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Appendix - Section 7

Financial Analysis Summary Report

H E A R T L A N D M E M O R A N D U M

TO: Scott Greenberg, City of Burien

CC: Mandi Roberts, Otak
Kristen Clem, Otak

FROM: Chris Fiori, Heartland
Matt Anderson, Heartland

DATE: June 29, 2009

RE: **Financial Analysis Summary for the Burien NERA Strategy Report**

Over the course of the past year, Heartland performed a market assessment and a series of financial models in support of Otak's creation of a redevelopment strategy for Burien's Special Planning Area 4: Northeast Redevelopment Zone (NERA). The market assessment, conducted in Summer 2008, examined four general land use categories: industrial, office, retail and residential. This work provided pricing and revenue assumptions for financial modeling activities that were conducted in Winter and Spring of 2009. The intent of this memorandum is to summarize key findings from the financial modeling activities performed over the past six months.

Approach to Financial Analysis

The City of Burien is seeking to promote future land uses in the NERA that are more compatible with airport-related activities than most existing uses. The tools available to the City of Burien are largely limited to zoning, some marketing activities, and, to an extent that is fiscally prudent, investment in predevelopment activities (environmental review, etc.) as well as some infrastructure items. Heartland's financial model may be used to assess how parties involved in potential redevelopment scenarios (*e.g.*, current land owners, future land developers, and the City of Burien) might logically respond to changes in zoning in conjunction with varying levels of potential City investment. To this end, Heartland performed a residual land value (RLV) analysis for six of the seven sub-areas in the NERA redevelopment zone.¹ In a RLV analysis, the assumed costs to create "finished" land, plus developer profit, is subtracted from the assumed "finished" land value to arrive at a residual land value for each proposed use, as summarized by the following formula:

$$\text{RLV} = \text{Finished Land Value}^2 - (\text{Costs to Improve Land} + \text{Developer Profit})$$

The residual land value is important to understand in a redevelopment context because the actions of two key parties, the existing landowners and the future development entities, tend to be very focused on land values. The City is interested in residual land values because, to the extent that the existing land value equation does not favor redevelopment, there may be a public purpose in intervening in the market via regulatory or fiscal intervention. Below is a short

¹ Subarea 6 was excluded from the analysis because the planning team determined that the combination of the area's topographical separation from adjacent redevelopment areas, large average lot sizes, and adjacency to single-family homes made it a poor candidate for major redevelopment activity.

² For the purpose of this analysis "finished land" is assumed to have appropriate roads and utilities brought to the site, land that has been brought to its final grade and appropriate zoning for the chosen future land use in place.

summary of how residual land values are frequently viewed from the perspectives of the three parties”:

- *Land owners* – Residual land values for the new use contemplating in a zoning change need to be at least as high as the existing value under the current zoning to motivate existing owners to sell to land developers seeking to develop a new use. Landowners are not typically interested in selling at a price that is less than the market value for the land under current zoning.
- *Developers* – From the developer, residual land value is the most one could afford to pay for the land for the future use. Therefore, the price of unimproved land needs to be less than or equal to residual land value for the future use to motivate a developer to buy the land for redevelopment purposes. Theoretically, the value increment between the land value under the existing zoning and the residual land value under the new zoning is split between the land seller and the land buyer. The degree to which the value would be shared between the parties depends on the amount of competition that there is for land with similar characteristics.
- *City of Burien* – The City of Burien can affect the relationship of the existing “as is” land values to residual values not just through zoning, but also through investment. To the extent that City investment in the area’s infrastructure reduces assumed development costs needed to produce “finished” land, land residual values will improve, thus increasing the likelihood that a positive increment in value would exist between current land values and residual land values with rezoning. Like other parties, Burien should want to assess its return on investment in terms of the cost of investment relative to projected increases in future tax revenues, but other non-financial factors, such as job creation, and amelioration of noise pollution for residents, will likely be taken into consideration when assessing the costs and benefits of public investment.

