M E M O R A N D U M

DATE: January 25, 2005

TO: Al Zelinka, RBF/Urban Design Studio

FROM: Matt Kowta, Principal

RE: Pro-Forma Analysis for South Auburn St. Plan

Overview

Attached please find draft pro-forma worksheets for the three building prototypes specified for our financial analysis: 1) Two-story restaurant building; 2) two-story office building; and 3) 3-story mixed use building with office over ground floor retail. (See Tables 1, 2, and 3, respectively.)

The purpose of this memo and the accompanying pro-forma worksheets is to provide RBF/Urban Design Studio and the City of Grass Valley with a conceptual analysis of financial feasibility for building prototypes that illustrate the types of buildings that could be developed during the implementation of the proposed S. Auburn Street Master Plan. This analysis is intended to provide an assessment of the extent to which potential development profits will entice the private sector to undertake projects of the type envisioned in the master plan or to identify the possible need for public subsidies that could be required in order to attract developers to undertake desired projects.

Methodology

The pro-forma analysis involved first collecting information regarding the potential lease revenues for various types of buildings in the downtown Grass Valley area. This involved a review of available properties via various real estate broker web sites as well as telephone interviews with knowledgeable local real estate brokers.

BAE then developed basic cost assumptions to develop the different building types, based on the building specifications provided by RBF/Urban Design Studio. BAE's estimates for hard construction costs are based on a review of construction cost manuals, and conversations with developers and contractors with experience constructing similar types of buildings in other locations. Development soft costs are based on general industry rules of thumb for putting together financial projections at this conceptual stage. BAE reviewed the City's development impact fee schedule to ascertain that impact fee levels would fall within the normal range of soft costs for development projects of these types.

We have set land cost portion of the cost section at zero. This allows us to calculate all other costs and determine what amount of project cost could be allocated to site acquisition costs once all other costs are accounted for.

Next BAE assembled the income and cost information into pro-forma spreadsheets that calculate the potential return on investment for each building prototype. The spreadsheets calculate the stabilized annual Net Operating Income (NOI) for each of the properties, assuming a 90 percent occupancy rate. BAE has applied typical building expense ratios for retail, office, and residential properties in order to arrive at the NOI. NOI is then divided by total building development costs to estimate a return on investment.

Based on our experience analyzing these types of projects in a range of locations throughout the greater northern California area, we estimate that the required returns on investment are equal to approximately nine to ten percent. We have assumed that the retail and office products will require a ten percent return and that the mixed-use project, which has a large residential component, will require a slightly lower return of nine percent, based on the lower risk typically associated with the residential development in today's market. If we project that a prototype can exceed these developer profit thresholds, then we begin to add a land cost component to the model and increase the land cost until the return on investment equals the targeted rate of return. This then tells us the price that a developer could afford to pay for the building site and still earn the required rate of return on the project.

Feasibility Results

Tables 1 through 3 show that none of the three prototypes achieve the required rate of return, although the retail and office projects, both at 8.9 percent return on investment, are close to meeting the ten percent return on investment threshold, without allowing for any land cost. This means, for example, that developers would consider the projects marginally feasible if they did not have to pay to acquire the sites.

Comments on Retail Building Feasibility. As indicated above, the calculations in Table 1 indicate that the retail building is marginally feasible, if the developer did not have to pay to acquire the site. One possible scenario could involve the City owning the site and acting as the owner of the project. The City would then establish a business relationship with a "fee developer" who would handle the development of the project for a set fee that would be taken out of the project's annual net operating income.

We note that the parking requirements for the retail building are very high – at 90 total spaces, or approximately 13 spaces per 1,000 square feet of space. At the same time,

the City's downtown parking in-lieu fee ordinance specifies a cost of $2,000 per 200 square feet of building area. If the City allowed the project to pay the in-lieu fee instead of providing its own parking, the project could save approximately $115,000 in hard costs and this would allow the project to exceed the required 10 percent return (again, without having to pay for land).

Comments on Office Building Feasibility. Like the retail building, this project appears marginally feasible, if the developer did not have to pay to acquire the land, just missing the required return on investment threshold. The City might be able to attract a developer partner through "fee developer" arrangement like that described above for the retail project, if the City already owned the land. Unlike the retail project, the office project would not benefit substantially from being able to pay the parking in-lieu fee as opposed to providing its own parking.

Limited information that we were able to collect on current office real estate market conditions suggests that a premium may be placed on the value of smaller office property that is intended for owner-occupancy. In many markets the owners of smaller professional services businesses prefer to own their own buildings, due to the long-term investment potential and a distaste for "throwing money away on rent".

Highland Commercial Real Estate indicated that a converted Victorian with approximately 1,100 square feet of office space on a an approximately 4,000 square foot lot was selling for over its listed price of $321 per square foot in the South Auburn Street area. While the office building project may not be readily attractive to a developer as a rental income property, this prototype is of a size such that a local business might be interested in having the building built to purchase. In the case of the office building prototype shown in Table 2, the developer would want to recoup approximately $140 per square foot for the building itself. If the business were willing to pay $300 per square foot to own its own building, then the site acquisition cost could be approximately $1 million. A project of this type would most likely entail a developer identifying an established local business that is interested in either expanding or relocating to the downtown and then putting together a project to acquire the site and construct the building for sale to the business upon completion.

