MEMORANDUM

To: Mark Wardlaw, Sandra Moberly and Pam Kobylarz

From: Walter Kieser

Subject: Old Mammoth Place CBIZ Financial Analysis; EPS #19117

Date: December 23, 2009

The Economics of Land Use

This memorandum provides a peer review of a financial analysis of the Old Mammoth Place project included in a Memorandum dated December 18, 2009 (KMA Memorandum) prepared by Keyser Marston Associates (KMA) as a part of the landowner's application for a hospitality-anchored mixed use project located along Old Mammoth Road near its intersection with Main Street. As you are aware this peer review effort has been collaborative; we have met with KMA three times to discuss technical issues and approach.

In summary, the resulting KMA Memorandum reflects our technical collaboration; the methods and assumptions used are consistent with our agreements. Additionally, I am in complete agreement with the results of the analysis regarding the value of the potential increase in land value associated with the incentive zoning and the value of community benefits. While there remain various policy questions I unhesitatingly find the KMA Memorandum to be a good basis for the Town's decision-making on the matter.

The proposed project would double existing zoning district limitations of 40 lodging units per acre to 80 units per acre, pursuant to the Town's new Community Benefit Incentive Zoning (CBIZ) policy. The policy establishes more guidance as to what are standard expectations of new development, what is a "benefit" associated with a requested increase above base density, and an evaluation methodology for those seeking an increase above base density. The CBIZ policy also requires a financial analysis demonstrating that the added "incentive" density is proportionate to "community benefits" as they are generally defined in the policy. Appropriately, the CBIZ policy does not attempt to precisely quantify what a "fair financial balance" between developer and community benefit should be, since the policy is intended to be flexible enough that it can be applied in different contexts and situations, and in consideration of a broader evaluative framework (including project merits relative to Town goals and policies) than financial analysis alone can provide.

Economic & Planning Systems, Inc.
2501 Ninth Street, Suite 200
Berkeley, CA 94710-2515
510 841 9190 tel
510 841 9208 fax

Berkeley
Sacramento
Denver

www.epsys.com

Nonetheless, since Old Mammoth Place is the first project to submit a CBIZ application, an additional goal of the submittal and the analytical process currently underway is to refine the process outlined in the CBIZ policy's guidelines and define objective criteria and related metrics that can be relied upon by future property owners in their assessment of land use incentives relative to the community benefits.

Accordingly, the KMA analysis can be considered prototypical in setting an analysis methodology as well as specifically addressing the Old Mammoth Place Project. As was necessary, the KMA analysis includes various decisions and assumptions regarding the CBIZ policy. It is recognized that such decisions and assumptions may require further consideration given the broader policy objectives of the Town; however, at least as a starting point, I am in agreement with the methodological decisions KMA has deployed in this case. Regarding the specific assumptions KMA has used as part of their analysis, while such assumptions will always be subject to query and review, they appear to be plausible and a sound basis for this analysis. My specific comments on the KMA Memorandum correspond with the structure of the KMA Memorandum, addressing each topic as it is presented.

CBIZ Policy

The KMA Memorandum, following a brief statement of conclusion, provides a summary of the CBIZ policy that appears to effectively identify the relevant requirements of the policy. I agree that such analyses should include such a recital of policy for reference purposes.

Application of the CBIZ Policy to the Subject Property

This section describes the subject property and the distinction between its development potential under its existing zoning and the project that could occur given the density incentive. This information appears to be consistent with existing documentation regarding the site and the proposed project as it has been presented to date. As a matter of form in the CBIZ policy analysis, it will always be necessary to posit a “base case” as a point of reference for the identification and valuation of community benefits related to the “incentive” project. The Base Case Scenario that has been proposed by KMA in my opinion reflects a realistic option for the land owner and thus is a good point of comparison.

Town of Mammoth Lakes Foundational Documents

Reference is next made to “foundational documents” that KMA felt relevant to this case (there may be others). I concur that this (placing the project in a broader policy framework) is very important in the context of the CBIZ policy simply because the added density is not simply a benefit to the property owner but may also respond to a variety of adopted Town policies and programs. For example, the policies of the General Plan and the cited Specific Plan and District Plan surrounding the project site are probably not achievable without density above that reflected in the Zoning Ordinance. Accordingly, a key unacknowledged “community benefit” may be implementation of Town planning and/or economic development policy. Specifically, the redevelopment and revitalization that is sought by the Town as a matter of policy is in most instances simply not feasible without considerable increases in density above existing development and Zoning Ordinance provisions. I generally place this consideration under the category of “project merit”—does the project further broader Town policy, or not? Another aspect of “project merit”, in my opinion, is the project’s ability to successfully mitigate potential environmental effects as determined by CEQA review, to “less than significant”. Clarifying and

reaching consensus upon the merits of the project provides, in my view, a proper framework for the consideration of community benefits and the project's ability to provide these benefits. (Please see the discussion below for additional discussion on this topic.)

