Natelson Dale Group Pacific Avenue Memo

M E M O R A N D U M											
то:	Diane Bathgate, AICP Manager of Planning BRM Design Group	DATE:	August 29, 2017								
FROM:	Roger Dale Managing Principal The Natelson Dale Group, Inc. (TNDG)	FILE:	#4079								
SUBJECT:	Update of Long Beach General Plan Land Use Element – Evaluation of Market-feasible Building Heights for Pacific Avenue Corridor										

## **Background**

As part of the update process for the Land Use Element of the Long Beach General Plan, the City is considering Neighborhood Serving Commercial (NSC) for the Pacific Avenue corridor between 20<sup>th</sup> Street and 25<sup>th</sup> Street. Existing development within this corridor mostly consists of older, one-story commercial buildings. The NSC designation would allow for residential, commercial and vertical mixed-use development.

The City initially proposed a 4-story height limit for this segment of Pacific Avenue. Based on community concern about the potential increase in building heights, the City is now considering height limits in the range of two to four stories.

Given the built-out nature of this corridor, most future development would involve smaller infill and/or redevelopment projects. The City has asked TNDG to provide an analysis of the likelihood of incentivizing the redevelopment of older properties based on a 2-, 3- or 4-story height limit, given the lot depth and other characteristics of the area. TNDG's work scope for this assignment has included the following steps:

- Interviews with residential and mixed-use developers currently active in Long Beach and familiar with the economic challenges of urban infill/redevelopment projects. A total of four developers participated in the interviews<sup>1</sup>.
- A pro forma financial analysis that compares the financial feasibility of several development prototypes (with varying building heights) within the corridor. The financial pro forma is not sufficiently detailed to evaluate the feasibility of specific individual development projects, but provides generalized conclusions regarding the feasibility of alternative development densities.
- Identification of other issues to consider when drafting plans and policies for encouraging revitalization along this particular street.

<sup>&</sup>lt;sup>1</sup> The participating firms were Ensemble Real Estate Investments, JR van Dijs, Inc., LMC/Lennar, and Ratkovich Properties.

Due to the fairly limited scope of this analysis, TNDG's conclusions are not represented as definitive (and are not necessarily applicable to all properties within the corridor), but are intended to provide a general framework for understanding the potential economic dynamics of future intensification of this area.

The crux of the challenge in this type of setting is that, even though many properties are developed in a manner that does not represent their current highest and best use, the existing older buildings on these sites often provide stable cash flows for the owners (whether used for owner-occupied businesses or leased to other tenants) which, given the owner's low cost-basis, provide acceptable returns on investment. As such, there is often little incentive for the property owners to assume the risk (and usually substantial additional debt) required to reinvest in older properties unless the potential payback in terms of increased development value clearly outweighs the risk. The question is, how much additional density is needed to incentivize landowners to take the risk of redeveloping their properties, thereby facilitating revitalization of the overall corridor? The answer, as discussed below, is not as simple as "four stories works and three stories does not," but is better framed in terms of the relative *likelihood* of inducing redevelopment at different density levels.

## **Summary Conclusion**

TNDG believes that, given existing property values in the area, an allowable building height of at least three stories (assumed here to be configured as two stories of residential development above one level of at-grade parking shared with ground-floor commercial space) would be needed to allow for feasible redevelopment of older properties. Maintaining the existing 2-story height limit would likely result in relatively static conditions in the area (i.e., if the 2-story height limit were retained, it is likely that few property owners would find it economically attractive to redevelop their sites with new buildings).

The simplified financial analysis prepared by TNDG indicates that the 3-story prototype would support a land purchase price of \$141 per square foot and still allow a developer to achieve a reasonable rate of return on the investment required to produce the project. Based on the very limited number of "comparable" properties currently listed for sale in the vicinity of Pacific Avenue, TNDG estimates an existing site acquisition cost of approximately \$100 per square foot of land (although actual asking prices vary widely and can be several times higher than this roughly estimated average).