Comments on Mixed-Use Building Feasibility. In the case of the mixed-use project, the estimated return on investment is 5.9 percent, which is well short of the nine percent target. For this project, we estimate that the developer would have to be able to acquire the land at no additional cost and, in addition, would require cost subsidies of approximately $1 million, or about one-third of the project cost. This project performs poorly compared to the other two projects because of several factors. The multifamily residential component generates rents that are below those for retail and office space (about $1.00 per square foot vs. $1.15 to $1.40 for retail and office, respectively. At the

same time, while expenses are assumed to be relatively low for retail and office space leased on a triple-net basis (meaning that in addition to rent, the tenants pay for most building operating expenses, such as property taxes, insurance, and utilities), the expenses are relatively high (30% of rent) for apartments. Additionally, because of the need to dedicate space for non-leasable circulation and access for the multifamily units, a reduced amount of the building space generates income. Overall we have assigned a slightly higher cost to the hard construction cost for the mixed-use building, because of the increased code requirements for building that can accommodate multiple uses.

A knowledgeable local real estate broker indicated that he felt that there was no real market for for-sale residential units in downtown Grass Valley other than subsidized housing at this time. Otherwise, this might be an option capture higher values for the residential component of the project. At this time though, an unproven market for for-sale downtown housing, coupled with high developer costs to develop for-sale multifamily units, means this would be a risky approach.

Conclusions

In general, current market conditions and the results of this analysis indicate that downtown Grass Valley does not yet command a location premium that makes higher density urban infill development projects readily attractive to developers. Public financial assistance would be necessary in order to spur redevelopment, in most cases.

We have identified some scenarios whereby the City, acting in partnership with developers, might be able to put together some small single-use, single tenant retail or office projects; however, the City would need to not only contribute substantial capital to acquire sites, but it would also assume development risk. In exchange for a portion of the financial returns, the developer partner would lend its expertise in development, construction management, and recruiting tenants.

Under current conditions, the City may be able to take a different tack in order to spur some downtown redevelopment, as discussed above in regard to the office prototype. The City's role would be to help facilitate the process for local businesses to purchase buildings on a built-to-suit basis. The City would assist by identifying and helping to match interested businesses with interested local developers. In addition, the City could make a valuable contribution to this process by identifying available sites, and streamlining and facilitating the site planning and permitting process.

In order for feasible development of the prototype projects on a speculative, rental-income producing basis, the market rents will need to increase substantially. Ultimately, we believe that with the enhancement of the downtown's intrinsic assets through the master planning process and other civic efforts, the market will place a

premium on space in the downtown and rents will rise to a level that will support redevelopment and new construction. Experience in other communities undergoing downtown revitalization and infill has shown that users will often pay a premium for downtown urban infill space and that investors will pay a premium to purchase these types of buildings once they are successfully built and occupied. By providing financial assistance to a limited number of quality projects in the interim, the City can help to establish the standard for future redevelopment efforts, and demonstrate market viability.

Table 1: Retail Space for Restaurant (Two-Story, Single Tenant)

Major Assumptions			Pro Forma Analysis	
Development Program	**Number**	**Unit**	**Development Costs**	
Lot Size	0.12	Acres	*Hard Costs*	
Building Square Feet	6,460	Bldg. Sq. Ft.	Land	$0
Parking (Surface)	90	Spaces	Site Development	$12,975
			Construction Costs (a)	$581,400
Development Costs Assumptions	**Price Per Unit**	**Unit**	Parking Costs	$180,000
Hard Costs			*Sub Total*	*$774,375*
Land Costs	$0	/Lot Sq. Ft.		
Site Development Costs	$2.50	/Lot Sq. Ft.	*Soft Costs*	*$232,313*
Construction Hard Costs (Shell only)	$90	/Bldg. Sq. Ft.		
Parking Costs (Surface, off-site)	$2,000	/Space	**Total Development Cost**	**$1,006,688**
Soft Costs	30%	of Hard Costs	**Development Feasibility**	
Developer Profit Assumption (NOI/Total Cost)			*Rent Revenue*	
Developer Profit Threshold	10%	of Total Costs	Retail Leasing Revenue	$97,675
			Total Rent Revenue	*$97,675*
Rental Space Revenues			*Less Operating Expenses*	
Restaurant Shell	$1.40	/bldg. sq. ft. NNN	Operating Expenses	($7,752)
			Total Operating Expenses	*($7,752)*
Expenses			**Net Operating Income (NOI)**	**$89,923**
Retail NNN	$0.10	/bldg. sq. ft.		
			Return on Costs	**8.9%**
Occupancy Rate	90%	of Total Sq. Ft.		
			Required Cost Subsidy to Meet Developer Profit Threshold	**$107,456**
				plus site acquisition costs

Notes:
Soft costs include architecture, engineering, permits, impact fees, financing, legal, interim property taxes, and developer overhead.