Identification and Valuation of Community Benefits

The general definition of "community benefit" in the context of a developer incentive is "a project component or off-site improvement that would not be obtainable by the local jurisdiction through its normal ordinance-based requirements or CEQA impact mitigation." Sections A.1.b. and A.2.a. of the CBIZ policy correspond to this definition. However, even with this general definition of what items constitute a "community benefit," there will always be debate, both with regard to whether an item is truly a community benefit and beyond that, how much it may be worth to the community. As an approach to this matter, KMA has provided an inclusive list of items that reflects a broad interpretation of the CBIZ and other Town policy. Since many of these benefits are features of the proposed project, there is the added problem of determining whether they are equally beneficial to the project and would be included with or without the density incentive. In an effort to reflect this mutual benefit circumstance, KMA has selectively discounted or not counted certain items as community benefits. However, it is not KMA or EPS's role to ultimately make this determination; all that can be done technically is to interpret the policy and make a technical case for why certain project components or off site improvements conform to the definition. Based on this consideration, I have no problem with the community benefits that KMA has identified or the manner in which they have discounted certain items.

Another issue is how the community benefits are to be valued. Normally when community benefits are considered (e.g., in the context of a Development Agreement negotiation) a cost-based approach is taken—reflecting how much it would otherwise cost the public to obtain the community benefit. The cost approach also allows a division of the proposed benefit between the community and the project. As noted above most of the cited community benefits are in fact components of the project that arguably benefit the project as well as the broader community. As noted in the KMA Memorandum a number of the listed potential community benefits costs are either divided, with only a portion of cost considered, or excluded entirely since it is too difficult to determine the degree of public benefit.

Other Benefits

The CBIZ policy is noticeably silent with regard to economic of fiscal benefits, which are often a topic of concern regarding new development. This concern is particularly acute in a resort community such as Mammoth Lakes where continual reinvestment is essential to maintaining the vitality of the resort and sustaining the quality of municipal services to the residential community. Accordingly KMA has made an estimate of these economic and fiscal benefits including increased sales and transient occupancy taxes and contributions to the local economy (jobs). As might be expected the economic and fiscal benefits of the project reflect a considerable increase over the base case. While no offsetting costs (e.g., additional municipal service costs) are shown in the analysis it is difficult to imagine that the project, assuming its commercial success, will be anything but fiscally and economically positive for the Town.

Approach to Financial Analysis

A central aspect of the CBIZ policy is that the "additional land value or developer profit" conferred through the increased density be "commensurate" with the community benefits received. As there is no actual project or financial data or results to evaluate, calculating additional land value or developer profit requires a "pro forma" financial analysis—an analysis of expected project costs and revenues and the resulting returns to land or equity invested.

There are basically two forms of pro forma financial analysis, "static" and "time-series." Both forms of analysis vary in actual applications as to detail, precision, and purpose. Static analysis provides a summary schedule of all project costs (predevelopment, site improvement, mitigation, and vertical construction costs) and expected revenues (real estate sales, capitalized value of rents, etc.), sets a threshold return to investors (profit) and yields a "residual land value" (how much a rational investor should be willing to pay for the land). The static pro forma method is common for project comparative analysis or due diligence work because it is relatively simple and utilizes a combination of specific project description data and industry-standard assumptions to produce its result.

Time series analysis is used to create an estimate of "developer profit." Time series or "cash flow" analysis typically requires far more data and/or assumptions regarding future events and circumstances associated with a particular development project, little of which is known at this time. As an example, a typically pro forma cash flow analysis (required to calculate "developer profit") requires a return to the original land purchase (basis) and related holding and pre-development costs, a more-or-less precise development program, pricing and absorption assumptions, as well as details regarding the equity capital and lending required for the project. It is also important to note that "developer profit" reflects the return to equity investment that is necessary to attract the equity. Without the opportunity to achieve threshold levels of profit to cover the cost of funds and risks private sector development will simply not occur. Moreover, it likely that even if such a detailed pro forma cash flow analysis were possible at this time, it might produce marginal or even negative financial returns, especially given current market circumstances and related time delays before the project may be realized. It is also possible that the status quo scenario (i.e., development under existing zoning) could be shown to produce higher risk adjusted returns.

