MEMORANDUM

To: Kerri Heusler, City of Cupertino

From: Sujata Srivastava

Date: July 16, 2019

Project: Economic Feasibility Report of BMR Program

Subject: Response to Peer Review Questions

INTRODUCTION

Strategic Economics submitted a draft report summarizing the results of an economic feasibility analysis of the City of Cupertino's Below Market Rate (BMR) Housing program. The City of Cupertino then retained Lesar Development Consultants to peer review the draft report. Lesar Development Consultants identified a number of key questions to assist with the peer review. This memo report provides responses to those questions.

RESIDENTIAL ANALYSIS

1. It is hard to understand the step-by-step process that SE used for its methodology. The report lacks a clear narrative how it got from point A to point B to point C. It would be helpful to explain in simple language how the process works and why the particular data points are used.

Strategic Economics has edited the draft report to include a summary of the financial feasibility methodology and the data sources.

2. Most inclusionary feasibility studies we typically see are based on a residual land cost analysis, rather than on a return on cost (ROC) or yield on cost (YOC). Can SE provide more background as to why ROC and YOC analysis were used rather than a residual land cost analysis and if that difference would meaningfully change any of the reported results?

There is no single methodology used by economic consultants to measure the financial feasibility of inclusionary requirements. Last year, the Terner Center, Grounded Solutions Network, and the Lincoln Land Institute convened a group of stakeholders to identify "best" practices in feasibility analysis, bringing together economic consultants (including a participant from Strategic Economics), as well as academic researchers, nonprofits, and public agencies that commission these studies.[1] According to

[1] Grounded Solutions Network, UC Berkeley Terner Center, and Lincoln Land Institute, "Strengthening Inclusionary Housing Feasibility Studies Convening Report," December 2018. https://inclusionaryhousing.org/wp-content/uploads/2018/11/ih-feasibility-studies-convening-report.pdf

the summary report, return on cost and yield on cost were more commonly used to measure feasibility than residual land value; however, the "participants generally agreed that there was no one best measure in all cases and no reason to encourage every study to use the same metrics."[2]

Strategic Economics chose to use the yield on cost metric because it is a commonly used approach that allows one to compare the return achieved from the development project to other real estate investments. This method is often more intuitive for stakeholders than the residual land value of a project. Nevertheless, because the key inputs (developer return and land prices) would be the same using either of these approaches, the outcome of the analysis would not change if we had solved for the residual land value instead.

3. The ROC analysis's sources on page 10 reference "recent project proformas" and developer interviews. Can further documentation be provided on what recent proformas were analyzed, and what developers were interviewed?

Some of the pro formas reviewed are not public documents. Strategic Economics interviewed the following developers and brokers for this analysis:

- Alex Kang, single-family builder
- Suejane Han, single-family builder
- Christopher Huang, Marina Plaza (retail)
- Brandon Bain, Cushman & Wakefield (office)
- Edward Chan, Hyatt House (hotel)
- Michael Strahs, Kimco (hotel)
- Reed Moulds, Sand Hill (multi-family residential and office)
- Tim Steele, Sobrato (multi-family residential and office)

Strategic Economics also reached out to the following stakeholders, but did not receive a response:

- Mike Ducote, Prometheus
- Nandy Kumar, Main Street Apartments
- Greg DeLong and Mike Benevento, CBRE
- Phil Mahoney
- Alexandra Reynolds, Federal Realty
- Steve Horton, Cushman & Wakefield
- Jill Arias, Newmark Knight Frank
- Andy Poppink, Jones Lang Lasalle
- Mark Calvano, Calvano
- Curtis Leigh, Hunter Properties
- Gene Payne, Broadreach Capital Partners

4. I am curious about the use of Redfin for data in the analysis. There are a number of professional data aggregators that one typically sees, such as DataQuick, Costar, etc. which SE does use for some

[2] Ibid, page 6.

of the analysis. What was the thought behind using Redfin (which I personally experienced containing incorrect data in reporting sales)?

Costar only tracks rental apartments, and does not contain information on ownership residential data, so it cannot be used to determine the sales prices on ownership products. CoreLogic (formerly DataQuick) reports on transactions for ownership residential (single-family and condominiums/townhouses); However, CoreLogic data has a significant cost, and frequently the data shows many errors. It can also be very difficult to break out the multi-family ownership from the single-family ownership products using the CoreLogic dataset. For these reasons, Strategic Economics used Redfin for the analysis.

5. The report uses comps for townhomes and other housing types in Cupertino that are quite old. Typically, if the review of comps finds that no development is currently taking place, then adding an additional requirement would further constrain the development of housing. Is that the case here, or are there other market factors influencing the types of projects proposed and approved in Cupertino?

