

MEMORANDUM

To: John Shenk, LG Business Park, LLC

From: Teifion Rice-Evans, Ashleigh Kanat and Walker Toma

Subject: Albright Development, Reduced Area Alternative Feasibility Analysis; EPS #121103

Date: April 4, 2013

The Economics of Land Use



At the request of LG Business Park, LLC, Economic & Planning Systems, Inc. (EPS) has independently evaluated the financial feasibility of developing the 350,000-square foot Reduced Area Alternative and compared the development feasibility of the Reduced Area Alternative relative to the 550,000-square foot Proposed Project. The purpose of this analysis is to provide planning level guidance on the viability of different development configurations under current market conditions. It should be noted that changes in market conditions and/or unforeseen changes to development costs could alter the conclusions of this analysis.

EPS developed financial feasibility pro formas (see **Tables 1 and 2**) to demonstrate the results of our analysis. The analyses are based on a combination of standard, industry-accepted development cost assumptions; EPS-vetted, project-specific assumptions provided by the Developer; and, market revenue research based assumptions developed internally by EPS. Applying these assumptions (described further below), EPS has estimated the potential development return for the Reduced Area Alternative and the Proposed Project. In EPS experience, a return on cost of 7 to 9 percent is typical (calculated as annual stabilized income divided by total project costs). EPS has identified a development return of 7 percent as the minimum "hurdle rate" required for development feasibility.

EPS tested the robustness of our analysis by varying the lease revenue assumptions to determine how sensitive the development return is to changes in revenue. The results of the sensitivity analysis are shown on **Table 3**.

*Economic & Planning Systems, Inc.
2501 Ninth Street, Suite 200
Berkeley, CA 94710-2257
510 841 9190 tel
510 841 9208 fax*

*Berkeley
Denver
Los Angeles
Sacramento*

www.epsys.com

Key Findings

1. ***Under EPS's base case lease rate assumptions (\$40 per square foot), the Reduced Area Alternative is not financially feasible as the development return is below 7 percent.***

The Reduced Area Alternative is projected to generate approximately \$12.6 million in net annual income. Projected development costs, including land costs, are approximately \$199.1 million. This results in a development return of 6.3 percent, below the 7 percent "hurdle rate" EPS identifies as an indicator of feasibility.

2. ***Under EPS's base case lease rate assumptions (\$40 per square foot), the Proposed Project is financially feasible with a development return of 7.1 percent.***

The Proposed Project is projected to generate approximately \$19.8 million in net annual income. Projected development costs, including land costs, are approximately \$280.5 million. This results in a development return of 7.1 percent, a return on costs that EPS identifies as marginally above the "hurdle rate" required for feasibility.

3. ***A sensitivity analysis to test the robustness of these findings suggests that the Reduced Area Alternative remains infeasible even under improved market conditions.***

Increasing the annual lease revenue to \$42 per square foot results in a development return of 6.6 percent (still below the hurdle rate of 7 percent). Reducing the annual lease revenue to \$38 per square foot further erodes the development return to 6.0 percent.

The development return under the Proposed Project increases to 7.4 percent when annual lease revenues increase to \$42 per square foot. The development return decreases to 6.7 percent when annual lease revenue decreases from \$40 per square foot to \$38 per square foot.

Site Description

The 21.5-acre- Los Gatos Business Park site is currently developed with ten buildings (total of 250,000 square feet of existing development) and accompanying surface parking at the intersection of Winchester Boulevard and Albright Way in Los Gatos. The existing buildings consist of one and two-story office/R&D developments and were constructed in the 1970s and 1980s. The Project site is bounded by Highway SR 85 to the north, Winchester Boulevard to the west, and the Los Gatos Creek Trail to the east.

Project Description

Proposed Project

The Proposed Project consists of four 4-story, 137,500-square foot buildings with a height limit of 65 feet, totaling 550,000 square feet of office/R&D space. In addition to a reconfiguration of the existing surface parking, the Proposed Project would include a structured parking garage to accommodate the site's parking.