The Heartland RLV analysis compared residual land values for specified uses contemplated under various rezoning scenarios to the existing land values under the existing zoning to gain a better understanding for how the landowners, developer and City would be likely to respond to a change in rezoning, along with potential levels of public investment that might serve to affect land values.

We examined the proposed uses identified in both the Airport/Industrial Redevelopment Option and the Auto Mall/ Airport Industrial Redevelopment Option. In both redevelopment options, the uses remained constant in Area 1 (Retail), Area 4 (Airport Industrial) and Area 5 (Flex-Tech). In the Airport/Industrial development option, the airport-related uses, both flex-tech and airport-related warehousing, were extended into Area 1, Area 3 and Area 7. In the Auto Mall/ Airport Industrial Option, an auto mall was assumed in Area 1, Area 3 and Area 7.

Definitions

The RLV approach compares the residual land value under a rezoning scenario to existing land values, or land basis. To arrive at a Residual Land Value, we used the following information:

- *Finished Land Values* – We used recent sales of similarly zoned and similarly located “finished” land to arrive at per-square foot value assumptions. Because there are very few recent comparable sales in the area for some of the uses we examined, in some cases we needed to triangulate between land that is likely of higher value (e.g., the southern

Duwamish) and land that is likely of lower value (e.g., the Kent Valley). Other uses like retail and industrial warehouse provided a much larger set of proximate and recent sales comparables.

- *Development Costs* – Projected development costs by sub-area were provided by Otak, and included items such roadway projects, wet and dry utilities, and site demolition and grading. These costs were assumed to be born by the developer/land in the baseline scenario (“High Developer Responsibility”), but we also utilized two other scenarios (“Medium Developer Responsibility” and “Low Developer Responsibility”) with varying levels of City investment.
- *Developer Profit* – A 15% margin on costs was assumed for all redevelopment assumptions and sub-areas.
- *Land Basis* – Land basis assumptions varied by landowner. For land zoned single-family, the assessed home values as of January 2009 were used as the land basis. This may be a somewhat conservative proxy for valuation, however, as the most recent sales within the 130 MLS subarea in which Burien is located have generally been running 5-15% below assessed values in Q2 2009. Because assessed values are calculated on a three-year moving average, the decline in assessed values will almost certainly lag the decline in home values for a least a year looking ahead. Because single-family homeowners own a significant amount of land in the NERA zone, one recurring point of comparison was between future commercial values for land and existing residential home values. As a simple example, if a home on a 10,000 square foot lot is valued at \$300,000, the residual land value for commercially-zoned land would need to be significantly higher than \$30 per square foot to motivate the land owner to sell in most circumstances. For most non-residential properties, the assumed “as is”, as zoned values were used as land basis, with the major exception being properties owned by the Port of Seattle, where the land basis was assumed to be its acquisition price. However, to the extent that the land acquired by the Port for the construction of the third-runway can be thought to be a “sunk cost” needed for the completion of a capital project in the past, the basis for the land can be considered zero. That is to say that the Port likely is motivated to lease or develop the land regardless of what might have been paid for it in the past given that the current income stream from the land is negligible.
- *Tax Benefits to the City* – Heartland worked with the City of Burien’s Finance Department to create defensible assumptions for what the various redevelopment scenarios might be expected to yield in terms of tax benefits, including sales taxes during construction and operation, property and leasehold taxes, and B&O taxes. Other general fund revenue streams were considered but, for the purpose of this analysis, were assumed to constitute a minimal amount of value to the City. Heartland used common assumptions for bonding terms and cost of capital to arrive at an assumed present value for City investments by sub-area.

Findings

RLV analysis presented several key findings, listed below:

- 1) **Challenging Development Conditions Are Pervasive Across the NERA:** While conditions vary dramatically across the NERA zone, the overall conditions for redevelopment are generally very challenging. The uses that have been identified as most marketable for this location – “flex-tech” and warehouse industrial uses in particular – are not typically land uses that lend themselves to high land values. In addition, identified development costs are quite

high, at almost \$50 million, or over \$700,000 per developable acre, owing to both topography and a lack of infrastructure for such a large, urban infill site.

