Transforming Aging Malls and Office Parks

Finance & Implementation Guide

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Changes in consumer preferences, e-commerce, and the pandemic have resulted in underutilized commercial space, both in malls and office parks. The cities with the largest need for housing are also often the most land constrained, leaving only infill opportunities for development. The combination of housing demand and declining malls and office parks provides tremendous opportunities for local jurisdictions to solve two problems together by including housing in mall and office redevelopment. This Guide provides an overview of the real estate redevelopment process and highlights key levers available to local jurisdictions to incentivize developers to provide community benefits as they pursue redevelopment projects and provide additional housing units. It takes users step by step through the process, beginning with Planning & Predevelopment before turning to Entitlements and Negotiation and finishing with Infrastructure & Project Buildout.

Real Estate Development Process And Key Considerations

Planners seeking to employ the right tools to shape mall and office redevelopment and secure community benefits on their jurisdictions' behalf must be mindful of the different stages through which a typical real estate development process advances. Different tools and points of leverage are relevant at each stage. Each consecutive stage increases the value of a development site. As public sector leverage declines once value has been created, **community benefits discussions should proceed as early as possible within the development process.**

Figure 1. Key Stages of Real Estate Development

The Guide is part of a suite of resources to spur mall and office park transformation across the Bay Area. Complementary resources addressing planning, urban design, maximizing affordable housing, and more are available at the Mall & Office Park Transformation Guide webpage.

Stage 1 | Planning and Pre-Development

The Planning and Pre-Development Stage is the period before a project is proposed by a landowner or developer. During this stage, the public sector can establish and communicate the community's baseline **development expectations** for site redevelopment - requirements that are set during or before the Planning and Development Stage, such as inclusionary housing requirements, as well as project features such as open space requirements, LEED requirement, etc.. This will help to anchor future development-specific negotiations and minimize real estate speculation that can consume publicly created value without delivering benefits.

Public & Private Sector Actions During Planning & Predevelopment

Key Public Sector Actions

- Set baseline development expectations
- Establish community vision and calibrate policy tools to economic feasibility
- Understand economic fundamentals

Key Developer Actions

- Site acquisition/consolidation
- Preliminary feasibility analysis

Baseline development expectations can be communicated via a published community vision, and via policy tools calibrated to address economic fundamentals for the local market. This can be achieved through area-wide planning such as General Plan updates, regional plans and resources, housing elements, etc., as well as specific regulatory tools like zoning, inclusionary housing ordinances, adaptive reuse ordinances, parking ordinances, and housing, transportation, or other impact fees (See below for sample documents).

During this period, developers may themselves be focused on acquiring or consolidating properties and undertaking their own preliminary feasibility analysis to understand development potential – analyses that will be informed by the message conveyed by the public sector surrounding baseline expectations for the site.

Baseline Development Expectations – requirements that are set during or before the Planning and Development Stage such as inclusionary housing requirements, as well as baseline project features such as open space requirements, LEED requirement, etc.

Reference Documents:

Document	Link
Inclusionary Housing / Local Density Bonus Program	City of Santa Monica Affordable Housing Production Program https://www.santamonica.gov/housing-ahpp-developers City of San Jose Inclusionary Housing Ordinance (2021) https://www.sanjoseca.gov/your-government/departments-offices/housing/developers/inclusionary-housing-programs ; https://library.municode.com/ca/san_jose/codes/code_of_ordinances?nodeId=TIT5HO_CH5.08INHO
Adaptative Reuse Ordinance	Downtown Los Angeles Adaptive Reuse Ordinance (2001) https://www.ladbs.org/docs/default-source/publications/ordinances/adaptive-reuse-ordinance---l-a-downtown-incentive-areas.pdf
General / Specific Plan update	City of Montclair Montclair Place District Specific Plan (2020) https://www.cityofmontclair.org/documents/montclair-place-district-specific-plan/
Affordable Housing Overlay Zones	City of Los Angeles Transit Oriented Communities Incentive Program (2017) https://planning.lacity.org/plans-policies/transit-oriented-communities-incentive-program
Middle/moderate-income policy	City of Long Beach Middle-Income Housing Program (2022) https://longbeach.legistar.com/View.ashx?M=F&ID=10393881&GUID=615C3B17-D982-48E9-931D-2672C6B05494
Residential & Commercial Anti-displacement policies	City of San Jose Anti-Displacement Strategy (2020) https://www.sanjoseca.gov/home/showpublisheddocument/88627/637959126672100000

