COMMUNITY DEVELOPMENT DEPARTMENT

The staff report is being released early on March 25, 2010.

Council Meeting Date: April 6, 2010
Staff Report #: 10-044

Agenda Item #: F-1

REGULAR BUSINESS: Consideration of the proposed Term Sheet for the Menlo Gateway (Bohannon Hotel & Office) Development Agreement

(Please note: There will be a special Council presentation on the Final Environmental Impact Report (EIR) and Fiscal Impact Analysis (FIA) from 5:30 p.m. to 6:45 p.m. preceding the regular Council meeting).

RECOMMENDATION

Staff recommends that the City Council consider the proposed Term Sheet for the Menlo Gateway (Bohannon Hotel & Office) Development Agreement (Attachment A) and proceed with the review process based on the Term Sheet, according to the previously established schedule as follows:

- April 7: Housing Commission recommendation on the BMR (Below Market Rate) Housing In Lieu Fee Agreement;
- April 19: Planning Commission public hearing on all aspects of the project;
- May 3: Planning Commission recommendation on all aspects of the project;
- May 25: City Council public hearing on all aspects of the project;
- June 15: City Council first step of actions on the entire project; and
- June 22: City Council second (and final) step of actions on the entire project.

The policy decision to approve a project of the proposed size at this location, balancing the benefits and impacts, is a Council decision. The Planning Commission will be asked to make a recommendation on this policy decision at its meeting on May 3. The City Council would then need to consider all inputs, including comments from the community, in making the policy decision, which is currently scheduled for June 15, 2010.

BACKGROUND

Project Description

The Bohannon Development Company has submitted a proposal for a mixed-use office, research and development (R&D), hotel, and health club development on nine properties addressed 100 to 190 Independence Drive (Independence Site) and 101 to

155 Constitution Drive (Constitution Site). An area plan showing the project in context of its surroundings is included as Attachment B. The proposal is currently branded as the Menlo Gateway project, although it has also been referred to informally as the Bohannon hotel and office project. The proposed project would require the following actions:

1. **General Plan Amendment** to create a new Mixed-Use Commercial Business Park land use designation, which would allow research and development (R&D) facilities, offices, hotels/motels, health/fitness centers, cafes and restaurants, and related commercial uses. The maximum floor area ratio (FAR) would be set at 100% for offices, R&D, and related commercial facilities, 12.5% for health/fitness centers, cafes and restaurants, day care facilities, and related retail/community facilities, and 25% for hotels/motels (total maximum FAR of 137.5%);
2. **General Plan Amendment** to change the land use designation of the properties from Limited Industry to Mixed-Use Commercial Business Park;
3. **Zoning Ordinance Amendment** to create a new M-3 (Mixed-Use Commercial Business Park) zoning district, consistent with the General Plan Amendment described above, and undertake associated modifications to other sections of the Zoning Ordinance, in particular the creation of specific parking requirements for the M-3 district;
4. **Rezoning** the properties from M-2 (General Industrial) to M-3 (Mixed-Use Commercial Business Park);
5. **Development Agreement** to create vested rights in project approvals, address implementation of the proposal, and specify benefits to the City;
6. **Architectural Control** approval of specific project plans for the construction of new buildings with a maximum of 955,170 square feet of gross floor area (137.5 percent FAR) and a maximum building height of 140 feet;
    - The Constitution Drive site would include two eight-story office buildings totaling 494,669 square feet; potential neighborhood-serving convenience retail and community facility space; and two multi-story parking structures;
    - The Independence Drive site would include a 200,000-square-foot, eight-story office building; a 171,563-square foot, eleven-story, 230-room hotel; a 68,519-square-foot health and fitness center; a 4,245-square-foot restaurant; potential neighborhood-serving convenience retail and community facility space; and a shared multi-story parking structure;
7. **Tentative Parcel Maps** (one on the Independence site and one on the Constitution site) to merge lots, adjust lot lines, and establish easements.
8. **Heritage Tree Removal Permits** to remove 36 heritage trees on the Independence site, 31 heritage trees on the Constitution site, seven off-site trees along Chrysler Drive, one off-site tree along Independence Drive, and two off-site trees along Marsh Road;
9. **BMR Agreement** for the payment of in-lieu fees associated with the City's Below Market Rate Housing Program; and
10. **Environmental Impact Report (EIR)** to analyze the potential environmental impacts of the proposal. In addition to analyzing the proposed project, the EIR considers an

optional approach to the proposed General Plan Amendment and Zoning Ordinance Amendment that would involve the “X” Conditional Development overlay zoning district and an associated Conditional Development Permit.

