MEMORANDUM

To: Erick Serrano and Kerri Heusler, City of Cupertino

From: Sujata Srivastava, Strategic Economics

Date: December 16, 2019

Project: Economic Feasibility Study of Inclusionary Requirements

Subject: Follow-up Analysis and Research

Introduction

This memorandum report summarizes the results of supplemental research and analysis for the City of Cupertino's BMR Housing Program, based on direction from City Council. This report provides information on three topics:

1. **Feasibility analysis testing the potential for new multi-family rental development to provide extremely low income (ELI) units.** Using an updated pro forma model, Strategic Economics estimated the number of ELI units that could be provided on-site under different assumptions about density and parking requirements.

2. **Case studies of community benefits incentive programs that create opportunities for cities to obtain higher affordable housing contributions than the basic requirements.** These programs allow for increased densities in residential and non-residential projects in exchange for the provision of more affordable housing or other community benefits.

3. **Historic capitalization rates.** Strategic Economics reviewed historic capitalization rates (or cap rates) to provide the City with information on how the rate of return expectation for cap rates may change over time.

Feasibility of Extremely Low Income Units

Strategic Economics updated its feasibility analysis from June 2019 to evaluate the potential for new multi-family rental development projects to provide extremely low income (ELI) units on-site, under different development standards and requirements.

PROTOTYPES

The previous analysis tested two multi-family rental prototypes, a lower density prototype with a density of 35 units per acre, and a higher density prototype with a density of 76 units per acre. Strategic

Economics found that the lower density multi-family rental prototype was not financially feasible to build, and would not be able to contribute any affordable units or affordable housing in lieu fees. The higher density multi-family rental prototype could feasibly provide in lieu fees, but no affordable units on-site. The report concluded that it would not be financially feasible for these development projects to include units for extremely low-income households.

This updated feasibility analysis tests the feasibility of a new multi-family rental prototype (Prototype 6) that has a higher density, smaller unit size, and lower parking requirements than are currently permitted by the zoning code.

Figure 1 summarizes the building prototype's characteristics. As shown, this is a residential prototype containing 100 units on a one-acre parcel, with no commercial space.

Figure 2 shows the unit mix, unit size, and rental rate assumptions for this updated prototype. The unit mix is 50% studios, 35% one-bedrooms, and 15% two-bedroom units, for an average unit size of 686 square feet. The average monthly rent ranges from $3,300 to $4,700, depending on unit size. The other key assumptions regarding costs and developer return are unchanged from the original analysis.

FIGURE 1: NEW PROTOTYPE CHARACTERISTICS

Description	Prototype 6
Tenure	Rental
Unit Mix	Studios, 1 bedroom, 2 bedrooms
Format	Higher density, small sites
Residential Stories	6
Number of Units	100
Parcel Size (Acres)	1.0
Parcel Size (Sq. Ft.)	43,560
DU per Acre	100
Commercial (Sq. Ft.)	0
Parking Type	Podium
Parking Requirement (Per Unit)	1
Parking Requirement (Commercial)	n/a
Required Parking Spaces	100

Source: Strategic Economics

FIGURE 2: UNIT MIX, SIZE, AND RENTAL RATE ASSUMPTIONS

Unit Type	Unit Mix	Avg. Size (Sq. Ft.)	Monthly Rent per Unit	Monthly Rent per Sq. Ft.
Studios	0.5	550	$3,300	$6.00
1-BD	0.35	725	$3,600	$4.97
2-BD	0.15	1050	$4,700	$4.48

Source: Strategic Economics

RESULTS

The financial feasibility analysis shows that the updated prototype could support an inclusionary requirement of 15% BMR units, including ELI units, if city fees were reduced by 50%. The yield on cost is above the minimum required rate of return (4.75%) for each of the following scenarios:

- Scenario 1: The prototype can support an inclusionary requirement of 15% BMR units in accordance with the existing policy, which requires 9% units for very low income and 6% units for low income, if city fees are reduced by 50%.
- Scenario 2: The prototype can support an inclusionary requirement of 15% BMR units that includes 5% for ELI households, if city fees are reduced by 50%.
- Scenario 3: The prototype can support an inclusionary requirement of up to 13% ELI units if city fees are reduced by 50%.