TNDG's analysis suggests that a 4-story project would support land values approximately 50% higher than the land values supportable by the 3-story project, and a 5-story project would support land values that are nearly double the values supportable by the 3-story project. Thus, while a 3-story project could technically allow for feasible redevelopment, the 4- or 5-

# story projects should be considerably more lucrative and thus would be more likely to create an incentive for property owners to initiate redevelopment of their sites.

**Developer opinions.** The four developers interviewed for this project have varying opinions about the viability of various development densities and configurations. Some expressed doubt about the viability of densities that would require the additional cost of underground parking, while others expressed the opinion that this was a common form of infill projects throughout the southern California region. Two of the interviewed developers believe that a relatively low-density configuration of no more than two floors of apartments above a parking/commercial-space deck, with no underground parking, could be viable in the area. The others believe that a building height of at least four stories (triggering the need for underground parking) would be needed to attract significant developer interest in the project area. The interviewed developers also provided input on what they believed to be typical development costs and rents for the area.

Land residual model (simplified financial pro forma). The table at the end of this document summarizes three redevelopment scenarios for a hypothetical "case study" property type on Pacific Avenue. The intent of the table is to compare "residual land value" effects of projects developed at different heights/densities, using the same hypothetical site and same unit cost and other financial assumptions. The unit cost, size, and other assumptions are based on a combination of the results of interviews TNDG conducted with four developers knowledgeable about the area and other sources including TNDG development-data files.

In the residual land value concept, costs of constructing a project (including other development expenses) are subtracted from the hypothetical "capitalized value" of the project, which would have been estimated based on income derivable from the project divided by a "capitalization rate" typical for projects of its type in the same general area. The remaining dollar amount represents the theoretical value, or maximum price that could be paid, for the land upon which the project is built.

The hypothetical site used in this analysis approximates three typically sized lots fronting Pacific Avenue, combined in order to provide for a reasonable scale at which to develop each of the three project scenarios. The three scenarios are similarly configured, the primary difference is the number of stories and the use of either podium-based parking or a combination of podium and underground parking. Retail space occupies varying amounts of the site at street level, in combination with parking space, and apartments are built on top of the podium.

In the pro forma model, project profitability, and hence the residual land value, is primarily affected by both the amount of building area that can be developed and the increased cost associated with the need for underground parking, as densities increase. The essential differences in the scenarios are summarized below:

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- Scenario 1, at three stories total, maintains all parking at grade, within the podium, which constrains the area of retail space that would also occupy the ground floor, and in this case the amount of residential space developable on the two floors atop the podium (both retail and residential space were constrained in order to accommodate the parking at grade level).
- Scenario 2, four stories, is configured so that one full floor of underground parking is added to the project, allowing for increased retail space compared to Scenario 1, in addition to additional apartment units.
- Scenario 3, five stories, has two full floors of underground parking, which allows an even larger retail area compared to Scenario 2, along with the additional apartments allowed by the added floor.

Results of the analysis are summarized, in the Pro Forma Analysis table, on the row labeled "Feasible Land Price (SF). . ." (# 22), within the "Total" column applicable to each of the three scenarios. Note that the theoretical land values increase as densities increase, demonstrating that, based on the assumptions in this model, increased costs associated with underground parking are more than offset by the resulting increased building area.

The results of this model should be viewed in a comparative rather than absolute sense. That is, the estimated residual land values should not be construed to represent actual, market-based values, due at least to the following considerations:

- Value computations in this type of model are very sensitive to relatively small changes in cost, capitalization rate, and other inputs.
- In this simplified form, the model is unlikely to capture all of the cost and other financial conditions that may be applicable in the real world.

**Conclusions.** In corridors such as Pacific Avenue, generalized observations must always be weighed against the fact that unique conditions abound within areas such as this, and any particular property or group of properties will have circumstances that may greatly affect redevelopment feasibility. Similarly, it is not surprising that developers will have varying opinions about how to work with this kind of area, as their opinions will be shaped, for one thing, by what they have become especially familiar with in their own particular experiences.