- 2) **Great Variation Exists Among Sub-areas:** The analysis results illustrated a supposition that had been present since our team first began site analysis, which is that dramatically different levels of near-term redevelopment opportunity exist across the subject area. Near-term redevelopment is much more likely where positive value increment exists between the residual value under the rezone scenario and the existing land basis. This condition is most likely to be present in areas where land basis is low (or assumed to zero), the development costs are low and assumed finished land value is high. Port of Seattle-owned properties generally have the best opportunities for near-term redevelopment because small parcels have already been assembled and to the extent that the Port is a motivated landowner with little productive use occurring on the land at present. By contrast, areas with large amounts of existing single-homes present the biggest hurdle for redevelopment.
- 3) **Identification of Opportunity Areas:** Areas with the best combination of low land basis, low development costs and high-value "finished land" values include Area 1 and Area 5 in both redevelopment options, as well as Area 2 in the Auto-Mall Option. These areas all have positive residual land values, meaning that if the land basis is low enough (i.e., the landowner is willing to part with it at a low enough price) redevelopment would be possible. By contrast, in cases where residual land values are negative, redevelopment for the specified use is not likely to occur regardless of the asking price for the land.

The following graphics depict the comparative residual land values (in green) and land basis (in purple) for the three most-promising sub-areas and scenarios for redevelopment. In each case, the land value under the use contemplated in the rezone is compared to the existing land value (land basis). The dotted red line in each graphic indicates the land basis price equal to the residual land value.

Area 1: Retail in Both Redevelopment Options

The assumed finished land value is above \$35 per square foot and the costs, including developer margin, are assumed to be approximately \$18 per square foot, for a residual value of approximately \$17 per square foot before consideration of any City contribution to, or reduction of, required land development costs. The owner of this property is the Port of Seattle, which is important to note because that organization is likely to think differently about the price at which it is willing to sell or lease land than an individual single-family homeowners. First, even though the Port paid a substantial sum for the land, that cost can be considered sunk, as that cost cannot be recovered (it was spent in pursuit of a past capital project) and therefore should not affect decision making going forward with respect to maximizing the value of the property. Second, the property as it exists presently has no positive value from present improvements, so the opportunity cost of putting the land into a new use in the future is low. For all these reasons the land basis, in this case the price that the Port paid for the property in the past (as indicated in the purple bar chart), can be ignored for Area 1 and all of the Port properties.

More important is the fact that the RLV for the proposed use is significantly positive, which means that enough value should exist to interest development entities in the property, if zoned for a flexible mix of retail uses. That said, at almost \$15 per square foot in assumed development costs, which equates to over \$650,000 per acre, the development costs are very high relative to a typical big box development site.



