CAPITOLA MALL COMMERCIAL DEVELOPMENT INCENTIVES

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INTRODUCTION

Kosmont Companies ("Kosmont"), a real estate & economics advisory firm serving hundreds of cities and local governments for over 38 years, has been retained by the City of Capitola ("City") to evaluate City's zoning and Development Standards and present land use/economic policies to the City to help facilitate more commercial redevelopment of the Capitola Mall into a blended use project.

- **Kosmont's expertise covers a full range of economics & real estate advisory services including:**
  - Market and Feasibility Analyses
  - Fiscal Impact & Economic Benefit Studies
  - Economic Development Strategies & Implementation
  - Business/Retailer & Developer Recruitment
  - Identification of Funding Sources & Financing Strategies
  - Public-Private Transaction Structuring & Negotiation
- **Winning track record of initiating and implementing projects for municipalities**
  - In-house team includes economists, registered municipal advisors, financial analysts, lawyers, real estate professionals, former city managers
  - Extensive network of brokers, investors and market data for real-time information, and industry leadership

EXECUTIVE SUMMARY

In general, regional malls across the State need to be reimagined. Large box retail and department stores are facing obsolescence and mall sites are ideal candidates for a blend / balance of land uses to include residential. In other words, we are over-retailed and under-housed.

The City recently worked with HCD to achieve a certified Housing Element including increases of the Capitola Mall area height limit to 75 ft. and maximum building FAR to 2.0. The City desires redevelopment of the Mall to not only include high density residential, but also a healthy blend of commercial / retail. Kosmont identified key market conditions below followed by potential incentives for City consideration to help attract/retain commercial development within a future blended use project at the Mall.

- Land use approvals are the most powerful tool the City has to require commercial development. Through use of a CUP or Development Agreement for large scale projects, the City can negotiate terms with the developer to include hotel, restaurant, entertainment uses. However, the profit to the master developer from new commercial uses is significantly less than could be achieved from residential uses, so the City will need to consider concessions / incentives to reduce the risk.

EXECUTIVE SUMMARY

- The City code allows horizontal mixed/blended use that permits commercial and residential uses to be stand alone (adjacent to each other), if both uses are on the same parcel. Kosmont believes this is the most viable option, as it appropriately separates operational issues (e.g., access, parking/traffic, noise, odors) associated with commercial uses from residential development and is more financeable in this high construction cost and interest rate environment.

- Vertical mixed/blended use generally requires commercial uses to be built underneath multi-level residential. Kosmont believes there are limited such opportunities in Capitola. There are significant cost implications and viability is typically only found in high density communities (i.e., downtown SF or LA or oceanfront promenades), as market rents need to be much higher, and foot traffic needs to be significant for at least 10-12 hours per day.

- For many years, dozens of suburban communities have required ground floor commercial under 4-5 story multi-family units and developers have found that such commercial space has high vacancy or community rooms or services use tenants that do not generate any significant sales tax.

EXECUTIVE SUMMARY

- Hotels are ideal commercial uses to incorporate into blended use projects and fiscally accretive, but the profit to the master developer may be low or negative based on residual land value, thus incentives may need to be considered.

Here are potential incentive programs, which are further analyzed along with a summary cost / benefit incentive matrix:

Fee Waivers – can speed up development and increases tax base earlier

Bonus Residential Floor Area/Height Limits – increased residual land value for residential can help developer achieve stronger financial feasibility to increase commercial (i.e., hotel and retail)

Local Tax Sharing Agreement – provides financial incentives and increases tax revenue

EIFD / CFD Special District Fundings – capture value through special tax increment and land secured based financing district

Infrastructure Cost Support (Bonds / Grants) - solve for development infrastructure costs and reduce development risk

Public Parking Structures – potential funding by city at lower cost of capital than private sector

BACKGROUND

The Capitola Mall is a 46.3 acre site with 640,000 SF of retail building area and 3,000 parking spaces controlled by half a dozen property owners/retailers. The City needs the Mall site to be a major commercial tax generator for long term fiscal stability.

