San Francisco Planning

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MEMO TO THE PLANNING COMMISSION

Supplemental

January 11, 2022

Project: Summary of SB 9 Financial Feasibility Analysis
Case Number: 2018-016522CWP
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Recommendation: None- Informational

Background

The San Francisco Planning Department has contracted with consultant Century Urban to analyze the financial feasibility for property owners and/or developers of adding housing units to an existing single-family home. As part of this work, Century Urban has analyzed prototypes based on potential projects that may be possible under recently enacted California Senate Bill (SB) 9, which allows for duplexes on most parcels currently zoned as RH-1 as well as the potential for a lot split with a duplex allowed on the resulting lots. More information on SB 9 can be found in a memo and presentation to the Planning Commission from October 21, 2021.

This summary highlights key findings and assumptions from high level financial analyses that Century Urban performed on development prototype projects in different neighborhoods representative of potential scenarios under SB 9 in San Francisco. This type of financial analysis is important to understand the potential financial costs and benefits of small multifamily housing developments, the types of owners or developers likely to undertake them, where such developments may be more likely to occur, and the barriers or challenges as well as potential tools for future research that might support the addition of more housing.

Assumptions

In late 2021, Century Urban analyzed potential for development of small multifamily buildings on sites with existing single-family homes. For this analysis, Century Urban reviewed prototype developments using general market assumptions for unit types, costs, rents, sale prices, financing, and other factors that shape feasibility and likelihood of development. While financial feasibility (discussed more below) was assessed using metrics typically used by housing developers, the prospective developments and their economic performance are largely similar for long time property owners wishing to add units to an existing property as for housing developers.

Development Scenarios, Tenure, and Neighborhoods

Century Urban analyzed six development prototype scenarios to assess potential financial costs and benefits to a property owner or developer of adding homes under SB 9. Century Urban analyzed both for-sale and rental versions of each of the scenarios and researched rents and sale pricing in different neighborhoods, specifically Bayview, Inner Richmond, and Pacific Heights. The first scenario assumes demolition of an existing single-family home and construction of a larger home along with a small additional unit. The other five scenarios retain the existing home and add from one to three units in the ground floor of the existing home, the yard, or in both the ground floor and yard. Prior to this analysis on SB 9, Century Urban, on behalf of the Controller's office, had conducted an initial feasibility analysis of 3- and 4-unit redevelopments of existing single-family homes in San Francisco. Early findings from this analysis showed much higher costs and lower financial feasibility for projects that demolish an existing home and, for this reason, the analysis described here focuses on retention of an existing home with the exception of the scenario of building a large single-family home and small additional unit. Planning will continue to work with Century Urban to analyze the financial feasibility of fourplex projects to inform pending legislation and will release information on this analysis when complete.

Defining Costs and Financial Feasibility

In this analysis costs for developing housing are broken down into three broad categories:

- Hard costs for construction labor and materials, and
- Soft costs for architecture and engineering, financing costs, permits and fees, etc. and
- Land costs for purchasing the parcel on which a project would be built.

In addition to development costs, there are costs for selling or renting new housing such as marketing and brokerage fees and for rental properties ongoing costs of maintenance, property taxes, and insurance. Given that someone must be compensated for their time spent developing a project as well as for the inherent risk associated with investing money in property development, the analysis assumes a return to the property owner/developer of 20% of hard and soft costs, a real estate industry standard.

Century Urban used two main metrics to assess financial feasibility:

- Return on cost, the annual rate of return the owner would receive relative to the total project development cost before debt service. The annual rate of return can be compared to other potential investments as a way to assess whether the project is an attractive investment.
- Residual value, the amount that a purchaser of a home or land can afford to pay for that home or land and still have a profitable project. Residual value is calculated by subtracting the hard and soft costs of the project and developer profit from the total net sale value of the project. If the residual value is below the estimated sale price for an existing single-family home then a property owner would be less financially motivated to invest in additional units and a developer would be unable to match typical offers from other single-family home buyers.

Even where projects are financially infeasible or unprofitable, homeowners may have other motivations to construct units at their properties, including creating housing for family members or friends; lack of concern with achieving a specific financial return; hope that, while not profitable now, the units may be more valuable or generate positive income in the more distant future; combining needed renovation with unit additions; or a preference for investing in their own property rather than in other potential investments.