The following table summarizes some of the key features of the proposal as represented on the most recent set of project plans, dated March 10, 2010:

Land Use	**Constitution Site** (Closest to SR 84)	**Independence Site** (Closest to US 101)	**Total**
Office/R&D	494,470 s.f	200,000 s.f.	694,470 s.f.
Hotel	n/a	173,436 s.f./ 230 rooms	171,436 s.f./ 230 rooms
Health Club	n/a	68,705 s.f.	68,705 s.f.
Café/Restaurant	n/a	4,285 s.f.	4,285 s.f.
Total	**494,470 s.f.**	**446,426 s.f.**	**940,896 s.f.**
Parking Structures			
Number	2	1	3
Spaces	1,504	1,017	2,521
Size	446,232 s.f.	313,220 s.f.	759,452 s.f.

Review Process

The applicant submitted an initial proposal in 2004, and submitted a revised proposal in 2007 to incorporate the features and needs of a specific full-service hotel, namely Marriott Renaissance ClubSport. A comprehensive listing of past public meetings and milestones associated with the each proposal to date is included as Attachment C. The staff report and the presentations from previous meetings are available for review on the City’s website or in the City offices.

On November 17, 2009, the City Council provided direction to enter into good faith negotiations on the Development Agreement with the applicant. The direction was accompanied with a number of caveats of what individual Council members felt was important for the City’s negotiating team to consider a project of the proposed size. The minutes from the meeting, including a summary of each Council Member’s caveats, is included as Attachment D.

On February 23, 2010, the Menlo Gateway Council Subcommittee, comprised of Council Members Cohen and Fergusson, submitted a report that included an updated public outreach and project review schedule. An excerpt of the schedule, as reviewed at that meeting, is included as Attachment E. On March 25, 2010, the Final Environmental Impact Report (EIR) and Fiscal Impact Analysis (FIA) were released and are available for review on the City’s website and the City offices. These documents provide necessary context for the Council and the community to consider the proposed Term Sheet. As such, there will be a special Council presentation on the Final EIR and FIA from 5:30 p.m. to 6:45 p.m. on April 6 preceding the regular Council meeting on this item. In addition, the Planning Commission meeting scheduled for April 19, 2010 is critical for obtaining timely public comment on all aspects of the proposal.

ANALYSIS

Development Agreement Term Sheet Negotiations

A Development Agreement is a contract between the City of Menlo Park and a project sponsor that delineates the terms and conditions of a proposed development project. A Development Agreement allows a project sponsor to secure vested rights, and it allows the City to secure certain benefits. The City Council is not obligated to approve a Development Agreement, but if the City Council does want to approve a Development Agreement, the terms of the Development Agreement need to be acceptable to both parties; one party cannot impose terms on the other party.

The Council Subcommittee played an integral role throughout the process, including the provision of oversight and advisory services during the Development Agreement negotiation. The City's negotiating team, comprised of the City Manager, the City Attorney, Deputy City Manager and Development Services Manager met multiple times a week over the past 18 weeks. The negotiating team met internally to discuss strategy and specifics, held negotiating sessions with the applicant team, and consulted with the Subcommittee on a variety of topics. Subcommittee Reports were issued monthly at City Council meetings to give the rest of the Council and the community updates on how negotiations were progressing.

As described above, the City Council provided direction to the negotiating team on November 17, 2009 in the form of caveats. One of the first tasks that the staff negotiating team performed was distilling the caveats into a set of parameters, which were reviewed by the Council Subcommittee. The parameters can be summarized as follows:

Highest Priority Items

- Timely guaranteed revenue
- Substantial vehicle trip reduction
- Substantial reduction in greenhouse gas emissions
- Limits on transferability without City approval
- Reasonable limits on the time for construction - Hotel in 1st phase
- Improvement to the footprint & aesthetics of the parking structures
- Priority hiring program for Menlo Park residents
- Commitment to pursue LEED gold for office and silver for hotel

Other Priority Items

- Improving bike and pedestrian connection to and from the Belle Haven neighborhood and in the Marsh Roar corridor
- Land for housing

- Increased revenue beyond FIA projections
- Undergrounding of transmission lines
- Developing a vision for the Menlo Park waterfront area
- Enhancing Bayfront Park
- Providing retail services or child care on-site or nearby
- Additional public benefits such as bus shelters and youth programs

The negotiating team provided the parameters to the applicant to establish expectations and a framework for conducting the negotiations.

