The REFM Case Collection: The Upzoning Decision

Overview

115 Arts Street (the "Artist Factory") is an existing three-story 20,000 square foot historic building located in an amenity-rich neighborhood just outside the downtown core of a major US city. Under the current zoning, the property can be redeveloped another two stories into 70 residential condominiums. Under the city's zoning process, there is a chance to get the parcel upzoned to allow for 130 units. But there are conditions for getting that extra density from the city, and it is never 100% certain that a rezoning will be successfully achieved.

Background

Donna and Terry became quick friends after meeting through a mutual acquaintance at a real estate networking event several years ago. They both worked for real estate development companies that were family businesses, but both were really entrepreneurs at heart. They eventually got fed up with working to inflate the bank accounts of these two wealthy families and decided to become business partners in a real estate development company. While it goes without saying, they named their company Modest Moguls ("MM").

After five years of successful operation, MM now has nine employees, including the two principals, and has profitably developed eight mid-size (fewer than 30 units) residential projects – all rentals, all in the close-in suburbs to the city. Each project lasted about eight to twelve months in duration and was mid-rise (6 stories or fewer) wood-frame construction.

Donna and Terry both have a keen interest in urban adaptive reuse and historic renovation projects, and crave the cachet of breathing life back into charming old buildings with the kinds of beautiful architectural details that are no longer being produced. MM had its eye on one property in particular in the city, 115 Arts Street, formerly home to an artist's workspace that produced three well-known 20th-century U.S. metals sculptors. They felt that the marketing campaign that could be tied to the history of the building could be incredibly creative and compelling, and that they could really make a splash with this as their first project in the city.

As of January 1, 2013, MM had signed a contract to purchase the now-vacant and decrepit Artist Factory building and the land beneath it for $3.0 million (other bids also came in around that amount, but MM prevailed in the end). They were currently in day 28 of the 60-day due diligence period.

The Big Opportunity

Most real estate development is accomplished "by-right" or "as a matter-of-right" (also referred to as "as-of-right"). Such development projects comply with all the standards of the zoning regulations, and there is a regular permitting process managed by the jurisdiction that does not require formal public input on design or use.

An upzoning is a planning tool that can allow for developments and associated public benefits that are superior to those that would result from matter-of-right projects. The upzoning process relaxes certain limiting regulations, such as height and FAR, in return for public benefits provided by the developer. However, an upzoning involves extensive review by public bodies and neighborhood residents and other interested groups.

MM had based its $3.0 million purchase price off of the property's 2.50 FAR by-right development potential of 70 residential units (which could be accomplished with wood-frame construction in conjunction with the existing structure), but recognized full well that they could possibly upzone the site in the future to the "BRD" (Bigger, Riskier Development) zoning designation, which had an FAR of 4.50. With this increased density, they could develop a total of 130 condominium units.

Donna and Terry knew that if they could pull off the upzoning, their land cost basis would be much lower than what it "should" be on a per-condominium-unit basis for the neighborhood. With those economics, they could generate significantly higher profits than they had pitched to their investors, who had committed to providing 90% of the equity capital for the by-right project. Donna and Terry could end up being heroes and become pretty rich themselves, too.

The Costs

MM would have to build in concrete/steel since the building would have to be seven stories tall to accommodate the higher unit count. Additionally, they would be required to sell 7% to 9% of the residential units (they would have to negotiate) at "affordable" prices based on a government-provided pricing schedule that dealt with Area Median Incomes, or AMI (which was not negotiable) **(Exhibit A)**. This requirement was part of the city's mandate of "inclusionary zoning", which strove to make all neighborhoods mixed-income in nature.

While the spirit of inclusionary zoning was entirely noble, it presented an economic dilemma for the developer in that certain units would have to be sold below what it cost to bring them to market. In order for the developer to keep their targeted profit margins, the market rate units would have to become that much more expensive to make up for what would otherwise be losses.

And while every developer had the sneaky idea of just making all of the Affordable units Studios (since it was better to lose money on a lower-priced unit than on a larger higher-priced unit), the city prevented that by requiring a ratio of Affordable unit types that matched the ratio of the Market rate unit types in the building.

From preliminary conversations with the zoning office's liaison, MM understood that they would likely also have to dedicate approximately 2,000 rentable square feet on the ground floor for a city-sponsored art exhibition space (set up legally as a commercial condominium unit within the overall building condominium regime), for which they would receive no rent whatsoever. While the city would not levy real estate taxes on the commercial condominium, MM as developer, and eventually the condominium owner's association, would have to bear the art exhibit curator's $45,000/year compensation package (which provided for 3% annual increases), and also the ongoing operating expenses of the commercial condominium unit itself, which they knew would be every bit of $15 per square foot per year, naturally subject to general expense inflation.

Along these lines, Donna remembered hearing something about how condominium developers needed to also carry the costs of the individual condominium units before they were closed on by the buyers. She thought she had it already built into the pro forma but made a note to double check the trending of it as units were closed and per-unit costs were shed on to the new unit owners.