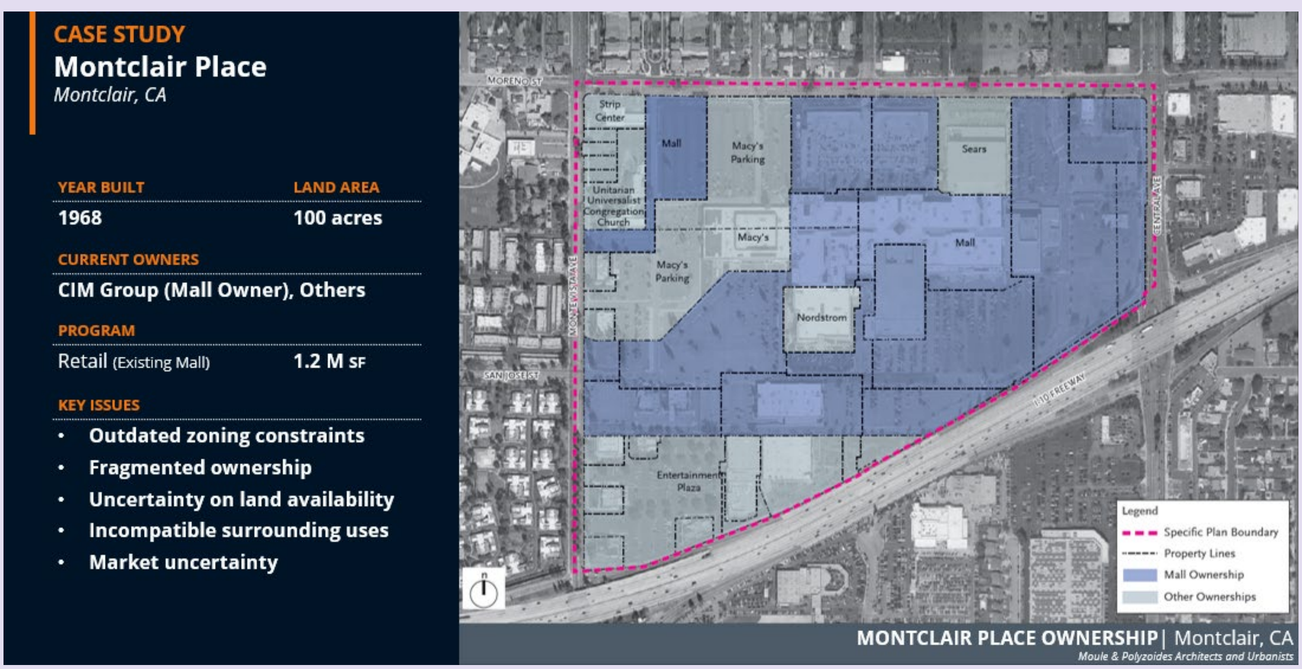
Key Considerations:

1. Understand project **value fundamentals** – the key factors that affect project valuation (i.e., net operating income, capitalization rate) - and **redevelopment "pain points"** (financial obstacles) to determine enablers and inhibitors of project feasibility.
2. Leverage **area-wide planning** and **policy interventions** to establish and promote a **baseline development expectation** and ensure that any community benefit requirements are grounded in market realities with built-in mechanisms to accommodate potential changes in market dynamics.

Value Fundamentals– the key factors that affect project valuation (i.e., net operating income, capitalization rate).

Case Study: Montclair Place, *Montclair, CA*

Redevelopment projects are often larger-scale projects with a phased development approach and their own unique "pain points," which sometimes require additional efforts from local jurisdictions to attract developer interest. Site Constraints (i.e., uncertainty on land availability, legacy leases and easements, incompatible surrounding uses) are a common issue for mall and office redevelopment projects, which often face unique site constraints due to complex ownership status and historic easements.



When developer CIM Group purchased the Montclair Place Mall in the City of Montclair, it only acquired approximately 70 acres out of the entire 100-acre superblock. Remaining pads were owned by independent retailers and institutions. The developer intended to redevelop the entire superblock into a mixed-use district as it is within walking distance to a commuter rail station with future light rail connecting to Pasadena and downtown Los Angeles. Meanwhile, there was a high level of uncertainty on land availability due to fragmented land ownership.