As noted above, the results of generalized feasibility models cannot necessarily be applied to specific cases. However, model results do suggest that redevelopment at fairly low densities (such as the Scenario 1 configuration described above) could be feasible, even though higher densities will tend to yield higher project values. The possibility of higher yields will also encourage existing property owners to redevelop or sell their properties – the greater the

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spread between existing values and potential future values the more likely it is that any kind of redevelopment will occur.

**Other issues to consider.** These observations highlight the need to consider a broad range of factors (other than just building heights) when recommending development policy for Pacific Avenue and similar areas, such as:

- Given an intent to encourage revitalization, what sort of minimum threshold of redevelopment activity should be considered as a target that would represent a minimal level of "success," and how might plans/policies be configured to help ensure the achievement of that minimum level?
- What is the ideal carrying capacity of the corridor (from a technical standpoint but also in terms of aesthetics, the local economy, social cohesion, and other considerations), in terms of not only additional population but also other uses that might be considered under policies that encourage revitalization?
- Increasing heights and densities within the corridor could be objectionable to some of the existing residents, but additional population could also bring benefits in terms of generating a more vibrant local business community. Is it advisable to illustrate these kinds of trade-offs as part of the planning process?
- How would successful revitalization of targeted areas along Pacific Avenue affect other areas of the City? Additionally, are plans and policies that might be devised for Pacific Avenue to encourage revitalization potentially applicable to other parts of the community; and to the extent that could be possible, what are the implications for overall development patterns throughout the City?
- The advent of autonomous vehicles, providing a new form of conveyance that may quickly become very widespread in the relatively near future, will measurably change the formulas for successful revitalization in areas such as Pacific Avenue. To what extent should these potential changes be considered now?
- The developers interviewed for this process had several useful suggestions for other ways (in addition to increasing allowable building heights) to attract developer interest and incentivize property redevelopment in this area:
  - Waive/defer City fees;
  - Offer expedited entitlement and permit processing;
  - Apply NSC (and increased building heights) to a larger area than the five-block corridor under consideration (and extend to the blocks east and west of Pacific), to facilitate assembly of viable development parcels with more workable lot depths;

- Reduce parking requirements (this could potentially change development costs enough that it would reduce the need for projects to exceed 3-story building heights);
- Reduce or eliminate side yard requirements (which can be a "deal killer" for small parcels);
- Offer administrative/by-right entitlement (rather than discretionary approval process).