Assumes developer pays for off-site surface parking. If developer is allowed to pay downtown parking in-lieu fee, signficant ($100,000+) cost savings would be realized.

Assumes developer provides a bare shell with venting for range hood. Restaurant tenant would pay for buildout of restaurant space or negotiate tenant improvement package in conjunction with rent add-ons.

Source: BAE, 2005.

Table 2: Office (Two-Story, Single-Tenant)

Major Assumptions			Pro Forma Analysis	
Development Program	**Number**	**Unit**	**Development Costs**	
Lot Size	0.12	Acres	*Hard Costs*	
Building Square Feet	7,100	Bldg. Sq. Ft.	Land	$0
Parking	36	Spaces	Site Development	$12,975
			Construction Costs (a)	$603,500
Development Costs Assumptions	**Price Per Unit**	**Unit**	Parking Costs	$72,000
Hard Costs			*Sub Total*	*$688,475*
Land Costs	$0	/Lot Sq. Ft.	*Soft Costs*	*$206,543*
Site Development Costs	$2.50	/Lot Sq. Ft.		
Construction Hard Costs	$85	/Bldg. Sq. Ft.	**Total Development Cost**	**$895,018**
Parking Costs	$2,000	/Space		
Soft Costs	30%	of Hard Costs	**Development Feasibility**	
			Rent Revenue	
Developer Profit Assumption (NOI/Total Cost)			Office Leasing Revenue	$88,182
Developer Profit Threshold	10%	of Total Costs	*Total Rent Revenue*	*$88,182*
			Less Operating Expenses	
Rental Space Revenues			Operating Expenses	($8,520)
Office Space	$1.15	/bldg. sq. ft. NNN	*Total Operating Expenses*	*($8,520)*
Expenses			**Net Operating Income (NOI)**	**$79,662**
Office Space	$0.10	/bldg. sq. ft.		
			Return on Costs	**8.9%**
Occupancy Rate	90%	of Total Sq. Ft.		
			Required Cost Subsidy to Meet Developer Profit Threshold	**$98,398**
				plus site acquisition costs

Notes:
Soft costs include architecture, engineering, permits, impact fees, financing, legal, interim property taxes, and developer overhead.

Assumes developer provides a shell, demising walls, and HVAC. Office tenant would pay for buildout of interior spaces or negotiate tenant improvement package in conjunction with rent add-ons.

Assumes rental of building as single-tenant office space.

Source: BAE, 2005.

Table 3: Mixed Use Building (Ground Floor Retail with 2 Floors of Office Above)

Major Assumptions		
Development Program	**Number**	**Unit**
Lot Size	0.34	Acres
Residential Units	16	Units
Average Unit Size	731	Sq. Ft.
Retail Space	7,000	Sq. Ft.
Gross Building Square Feet	21,870	Bldg. Sq. Ft.
Parking (Surface)	66	Spaces
Development Cost Assumptions	**Price Per Unit**	**Unit**
Hard Costs		
Land Costs	$0	/Lot Sq. Ft.
Site Development Costs	$2.50	/Lot Sq. Ft.
Construction Hard Costs	$100	/Bldg. Sq. Ft.
Parking Costs (Surface)	$2,000	/Space
Soft Costs	30%	of Hard Costs
Developer Profit Assumption (NOI/Total Cost)		
Developer Profit Threshold	9%	of Total Costs
Lease Revenues		
Retail Space (NNN)	$1.40	/Sq. Ft.
Multifamily Units	$731	/unit.
Expenses		
Retail Space	$0.10	/Sq. Ft.
Multifamily	$219	/unit
Occupancy rates	90%	of Total Sq. Ft.

Notes
Soft costs include architecture, engineering, permits, impact fees, financing, legal, interim property taxes, and developer overhead.

Assumes developer pays for off-site surface parking.

Assumes developer provides a bare retail shell. Retail tenant would pay for buildout of retail space or negotiate tenant improvement package in conjunction with rent add-ons.

Pro Forma Analysis		
Development Costs		
Hard Costs		
Land		$0
Site Development		$37,500
Construction Costs (a)		$2,187,000
Parking Costs		$132,000
	Sub Total	*$2,356,500*
Soft Costs		$706,950
Total Development Cost		**$3,063,450**
Development Feasibility		
Rent Revenue		
Retail Lease Revenues		$105,840
Multifamily Lease Revenue		$126,360
	Total Rent Revenue	*$232,200*
Less Operating Expenses		
Operating Expenses - Retail		($8,400)
Operating Expenses - Residential		($42,120)
	Total Operating Expenses	*($50,520)*
Net Operating Income (NOI)		**$181,680**
Return on Costs		**5.9%**
Required Cost Subsidy to Meet Developer Profit Threshold		**$1,044,783** *plus site acquisition costs*

Source: BAE, 2005.