Development Agreement Term Sheet

The proposed term sheet is included as Attachment A, along with a cover letter from the applicant. The term sheet covers 12 topics. These topics would get fleshed out into specific legal language into a much more extensive Development Agreement. Some of the topics crossover into mitigation measures from the EIR and potential conditions of approval. When considering the terms of the Development Agreement, it is important to remember that it reflects a negotiated package and any one aspect cannot be viewed in isolation. Staff believes that a majority of the parameters have been achieved in the proposed Term Sheet as summarized below.

Term #1: Quality Hotel

The applicant has agreed to construct a four star quality, full-service hotel either before or concurrent with any office construction. The basic rationale and justification for the City to consider a proposal for zoning changes to increase the maximum allowed density for office uses is tied to the provision of a quality hotel that generates substantial revenue to the City through transient occupancy tax (TOT). The main benefit that the Menlo Gateway proposal offers to the City is the potential revenue and amenities of a quality hotel. Hotel quality affects room rates, which affects transient occupancy tax. Therefore, it is important from the City perspective to ensure that a quality hotel will be built, and that it will be built first.

Term #2: Revenue Guarantee

Using the projections in the City's FIA as a guide, the applicant has agreed to guarantee revenue to the City to the extent that actual revenue from TOT and sales tax does not meet projections, up to $225,000 per year for a maximum of 20 years. The guarantee, based on the revenue schedule referred to as Exhibit A of the Term Sheet (Attachment A-6), would commence three years after the hotel opens. For context, Attachment F provides summary information from the City's FIA for revenue and expenditure projections for the low, medium and high scenarios. The summary table shows that the projected property taxes alone would cover the City's expenses related to the project. The revenue target established in the term sheet combines the low TOT projection and the medium sales tax projection, to establish the base year 2008 revenue target of $1.2

million, comprised of $1,050,783 of TOT and $150,504 of sales tax, which would escalate at two percent per year. Since the revenue target includes sales tax, it creates an incentive for the applicant to lease to tenants that have the potential to generate sales tax. The guarantee also helps protect the City against the poor performance of the hotel. The negotiating team and the applicant explored an number of options related to revenue guarantees, including the possibility of structuring the revenue guarantee as a percentage of gross office rents. Although appreciating the elegance of the concept, it proved unworkable for the applicant, especially with respect to being able to finance the project or separating ownership of the hotel from the office portion of the project in the future.

Term #3: Term for Retaining Development Rights

The initial term of the Development Agreement would be 5 years. By the fifth year of the agreement, the applicant either would have to make a complete building permit submittal, which would likely cost hundreds of thousands of dollars to prepare the necessary documents or pay a fee to the City in the amount of $300,000 for a two year extension, with the ability to get a third year if a complete building permit submittal is made by the end of the second year, i.e. year seven. If submittal for building permits was made by the fifth year, then there would be an automatic three year extension of the Development Agreement. To keep the Development Agreement active, the applicant would have to obtain a building permit and start construction by the end of the eighth year. Once construction starts on the Independence (Hotel) phase, then the applicant would have until the 15^{th} year to start construction on the first office building on the Constitution phase. Upon starting construction on the first Constitution office building, the applicant would have an additional five years to start construction of the second Constitution office building. The overall timeframe reflects current market conditions and overall timeframes for preparing necessary permit documents, permit reviews, construction, and market absorption. The incentives are aligned to encourage the applicant to commence construction of the hotel, and the office development cannot proceed in advance of hotel construction.

Term #4: Public Benefits

The term sheet includes three separate types of public benefit. The first type involves $1 million worth of capital improvement projects allocated to (1) the Belle Haven neighborhood and (2) Bedwell Bayfront Park or other City-wide recreational improvements, which would be funded, designed and implemented by the applicant. These specific projects would be based on City-conducted outreach and ultimately be at the discretion of the City Council. The money would be indexed for inflation starting in 2010 and the work would need to be completed prior to the completion of the first office building on the Constitution phase. This approach allows at least half, potentially more, of the benefits to be focused on areas near the project, and give the City Council decision-making authority on how money is spent.