Project Funding

For this analysis Century Urban used a simplifying assumption that a property owner or developer would be able to borrow 60% of the project cost to build the new units. The construction loans would range from an estimate of more than $100,000 for a small ground floor unit to $600,000 for two rear yard units to nearly $2 million to build a large single-family home with a small additional unit. This analysis has not addressed how the loan would be secured, but it would likely require a senior lien on real property or a qualified guarantor. In addition to the loan amount, the owner or developer would need to provide the remainder of the development cost likely through their own equity. The equity needed for the prototypes ranged from $76,000 for a small garage unit to $416,000 for the two rear yard units to $1.3 million for the large single-family home with small additional unit. An existing home could be used as an equity source, however, this would depend on the amount of equity available and the property owner's ability and willingness to take on additional debt.

Key Findings

Below are key findings from the financial feasibility analysis performed by Century Urban.

At Current Costs, Rental Rates, and Single-Family Prices, Financial Feasibility of Adding New Units is Challenging

In the scenarios analyzed, estimated residual values for a property on which a homeowner could add units (i.e., the amount someone could pay for the property) fell below current single family home prices in most cases. This indicates that it would be difficult for homeowners or developers to utilize or acquire a typical single-family home to add units at a cost that would result in a financially feasible project. In other words, single-family home buyers paying current prices for most homes would typically outbid a developer for the same property. For prototype scenarios in which a current homeowner planned to add units, remain in the property, and collect rental income, neither the projected investment returns nor the amount of annual cash flow is projected to be compelling compared to other potential investments.

The analysis is based on average or median costs, prices, and rents, and there may be circumstances when the price of an existing home is low enough that it is feasible for a developer to acquire an existing single-family home and construct additional units. For example, when a home is unusually small and/ or poorly maintained, a developer may face less competition from homebuyers who can afford single family home prices in San Francisco where the median price is over $1.5 million.

Hard Costs are by Far the Largest Cost of Adding Units

Construction costs, including labor and materials, are the largest component of the development costs for adding new units, typically representing 70-80% of development costs excluding land costs. As a result, while reducing other costs such as permits, fees, transaction costs, or compensation for a developer's time or investment may improve feasibility, the fundamental challenge with new project feasibility stems primarily from cost of construction relative to the value generated from rents and sale prices. Construction costs in San

Francisco, which are among the world's highest, are therefore a significant barrier to adding units to existing homes but also represent an area where cost reductions could make a substantial difference to feasibility.

For-sale Projects Are Stronger Than Rental Projects

Given similar construction costs, the for-sale scenarios resulted in higher residual land values or greater feasibility than the rental versions. In addition, the annual cash flow after debt service for the majority of the rental scenarios ranged from almost no income to less than $1,000 per month. Only in the highest rent areas studied such as Pacific Heights was estimated rental income after debt service likely to be more than a few thousand dollars per month for projects adding three units. This rental income would only be generated after investing tens if not hundreds of thousands of dollars, as discussed above, and at least a year in developing the project, limiting the financial appeal of adding rental units.

Financial Feasibility Does Not Change Significantly by Neighborhood

Financial feasibility is not substantially different in any of the neighborhoods reviewed. Pacific Heights, with higher rents and sale prices, also had high single-family home purchase prices, a barrier to adding units. Though neighborhoods like Bayview may have lower home prices, they may also have lower sales prices and rents while construction costs do not vary meaningfully by location and create a barrier to adding units in these neighborhoods. The scenario where an existing home is demolished and replaced with a larger home with a small additional unit seems to be possible only in the highest priced neighborhoods like Pacific Heights. Adding units to sell may be financially feasible in a minority of cases in mid-price areas like the Inner Richmond. In lower priced areas like the Bayview, adding a small ground floor unit to sell may be feasible in some cases but most other scenarios seem less likely.

Property Owners Face Financial Barriers but May Have Different Goals than Developers

Homeowners wanting to add units to their home may be intimidated by risk, lengthy timelines, high costs, and limited financial returns relative to the value of the existing home and relative to other potential investments. On the other hand, property owners may be motivated by other factors including the housing needs of family and friends and some may have the interest, time, and training to build additional units themselves. The City can explore additional tools and incentives to lower costs for property owners who wish to add housing units to their properties.