The results of each of these scenarios is summarized in **Figure 3.**

FIGURE 3: RESULTS OF FEASIBILITY ANALYSIS FOR UPDATED PROTOTYPE

Scenario	% BMR Units	% ELI Units	City Fee Reduction	Yield on Cost
Minimum Required Rate of Return				4.75%
Market-Rate Scenario: No Inclusionary	0%	0%	n/a	5.01%
Scenario 1: 15% BMR Units (9% VLI, 6% LI) City Fees Reduced by 50%	15%	0%	50%	4.80%
Scenario 2: 15% BMR Units (with 5% ELI; 5% VLI, 5% LI) City Fees Reduced by 50%	15%	5%	50%	4.76%
Scenario 3: 13% BMR Units (all ELI) City Fees Reduced by 50%	13%	13%	50%	4.76%

Source: Strategic Economics

Community Benefits Incentive Programs

Many California jurisdictions use density bonus programs and other incentive programs to extract the value generated from additional density and gain public benefits from new development, including additional affordable housing. Developers that seek a higher density than is allowed by-right can do so if they also provide a community benefit, such as affordable housing, that exceed the existing inclusionary affordable housing mitigation fee requirements.

These incentive programs can be structured in a variety of ways. Some jurisdictions require that the community benefit be built on-site or within a specific plan area, while others allow developers to provide a financial contribution into a community benefits fund. The contribution can be measured through a financial analysis that quantifies the value of the density bonus. Some jurisdictions negotiate with developers on individual projects that apply for a density bonus through a ministerial process, and others go through a discretionary review process with City Council.

While most existing density bonus programs are for residential development and mixed-use projects, there are also examples of incentive programs for office or other non-residential development. Below is a summary of policies for Santa Monica, Belmont, Mountain View, and Menlo Park.

- **Santa Monica: Community Benefits Program (Citywide).** Santa Monica's community benefits program is applicable in most multifamily and commercial zoning districts throughout the city, "Tier 2" projects that seek to exceed the base density (floor-area-ratio) must contribute higher impact fees. Proposals are managed under a discretionary review process.[1] [2]
- **Belmont: Belmont Village Specific Plan Increased FAR, Height, and Density Incentives for Community Benefits.** In the Belmont Village Specific Plan area, there are baseline requirements that apply for projects that comply with the base density. Residential and non-residential projects that seek an increased density or FAR are only approved if the City Council has determined through a discretionary process that the project is including substantial community benefits above and beyond existing requirements. [3]
- **Menlo Park: El Camino Real Downtown Specific Plan Public Benefit Bonus Program.** This program relies on a developer structured negotiation approach, where a developer seeking a density bonus in the specific plan area for both residential and commercial projects could select from a large menu of community benefits to provide, and is required to conduct a public study session with the city's Planning Commission for evaluation (and also potentially with the City Council depending on the scale and complexity of the project). [4]
- **Mountain View: North Bayshore Precise Plan in Mountain View**

    a) Bonus Floor Area Ratio Non-residential projects in the precise plan area are eligible to apply for incremental increases in FAR above the minimum FAR in exchange for providing community benefits, up to an established maximum FAR. The four "Character Areas" in the precise plan each have their own standards, and the two densest areas provide opportunity for up to three and four cumulative bonuses. The City Council reviews all projects applying for bonus FAR to determine if they meet the Bonus FAR Review Guidelines. Once the 3.6 million sq. ft. of net new office space capacity is accounted for in

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[1] "Chapter 9.23- Community Benefits," Santa Monica Zoning Ordinance, 2017.
[2] Zoning Ordinance Update: Implementing Tier 2 Community Benefits," City of Santa Monica, 2013.
[3] "Chapter 4- Urban Design," Belmont Village Specific Plan, 2017; "Chapter 31.4-Village Zoning District Standards," Belmont Zoning Code, 2017.
[4] "Chapter E-Land Use + Building Character," El Camino Real Downtown Specific Plan, 2012

new developments, no new FAR bonuses are allowed to be issued unless further building area capacity is authorized by a new CEQA analysis.

b) Floor Area Ratio Exemptions: Developers may also exempt small business and public-serving spaces when calculating the FAR in their buildings, provided they account for less than 5 percent of the Character Area's maximum allowable FAR for a development. Developers of mixed-use projects in most parts of the precise plan area can also exempt retail and grocery spaces from counting toward total FAR. These exemptions fall under the ministerial development review process.[5]

The community benefit options available to developers are similar among the four jurisdictions, and are primarily related to affordable housing, green building construction, transit, open space, environmental protection, and cultural resources. While all four cities encourage developers to provide affordable housing as a benefit, Santa Monica is the only jurisdiction that explicitly requires an affordable housing contribution in order to receive the bonus. Santa Monica's policy, which is the narrowest of the four, and is broadly applicable throughout the jurisdiction, is also the only policy that requires the community benefits be provided through monetary contribution. For the other three policies, which are only applicable in specific areas of the jurisdictions, there is more flexibility in how developers provide the benefits. Additional features of these programs are displayed below in **Figure 4.**

The City of Cupertino could implement a similar program for both new residential and non-residential development in order to get additional benefits beyond what is required under the existing BMR policy. If it is in the City's interest, it could prioritize affordable housing as a community benefit, and encourage developers to provide site units or dedication of land, to increase the amount of affordable units created from new development.