- Merlone Geier Partners (“MGP”) controls about 2/3rds or 31.5 acres that contain 181,000 SF of Mall retail stores, the 74,000 SF Kohl’s and 110,000 SF former Sears store
- Macy’s owns 5.3 acres and a 102,000 SF store and Target owns 2.6 acres and a 93,000 SF store
- Site plan building layout and parcel ownership is shown on the following slide

Challenges

- Retail industry continues to be impacted by growth in online sales
- Transitioning large malls to more urban environments typically requires structured parking, which can be costly
- Investment capital requires higher return for retail based on higher expected risk than return expectations for residential, which has lower expected risk

CAPITOLA MALL

TOTAL SITE IS 46.3 ACRES MGP OWNS MAJORITY 31.5 ACRES SHOWN IN BLUE - OF WHICH 10.1 ACRES ARE UNDER LESSEE CONTROL

NOT A PART (N.A.P) BUILDINGS AND PROPERTY ARE SHOWN IN RED

Legend

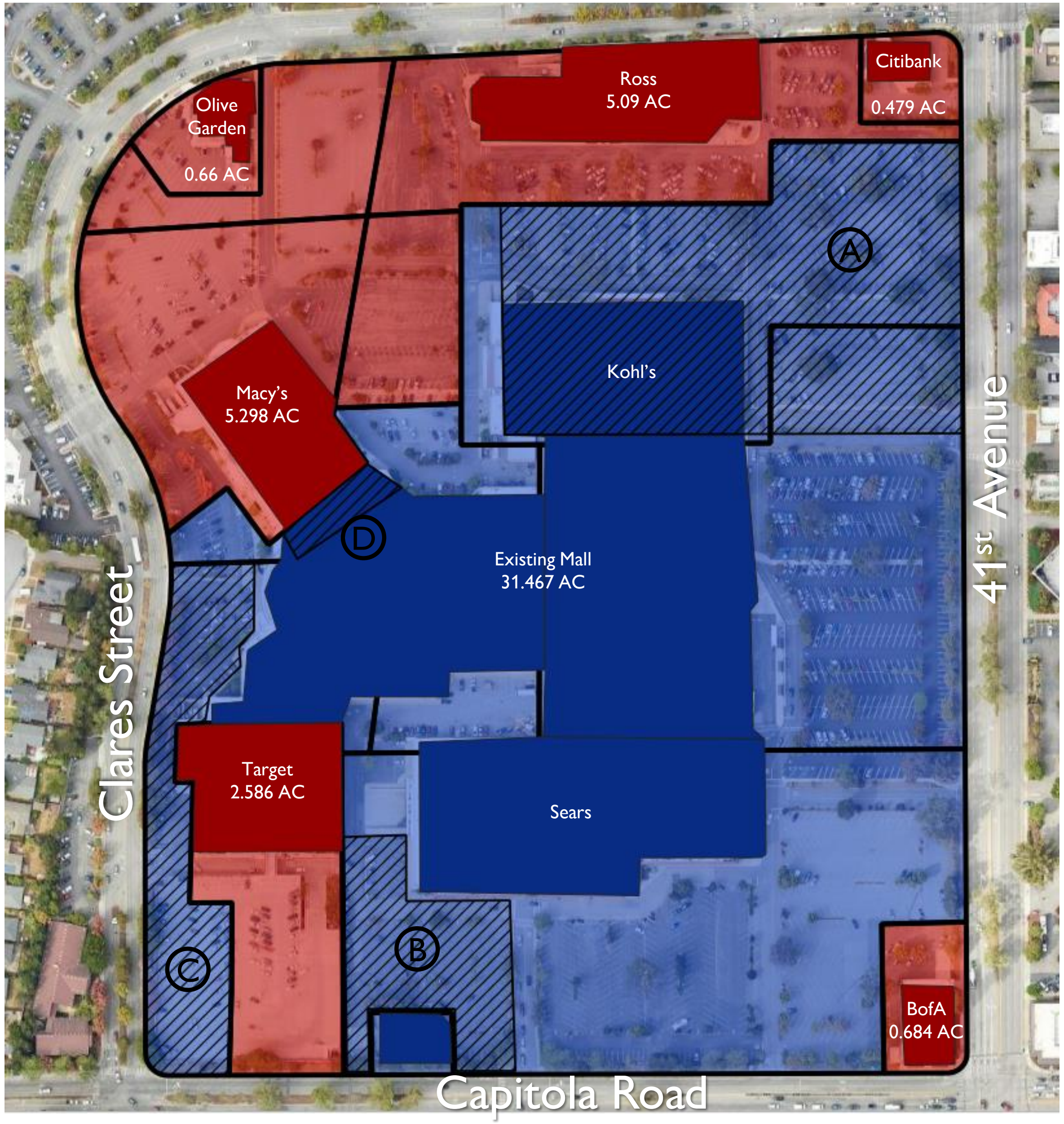
N.A.P. Buildings

N.A.P. Property

Tenant Lease Control Area

MGP Owned Buildings

MGP Owned Property



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APPROACH AND CONTEXT

The intention of Kosmont's analysis is to present a menu of options for the City to assist in Mall redevelopment with pros/cons of each, including cost to City and incentivization to spur redevelopment.

Challenges to getting the Mall redevelopment to occur are mainly driven by market, economic and financial forces along with planning / entitlement limitations. Of course, the solution to market and economic issues can be aided by variances to building codes / permit processes that facilitate entitlement, increase density and/or reduce costs.

In addition to incentives, City could also establish a minimum objective Development Standard for commercial development with residential development proposal on the Mall site (e.g. 25% of gross area on the site must be retail, restaurant or hotel uses). For example, with 1,000 new units, ~300,000 SF of commercial would be required to be retained/added. Kosmont also recommends using a Development Agreement process with MGP to provide flexibility in achieving City's long term fiscal sustainability.