The second type of public benefit would be a voluntary imposition of an additional one percent TOT on the hotel for a total TOT of 11 percent for the life of the hotel, provided the City TOT remains at the current rate of 10 percent; the additional 1 percent would terminate if the City raises its TOT to 11 percent or above. This concept is one of the supplemental revenue ideas from the City's FIA. This public benefit provides funds, approximately $105,278 on the low end and $146, 986 on the high end (both in 2008 dollars) with the first phase of development and does not have any restrictions associated on how future City Councils would decide on how to spend the money. The applicant does provide a couple of suggestions that the money could be spent for further trip reduction or greenhouse gas reduction efforts in the City.

The third public benefit item is a commitment to a priority hiring program with JobTrain for Menlo Park residents.

The negotiating team and the applicant did explore the potential to achieve some of the other parameters, which could be categorized as public benefit items, such as the provision of land for housing, undergrounding the electrical transmission lines along the Constitution site, developing a vision for the Menlo Park waterfront, and providing retail services or child care on-site or nearby. The applicant determined that these items were not financially feasible and the negotiating team determined that these were not as high of a priority compared to other parameters. The City Council could consider funding these or other items once the City starts receiving the projected TOT if the project is approved and built.

Term #5: LEED Building Standards

The applicant is committed to designing the office buildings to achieve LEED (Leadership in Energy and Environmental Design) gold and for the hotel and health club to achieve LEED silver based on the registrations that occurred in the Spring of 2009. The applicant is required to make a good-faith effort to obtain certification for the applicable levels.

Term #6: Vehicle Trip Reduction

The applicant has agreed to reduce the projected net new average daily trips from 11,113 to 9,242, which reflects a 17% reduction in trips. The applicant has agreed to annual monitoring to verify trip counts after occupancy of the second Constitution office building. If the project is not in compliance with the trip limits, then the project would be subject to a fee of $100 (indexed to inflation) per daily trip in excess of the trip limit with funds to be used by the City for trip reduction programs. Much of the work to come up with the trip limit came from efforts to reduce the project's greenhouse gas emissions. Even though the greenhouse gas analysis shows that trips could increase and still meet the Bay Area Air Quality Management District (BAAQMD) draft thresholds for emissions, the applicant agreed to a permanent trip limit to address the Council caveat regarding trip reduction. By agreeing to this trip limit and penalty structure, this requirement was able to be applied to the EIR to eliminate three significant and unavoidable transportation impacts, one air quality impact, and one noise impact. The trip limit would remain in place beyond the life of the Development Agreement for the life of the project.

Term #7: Greenhouse Gas Reduction

The applicant spent time refining project features to reduce greenhouse gas emissions in order to satisfy requirements of the EIR. Through the Development Agreement negotiations, the applicant has agreed to go a step further to reduce greenhouse gas emissions associated with the energy consumption of the buildings by participating in a program such as PG&E's Climate Smart or comparable offset program so that the buildings energy consumption/use will be carbon neutral. This requirement would be beyond the life of the Development Agreement for the life of the project.

Term #8: Permit Processing

The term sheet calls for the City to expeditiously process permits and future approvals for the project. In addition, the term sheet would allow the City Manager to extend performance times called for in the Development Agreement up to a maximum of 180 days if the applicant is proceeding expeditiously. These items demonstrate the City's commitment to making the project a success and allows the project to move forward with some flexibility in the schedule if unforeseen delays are encountered.

Term #9: Land Use Vesting Rights

The term sheet calls for the applicant to have the vested right to build the project consistent with the various project approvals generally based on the laws in affect at the time of approval. This provision gives the applicant certainty during the term of the Development Agreement. This is a standard term of Development Agreements to minimize risks to property owners and investors.

Term #10: City Fees

The term sheet calls for the City fees to be capped at the current levels at the time of approval of the Development Agreement, except for fees that are subject to indexing or the imposition of new Citywide fees. Two of the City's highest fees are the Below Market Rate (BMR) housing in lieu fee and the traffic impact fee, both of which are indexed. The Utility Users Tax (UUT) is not fixed, and the project will pay the same rates as other comparable Menlo Park properties. The project would be subject to any new fees and taxes that are applicable Citywide.

Term #11: Project Modifications

The applicant has already prepared options that incorporate the use of landscape reserve parking and modify the footprints of the three parking structures, which are analyzed in the Final EIR. The applicant is committed to making further improvements to the exterior of the parking structures, regardless of the garage footprints, subject to City staff review and approval. In addition, the term sheet calls for other project modifications to be approved by City staff if the changes are substantially consistent with original project approvals.