Conclusion and Next Steps

The analysis provided by Century Urban implies limited financial incentive for property owners and developers to undertake prototype projects using SB 9, however, does not rule out that some property owners may undertake projects to add housing using SB 9 in the future or that development may be financially feasible in projects differing from the average assumptions used in the prototypes. In general, changes in key factors, for example construction costs, could affect project feasibility and likelihood of adding units for existing property owners and developers alike. Planning will continue to work with Century Urban on analysis of financial feasibility of small multi-family (e.g. fourplex) developments on existing single family home parcels and will publish findings from this analysis in the near future to inform proposed legislation and local policy.

See Attached Small Multifamily Analysis From Century | Urban focused on SB 9 Prototypes.

Century | Urban

Strategic Real Estate Advisory Services

Small Multifamily – Conceptual Analysis

Presented to:

City of San Francisco, Planning Department

December 14, 2021

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SMALL MULTIFAMILY – CONCEPTUAL ANALYSIS

TO: City of San Francisco, Planning Department

FROM: Century | Urban

SUBJECT: Small Multifamily – Conceptual Analysis

DATE: December 14, 2021

Summary

The City of San Francisco, Planning Department (the "City") has engaged Century | Urban to conduct certain analyses regarding potential new residential development that may result from the passage of California Senate Bill 9. Specifically, the City has requested analysis of the following scenarios: 1) redevelopment of a single family home into a larger prototype home with an additional unit (Scenario 1), or 2) the development of up to three additional units on a lot with an existing single family prototype home (Scenarios 2-6).

Century | Urban prepared a high-level conceptual analysis, including six scenarios identified by the City. Each scenario included both for-sale and for-rent versions, and each scenario was applied to three neighborhoods, Pacific Heights, the Inner Richmond, and the Bayview. The specific scenarios and preliminary results of the analysis are summarized in the attached Exhibit A.

Analysis Qualifications

The analysis referenced in this memorandum utilizes prototypical projects that represent high-level average or median project assumptions observed in the market at the time of analysis preparation. The prototypical projects do not correspond with any particular actual project or actual economics. Any actual project may reflect dramatically different costs, rental rates, sale prices, or other details and by contrast to the prototype is driven by the particular circumstances of that project including its sponsor, history, site conditions, contractor, business plan, and/or other factors. Moreover, the criteria and assumptions utilized in selecting and analyzing the prototype assumptions are specific to the time the analysis was prepared and the research was conducted, and any such assumptions will likely change over time as sale prices, rental rates, development costs, lender/investor return targets, and land costs change over time based on market conditions.

Key Assumptions

For the analysis, Century | Urban utilized lot and unit sizes provided by the City and assumptions shown in the attached Exhibit B. To prepare the analysis, Century | Urban researched rental rate and sale comparable information for the three neighborhoods.

This conceptual analysis includes several simplifying assumptions including assuming similar hard costs and designs across the three neighborhoods, 60% loan-to-cost construction financing for the projects, sale of additional units as separate condominium units, as well as other assumptions. In addition, while 12 months of past sale comparable information and available comparable rental rates were utilized for each of the various size prototype units in each of the neighborhoods, the amounts shown in Exhibit A are based on averages or weighted averages of the research data. Consequently, unless otherwise noted, the results of this analysis reflect potential outcomes for an average unit or home, not for any particular instance or case.[1]

Century | Urban calculated the residual value of each scenario by subtracting the estimated development costs from the projected net sales value of the completed development projects. The residual value represents the maximum cost of land / initial home cost at which a homeowner/developer would achieve "economic feasibility" for the development project.[2] Typically, where the market value of land exceeds residual value, proceeding with development would not be considered feasible.

High Level Conclusions

- Projected equity capital requirements based on the 60% loan-to-cost assumption for the six prototype scenarios are shown in Exhibit A. The required equity capital contribution amounts may exceed the available funds or home equity of many homeowners, which may affect a homeowner's ability to pursue new development or redevelopment.
- In Exhibit A, Century | Urban estimates the amount of annual net operating income for a rental use for the six scenarios[3], which suggest several potential conclusions: 1) the amount of potential income may not be sufficient to incentivize for-profit third-parties to develop such projects themselves or to partner with homeowners to develop these projects; 2) for homeowners, the projected annual income generated from the project may not be worth the time, effort, and risk required to pursue development.
- The estimated annual return on cost for renting additional units are shown in Exhibit A. These returns indicate that while higher returns may be generated in higher rent

[1] Century | Urban notes that construction costs vary over time, additional unit sizes are in practice driven by actual available buildable square footage at a property, and rental rates and sale costs respond to macro- and micro-economic market conditions. Therefore, the general conclusions noted below apply to the prototypes examined at the time of the examination, but not necessarily over a larger timescale or in specific instances.