It is important to understand that enhancements / incentives cannot assure timely redevelopment of the Mall at this point in the national economic cycle. To advise the City regarding certain financial challenges, Kosmont also prepared financial feasibility illustrative pro forma analyses (appendix) to demonstrate the magnitude of the challenges facing redevelopment.

CAPITOLA DEVELOPMENT STANDARDS (UPDATED)

Chapter 17.24 Commercial and Industrial Zoning :

- The Mall is located within Regional Commercial (C-R) zoning.
- New office, including medical, prohibited on first floor.
- Multifamily Residential allowed as part of mixed us projected integrated with commercial on the same development site.
- Setbacks: For the C-R Zone there is a 15-foot setback required on street facing buildings.
- Maximum height of 40 feet is permitted. Housing Element to update Chapter 17.88 to allow up to 75 feet for mall redevelopment
- Floor Area Ratio (“FAR”): Maximum FAR is 1.5 in C-R. Chapter 17.88 allows up to 2.0 for mall redevelopment.
- Multi-level parking structures are counted in the FAR. Housing Element commits to update in Chapter 17.88 to remove multi-level parking structures from FAR.

Chapter 17.76 Parking Requirement

- The code requires 2.5 spaces per residential unit.
- There is a 10% reduction allowed for regional transit adjacent facilities (for which the Mall qualifies).
- Independent shared parking studies for mixed-use development may be able to demonstrate further reductions are warranted.

CAPITOLA DEVELOPMENT STANDARDS (UPDATED)

Chapter 17.88 Special Incentives:

This chapter was added in 2018 to help facilitate the redevelopment of underutilized commercial properties, including those along 41st Avenue. Subsection A lists a wide range of community benefits that developers can provide to get incentives. Subsection B identifies the Capitola Mall properties as being eligible if the property is subdivided into smaller blocks with interior intersecting streets and may include extension of 40th Avenue into the the site.

Incentives:

1. Increase in the FAR from 1.5 to 2.0
2. Increase in the Height Limit from 40 ft to 50 ft.

Per 2024 Housing Element – City will increase FAR on Mall site to 2.0 and excludes structured parking from the floor area, the maximum height limit will increase to 75 feet, and the standards will be amended to be objective.