Term #12: Transferability

Transfer or sale of the property prior to completion of the hotel would be limited and subject to City Manager approval. Transfer after completion of the hotel would be allowed subject to certain conditions without City approval. All obligations of the Development Agreement, such as environmental mitigations, public benefit payments, revenue guarantees, and conditions of approval, would be assumed by any new owner or transferee of any portion of the property. The applicant has a long-term stake in the community that involves buying and holding property, not selling property.

Financial Analysis

The City retained the services of two experts, Suzanne Mellen of HVS Consulting & Valuation and Rob Perrino of Cushman & Wakefield, to provide guidance regarding the financial feasibility of the hotel and office aspects of the project. The funds for these services were provided to the City by the applicant and the City in turn contracted directly with the respective firms. The firms were tasked with performing market studies, financial projections and valuations of portions of the project as well as an overall project pro-forma to determine the overall feasibility of the project and the value of entitlements. The financial consultants from HVS and Cushman & Wakefield will be in attendance at the April 6, 2010 meeting and will be available to answer Council questions.

Hotel Analysis

The executive summary of the Hotel Analysis is included as Attachment G. A full copy of the HVS Report has been made available to Council Members and is available for review by the public at the Community Development Department at City Hall and is available on the City’s website. The following is a summary of the HVS analysis and findings.

HVS determined that the proposed Marriott Renaissance ClubSport project is feasible from a market demand perspective, assuming that the approximately 700,000 square feet of office space is developed adjacent to the hotel. While the Renaissance ClubSport is projected to operate profitably, HVS concludes that the development costs of the project coupled with the challenge of getting a hospitality product of this magnitude financed, leads it to conclude that the hotel project can only be rendered feasible if it is developed in conjunction with the more economically viable office product.

The subject site, while providing excellent access and visibility from U.S. 101, is relatively isolated, in that it is removed from demand generators at the current time. With the simultaneous development of the ClubSport and the office space, the hotel will offer an environment attractive to not only the adjacent office users, but also transient guests from other sub-markets as well. The hotel/club/office mixed-use development is very synergistic – each component enhances the revenue potential of the other by providing amenities that generate demand and a rental rate premium.

HVS undertook a complete market analysis for the proposed hotel. They anticipate that the hotel will compete with nine hotels totaling approximately 2,000 hotel rooms in the Menlo Park and Palo Alto area. While the local hotel market is depressed at the current time, having experienced a 21% decline in room revenue in 2009, they anticipate that the market will gradually recover to pre-recession occupancy levels by 2013. As occupancy recovers, they anticipate a rebound in average room rates reaching 2007 levels by 2013 (unadjusted for inflation). They have projected the hotel to achieve a stabilized occupancy of 74% and an average rate of $243 in 2017, its fourth year of operation.

According to HVS, the market for athletic facilities has fared better during this economic downturn - local athletic clubs have, for the most part, sustained their membership levels and initiation fees and monthly dues have not seen a significant decline. The eleven athletic facilities in the subject's market area were evaluated, however only the Pacific Athletic Club was considered by HVS to be truly competitive with the subject ClubSport. They project the club to ramp up to a stabilized level of 4,600 members by the end of 2017.

HVS made the following assumptions in its analysis:

1. That the Renaissance ClubSport will be complete and operational by January 1, 2014;
2. That the hotel market, which is depressed at the current time, will have fully recovered, from a demand perspective, as of the date of opening;
3. That average room rates will rebound once lodging demand recovers;
4. That the ClubSport will begin pre-selling memberships prior to the health club's opening and that 40% of the memberships will be pre-sold, creating positive cash flow to the operation at day one.
5. That the Renaissance Hotel will attain operating ratios and a profit level typical for a first-class, full-service hotel of this nature. HVS' projections are based on a database of comparable operating statements and its hotel forecasting model, adjusted for the specifics of the property and its market;
6. That the ClubSport will generate operating ratios and a profit level typical for an athletic club of this nature. HVS' projections are based on comparable athletic

club statements provided by Leisure Sports and its forecasting model, adjusted for the specifics of the property and its market.

7. The combined hotel and club operating forecast was compared with the operating performance of the Renaissance ClubSport in Walnut Creek for reasonableness.