Area 5: Flex-Tech in Both Redevelopment Options

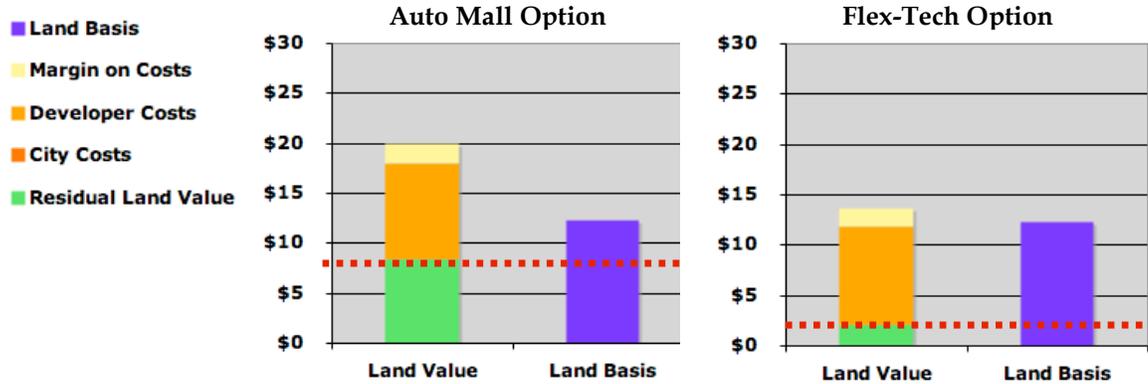
The assumed finished land value is above \$14 per square foot, which constitutes an assumed blend of airport-related warehouse uses and flexible light manufacturing and office space. Development costs, including developer margin, are assumed to be under \$8 per square foot, for a residual value of approximately \$6 per square foot before consideration of any City contribution to, or reduction of, required land development costs. The RLV for Area 5 is less than the land basis for the sub-area when viewed in aggregate, but one could extrapolate that if the eastern half of the sub-area, which comprises the largest lots and thus the lowest per square foot land basis, were to be examined on its own with a pro-rata share of assumed development costs, the RLV for that area would likely exceed the land basis. Relative to other NERA sub-areas, this area exhibits strong near-term development potential



Area 2: Auto Mall Option

Area 2 presents a good illustration of how the assumed land use affects the residual land value. The first graphic presented below depicts the residual land value for Area 2 assuming an auto-mall scenario where a dealership or developer could afford to pay \$20 per square foot for finished land. The second depicts the flex-tech option where finished land is assumed to be valued at approximately \$14 per square foot. While the land basis and development costs have remained constant, the change in assumption about finished lot value creates a different RLV in each case. In neither case is the residual land value greater than the land basis, but the auto-mall option comes much closer to that condition.

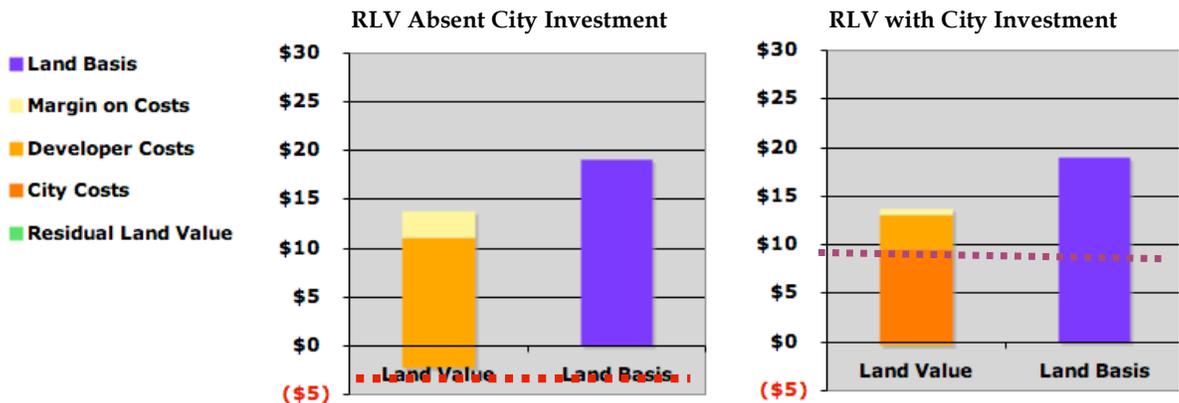
In addition, the potential for City contribution to or reduction of development costs has not been considered in either graph.



- 4) **Identification of Most Challenged Areas:** Several areas in the NERA exhibited negative land values under the future rezone, meaning the assumed development costs exceeded expected future land values. In such case the land will usually remain in its current use regardless of what that existing use is. To compound matters, in some cases the existing land basis was quite high, especially in areas with smaller, occupied single-family homes. Area 7 in the Flex-Tech Option is a case in point.