Chapter 18.02 Affordable Housing:

- Development of for sale residential units will reserve 15% of the total units for very-low, low and moderate income households for a period of 55 years
- Development of multi-family rental units pay an affordable housing in lieu fee currently set at $6.00 per SF

COMMERCIAL INCENTIVE PROGRAMS

Kosmont research has found numerous examples of city policies and programs that incentivize commercial development:

- **Fee Waivers**
- **Bonus Residential Floor Area/Height Limits**
- **Local Tax Sharing Agreement**
- **EIFD / CFD Special District Fundings**
- **Infrastructure Cost Support (Bonds / Grants)**
- **Public Parking Structures**

The following section describes the programs/policies, gives examples, suitability for Capitola and summarizes the financial impact.

FEE WAIVERS

Description – Cities can wave Development Impact Fees ("DIF") for development projects to ease the financial funding needs for a developer (e.g. 12-24 month window). Another fee policy change could allow developers to receive credit for existing development and only pay DIF on the incremental increase in commercial SF. A third option would be to reduce DIF or eliminate fees, if new commercial development is greater than 100,000 SF as an example threshold.

Examples – Various California cities have enacted fee waiver programs for development projects during periods of economic hardship. For example, Sacramento County established DIF credit policy to encourage redevelopment of older centers.

Financial Impact – City will lose revenue associated with the Fee Program, but will encourage developers to proceed more expeditiously and thus increasing the tax base years earlier.

BONUS RESIDENTIAL FLOOR AREA/HEIGHT

Description – Given residential development in Santa Cruz County provides the greatest return to a developer, the City can adopt a policy for commercial zones that provides *even greater residential height limits* and FAR in exchange for minimum hotel (e.g., 80-100-room hotel) and/or retail development (e.g., 10,000 SF of commercial per gross acre).

Examples – Cities across the state use a density bonus program that allow bonus residential units above existing zoning for projects that include affordable housing.

Financial Impact – Potential increase in commercial land value in the estimated range of $25,000 to $50,000 per new residential unit permitted can be used to subsidize hotel/retail financial gap. Capitola could benefit from new hotel TOT that could likely exceed $500,000 per year, and could also benefit from the increase in property tax base and indirect retail spending from new households.

LOCAL TAX SHARING AGREEMENT

Description – To incentivize desired development, many cities adopt policies to share the increase in future hotel/sales/property tax revenue generated by a new project with the developer. Projects are generally contingent on a financial feasibility assessment that "but-for" the subsidy, the project would not be built with the desired use. The value of a subsidy cannot be larger than the determined financing gap. Typical policy parameters:

- No more than 50% of tax revenue generated will be shared
- Some cities require a baseline amount to go to city before taxes are shared
- Establish number of years of tax revenue will be shared

Examples – City of Los Angeles Tax Sharing Program for both stand alone hotels and retail, the City has structured tax sharing agreements for dozens of projects. The most relevant to Capitola would be the city $25 million incentive provided to Westfield for redevelopment of the Westfield Topanga Mall project into a mixed-use residential, hotel and retail village. City also received various community benefits.

https://www.latimes.com/local/la-xpm-2013-jun-24-la-me-mall-subsidy-20130625-story.html

Financial Impact – A 50% share of a Capitola hotel TOT could yield a financial subsidy worth several million dollars to developer. The City will benefit from its share of the TOT and the retail spending by guests.

FORM EIFD / CFD

Description – In the post Redevelopment era, cities can form Enhanced Infrastructure Financing Districts (EIFDs) to help fund infrastructure, but will require six to nine months timeframe to establish. Similar to redevelopment districts, the EIFDs facilitate the local capture of future increases in property tax, referred to as tax increment. While such districts would benefit from the participation of other taxing agencies (i.e., the County), the EIFD can be formed by the City as a stand-alone District and the County could join later. They work well in conjunction with Mello-Roos Community Facility Districts ("CFD") that can generate upfront bonds equal to $1/3^{rd}$ of the as is land value.

Examples

- City of Napa EIFD – includes Napa Premium Outlets and others positioned for reimagination
- City of Citrus Heights – Sunrise Mall revitalization EIFD (in process)
- City of Buena Park – Buena Park Mall revitalization EIFD (in process)

Financial Impact – Assuming a +$500 million redevelopment associated with the mall and/or surrounding sites within a district, if the City for example designated 50% of their ~$400,000 per year of property and VLF tax increment to be used as developer reimbursement, or to pay special taxes on a CFD, or leveraged in the longer term through the issuance of a ~$3 million EIFD bond is possible.