In this case, the City initiated the *Montclair Place District Specific Plan* after the developer indicated interest, driving the Specific Plan process with the intent to streamline approvals to allow up to 6,300 dwelling units and have the developer pay for the costs of the study. The Specific Plan provided long-term flexibility on land uses and development density, supporting a phased approach with early buildout on developer-owned sites and alternative scenarios for the buildout of the remainder of the site to accommodate uncertainty in land availability and potential changes in the local real estate market.

The site was subdivided in a manner that allowed all or parts of the mall to continue operation while redevelopment proceeded across the site as pads become development-ready over time. The Specific Plan also tied key public amenities such as open space and public realm to phased development milestones to ensure that amenities were not back loaded.

Reference Documents:

Document	Link
Montclair Mall Specific Plan	https://www.cityofmontclair.org/documents/montclair-place-district-specific-plan/

Stage 2 | Entitlements and Negotiations

The Entitlements and Negotiations Stage is applicable to projects seeking development not permitted by-right. Projects seeking development that requires discretionary review will require **entitlements approvals.** Those seeking specific incentives or other public contributions will also require **negotiation of a development agreement** with the public sector, though not all projects seeking entitlements require such negotiation.

Public & Private Sector Actions During Entitlements & Negotiations

Key Public Sector Actions

- Leverage community outreach
- Prepare project specific plans and implementation strategies
- Secure public benefits and establish performance monitoring

Key Developer Actions

- Secure desired use and density
- Maximize market value
- Secure public/private financing

For entitlements, site-specific studies can be led either by the developers or the public sector, which could involve master plan development, Specific Plan updates, etc. During this process, a developer's pursuit of certainty about future land use and regulatory controls enables the public approvals process to secure community benefits. Development agreement negotiations may encompass incentive terms, community benefit commitments, and performance requirements. During this process developers are focused on securing project financing and confirming economic feasibility, while the public sector is focused on ensuring that penalties are in place should tangible community benefits fail to be delivered.

It should be noted that any additional public benefits negotiated at this stage should go beyond baseline development expectations. For instance, if the project is seeking additional density beyond the State Density Bonus, and thus increasing project value at stabilization, developers should be able to support additional public benefits which could include affordable housing, open space, infrastructure and other public improvements, employment opportunities, etc. from the additional project value created by additional density allowance. Moreover, benefits that developers would already provide to increase market value and target rental rates – such as rooftop amenities and LEED building standards – should not be counted toward public benefits delivered in exchange for zoning and land use variances.

Key Considerations:

1. Productive public benefits negotiations will rely on a shared understanding of **financial feasibility** levers as well as a project's expected **sources and uses** of funds.
2. Public benefits should be requirements that go **beyond baseline project features** or a citywide policy**.**
3. Build in **performance requirements** – requirements in development agreement where lack or delay of performance could trigger breach of contract and result in penalty and other remedy or termination of contracts - to ensure accountability and encourage timely delivery.

Performance Requirements – requirements in development agreement where lack or delay of performance could trigger breach of contract and result in penalty and other remedy or termination of contracts - to ensure accountability and encourage timely delivery.