The KMA financial analysis uses a static pro forma analysis to provide an estimate of the comparative land value that would result from two scenarios for the Old Mammoth Place site, a "base case" scenario that estimates what development and land value would result from development under the base density regulations and a "proposed project" scenario that estimates development and land value that would result if the density bonus were granted. The "static" pro forma (no time series) focuses upon estimating the increased "residual land value" supported by the two development scenarios. I fully support the use of a "static" land value residual analysis as the appropriate approach for a situation such as this because of its simplicity and focusing as it does on land value increases resulting from the increased density that may be granted and where precise project information is not available.

Financial Analysis Assumptions

As noted above the "static" pro forma analysis applies basic project-related assumptions regarding costs and revenues. My comments on the assumptions used follow:

- Program: The development programs for the two scenarios appear realistic, reflecting a substantial "rehabilitation and renovation" project in the Base Case Scenario and the proposed Old Mammoth Place project in the Project Scenario.

- Project Value at Completion: This section lists the values of the respective components of each of the development scenarios. Revenue from the base case scenario derives from the value of a renovated hotel property and renovated retail businesses. Specifically, rental income from these businesses, net of operating costs, has been "capitalized" to create an estimate of value. Revenue from the higher density scenario derives from sales of condominium hotel units as well as capitalization of rental income from retail and residential uses. Price points used to establish revenue presume a more normal market (not present market conditions) but are otherwise conservative given historical prices in Mammoth Lakes and in competitive resort communities. Note that some of the components (retail and affordable housing units) show values that are below cost. This suggests that these uses are not independently feasible and require a cross subsidy from the primary uses (lodging).

- Development costs: These costs reflect direct "vertical construction costs" and related building improvements including retail "tenant improvements" and hotel "furniture, fixtures, and equipment" (FF&E). The costs shown are conservative, i.e., they could be greater depending upon quality of construction, level of interior improvements, and cost inflation. One reason that Base Case Scenario has such low costs is that it assumes renovation of existing space, thus lowering overall construction costs (average cost per square foot) for the space shown.

- Residual land value: Residual land value is a simple "static" indicator of financial performance that involves solving for land value by holding other variables constant. The calculation involves deducting project costs, including assumptions for direct and indirect costs and developer profit and risk (in this instance set at 10 percent) of project costs. The time variable is excluded although "financing costs" will often include an assumption regarding how long investments must be carried before revenues flow. Also, the residual value analysis ignores "land basis," i.e., how much a developer may have paid for the land in the first instance.

Findings of the Financial Analysis

- Differential residual value: The KMA financial analysis indicates that the land value, given the development incentive of going from 40 to 80 units per acre, would result in an approximately 60 percent increase in land value, from $23 per square foot to $32 per square foot. Given that the data, assumptions, and methods used in the financial analysis applied in this case are plausible, the result properly expresses the value that a landowner might place on achieving the greater density as it would improve the site's value to a potential investor-developer.

  The result does bear some explanation because it may seem as if the higher density scenario, with over six times as much value as the base case scenario, might have a proportional impact on land value. However, this relationship (between density and land

value) is rarely linear, particularly in a redevelopment context. In this instance there is considerably more development cost, (almost seven times more), for the higher density scenario, as well as substantial additional risk and financing costs. Moreover, the Base Case Scenario is a realistic option because additional value can be captured (above current circumstances) through the renovation process.

- Value of Community Benefits: KMA has used a cost basis for estimating the value of the Community Benefits that have been identified, consistent with the CBIZ policy and related documentation. In total they estimate that these Community Benefits total some $26.3 million. As noted above some of the items initially identified as Community Benefits have been discounted because of the difficulty separating the item's project benefit from the Community Benefit. In any event this valuation of Community Benefits is a 10X factor on the land value increase, clearly exceeding the apparent standard of at the minimum, parity between the added land value and the Community Benefit value.

- Value of Other Benefits: As noted above KMA has estimated the fiscal flows and permanent jobs that would be generated by the two scenarios. While not "community benefits" in the strict CBIZ sense of the term, the fiscal benefits are shown to be nearly $2 million annually to the Town, assuming commercial success of the project. This revenue, in addition to supporting quality municipal services as the community grows, can be applied to funding community capital investments including park and recreation amenities and other public improvements.

During review of the draft Financial Analysis provided by KMA a number of questions arose regarding financial analysis and the project's performance and prospects. Several of these questions broach on policy and also the applicant's vision for the site, rather than financial analysis. In any event I will provide responses as best I can.