[2] Economic feasibility in this memorandum is used to mean that upon sale, the homeowner/developer would receive a return of their total investment plus a 20% profit on the new development cost expenditure. The 20% amount is assumed to compensate for homeowner for the significant time and capital invested to complete a San Francisco redevelopment project.

[3] These amounts do not include deductions for debt service or personal taxes.

submarkets, the returns may not be sufficiently compelling to attract third-party for-profit investment in these developments from traditional real estate investors.

- For Scenario 1, of the three neighborhoods, only the residual value of the Pacific Heights prototype home exceeds the estimated median home price for a 1,500 square foot home.[4] In the Inner Richmond and Bayview scenarios, the residual value of the large prototype home redevelopment does not exceed the estimated median home price. These results suggest that this redevelopment prototype may not be economically feasible for average single-family home lots in the Inner Richmond and the Bayview but may be feasible in Pacific Heights.
- In Scenarios 2-6, where units are added to an existing single-family home, residual values are calculated assuming either 1) for the for-sale scenarios, the sale of the units as separate condominium units or 2) for the rental scenarios, the sale of the single-family home with the value of up to three rental units attached.
    - While the residual value of the for-sale scenarios is greater than the residual value of the rental scenarios, the residual values of both the for-sale and for-rent scenarios fall beneath the estimated purchase prices by a typical single-family home buyer for a 1,500-square-foot home in the respective neighborhoods. The difference between the two ranges from $30,000 to over $600,000.
    - The difference between the estimated residual values and purchase prices again suggests that these development prototypes may not be economically feasible.

[4] Estimate based on review of last twelve months of home sales in each neighborhood.

Exhibit A

Residual Values of Single Family Additional Unit Scenarios

Note: Amounts are rounded to nearest $1,000 or $10,000

Scenario #	Scenario
1	4,500-square-foot home + 350-square-foot additional unit
2	1,500-square-foot home + one 350-square-foot garage additional unit
3	1,500-square-foot home + one 800-square-foot yard additional unit
4	1,500-square-foot home + one 350-square-foot garage additional unit + one 800-square-foot yard additional unit
5	1,500-square-foot home + two 800-square-foot yard additional units
6	1,500-square-foot home + one 350-square-foot garage additional unit + two 800-square-foot yard additional units
	1,500-square-foot home reduced by 50 square feet for garage additional unit and 250 square feet for yard additional units (pass

Costs and Capital Required for Homeowner / Developer

Scenario	*1*	*2*	*3*	*4*	*5*	*6*
Hard Costs	$2,800,000	$130,000	$420,000	$550,000	$840,000	$970,000
Soft Costs	$530,000	$60,000	$110,000	$150,000	$200,000	$240,000
Total Costs *	$3,330,000	$190,000	$530,000	$700,000	$1,040,000	$1,210,000
Assumed Financing	60%	60%	60%	60%	60%	60%
Approx. Equity Required	$1,332,000	$76,000	$212,000	$280,000	$416,000	$484,000

Returns and Values for Homeowner / Developer

Pacific Heights

	Scenario	*1*	*2*	*3*	*4*	*5*	*6*
Homeowner Return	Total NOI - Additional Units	NA	$12,000	$33,000	$44,000	$65,000	$77,000
	Return on Cost - Addit. Units	*NA*	*6.2%*	*6.2%*	*6.4%*	*6.3%*	*6.4%*
	Debt Service on Permanent Loan		$7,000	$18,000	$24,000	$36,000	$42,000
	Cash Flow After Debt Service		$5,000	$15,000	$20,000	$29,000	$35,000
Residual Value	For Sale Scenario	$2,650,000	$1,880,000	$1,740,000	$1,900,000	$2,010,000	$2,160,000
	For Rent Scenario**	NA	$1,780,000	$1,610,000	$1,670,000	$1,740,000	$1,800,000
Historic Purchase Cost	(Trailing 12 Months)***	Low	Median	High			
	for 1,500 SF SFH by Avg SF	$2,250,000	$2,500,000	$2,750,000			
	Avg 2 Bedroom Price		$2,550,000				
	Avg 3 Bedroom Price		$3,900,000				