Project Financial Feasibility and Levers

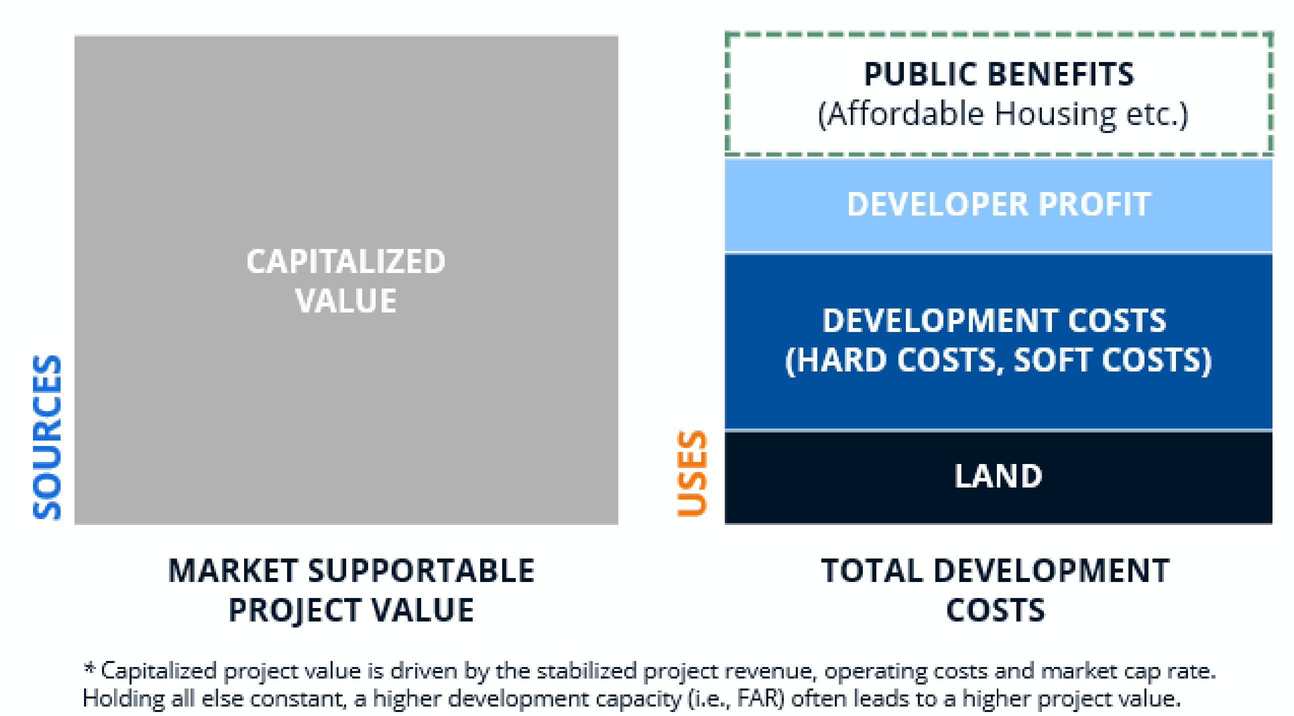
As discussed above, any type of community benefits requirements should be grounded in market realities and project feasibility to encourage redevelopment instead of hindering it.

The HR&A team developed a project feasibility modeling tool in Excel (the "Modeling Tool") to evaluate project feasibility by comparing the residual land value ("RLV") of the proposed development – what a developer can afford to pay for land and still achieve a feasible project -- to prevailing market land value. RLV is derived by subtracting development costs -- including hard and soft costs, development profit, and the monetary value of any required public benefits -- from the project's capitalized value, which is calculated based on the stabilized cash flow and capitalization rate for the project.

In general, if the estimated project value can cover all of the above and arrives at a RLV higher than prevailing market land value, the project is worth the redevelopment risks for a developer and can afford the required public benefits. On the other hand, if RLV becomes lower than prevailing market land value, it will make more sense to sell the land directly to receive the market land value in return instead of moving forward with the redevelopment process, with an expectation that a buyer would wait to advance development until investment conditions change.

If the Modeling Tool identifies an RLV beneath prevailing land values after factoring in proposed public benefits and other costs/assumptions when used to test the feasibility of desired site development, jurisdictions should (a) first examine the key development assumptions against the local market benchmark including rental rates, operating expenses, development costs, capitalization rate to ensure assumptions are accurate; and then (b) revisit the level of public benefits sought or explore other ways to increase project value or decrease project costs.

Figure 2. Real Estate Project Funding Sources and Uses



Key Strategies to Enhance Project Value:

Local jurisdictions can leverage site-specific discretionary approvals and provide capital investments to help grow the value of a project. For instance, project valuation increases with public investment in open space and transit, as well as with the reduction in parking requirements. When the local real estate housing market is robust and commands a rent level that can support high density construction, obtaining design variances and density bonuses that result in density increases will enhance project value. Meanwhile, if the potential value increase cannot cover the increase in development costs, developers would prefer to stay at baseline density with a smaller scale project.

Key Strategies to Reduce Project Costs:

The public sector can also use a combination of the following funding and financing mechanisms to assist developers to reduce capital outlay, close the feasibility gap, and support public benefits. This might include:

Value Capture:

- Value capture tools create a mechanism to capture future land value – often as reflected in property tax increases -- generated by public investment to fund upfront capital costs associated with public infrastructure or private development. Value is captured through either new assessment on top of existing taxes, or by capturing a share of tax increment as assessed values grow from the development. Community Facilities Districts (CFD) and Enhanced Infrastructure Financing Districts (EIFD) are common examples of each, respectively.