#### ATTACHMENT:

## PRO FORMA FINANCIAL ANALYSIS OF HYPOTHETICAL REDEVELOPMENT SCENARIOS ON PACIFIC AVENUE CORRIDOR

Variable Factors											
#	SCENARIO		1. 3 Stories,	constrained to poc	lium parking	2. 4 Stories, po	odium & undergr	ound parking	3. 5 Stories, pe	odium & undergro	ound parking
	Scenario		Residential, Rental	Retail		Residential, Rental	Retail		Residential, Rental	Retail	
	Land Area		13,800	13,800	13,800	13,800	13,800	13,800	13,800	13,800	13,800
	Land Lise Type		Apartment	Small-Area	Total	Apartment	Partial Ground-	Total	Apartment	Partial Ground-	Total
			mix	Retail	Total	mix	Floor Retail	Total	mix	Floor Retail	Total
	COST FACTORS										
1	Gross bldg area		15,180	1,380	16,560	25,254	3,036	28,290	33,672	5,520	39,192
2	Total Building Cost		\$2,774,145	\$74,175	\$2,848,320	\$4,615,169	\$163,185	\$4,778,354	\$6,153,558	\$296,700	\$6,450,258
3	Total parking spaces required		29	5	34	47	12	59	62	21	83
4	Number of Parking Spaces, Other					30			61		
5	Number of Parking Spaces, Podium		29	5	34	17	12	29	1	21	22
6 Parking type			Podium	Podium		Mix	Podium		Mix	Podium	
7	7 Parking Cost/Space, type 1					\$42,000			\$42,000		
8	8 Parking Cost/Space, type 2		\$30,000	\$30,000		\$30,000	\$30,000		\$30,000	\$30,000	
9	9 Total Parking Cost		\$870,000	\$150,000	\$1,020,000	\$1,770,000	\$360,000	\$2,130,000	\$2,592,000	\$630,000	\$3,222,000
10	Net Rented SF		12,690	1,245	13,936	21,112	2,740	23,852	28,150	4,982	33,132
11	Sub-Total Hard Costs		\$3,644,145	\$224,175	\$3,868,320	\$6,385,169	\$523,185	\$6,908,354	\$8,745,558	\$926,700	\$9,672,258
12	Soft Costs		\$728,829	\$56,044	\$784,873	\$1,277,034	\$130,796	\$1,407,830	\$1,749,112	\$231,675	\$1,980,787
13	Total Cost, Hard & Soft		\$4,372,974	\$280,219	\$4,653,193	\$7,662,202	\$653,981	\$8,316,183	\$10,494,670	\$1,158,375	\$11,653,045
	FINANCIAL FACTORS										
14	Space leasing income		\$380,714	\$27,649	\$408,363	\$633,370	\$60,828	\$694,198	\$844,494	\$110,596	\$955,090
15	Net Rental Income		\$380,714	\$27,649	\$408,363	\$633,370	\$60,828	\$694,198	\$844,494	\$110,596	\$955,090
16	Net Operating Income		\$304,572	\$26,681	\$331,253	\$506,696	\$58,699	\$565,395	\$675,595	\$106,725	\$782,320
17	Capitalized Value		\$6,768,256	\$533,626	\$7,301,882	\$11,259,917	\$1,173,976	\$12,433,893	\$15,013,222	\$2,134,502	\$17,147,724
18	Return on Hard (& Soft) Costs (min.) of:	15%	\$655,946	\$42,033	\$697,979	\$1,149,330	\$98,097	\$1,247,428	\$1,574,200	\$173,756	\$1,747,957
19	Capitalized Value less costs less min. return - Implied Land Value		\$1,739,336	\$211,374	\$1,950,710	\$2,448,384	\$421,898	\$2,870,282	\$2,944,352	\$802,371	\$3,746,723
20	Capitalized value less costs, as % of costs		39.8%	75.4%	41.9%	32.0%	64.5%	34.5%	28.1%	69.3%	32.2%
21	Total Theoretical Land Value/SF (no min. return on costs)		\$173.57	\$18.36	\$191.93	\$260.70	\$37.68	\$298.38	\$327.43	\$70.73	\$398.17
22	Feasible Land Price (SF) with Return on Hard (& Soft) Costs of:	15%	\$126.04	\$15.32	\$141.36	\$177.42	\$30.57	\$207.99	\$213.36	\$58.14	\$271.50
SITE DESIGN, OTHER FACTORS											
23	Number of Stories		3	1		4	1		5	1	
24	Number of units (30% studios, 70% 1-bedroom)		21		21	35		35	46		46
25	Floor Area Ratio		1.10	0.10	1.20	1.83	0.22	2.05	2.44	0.40	2.84
26	Residential units/acre		66.3			110.5			145.2		
Common Factors											
COST FACTORS											
27	Shell cost/SF		\$170.00	\$50.00		\$170.00	\$50.00		\$170.00	\$50.00	
28	Building Cost (including off-site, demolition, etc. @:)	7.5%	\$182.75	\$53.75		\$182.75	\$53.75		\$182.75	\$53.75	
29 Soft Cost Factor		20.00%	25.00%		20.00%	25.00%		20.00%	25.00%		
FINANCIAL FACTORS											
30	Leasing Rates (SF/Mo.)		\$2.50	\$1.85		\$2.50	\$1.85		\$2.50	\$1.85	
31	Vacancy Factor		5.00%	5.00%		5.00%	5.00%		5.00%	5.00%	
32	Operating/leasing Expense Factor		20.00%	3.50%		20.00%	3.50%		20.00%	3.50%	
33	Capitalization Rate		4.50%	5.00%		4,50%	5.00%		4.50%	5.00%	
			1.50/0	5.0070		1.5570	5.0070		1.5570	5.0070	