Inner Richmond

	Scenario	*1*	*2*	*3*	*4*	*5*	*6*
Homeowner Return	Total NOI - Additional Units	NA	$10,000	$20,000	$31,000	$41,000	$51,000
	Return on Cost - Addit. Units	*NA*	*5.4%*	*3.9%*	*4.4%*	*3.9%*	*4.2%*
	Debt Service on Permanent Loan		$7,000	$18,000	$24,000	$36,000	$42,000
	Cash Flow After Debt Service		$3,000	$2,000	$7,000	$5,000	$9,000
Residual Value	For Sale Scenario	$540,000	$1,600,000	$1,420,000	$1,560,000	$1,580,000	$1,720,000
	For Rent Scenario**	NA	$1,490,000	$1,100,000	$1,130,000	$960,000	$980,000
Historic Purchase Cost	(Trailing 12 Months)***	Low	Median	High			
	for 1,500 SF SFH by Avg SF	$1,575,000	$1,725,000	$1,950,000			
	Avg 2 Bedroom Price		$1,730,000				
	Avg 3 Bedroom Price		$2,570,000				

Bayview

	Scenario	*1*	*2*	*3*	*4*	*5*	*6*
Homeowner Return	Total NOI - Additional Units	NA	$7,000	$21,000	$28,000	$42,000	$49,000
	Return on Cost - Addit. Units	*NA*	*3.8%*	*4.0%*	*4.0%*	*4.1%*	*4.1%*
	Debt Service on Permanent Loan		$7,000	$18,000	$24,000	$36,000	$42,000
	Cash Flow After Debt Service		$0	$3,000	$4,000	$6,000	$7,000
Residual Value	For Sale Scenario	($1,580,000)	$1,020,000	$800,000	$820,000	$750,000	$770,000
	For Rent Scenario**	NA	$940,000	$690,000	$640,000	$530,000	$480,000
Historic Purchase Cost	(Trailing 12 Months)***	Low	Median	High			
	for 1,500 SF SFH by Avg SF	$975,000	$1,050,000	$1,200,000			
	Avg 2 Bedroom Price		$870,000				
	Avg 3 Bedroom Price		$990,000				

Notes:

** Excludes sale costs (marketing, brokerage), development profit, discount for loss of garage/yard, or condominium wrap insurance, which are factored into residual values below.*

*** Assumes original home sold as vacant single family home and additional units sold as rental apartments.*

**** Amounts are gross of sales costs, fees, and taxes.*

All financial and programmatic estimates are preliminary in nature for illustrative purposes and subject to change.

Exhibit B

Residual Values Scenarios - Key Assumptions

Unit Sizes				
Large Home Redevelopment	4,500	square feet		
Garage Unit	350	square feet		
Backyard Unit(s)	800	square feet		
Home Loss for Garage Unit	50	square feet		
Home Loss for Backyard Unit(s)	250	square feet		
Hard Costs				
Max SF Home	$550	per square foot		
Garage Unit	$350	per square foot		
Yard Unit	$500	per square foot		
Soft Costs				
Soft Costs as % of Hard Costs*				
Garage Unit Scenario	48%			
All Other Scenarios	19%	to	27%	
Development Return	20%	of hard and soft costs		
Revenue				
Gross Average Sale Prices	*Lowest Scenario*		*Highest Scenario*	
Pacific Heights	$1,219	PSF	$1,599	PSF
Inner Richmond	$1,025	PSF	$1,090	PSF
Bayview	$531	PSF	$756	PSF
Average Rent Estimates	*Lowest Scenario*		*Highest Scenario*	
Pacific Heights	$5.15	PSF	$5.27	PSF
Inner Richmond	$3.47	PSF	$4.85	PSF
Bayview	$3.53	PSF	$3.88	PSF
Expenses				
Vacancy	5%	of revenue		
General Operating Expenses	$6,000	per unit annually		
Insurance	$500	per unit annually		
Real Estate Taxes	Caculated based on projected total value			
Permanent Financing	Assumes take-out of construction loan with no cash out, 3.75% interest rate and 30 year amortization, no fees			
Additional Unit Capitalization Rates				
Pacific Heights	3.75%			
Inner Richmond	3.75%			
Bayview	4.00%			
Sales Costs / Value				
For Sale Brokerage	5%			
For Rent Brokerage	3%			
Transfer Taxes	Per City			
Loss of Yard/Garage Discount	Not currently included			

**Soft costs as a % of hard costs do not include sale costs (marketing, brokerage), development profit, discount for loss of garage/yard, or condominium wrap insurance.*
All financial and programmatic estimates are preliminary in nature for illustrative purposes and subject to change.