Tax Subventions:

- Tax Subventions are agreements made by municipalities to support development projects through payments of future tax revenue.

State and Federal Grants:

- State and Federal Grants are financial awards to development projects with a public purpose, i.e., Infill Infrastructure Grants, Surface Transportation Grants, and the Cap-and-Trade Program for Affordable Housing. HR&A has developed a federal infrastructure funding navigator, *IFN*, to help communities match with the right programs.

Debt Sources:

- Public debt financing sources provide developers with secure or low interest loans or bonds that must be repaid to finance development projects. These may include Transportation Infrastructure Financing and Innovation Act Loans, Revenue Bonds and Lease Revenue Bonds, Cal HFA Loan and Bond Programs, Qualified Residential Rental Project Bonds, FHA-Backed Loans, or other sources.

Case Study: Promenade 2035, *Los Angeles, CA*

Redevelopment projects often require changes in land use and other zoning requirements to support project feasibility due to their unique challenges, i.e., outdated zoning requirements, parking constraints, high infrastructure and/or remediation costs, misalignment between project feasibility and community aspirations. Local jurisdictions will not be able to trigger the desired developer interest and market response when proposed development guidelines are not grounded in financial feasibility.

The City of Los Angeles initially adopted the Warner Center Specific Plan in Woodland Hills in 1993 with the intention to revitalize the area as retailers and malls gradually fell into decline. Meanwhile, even after multiple revisions through the 1990s and 2000s, the restrictive development requirements including height limits and minimum commercial program requirements made redevelopment challenging. Only after the more recent adoption of the *Warner Center 2035 Plan* paved the way for higher density housing did a series of high value transactions advance, such as the redevelopment of Westfield Promenade. This project consisted of the demolition of the existing shopping center and construction of a multiple-phase, mixed-use development comprised of residential, retail/restaurant, office, hotel and entertainment uses.

Reference Documents:

Document	Link
Warner Center 2035 Specific Plan	http://www.aboutwoodlandhills.com/living/real-estate/warner-center-2035.pdf

Stage 3| Infrastructure and Project Buildout

Once the project has secured development rights, it moves on to the Infrastructure and Project Buildout stage where developers take the lead to carry out project and community benefits delivery.

At this stage, the public sector has to rely on previously established agreements and performance requirements to monitor performance and apply penalties if necessarily. Redevelopment projects often involve multiple phases carried out across different real estate cycles. Although it is important to build in performance requirements and phasing milestones with penalty clauses to encourage timely delivery of the project and keep the developer accountable for community benefits to unlock subsequent entitlements, it is also helpful to allow flexibility in project implementation in terms of program mix and transfer of uses across the site to accommodate changing real estate market conditions.

On the housing front, communities often have unique challenges and shifting housing goals as demographics and housing markets evolve. If the priority is to increase housing production for both market-rate and affordable housing, local jurisdictions should leverage state legislation as well as funding and financing sources to streamline approval processes and provide incentives for on-site and mixed-income housing projects. If the priority is to preserve existing affordable housing stock, it is critical to adopt anti-displacement policies ahead of redevelopment to prevent involuntary displacement and preserve naturally occurring affordable housing.

Public & Private Sector Actions During Infrastructure & Project Buildout

Key Public Sector Actions	*Key Developer Actions*
• Monitor performance	• Deliver community benefits

Key Considerations:

1. Enforcing **performance requirements** while allowing **flexibility** in implementation to meet evolving market conditions are key to ensure accountability and encourage timely delivery.
2. **Housing implementation strategies** should be tailored to local housing priorities (i.e., mixed-income vs. market-rate vs. 100% affordable housing, housing production vs. preservation).

Case Study: Downtown West, *San Jose, CA*

Entitlement Uncertainty (i.e., changing real estate market, community pushback)

A collaborative planning process between local jurisdictions and developers is helpful to create a community-driven vision grounded in the local real estate market and to reduce entitlement uncertainty for developers.