Reduced Area Alternative

The Reduced Area Alternative calls for the construction of four buildings (two 2-story buildings and two 3-story buildings). The four buildings would total 350,000 square feet of R&D/office. The Reduced Area Alternative would include a minimum of 1,155 parking spaces, consisting

primarily of surface spaces with a small structured garage to accommodate approximately 80 spaces.

Methodology

EPS has prepared financial pro formas for the Reduced Area Alternative and the Proposed Project that estimate the financial feasibility of development. Development feasibility is indicated by a return of 7 percent or higher (a typical range is 7 to 9 percent). Development return is calculated as annual net income divided by total project costs (including land). A development project that generates returns below the feasibility "hurdle rate" of 7 percent is unlikely to attract the necessary financing and would likely not result in development.

Key Revenue Assumptions

Lease Revenue

To identify an appropriate lease rate, EPS reviewed market comparables in the Silicon Valley region, as there are few, if any, appropriate comparables available in Los Gatos specifically. Annual lease rates for new, finished Class A office space range from \$40 to \$48 per square foot in multi-tenant buildings. Because the Owner is developing the space to warm shell conditions (which does not include improvements such as interior walls, flooring, fixtures, etc.) rather than full build out, achievable lease rates for this project will be lower than for finished spaces. In addition, unlike most of the available office development reflected in the comparables, these buildings are designed to attract single-tenant users who will take the full square footage. Such an arrangement is expected to be reflected in a discounted rent to account for the scale of the space being occupied when compared to lease rates for smaller or multi-tenant leases. Therefore, in this analysis, EPS assumes a lease rate of \$40 per square foot of warm shell office space. EPS also considered the location of the site relative to roadways and transit and the provision of tenant improvements of approximately \$50 per square foot.

Tenant Improvements

Tenant improvements (TIs) represent a cost to the Landlord but they are tied to achievable lease rates. In EPS's experience, TIs vary widely, depending on market conditions, the quality and condition of the space (in this case brand new warm shell construction), and the type of tenant. Tech tenants often require higher TIs due to specific heating/cooling needs related to their technology infrastructure. For these pro formas, EPS has estimated TIs of \$50 per square foot.

Key Cost Assumptions

Land Cost Basis

The land cost basis of \$52 million was provided by the property owner.

Hard Costs

Direct construction costs vary between the Proposed Project and the Reduced Area Alternative. Direct construction costs for the Proposed Project are assumed to be \$160 per square foot based on EPS experience in Silicon Valley for similar product types, assuming a warm shell condition. The cost per square foot is increased to \$170 for the Reduced Area Alternative to reflect the loss

of cost efficiencies associated with the shorter buildings.¹ This \$10 differential (approximately 6 percent) is conservative. EPS spoke with construction experts who felt a 10 to 15 percent differential would be appropriate depending on the number of "middle floors".

Garage construction costs also vary by alternative and according to the same "efficiency" logic. The Proposed Project will include a structured garage (ground level parking and one level of deck parking) for approximately 965 spaces. The Reduced Area Alternative will include a structured garage for approximately 80 spaces. Per space savings are realized in the larger garage as fixed costs (elevator, ramp, etc.) can be spread across more spaces. This analysis assumes \$25,000 per space (not including soft costs) for the Reduced Area Alternative garage and \$20,000 per space (not including soft costs) for the Proposed Project.

Demolition Costs

Demolition costs can vary widely. EPS has assumed \$3.50 per square foot, applied to the existing development of 250,000 square feet

Off-Site Costs

The off-site work estimate is provided by the owner and includes a new signalized intersection, the connection of four existing signalized intersections, street widening, and a new bus stop pad. EPS has no basis to verify or adjust this estimate.

Soft Costs

In EPS's experience soft costs can vary from 20 to 50 percent of hard costs depending on length and challenges of entitlement period, Agency-specific development fees, and other project-specific factors. EPS has used a soft cost ratio of 30 percent of hard costs, excluding tenant improvements, fees, and miscellaneous other costs. Soft costs include architecture and engineering, other professional services, taxes and insurance, and other soft costs. Other soft costs include testing and inspection, surveys, environmental, construction period real property taxes, construction period insurance costs, construction period, common area maintenance (CAM) expenses, financing costs, and emergency prevention costs. EPS has included a "Miscellaneous Costs" line item to account for potential lease buy-outs of existing tenants.