Additionally, if they increased the number of units in the building, they would have to build underground parking to accommodate the higher parking count requirement (they were able to get away with just surface parking otherwise). They had a nagging feeling in the back of their heads that there would be lots of "dirty dirt" from 50+ years of sculpting work, and knew that the deeper they went into the ground, the more of it they could find. While it sounded like an oxymoron, they would have to have this dirty dirt carted away at a premium cost to a "special dump".

They also would need to pre-sell significantly more units to be eligible for construction financing. Right now they were hearing that construction lenders were requiring at least 30% of units be pre-sold (purchase and sale contracts signed, and 10% cash deposits taken and held in escrow) before the lenders would seriously consider funding a condominium project. At an assumed pre-sales rate of 7 units per month, they would be in for a much longer haul before they could break ground. A longer runway like that could potentially put them in danger of missing the condominium market altogether by the time they were able to deliver the larger building.

They had been over the various elements of the two scenarios with their architect and likely general contractor, and summarized them side-by-side for their and their investors' ease of reference **(Exhibit B)**.

The Big Risk

Pursuing the upzoning would cost Modest Moguls both time and money. There would not only be significantly land use attorney's fees associated with the rezoning process, but MM would also incur various consultant's fees, as well as additional carrying costs to upkeep the property while the hearings took place. The rezoning process would certainly delay the start of the project, likely by at least 8 months, but Donna and Joan had heard horror stories that it could drag on for as many as 14 months. On the low end, they had estimated the upzoning pursuit would cost them $650,000, and on the high end, double that amount.

Donna and Terry knew that there was a very real chance that they could go through the entire rezoning process only to have the request for additional density rejected outright. At that point they would have lost time and money, and the IRRs to their investors would likely drop relative to what they were pitched. It would be a lot to go through just to end up doing the 70-unit project that they already had in hand.

While they had not themselves been through the rezoning process before, MM knew it was quite detailed and could be tricky, especially when dealing with a potentially prickly community that was known to value the status quo, mid-rise nature of their neighborhood.

Blue Screen Of Death

Just as Terry was making the final adjustments to the as-of-right scenario pro-forma for the upzoned scenario, his Windows computer crashed, giving him the dreaded Blue Screen Of Death **(Exhibit C)**. The machine then spontaneously combusted, melting instantly into a pile of smoldering noxious plastic. The timing couldn't have been worse! He and Donna had to present the alternatives and their decision to their investors (and potentially request more equity from their investors for the upzone scenario) on Monday, and it was Thursday night already.

To compound matters, Terry had never followed through on backing up his files to Dropbox, even though he had promised Donna that he would. After apologizing profusely to Donna, Terry found the as-of-right pro-forma file from his prior email to their investors **(Accompanying Excel file)**, saved it as a new file entitled "Upzone Scenario", and got back to work making the needed adjustments.

It was going to be a long weekend, but they were passionate about this deal, and were going forward with it one way or another. Plus, they reasoned, rebuilding the upzone scenario pro-forma would allow them a final opportunity to test their convictions with respect to their assumptions. In true entrepreneurial fashion, they turned on the coffee maker, ordered some pizza, and got to work in Excel on Donna's computer (an Apple with a flawless record of performance and strong graphic design capabilities).

Student Assignment

Put yourself in Donna and Terry's shoes. You need to run the upzone scenario analysis in Excel and compare and contrast the two alternatives (with appropriate sensitivity analyses for each scenario) such that you can make a decision as to which one to pursue. Then write up an Investment Committee memo recommending pursuing one scenario or the other, backed up by your quantitative and qualitative analyses.

To be clear: Donna and Terry are going forward with the development. You must take a side as to which path they should pursue, and detail why.

Assignment Deliverables

1. Two-page Investment Committee Memo in a Word file, which includes the following returns metrics:
    a. IRR based off of the monthly cash flows
    b. NPV based off of the monthly cash flows
    c. Multiple On Equity
    d. Profit Margin (Net Cash Flow divided by Gross Sales Proceeds)

2. Up to two additional pages of Exhibits pasted as images into the Word file

3. A quarterly Gantt chart of the project timeline for the Upzone Scenario from Time 0 of January 1, 2013 through the closing on the final residential unit.

    You may create your Gantt chart using a free trial of the service gantto.com (from which you can export to PDF and then print), or Microsoft Project if you own it. The Gantt chart should have all of the activities/tasks and milestones shown in the *Project Timing And Sales Velocity Assumptions* section of Assumptions tab of the accompanying Excel.

Guidance

For Parking Hard Costs, assume that the surface parking Hard Costs in the By-Right scenario are included in the "Residential Hard Costs" line item.

For the Underground Parking Hard Costs in the Upzone scenario, you can put those into the Retail Hard Costs line (and relabel the line). Let's assume there is no difference in cost between 2,000 SF of lobby, and the 2,000 SF of art exhibit space, so there is nothing to change on that front with respect to Hard Costs.

In both models, you can ignore the Storage Units input on the Assumptions tab, just as you can ignore the Owner Directed Hard Costs.

Assume that MM will contribute 10% of all equity invested.

You can run sensitivity analyses around some or all of the following variables:

1. Hard Costs
2. Sales Prices
3. Upzoning Approvals duration
4. Upzoning Approvals budget
4. Pre Sales Absorption Rate
5. Market Sales Absorption Rate

Good luck and enjoy the learning experience!