INFRASTRUCTURE COST SUPPORT

Description – Private developments often necessitate the enhancement of costly off-site public infrastructure, which can have a significant impact on project viability. Cities have the ability to cover the cost of these improvements by issuing bonds. Doing so can incentivize a desired project with positive public benefit and fiscal impact of the City.

Examples – South Gate, azalea retail shopping center

- City of South Gate provided bond funding to support a retail project by funding 100% of off-site costs
- Though it was not directly tied to a tax sharing program, the tax revenue to be generated by the project was estimated to exceed the bond funding provided over a 10-year period

Financial Impact – Public off-site improvements associated with large projects can often run into the millions of dollars. City covered bond payments through increased sales taxes. City also received $5 million in profit participation based on the project outperforming projections.

PUBLIC PARKING STRUCTURES

Description – Retail developments require high parking counts, typically 4 or more spaces per 1,000 square feet of rentable building area. In urban settings where parking often needs to be delivered in a multi-level structure, the cost for each parking space can run in excess of $40,000 per space, creating a significant cost burden for a project.

By establishing in lieu parking fees for new development in certain districts, the City can use public bonds to fund the cost of constructing a public parking structure on City property that replaces on site parking requirements. There are many examples that have enabled large scale commercial districts to thrive, but such a program could require several years to modify development standards and issue bonds.

Examples – Old Pasadena, 3rd Street Promenade Santa Monica, Downtown Ventura, San Luis Obispo

Financial Impact – Given the high cost of parking structures, the use of tax-exempt city debt can yield a significant financial benefit for a major retail development and facilitate future redevelopment throughout the district. However, the City does not own large lots of land adjacent to the Capitola Mall.

INCENTIVE MATRIX

Incentive	Cost to City	Benefit to City	Complexity to Implement	Value to Project
Fee Waiver	Foregone Fee Revenue	Accelerate development & increase tax base	Low	$
Bonus Residential FAR	None	Increase Tax Base	Low	$$ - $$$
Local Tax-Sharing	Temporary Loss of tax Revenue	Accelerate development & increase tax base	Medium	$$
EIFD / CFD	Loss of Future Property Tax Revenue	Accelerate development & increase tax base	High	$$
Infrastructure Cost Support	Requires City Bonds / Debt Service	Accelerate development & increase tax base	High	$$-$$$
Public Parking Structure	Requires City Bonds / Debt Service	Accelerate development & increase tax base	High	$$-$$$

FINANCIAL FEASIBILITY ILLUSTRATION APPENDIX

THE ANALYSES, PROJECTIONS, ASSUMPTIONS AND ANY EXAMPLES PRESENTED HEREIN ARE FOR ILLUSTRATIVE PURPOSES AND ARE NOT A PREDICTION OF FUTURE RESULTS. ACTUAL RESULTS MAY DIFFER FROM THOSE EXPRESSED IN THIS ANALYSIS, AS RESULTS ARE DIFFICULT TO PREDICT AS A FUNCTION OF MARKET CONDITIONS, NATURAL DISASTERS, PANDEMICS, SIGNIFICANT ECONOMIC IMPACTS, LEGISLATION AND ADMINISTRATIVE ACTIONS.

FINANCIAL FEASIBILITY ANALYSIS

Capitola Mall redevelopment must yield significant investment value to MGP sufficient to justify replacing older commercial buildings, which can still have significant value (e.g. approximately $3 million)

The following steps indicate the basic approach Kosmont followed in conducting the analysis:

- Gathered market data to estimate the achievable rents and buildout value of residential
- Estimated development costs
- Prepared illustrative financial pro formas to show investment value and resulting residual land value

Key MF apartment project cost components include site development, parking, new building construction, architectural and engineering fees, permits and fees, soft costs, and financing costs. The net operating income (NOI) calculation accounts for rents, vacancy factor, operating expense ratio and stabilized sales value at a threshold cap rate of 5.75%, which allows an industry standard developer profit margin on MF development equal to ~15% of stabilized value.

