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Date: March 9, 2017

To: City of Salinas

From: Vernazza Wolfe Associates Inc.

Re: Updated Financial Feasibility Analysis

Vernazza Wolfe Associates, Inc. was asked by the City of Salinas to update the financial feasibility analysis, originally completed in Fall 2015 as part of the Nexus Study. For this update, we examined several options.

First, we recalculated financial feasibility using current asking rents (2017) at the newly built Creekbridge Apartments. Based on slightly higher rents, the rental prototype is still marginally financially feasible since it generates a return on costs of 11%, while the market expectation could be closer to 14%. However, the cash flow could support a mortgage that would cover almost all the development costs. (See Appendix Tables A-1 and A-2.) This reflects the overall conditions in rental development in Salinas - it is more feasible to build and hold apartments, and more challenging to build and sell apartments.

We then considered what would happen to financial feasibility if a \$2/SF rental housing impact fee were adopted, given 2017 rents and development costs. The return on costs is lower at 10%, and the cash flow could support a mortgage that is slightly below development costs. (See Appendix Table A-3.)

Finally, we analyzed financial feasibility of a rental housing impact fee of \$2/SF projected to 2018. Under this third scenario, 2017 rents are increased by 9%. The 9% figure was chosen because a recent report by Apartment List, a company that lists rental units and analyzes trends, found this was the average increased from 2016 to 2017 in the Salinas market. Costs are increased by 4.4%. The increase in cost is based on the increase in construction costs for California between 2015 and 2016, according to the California Construction Cost Index (CCCI). We assumed that costs would continue to increase at this rate between 2017 and 2018. While this Index is based on construction costs only, we have increased all development costs, including

land, by this same percentage. Builders that own land or have firm options to buy land would likely not experience this increased cost, which would mean our calculations are more conservative. Based on these assumptions development will be feasible in 2018 with a \$2 per square foot fee.

Appendix Table A-4 shows that with increases in rents and development costs, the return on costs increases to 15%, with the \$2/SF rental housing impact fee. Furthermore, the cash flow could support a mortgage that is higher than development costs.

UPDATED FINANCIAL FEASIBILITY ANALYSIS APPENDIX

Table A-1: Cost and Return Assumptions Used in Feasibility Analysis

	Apartments (Multifamily)
Average Unit Sizes Based on Prototypes	1,060 SF
Revenue Assumptions	
Gross Revenues per Unit (Average of Units in Prototypes)	\$1,740 per Month
Sales Expenses/Vacancy Loss	Gross Rent Reduced by 5% (Vacancy Loss) and assumes operating expenses are 30% of net revenues
Cost Assumptions	
Site Improvement Costs per SF (1)	\$41.22
Building Costs per SF (2)	\$97.66
Soft Costs per SF (3)	\$31.15
Additional Costs per SF (4)	\$7.20
Land Costs per SF (5)	\$19.58
Total Costs per SF	\$196.81
Total Costs per Unit	\$208,619
Profit Based on Prevailing Market Expectations (2015)	
Return on Costs (6)	14%
Capitalization Rate (7)	6%
Interest Rate Used in Debt Service Calculation (8)	5.23%

Notes for Table A-1: Cost and Return Assumptions Used in Feasibility Analysis

- (1) Site Improvement Costs include demolition, grading, sewer, storm drain, water, PG&E, curb, gutter, erosion control, bio swales, water, storage, signing, landscaping, fencing, paving, etc.
- (2) Building Costs include foundation to carpet. Parking costs included in site improvements costs.
- (3) Soft costs include construction financing, contingency, developer fee (including impact fees) consultants, engineering, architect, and insurance.
- (4) Additional costs include general conditions, temporary fencing, utilities, toilets, labor, debris disposal, administrative project manager, superintendent, construction labor, and off-site administration.
- (5) Land costs are based on a prototype density of 16 – 24 DU/Acre.
- (6) The return on costs measure used is 14% for rental housing) is based on feasibility modeling included in a recent Oakland Fee Study examining new development in Oakland submarkets, such as East Oakland, that are similar to the Salinas market.
- (7) Capitalization Rate (Cap Rate) is used for rental housing feasibility. The Cap Rate used in this feasibility analysis is from Cushman and Wakefield
http://annualreview.cushwake.com/downloads/04_cap_market_report.pdf, accessed on November 12, 2015. The Cap Rate selected represents Sacramento's Class B space (estimated between 5.75% and 6.5%). This submarket was selected since among locations in California, it is the most comparable to the Salinas apartment market. A more current study by Freddie Mac indicated that this is still a valid number.
http://www.freddiemac.com/multifamily/pdf/freddieMac_mf_outlook_2016.pdf accessed on February 27, 2017.
- (8) Assumes interest rate of 5.23 % for a 30-year, fixed rate loan. Source is
<http://selectcommercial.com/apartment-building-loans.php> accessed on February 27, 2017.