Permits and Fees

Permits and fees estimates vary by Project/Alternative. EPS researched the City's development impact fees based on readily accessible fee information and prepared fee estimates for the Proposed Project and the Reduced Area Alternative. Owner Costs

Owner costs include leasing commissions, project administration and management costs, and owner contingency.

¹ There is a difference in cost of constructing the bottom and top floors of a structure (e.g., grading, foundation, utilities, and HVAC improvements) versus the middle floors, which are less expensive to construct.

Table 1
Pro Forma: Reduced Area Alternative
Albright Development; EPS #121103

Item	Assumption	Amount
DEVELOPMENT PROGRAM		
Gross Building Square Feet		350,000
Net Leasable Area (sq.ft.)	100% Efficiency Ratio	350,000
Parking Spaces		
Structured		80
Surface		<u>1,075</u>
Total Parking Spaces		1,155
ANNUAL INCOME		
Lease Revenue		
Annual Income (NNN) [1]	\$40.00 /sq. ft./yr.	\$14,000,000
(less) Vacancy/Mgmt/Reserves [2]	10.0% of Gross Revenue	<u>(\$1,400,000)</u>
Net Annual Income		\$12,600,000
DEVELOPMENT COSTS		
Land Cost Basis [3]		\$52,000,000
Hard Costs		
Demolition/ACM Abatement/Utility Removal [4]	\$3.50 /existing bldg. sq. ft.	\$875,000
Direct Costs	\$170 /gross sq. ft.	\$59,500,000
Garage Work [5]	\$25,000 /structured space	\$2,000,000
On-Site Work	\$20 /site sq. ft.	\$18,835,000
Off-Site Work [6]	fixed cost	<u>\$3,850,000</u>
Subtotal, Hard Construction Costs		\$85,060,000
Soft Costs		
Soft Costs [7]	30% of Hard Costs	\$25,518,000
Permits and Fees [8]		\$1,750,000
Tenant Improvements [9]	\$50 /net leasable sq. ft.	\$17,500,000
Miscellaneous Costs [10]		<u>\$500,000</u>
Total Soft Costs	53% of Hard Costs	\$45,268,000
Owner Costs		
Leasing Commissions [11]	\$18 /net leasable sq. ft.	\$6,300,000
Project Admin./Mgmt.	3% of Hard and Soft Costs	\$3,910,000
Owner Contingency	5% of Hard and Soft Costs	<u>\$6,516,000</u>
Total Owner Costs	20% of Hard Costs	\$16,726,000
Total Costs		\$199,054,000
Return on Cost [12]		6.3%

[1] Annual triple net lease based on Silicon Valley comps and assumes new, Class A construction to warm shell, freeway and transit accessibility, single tenant lease agreement, and \$50 per sq.ft. TIs.

[2] 10% is typical of other pro formas EPS has prepared.

[3] Provided by the Owner.

[4] Demolition costs based on existing square footage of 250,000.

[5] Garage costs are calculated on a per stall basis and shown without associated soft costs. Including soft costs, per stall costs equal approximately \$32,500. A higher per stall cost, relative to the Proposed Project, is assumed due to the lower number of total stalls and the need to spread fixed costs across fewer stalls.

[6] Off-site work estimate is provided by the Owner and includes a new signalized intersection, the connection of four existing signalized intersections, street widening and a new bus stop pad.

[7] Soft costs include architecture and engineering, other professional services, taxes and insurance, and other soft costs.

[8] Permit and fee estimate prepared by EPS based on readily accessible fee information.

[9] Tenant improvements vary widely and typically range from \$20 to \$100 per square foot, with tech tenants often requiring higher TIs. Higher TIs typically result in lower effective rents.

[10] Miscellaneous costs include potential lease buy-outs.

[11] Leasing commission estimate assumes \$18 per gross leasable square foot, and includes commission for both landlord and tenant brokers. Typical range is between \$16 and \$20 per square foot.