[5] "North Bayshore Precise Plan," City of Mountain View, 2014.

FIGURE 4. FEATURES OF COMMUNITY BENEFIT INCENTIVE PROGRAMS FOR SELECT MUNICIPALITIES

	Santa Monica (Citywide)	Belmont Village Specific Plan	Menlo Park El Camino Real Downtown Specific Plan	Mountain View North Bayshore Precise Plan
Types of Community Benefits	Affordable housing, open space, traffic mitigation, transit demand management, and cultural facilities.	On-site affordable housing, lot consolidation (sometimes referred to as a "graduated density bonus"), public access dedications and improvements, BMR commercial spaces serving community needs, recreational and cultural contributions.	Could include (but are not limited to) elements such as affordable units, senior housing, hotel facility, historic resource preservation, public space, shuttle services.	Affordable units, green building standards, public art, open space, district parking facilities, district transportation improvements, habitat expansion.
Method of Providing Community Benefit	Projects exceeding base FAR must pay additional city impact fees.	Projects exceeding base FAR must provide community benefits on-site or as fees.	Projects exceeding base FAR must provide community benefits on-site or as fees.	Projects exceeding base FAR must provide on-site or district-scale community benefits, some of which could be met by a fee contribution.
Applicability and Review	Except for 100% affordable projects, all projects involving new development in specified zones are eligible. Generally, community benefit requirements are consistent for both residential and nonresidential projects. Because additional fees associated with the bonus are delineated in the zoning code, and are broadly applied to all projects, the review process is administrative.	Any project within Belmont Village Specific Plan Area is eligible. Process for both non-residential and residential project applicants requires public hearing, and City Council would determine through discretionary review whether: 1) making award will help implement city's goals; 2) benefits would not be realized without granting bonus, 3) bonus is minimum necessary to realize benefits.	Both residential and nonresidential projects within the Specific Plan area are eligible and require case-by-case negotiation with either the Planning Commission or City Council depending on project scale.	Bonus FAR provisions solely apply to nonresidential projects located within North Bayshore Precise Plan Complete Neighborhood Area. which City Council would consider through a discretionary review. Residential projects undergo a separate process, in which providing an increased share of affordable units allows for an FAR increase, which is offered through two tier options.

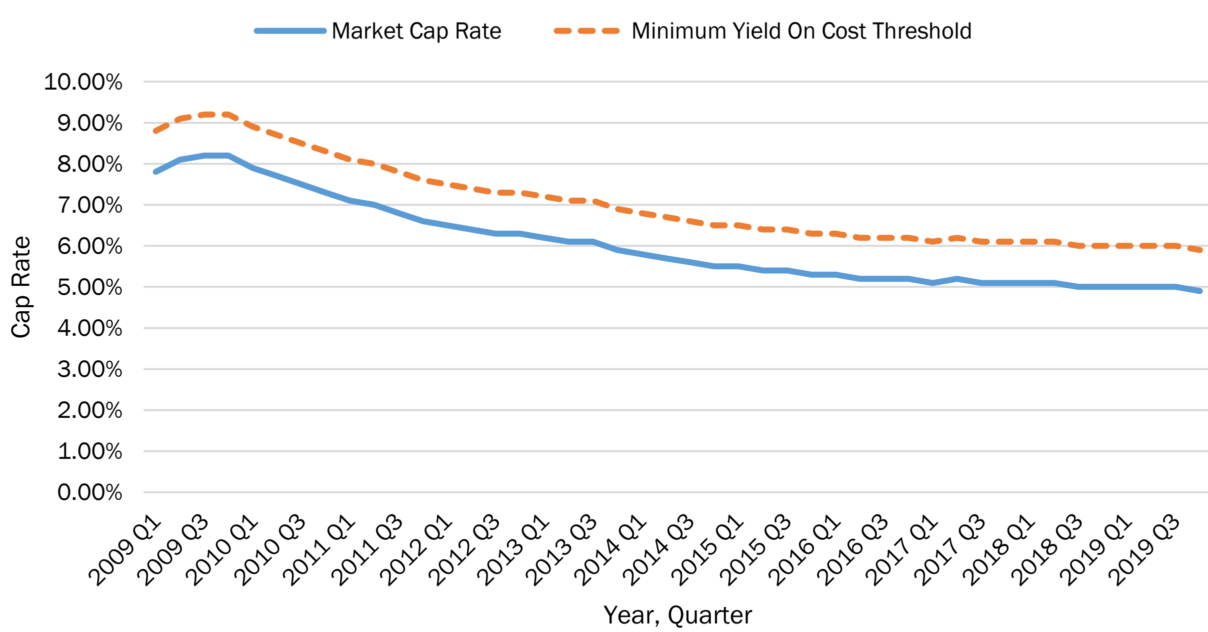
Historic Capitalization Rate Trends

Strategic Economics reviewed historic capitalization rates (or cap rates) to provide the Cupertino City Council with information on how the rate of return expectation for cap rates may change over time.