Table A-2: Financial Analysis of Base Case Apartment Prototype

	Per SF	Per Unit
A. Revenue – Initial Monthly Rents (100% Occupancy)	\$1.64	\$1,740
Annual Rents	\$19.70	\$20,880
B. Annual Rents, Net of Vacancy Loss, Assumed to be 5% of Total Revenues	\$18.71	\$19,836
C. Less Operating Expenses (30% of Net Revenues)	(\$5.61)	(\$5,951)
D. Net Operating Income	\$13.10	\$13,885
E. Value Based on Capitalization Rate of 6% (Assumes no debt service)	\$218.32	\$231,420
F. Development Costs (excludes return on capital)	\$196.81	\$208,619
F. Difference Between Value and Development Costs	\$21.51	\$22,801
G. Supportable Debt (30 year loan, 5.23% interest rate)	NA	\$207,963
H. Net Value Divided by Development Costs	11%	11%
I. Market Expectation of Net Value Divided by Dev. Costs	14%	14%

Source: Table 1.

Table A-3: Financial Analysis of Base Case Apartment Prototype, with a \$2/SF Housing Impact Fee

	Per SF	Per Unit
A. Revenue – Initial Monthly Rents (100% Occupancy)	\$1.64	\$1,740
Annual Rents	\$19.70	\$20,880
B. Annual Rents, Net of Vacancy Loss, Assumed to be 5% of Total Revenues	\$18.71	\$19,836
C. Less Operating Expenses (30% of Net Revenues)	(\$5.61)	(\$5,951)
D. Net Operating Income	\$13.10	\$13,885
E. Value Based on Capitalization Rate of 6% (Assumes no debt service)	\$218.32	\$231,420
F. Development Costs, excludes return on capital, and includes \$2/SF Impact Fee	\$198.81	\$210,739
F. Difference Between Value and Development Costs	\$19.51	\$20,681
G. Supportable Debt (30 year loan, 5.23% interest rate)	NA	\$207,963
H. Net Value Divided by Development Costs	10%	10%
I. Market Expectation of Net Value Divided by Dev. Costs	14%	14%

Source: Table 1.

Table A-4: Financial Analysis of Apartment Prototype (Rents and Costs Projected to 2018) with a \$2/SF Housing Impact Fee

	Per SF	Per Unit
A. Revenue – Initial Monthly Rents (100% Occupancy)	\$1.79	\$1,900
Annual Rents	\$21.51	\$22,800
B. Annual Rents, Net of Vacancy Loss, Assumed to be 5% of Total Revenues	\$20.43	\$21,660
C. Less Operating Expenses (30% of Net Revenues)	(\$6.13)	(\$6,498)
D. Net Operating Income	\$14.30	\$15,162
E. Value Based on Capitalization Rate of 6% (Assumes no debt service)	\$238.40	\$252,700
F. Development Costs, excludes return on capital, and includes \$2/SF Impact Fee	\$206.61	\$219,005
F. Difference Between Value and Development Costs	\$31.79	\$33,695
G. Supportable Debt (30 year loan, 5.23% interest rate)	NA	\$227,089
H. Net Value Divided by Development Costs	15%	15%
I. Market Expectation of Net Value Divided by Dev. Costs	14%	14%

Source: Table 1.