1. **Are the various development program elements well-integrated and synergistic and if so what would be the implication of changes to these elements?**

   By reference to typical resort projects involving a substantial lodging component, the Old Mammoth Place project reflects a trend toward integration of uses and amenities that create a "sense of place" and provide activities and services that guests can enjoy. It would be my opinion that eliminating or substantially reducing proposed project elements would be detrimental to its feasibility and success as a resort destination. Similarly, there is a "critical mass" concern and program linkages (e.g., between lodging rooms and restaurant/retail space that demand scale). This fact suggests that the feasibility of the project demands a given scale and beneath that scale (e.g., number of lodging rooms) the necessary synergy between program elements is lost. Moreover, a minimum scale is necessary to attract the prospective developers and investors to the project. While I am not aware of any independent analysis of these factors the project as proposed appears to be of adequate scale and contain the elements necessary to attract the required investment.

2. **Are on-site program elements versus cash payments/exactions achievable and fungible; what is the effect of such shifts upon project feasibility?**

   The on-site community benefits described in the KMA analysis respond, as I understand the matter, to Town policy and guidance and, at least with regard to adopted policy, appear to qualify as community benefits. They have the added advantage in most cases of creating value on site (for the project) thus achieving two related objectives—creating community

benefits and realizing Town planning and economic development goals and objectives. While it is ultimately the applicant that would need to respond to such questions, it seems to me that reducing features on site in lieu of an exaction (financial contribution) to a community benefit project elsewhere in town could have the effect of reducing the overall attractiveness of the project and its resulting financial feasibility.

3. How can "project benefits" and "community benefits" be separated and measured; how should community goal attainment be measured?

As noted above, some elements of the project have the character of both meeting criteria as community benefits while also providing a value to the project. For example, the Town considers sub-grade parking a "community benefit" because such investment will allow for efficient use of property, result in better design outcomes, and reduces the visual impacts of expansive parking fields. At the same time, structured parking allows more intensive site utilization and is expected in higher end lodging products. My view is that these are separate, although linked considerations and thus should be simply acknowledged as such without further ado. There may be some cases, as presented in the KMA analysis where the value of the project element is appropriately parsed or split between community and developer benefit.

Regarding how community goal attainment can be measured it seems to me that these goals need to be clearly documented, extracting from the General Plan or other adopted policy documents as they may relate to this project. This gets back to my point regarding "merit" of the project, as conformance with community goals is a large component of its merit. A set of metrics may be necessary with regard to each goal (or policy or program) that is identified. In some instances this can be as simple as "complies" or "does not comply". In other instances more measurement may be in order documenting how the project may relate to an overall quantitative goal. For example, the District Plan may envision redevelopment of a given acreage in the Main Street Corridor so a reasonable metric would be what percentage toward reaching that goal would be achieved by the Old Mammoth Place project.

4. Describe the nature of financial feasibility and threshold (measures) of project feasibility.

Financial analysis always involves or addresses prospective financial feasibility. In some cases benchmark returns (profit) is assumed, in other cases returns are what is solve for in the analysis. Implicit in either case is the recognition that the investment of substantial at risk capital demands proportionate financial returns, at least at the pro forma stage of analysis. The various measures of financial return (e.g., internal rate of return, net present value, cash-on-cash return) are deployed to meet the precise needs and type of analysis. The benchmark returns are proportionate to risk. For example the price of purchasing an existing income producing property implies a capitalization rate reflecting the time value of invested capital, business, and market risk involved in sustaining the cash flow from the property. Prospective development, especially where entitlements are required, bears substantially greater risk and thus demands greater returns, especially to the pre-development commitments of capital for land acquisition, processing, etc. In all instances uncertainty is the major issue affecting the returns required to attract investment—the greater the certainty the lower the returns required. For purposes of the KMA financial analysis the "cash-on-cash" measure is used with an assumption of roughly 10 percent on costs. This assumption falls in the range of "industry standard" for this measure. Lowering

returns below the industry standard range will likely result in the project being infeasible—the necessary investment capital and entrepreneurial talent (developer/operator) simply will not be attracted.

5. How do recent fee reductions affect feasibility conclusions?

Regarding feasibility of the Old Mammoth Place project as proposed, and the impact of project changes (e.g., reduction of program elements, etc.) or changes in costs (e.g., reduced costs for impact fees and housing mitigation), it is important to note that assumptions used by KMA are not reflective of current market conditions, i.e., the project is not feasible from a market perspective at this time, regardless of possible cost reductions. It is assumed that the lodging market and prices will improve and as such the assumptions used are reasonable. In any event it is likely that project feasibility will remain an issue given the high costs of construction in Mammoth Lakes and uncertain market conditions. The Town, assuming that it finds the project consistent with its policy objectives, should observe this reality, and thus moderate financial requirements while at the same time balancing the need for mitigation of impacts and achieving community goals. The lower development impact fee schedule and the lower housing mitigation requirements will accelerate the timing of development or may even provide the positive tipping point of feasibility even with improved market conditions.