A capitalization rate, which is expressed as a percent, is a measure of a property's net operating income divided by the property's capitalized value, (the property's expected sale value). There is a direct relationship between the market area's capitalization rate and the expected risk of a real estate investment in that area. If a cap rate decreases in a market, it suggests that real estate investments have become less risky, and that expected rate of return required for the project to be considered feasible has also decreased, meaning more projects are likely to be feasible. Developers typically assume that the minimum yield on cost for a project, which is the net operating income divided by the total development cost, should be no less than one percentage point above the expected cap rate for the project to be considered feasible.

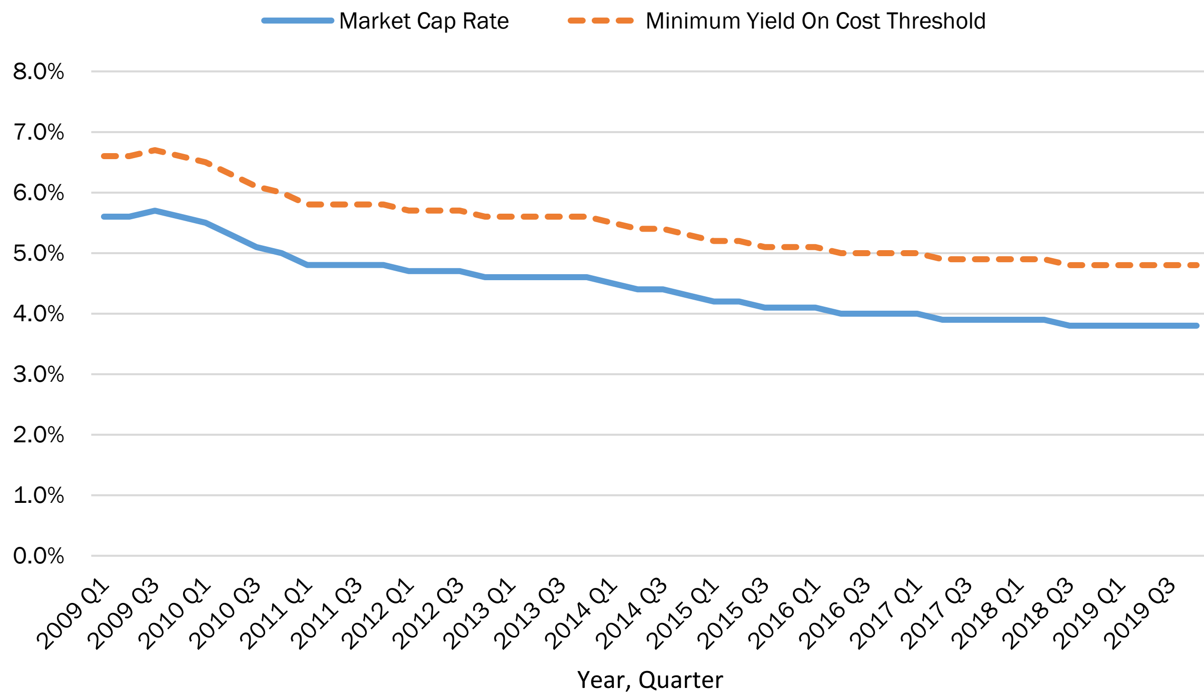
Figure 5 and **Figure 6** show cap rate trends for office and multifamily properties in Santa Clara County over time. As these figures show, current market cap rates are the lowest they have been since the Great Recession in 2009. This indicates a very strong market, as the minimum rate of return threshold is the lowest it has been over the course of the period measured. If the market were to slow down in the future, cap rates would increase again while expected rents would likely decrease, and a project would require a higher rate of return than what is required today to be feasible.

FIGURE 5. SANTA CLARA COUNTY OFFICE CAP RATES AND MONTHLY RENT PER SQ. FT., 2009-2019



Source: Costar, 2019; Strategic Economics, 2019.

FIGURE 6. SANTA CLARA COUNTY MULTI-FAMILY CAP RATES AND MINIMUM YIELD ON COST THRESHOLD, 2009-2019.



Source: Costar, 2019; Strategic Economics, 2019.