[12] Typical return on cost is 7 to 9 percent.

Sources: Loopnet; Silicon Valley brokers; LG Business Park, LLC; Economic & Planning Systems, Inc.

Table 2
Pro Forma: Proposed Project
Albright Development; EPS #121103

Item	Assumption	Amount
DEVELOPMENT PROGRAM		
Gross Building Square Feet		550,000
Net Leasable Area (sq.ft.)	100% Efficiency Ratio	550,000
Parking Spaces		
Structured		965
Surface		<u>970</u>
Total Parking Spaces		1,935
ANNUAL INCOME		
Lease Revenue		
Annual Income (NNN) [1]	\$40.00 /sq. ft./yr.	\$22,000,000
(less) Vacancy/Mgmt/Reserves [2]	10.0% of Gross Revenue	<u>(\$2,200,000)</u>
Net Annual Income		\$19,800,000
DEVELOPMENT COSTS		
Land Cost Basis [3]		\$52,000,000
Hard Costs		
Demolition/ACM Abatement/Utility Removal [4]	\$3.50 /existing bldg. sq. ft.	\$875,000
Direct Costs	\$160 /gross sq. ft.	\$88,000,000
Garage Work [5]	\$20,000 /structured space	\$19,300,000
On-Site Work	\$20 /site sq. ft.	\$18,835,000
Off-Site Work [6]	fixed cost	<u>\$3,850,000</u>
Subtotal, Hard Construction Costs		\$130,860,000
Soft Costs		
Soft Costs [7]	30% of Hard Costs	\$39,258,000
Permits and Fees [8]		\$4,250,000
Tenant Improvements [9]	\$50 /net leasable sq. ft.	\$27,500,000
Miscellaneous Costs [10]		<u>\$500,000</u>
Total Soft Costs	55% of Hard Costs	\$71,508,000
Owner Costs		
Leasing Commissions [11]	\$18 /net leasable sq. ft.	\$9,900,000
Project Admin./Mgmt.	3% of Hard and Soft Costs	\$6,071,000
Owner Contingency	5% of Hard and Soft Costs	<u>\$10,118,000</u>
Total Owner Costs	20% of Hard Costs	\$26,089,000
Total Costs		\$280,457,000
Return on Cost [12]		7.1%

[1] Annual triple net lease based on Silicon Valley comps and assumes new, Class A construction to warm shell, freeway and transit accessibility, single tenant lease agreement, and \$50 per sq.ft. TIs.

[2] 10% is typical of other pro formas EPS has prepared.

[3] Provided by the Owner.

[4] Demolition costs based on existing square footage of 250,000.

[5] Garage costs are calculated on a per stall basis and shown without associated soft costs. Including soft costs, per stall costs equal approximately \$26,000. A lower per stall cost, relative to the Reduced Area Alternative, is assumed due to the higher number of total stalls and the opportunity to spread fixed costs.

[6] Off-site work estimate is provided by the Owner and includes a new signalized intersection, the connection of four existing signalized intersections, street widening and a new bus stop pad.

[7] Soft costs include architecture and engineering, other professional services, taxes and insurance, and other soft costs.

[8] Permit and fee estimate prepared by EPS based on readily accessible fee information.

[9] Tenant improvements vary widely and typically range from \$20 to \$100 per square foot, with tech tenants often requiring

[10] Miscellaneous costs include potential lease buy-outs.

[11] Leasing commission estimate assumes \$18 per gross leasable square foot, and includes commission for both landlord and tenant brokers. Typical range is between \$16 and \$20 per square foot.

[12] Typical return on cost is 7 to 9 percent.

Sources: Loopnet; Silicon Valley brokers; LG Business Park, LLC; Economic & Planning Systems, Inc.

Table 3
Sensitivity Matrix
Albright Development; EPS #121103

Alternative	Annual Rent (per sq.ft.)		
	Low \$38	Base \$40	High \$42
Reduced Area Alternative (350,000 sq.ft.)	6.0%	6.3%	6.6%
Proposed Project (550,000 sq.ft.)	6.7%	7.1%	7.4%

Source: Economic & Planning Systems, Inc.