Area 7: Flex-Tech/Industrial Option

The assumed finished land value is above almost \$14 per square foot, which constitutes an assumed blend of airport-related warehouse uses and flexible light manufacturing and office space. Cost, including developer margin, are assumed to be over \$16 per square foot, for a residual value of approximately -\$2 per square foot before consideration of any City contribution to, or reduction of, required land development costs. In addition, the land basis of the existing homes is almost \$19 per square foot. This means that in Area 7, even if the City were to come out of pocket for all development costs related to infrastructure except site and grading improvements (about \$6.4 million, or \$10 per square foot), existing land values would still need to fall by about 50% before the value equation would work from the perspective of a third-party developer seeking to purchase land at a market rate.



- 5) **Targeted Opportunities for City Investment and/or Cost Reduction:** As noted earlier, total development costs across the NERA were estimated by Otak at about \$45 million, based on existing City of Burien development standards. In the RLV analysis, we termed this baseline assumption the "High Developer Responsibility" scenario. In addition, we looked at a "Medium Developer Responsibility" scenario, in which the City would bear the costs of half-street improvement, watermain improvements and utilities. This total cost born by the City across the site would be \$10 million, reducing the land development costs to \$35 million. Finally, in the "Low Developer Responsibility" scenario, the developer is assumed to only pay for site work, with the City paying for the entirety of the infrastructure costs associated with redevelopment. The City portion would total approximately \$33 million, reducing the development burden to \$11 million. As can be seen from the table entitled "Summary of Potential Levels of City Investment" on the following page, the City would need to invest in the site at the magnitude of the "Low Developer Responsibility" level for the resulting residual land value to be comparable to the existing land basis. At that level of investment, the potential for redevelopment would still vary greatly across the site, and the assumed ROI to the City on such a level of investment would only be likely to recoup one-third of its financial investment on a present value basis.

Recognizing that limited financial resources exist for any type of infrastructure investment in the NERA, the City should set expectations for potential levels of improvement of the public realm. That said, the City may have a legitimate opportunity to help catalyze one or two development projects that could serve to lift the value of finished land across the redevelopment area, which in turn could make redevelopment across much of the NERA more financially feasible than it is presently. In addition to implementing the appropriate zoning (which the finished land values already assume is in place), the City can help catalyze redevelopment through either reducing the cost of redevelopment or investment in some elements of the redevelopment.

Summary of Potential Levels of City Investment

Flex-Industrial Redevelopment Scenario	Level Of Developer Investment		
	High	Medium	Low
Estimated Finished Land Value	\$66,274,170	\$66,274,170	\$66,274,170
less Development Costs	(\$45,609,450)	(\$45,609,450)	(\$45,609,450)
less Margin on Costs	(\$9,121,890)	(\$7,029,770)	(\$2,331,600)
Residual Land Value	\$11,542,830	\$13,634,950	\$18,333,120
Land Basis	\$64,376,371	\$64,376,371	\$64,376,371
Value Surplus/(Deficit) to Land Basis	(\$52,833,541)	(\$50,741,421)	(\$46,043,251)
City Investment	\$0	\$10,460,600	\$33,951,450
Value Surplus/(Deficit) to Land Basis w/City Investment	(\$52,833,541)	(\$40,280,821)	(\$12,091,801)
PV of Tax Benefits to City	\$11,129,604	\$11,129,604	\$11,129,604
ROI of City Investment	100%	6%	-205%