It is preferable to use new development projects as comparables for a feasibility analysis. However, in the case of Cupertino, there were no recent examples of newly built townhomes. Based on our understanding of the strong demand for housing of all types in Cupertino, Strategic Economics believes that the market for townhouse development is strong. There may be many other factors that have inhibited recent development of townhomes, including a scarcity of sites, competition from other types of land uses that can pay more for land (including multi-family residential and nonresidential uses), and the complexity of the approvals/entitlements process.

6. Figure A-3 in the appendix is titled "Recent Re-Sales of Condominium Comparables" when in fact the table shows rents. Figure A-4 repeats this information but calls the table "Recently Built Rental Comparables." Can SE update the table to include the dates when these comps were built?

This was an error. Strategic Economics has inserted the correct table under Figure A-3. Strategic Economics added a column in Figure A-4 showing the year that the project was built.

7. On page 11, the sales prices per unit are in some cases significantly different than what was shown in the KMA report just four years ago. For example, condominiums in the 2015 report were on the order of $800,000. What accounts for the more than 100% increase in four years? Is this the result of construction cost escalation, and can SE say more about the market's ability to sustain the higher current sale prices while absorbing additional affordability requirements?

Strategic Economics cannot comment on KMA's data sources and research from the 2015 nexus study. However, a review of data collected by the Santa Clara County Association of Realtors shows that the median price for existing condominiums increased from $895,500 in 2014 to $1.4 million in 2018.[3] This feasibility analysis assumes average price of $1,485,000 for a new two-bedroom condominium unit, and an average price of $1.6 million for a new three-bedroom unit . This is slightly higher than the median in 2018, because the assumption is that a newly built condominium unit would

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[3] Santa Clara County Association of Realtors, 2014 and 2018.

https://www.sccaor.com/pdf/stats/2014.pdf

https://www.sccaor.com/pdf/stats/2018.pdf.

be priced higher than the median for all existing condos, which include older units. Using a lower sales price assumption would make it less likely that a new development project could feasibly provide inclusionary units.

The report has been amended to discuss general trends in sales prices and rents in the city and region.

8. In addition, rents shown on that page are also substantially higher than in KMA's study. Can SE provide some additional explanation about the market forces that are driving these increases?

Similar to the dynamics described above with condominium prices, rental rates in Santa Clara County have increased rapidly in the last five years. There is significant pent-up demand in Santa Clara County and the broader Bay Area region, as housing development has not kept up with employment growth. Between 2009 and 2015, Santa Clara County added over 170,000 new jobs between 2010 and 2015, but only 29,000 new housing units.[4] Apartment rents accelerated beginning in 2011, as the economy emerged from the Great Recession, and continued growing at an average annual rate of nearly eight percent until 2015. Since then rents have continued to grow at a slower pace of about four percent.

The report has been amended to discuss general trends in sales prices and rents in the city and region.

9. On page 13, should the income limits be updated to the 2019 counts? Would showing increased rents using the 2019 data result in higher affordability requirements being feasible?

Strategic Economics completed the technical modeling and analysis before the new limits were published for 2019. In 2019, the area median income (AMI) for Santa Clara County is $131,400. This is a slight increase from the AMI of $125,200 in 2018. Because the income change from 2018 to 2019 is relatively minor, Strategic Economics does not believe that updating the affordable rents to 2019 figures would create significant differences in the feasibility findings.

Non-Residential Analysis

1. KMA provided information on mitigation fees as a percentage of total development cost as one way to measure a fee's reasonableness. How does SE's methodology compare?

The pro forma model provides more information about the feasibility of a development by comparing the revenues and costs of a development, and determining whether it would be likely to attract development. Measuring the commercial linkage fees as a percentage of total development cost provides information about the extent to which proposed fees would increase overall development costs, but it does not allow one to draw conclusions about feasibility.

In order to provide some consistency between the 2015 nexus study and this report, Strategic Economics has added rows to the pro forma showing the commercial linkage fee levels tested in the pro forma analysis as a percentage of total development costs.

2. The pool of comparables used in the analysis is quite small. Would that impact the resulting outcomes?

Strategic Economics reviewed comparables – recently built nonresidential development projects and property transactions – to estimate land values, office rents, hotel room rates, and retail rents. The analysis of comparables was not the only source of data. It was supplemented with findings from

[4] SPUR, "Room for More: Housing Agenda for San José," August 2017.

stakeholder interviews, as well as data vendors like Costar and Smith Travel Research. Because we have used a mix of sources to inform our inputs, we feel comfortable that we used selected comparables that represent the market conditions in Cupertino.