CASE STUDY

Downtown West

San Jose, CA

YEAR BUILT	LAND AREA
N/A	80 acres

CURRENT OWNERSHIP

Google

ENTITLED PROGRAM

Office	7.3M SF
Residential	4,000+ units
Retail/Cultural/Hotel	500,000 SF
Open Space	15 AC

KEY ISSUES

- **High aspirational target for community benefits**
- **Anti-displacement strategies/community stabilization to mitigate impacts**

When Google initiated the *Downtown West* project in the City of San Jose, which aimed to entitle 7 million sq. ft. of office space and more than 4,000 residential units on a collection of older industrial sites and parking lots. While it was helpful that the City has already initiated the *Diridon Station Area Plan* which was adopted in 2014, in establishing a vision for the area, particularly in response to the planned confluence of planned transit investments, both market conditions and a number of key land use assumptions in the plan had changed significantly by the time Google had completed most of their property acquisitions. For example, the original plan had assumed the relocation of a ballpark into the district, which was no longer viable, freeing up significantly more development capacity that Google wanted to utilize. In addition, both Google and the City wanted to be much more aspirational and wanted to have a deliberate focus on community benefits. Shared goals were established early on through a *Memorandum of Understanding* and later codified in *the Development Agreement* with details regarding community benefits and delivery timeline. The City and Google then worked closely with the community to update the land use plan in a manner that the City's re-zoning and re-calibration of development standards were able to create more economic value which allowed for a more robust package of community benefits that are aligned with local priorities.

Reference Documents:

Document	Link
Downtown West Mixed Use Plan Summary Page	https://www.sanjoseca.gov/your-government/departments-offices/planning-building-code-enforcement/planning-division/major-development-projects/downtown-west-mixed-use-plan
Downtown West Development Agreement	https://www.sanjoseca.gov/home/showpublisheddocument/77459/637680918932500000
Downtown West MOU	https://sj-admin.s3-us-west-2.amazonaws.com/2018_1204_CityofSJ&GoogleLLC_MOU.pdf
Downtown West Design Standards and Guidelines	https://www.sanjoseca.gov/home/showpublisheddocument/77463/637680919040770000
Diridon Station Area Specific Plan	https://www.sanjoseca.gov/home/showpublisheddocument/77461/637680918957970000

Glossary

Entitlement: Land entitlement is a legal right created by an agreement with a local regulatory body. It dictates how a given piece of property may or may not be used. These are usually part of a county or city's general plan, which establishes land use and development requirements. There are specific areas set aside for residential, commercial, and public use areas.

Capitalization Rate: The ratio of a building's net operating income to market value. Can be calculated based on a specific transaction or as an average for a particular use in a market, fluctuating with market conditions.

Capitalized Value: The estimated purchase or sale value of a building as a multiple of the building's net operating income.

Community Benefits Agreement: A contract between a developer and community-based organizations representing residents' interests. The agreement spells out the benefits the community will receive in return for supporting the developer's project in their neighborhood.

Developer Return: The minimum return required by a developer to complete a project.

Discount Rate: A compound interest rate used to convert expected future income into a present value. Discount rates are often equal to the investor's cost of capital, representing the "opportunity cost" of capital deployment.

EIFD: An Enhanced Infrastructure Financing District is a governmental entity established by a city or a county and financed through tax increment generated from the growth in property taxes. It is often used as a financing tool for large scale community-wide benefit projects and urban/rural in-fill projects.

Ground Lease: A lease agreement where the landowner (lessor) agrees to lease their land for a set period.

Hard Costs: The cost of construction materials and construction labor.

NOI: Net Operating Income is the building income after accounting for vacancy and after deducting operating costs borne by a building's owner.

NPV: Net Present Value is the present value of all future inflows and outflows of cash associated with a given investment or project.

Proforma: A proforma analysis is a set of cash flow projections that projects the financial return that a proposed real estate development is likely to create.

Glossary

Residual Land Value: The amount a developer should be willing to pay a landowner for the right to build a given project. RLV is equal to the total project revenues minus project costs and developer return.

Subvention: Subventions are local shares of revenue levied by the state or federal government and then allocated to local governments on a formula basis. Local governments may contribute portion of the new tax revenue to provide financial assistance through subvention.

Soft Costs: The cost of project design and other professional work, permits, fees, construction loan interest and other costs.

Yield: In the context of commercial real estate, yield refers to the annual income from the investment.