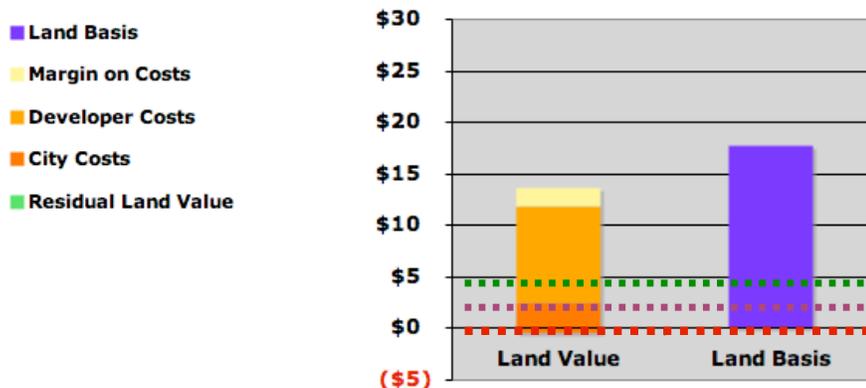
Auto Mall Redevelopment Scenario	Level Of Developer Investment		
	High	Medium	Low
Estimated Finished Land Value	\$75,378,141	\$75,378,141	\$75,378,141
Development Costs	(\$45,609,450)	(\$45,609,450)	(\$45,609,450)
Margin on Costs	(\$9,121,890)	(\$7,029,770)	(\$2,331,600)
Residual Land Value	\$20,646,801	\$22,738,921	\$27,437,091
Land Basis	\$64,376,371	\$64,376,371	\$64,376,371
Value Surplus/(Deficit) to Land Basis	(\$43,729,570)	(\$41,637,450)	(\$36,939,280)
City Investment	\$0	\$10,460,600	\$33,951,450
Value Surplus/(Deficit) to Land Basis w/City Investment	(\$43,729,570)	(\$31,176,850)	(\$2,987,830)
PV of Tax Benefits to City	\$11,129,604	\$11,129,604	\$11,129,604
ROI of City Investment	100%	6%	-205%

Area 4 is a prime example of a sub-area where targeted investment or reduction of development costs may be warranted in order to catalyze private sector activity where it might not otherwise occur. As displayed in the graphic below, at present the sub-area's RLV is negative given the amount of development costs that are assumed to burden this sub-area (almost \$14 per square foot, including developer margin), absent any city investment. At the level of "Medium Developer Responsibility," also depicted by the purple dotted line, the residual land value becomes positive, at approximately \$2 per square foot. In this scenario, the City would invest approximately \$2.50 per square foot in the site, for a total of about \$2.5 million. Because the present value of the tax benefits would only suggest an economic value to the City of only about \$1.3 million, the City would need to consider if other non-financial benefits could bridge the value gap between the present value of costs and revenues, should funds even be available to consider investment.

In addition to direct investment, the City could also consider how to reduce development costs in a manner consistent with city policies. In the case of Area 4, almost \$4 million of the total costs is attributable to roadway improvements. Should the City be able to work with the city of Sea-Tac to lower the threshold for improvements, for example, or work to create a LID or other financing mechanism that could more broadly share the costs of roadway improvements over time, the resultant cost reductions could directly affect the feasibility of redevelopment within the sub-area, given the anticipated uses and the motivated landowner. The green line depicts the RLV after an assumed City investment and a 50% reduction on road improvement costs as a hypothetical scenario. While the overall residual value does not appear overwhelming in the graphic, such a reduction in costs would result in the RLV improving from (-\$300,000) to almost \$5 million.

Once again, this line of thinking assumes that the Port, the prime landowner in Area 4, has little or no basis in the land.

Area 4: Nearly Feasible if No Land Basis is Assumed



Summary

The RLV analysis model presents one framework for assessing near-term redevelopment opportunities that may be presented by an area-wide rezone, along with some level of City infrastructure investment. The RLV analysis indicates that levels of redevelopment opportunities vary across the site, but several sub-areas seem to have marginally feasible redevelopment opportunities that could be bolstered by City of Burien activities, either in terms of investment in infrastructure, reduction of costs, or even marketing activities. Given limited resources, we recommend focusing resources in those areas of the NERA with the greatest near-term redevelopment potential, while putting in place the appropriate zoning needed to serve both the near-term opportunities and longer-term ones. In addition, the RLV suggests that several areas of the NERA, most notably Area 7 (along with Area 6, which was not studied), in addition to the western portion of Area 5, may be many years away from financially feasible private sector redevelopment opportunities, barring major changes in the inputs used to generate the RLV outputs, such as land basis, develop cost or finished land values. Communication of this expectation to stakeholders in such areas may be advisable.