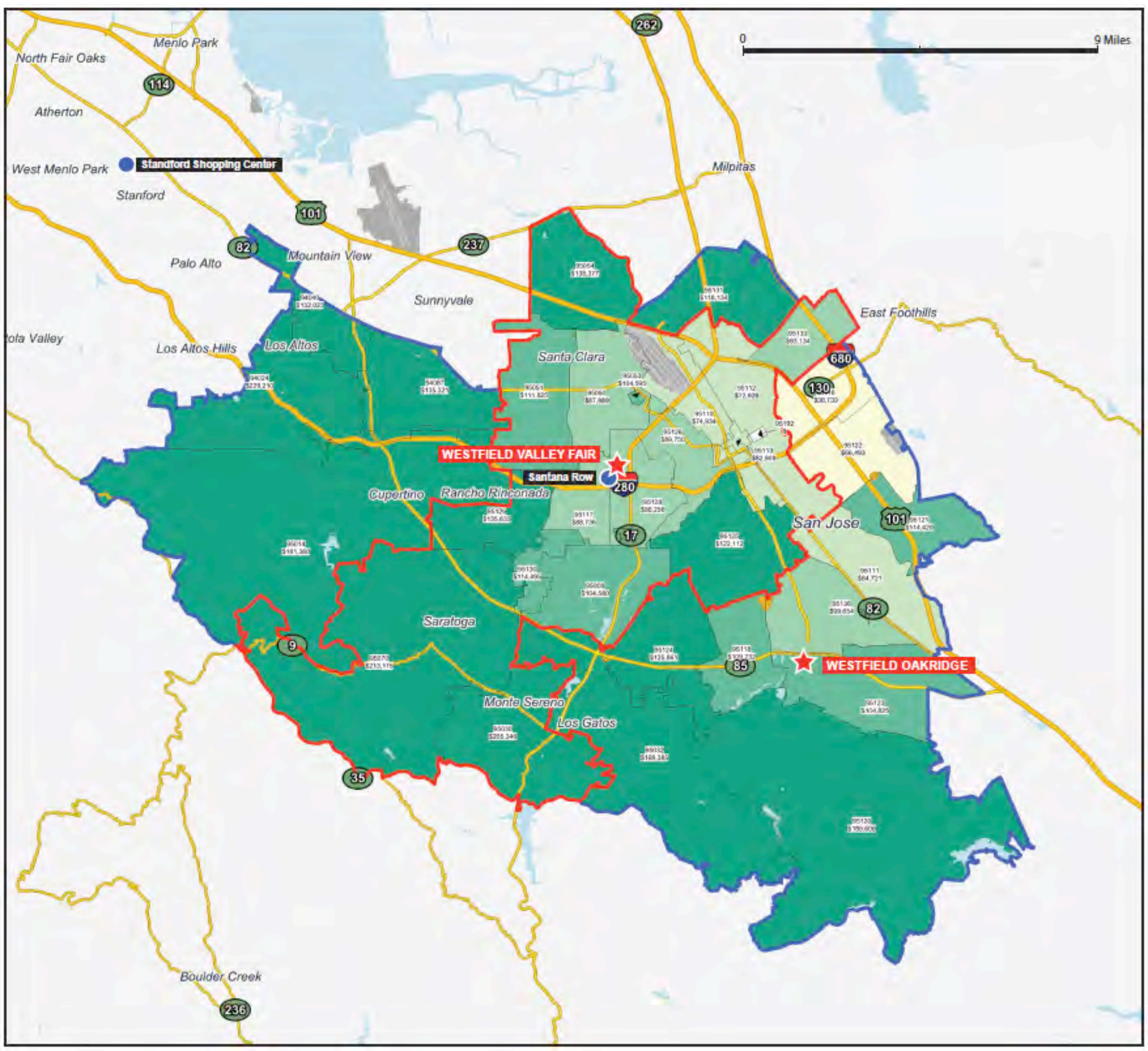
Attachment "B"

Summary of Competing Specialty Shopping Destinations

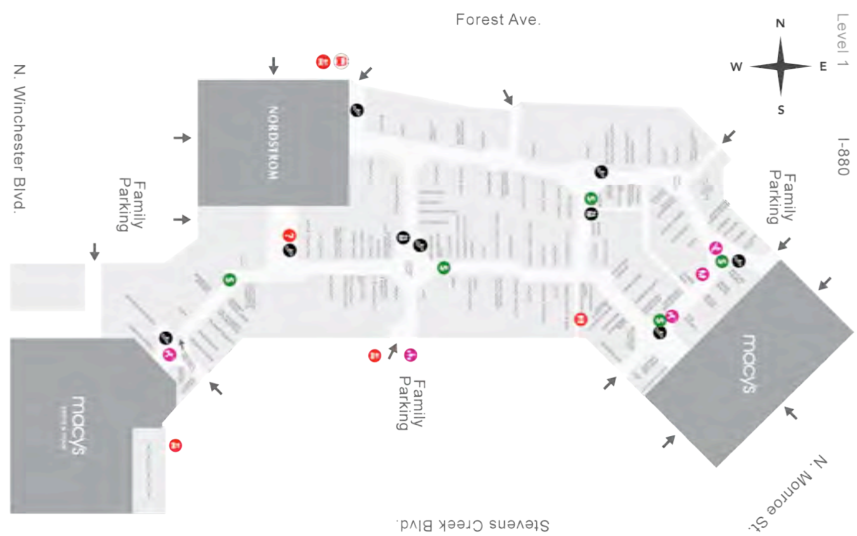
The 9212 initiative proposes preserving Vallco to be a competitive project with Valley Fair, Santana Row, and Stanford Shopping Center. Each project's current status is described below for reference:

Westfield's Valley Fair Shopping Center opened in 1986. Presently 1,477,393 square feet, the Mall is home to 272 retailers including Nordstrom, Macy's, Apple and Cartier producing $494.9 million in annual sales from over 16 million annual customer visits. Following is a map showing how Valley Fair defines its trade area:



Valley Fair is often cited as the highest performing mall in Northern California. This map shows the breadth an "A" mall draws from up to and including from its biggest competitor, Stanford Shopping Center. New merchandising strategies such as Valley Fair's "Luxury Collection," a curated cluster of upscale tenants gives shoppers from a wider geographic area reason to make the trip to Valley Fair. Likewise, additional draw can be expected from Bloomingdales, a planned new anchor. Shopping destinations such as the Luxury Collection and Bloomingdales broaden the base for future leasing efforts, so Valley Fair can be expected to continue to increase in size and market share.

Valley Fair's leasing plan is shown below:



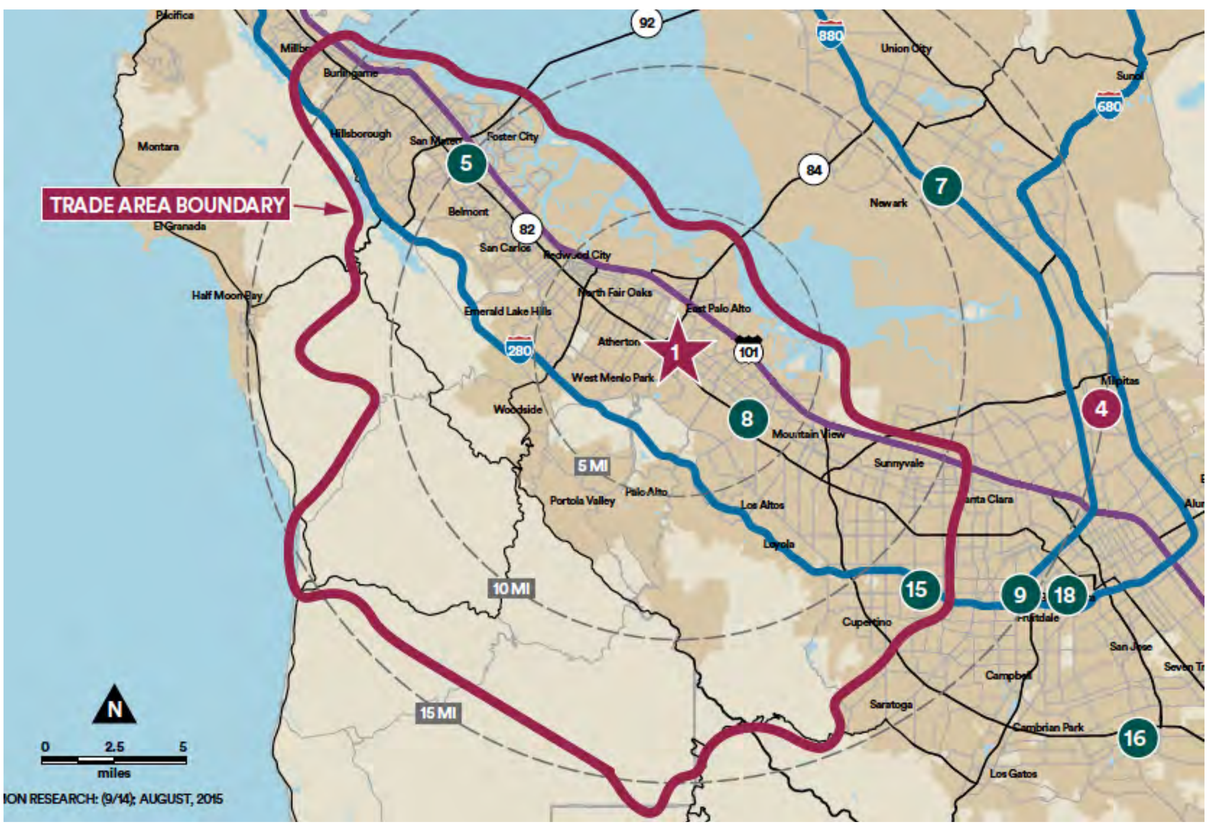
Westfield recently remodeled its food court to create its "Dining Terrace."

This amenity creates a place for people to gather, mingle, and linger. Lighting, materials, and the inside-outside connection expand the open environment during warmer seasons. Banquettes, tables that can be moved together, and internet stations allow visitors with various needs (groups, families, couples) to patronize the dining terrace. Again, these sorts of amenities broaden the appeal and trade area for the mall.

Opened in 2003, Santana Row is a 647,000 square foot mixed-use project with retail, hospitality, office, and residential components. There are over 3,500 parking stalls supporting the 70 shops, 20 restaurants, the 212 room Hotel Valencia, 622 rental units, 219 condominium units, and 65,000 square feet of office space.

Originally built in the mid-1950s, Stanford Shopping Center has evolved into a regional mall with 1,364,000 square feet of retail space and restaurants with 140 stores including anchors Neiman Marcus, Bloomingdale's, Macy's, and Nordstrom. Simon recently completed a major remodel that created four new shop buildings totaling about 140,000 square feet located where Bloomingdale's formerly operated. Bloomingdale's relocated to Fleming's former location, and Fleming's moved to a new building. The total GLA of the mall, which generates approximately $5.4 million in sales taxes annually, stayed roughly the same.

Stanford Shopping Center's trade area is defined by its owner in the following graphic:



Attachment "C"

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