EXISTING RETAIL VALUE PRO FORMA

Exhibit 1 on following page illustrates estimated “As Is” value for 11-acre parcel with 150,000 SF of retail.

- The pro formas show:
  - ➢ Assuming conservative market rents of $1.75 psf / month and 15% vacancy, the existing 150,000 SF of underperforming retail has a value of $30-$36 million, or approximately $3 million per acre of land

EXHIBIT 1

AS IS RETAIL VALUE

Exhibit 1 shows a range of net operating income and estimated sales value for existing commercial space on the underperforming portion of mall on 11 acres of land.

The analysis indicates an "'As Is" value of approximately $3 million per acre

				Scenario 1 Conservative	Scenario 2 10% Higher	Scenario 3 20% Higher
Commercial SF	150,000	SF				
Stabilized Income:						
Commercial Gross income		$1.75	PSF	$3,150,000	$3,465,000	$3,780,000
Less: Vacancy Factor		15.0%	of rent	($472,500)	($519,750)	($567,000)
Effective Gross Income				$2,677,500	$2,945,250	$3,213,000
Maint., Taxes & Insurance		10.0%	of EGI	($267,750)	($294,525)	($321,300)
Net Operating Income				$2,409,750	$2,650,725	$2,891,700
B. As Is Value	8.00%	Cap Rate		$30,121,875	$33,134,063	$36,146,250
Value per Acre for	11	acres		$2,740,000	$3,010,000	$3,290,000

HIGH DENSITY MULTI-FAMILY RESIDUAL LAND VALUE

Exhibit 2 on following page illustrates a stabilized pro forma for an 880-unit MF Apt project that is applicable on 11-acre parcel under a revised 2.0 FAR, but with a 75 ft height limit to illustrate the increased residual land value that improves feasibility.

- The pro formas show:
  - With market rents of $3,800 per month, the high-density project has a residual land value of $2 million per acre
  - However, if rent are 5-10% higher, the residual land value increases to $4 to $6 million per acre which should justify redevelopment

EXHIBIT 2

RESIDUAL LAND VALUE MULTI-FAMILY (75' HEIGHT)

Exhibit 2 shows development parameters and estimated total development cost for 80-unit per acre MF with 75 ft height on an 11-acre site.

This results in a residual land value of $2 - $6 million per acre depending on market rents

				Scenario 1 Conservative	Scenario 2 5% Higher	Scenario 3 10% Higher
Residential Units	880	850	sf (net)			
Stabilized Income:						
Residential Gross income	880	$3,800	per mth	$40,128,000	$42,134,400	$44,140,800
Less: Vacancy Factor		5.0%	of rent	($2,006,400)	($2,106,720)	($2,207,040)
Effective Gross Income				$38,121,600	$40,027,680	$41,933,760
Maint.,Taxes & Insurance		35.0%	of EGI	($13,342,560)	($14,009,688)	($14,676,816)
Net Operating Income				$24,779,040	$26,017,992	$27,256,944
Development Costs						
Onsite Improvements	$20.00	490,000	SF	$9,800,000	$9,800,000	$9,800,000
Arch & Engineering	5.0%			$14,740,000	$14,740,000	$14,740,000
Permits & Fees	$ 25,000	per unit		22,000,000	$22,000,000	$22,000,000
Resid. Construction	$275	psf		$242,000,000	$242,000,000	$242,000,000
Construction - Parking	$60,000	per unit		$ 52,800,000	$52,800,000	$52,800,000
Financing	6.0%	27 mths		$26,854,740	$26,854,740	$26,854,740
Taxes & insurance	2.0%			$6,630,800	$6,630,800	$6,630,800
Developer Overhead	3.0%	of costs		$11,244,766	$11,244,766	$11,244,766
Contingency	6.0%	of costs		$22,489,532	$22,489,532	$22,489,532
A. Total Costs				$408,559,839	$408,559,839	$408,559,839
B. Threshold Return	5.75%			$430,939,826	$452,486,817	$474,033,809
Residual Land Value (B - A)				$22,380,000	$43,930,000	$65,470,000
Value per Acre for 11 acres				$2,030,000	$3,990,000	$5,950,000

CITY OF CAPITOLA

DEVELOPMENT INCENTIVES

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