The proposed project was valued as of the date of opening, January 1, 2014, to evaluate what the developer could sell the project for once it is completed. The valuation was based on a discounted cash flow analysis based on market rates of return. The discounted cash flow analysis was based on the annual cash flow (net income available for debt service and return on owner's equity) to be generated by the property over a ten year period, plus the reversionary sales proceeds from an assumed sale of the project at that time, i.e. as of December 31, 2023. The annual cash flow and reversion were discounted at a rate of 12.5%, which reflects a blended cost of debt and equity capital. The concluded value, as of January 1, 2014, was calculated to be $107,400,000, including membership pre-sale revenue.

The cost to develop the property must be taken into consideration to determine whether the project is feasible. In addition, in order to determine the value of the land intended for the Renaissance ClubSport, HVS performed a residual analysis whereby the value of the land was estimated by determining the value of the hotel as of the date of opening, and deducting the cost to develop the property. The remainder is what a developer could afford to pay for the land. In this particular case HVS did not deduct a typical entrepreneurial incentive as a cost of development, as would normally be the case. If HVS had deducted what it stated is a typical entrepreneurial incentive of 15% of development costs, there would be no residual value to the land, reflecting the marginally feasible nature of the hotel portion of the overall project, i.e. the developer must earn its profit from the office component. HVS based its land residual analysis upon the following assumptions:

1. The hotel's budgeted development cost, provided to HVS by the developer based on its contractor's estimate, equates to $89,138,965 ($359.46 per square foot x 248,672 square feet). This cost, which is exclusive of land cost, was compared to the development cost of the recently constructed Renaissance ClubSport in Aliso Viejo, California for reasonableness and was found to reasonable.

2. To the budgeted development cost HVS added 50% of the pre-development monies spent to date ($4,000,000) – assuming that this cost is shared with the adjacent office building.

3. In addition, a developer's fee to cover overhead during the pre-development phase was estimated at $3,000,000, based on HVS' database of detailed hotel development budgets.

4. A worst case scenario for this analysis was included, which was based on the assumption of a $10 lower average room rate, two percentage point lower

occupancy, $10 less membership dues per month and a $90 lower club initiation fee.

HVS concludes that the residual value of the Renaissance ClubSport site is estimated to be $11,300,000 as of the date of the project's completion (January 1, 2014) and $9,300,000 as of January 1, 2010, assuming an annual discount rate of 5%. Note that no developer's incentive has been included in HVS' analysis, i.e. HVS concluded that if a developer paid $9,300,000 for the land today (valued at $11,300,000 in 2014) and developed the Renaissance ClubSport for a total of $96,100,000, that they would be able to sell the project for $107,400,000, or an amount just equal to their total investment, without any imputed profit. According to HVS, real estate developers require some incentive to undertake the enormous risk of developing projects, particularly ones of this nature, which require a substantial investment for many years before any positive cash flow is generated. HVS concluded that the developer of the Renaissance Clubsport will have to wait until the office buildings are sold or refinanced to earn any profit on the development of the Renaissance ClubSport component of this project.

Office Analysis

The executive summary of the Office Analysis is included as Attachment H. A full copy of the Cushman & Wakefield Report has been made available to Council Members and is available for review by the public at the Community Development Department at City Hall and is available on the City's website. The following is a summary of the Cushman & Wakefield analysis and findings.

Cushman & Wakefield prepared a valuation consulting assignment of the office and retail portion of the Menlo Gateway Project performing the following work:

- Subject property inspection to the extent necessary to adequately identify the real estate
- Research relevant market data, in terms of quantity, quality, and geographic comparability, to the extent necessary to produce credible valuation consulting results
- Review of architectural renderings
- Review relevant studies prepared by other consultants
- Interview the developer
- Review and analyze developer's development cost estimates and pro-forma
- Interview Menlo Park Planning Personnel assigned to the Menlo Gateway Project

- Develop a market value estimate of the fee simple interest, as of January 1, 2010, for the subject land based on current zoning assuming a maximum Floor Area Ratio (FAR) of 45%
- Develop a market value estimate of the fee simple interest, as of January 1, 2010, for the subject land based on the proposed office and retail development
- Determine the general overall feasibility of the office/retail component of the project by utilizing the discounted cash-flow (DCF) methodology.

Cushman & Wakefield made the following market/economic observations in performing its analysis:

- Job creation for Bay Area employment will improve the project's probability of success
- An increase in initial round venture capital funding will lead to job creation and office space demand (leasing)
- Office space leasing at the project creates demand for Renaissance ClubSport
- Current office rent levels are flat
- Current class A office vacancy rates remain high with landlord concessions (free rent, generous tenant improvement allowances)
- Demand analysis indicates there is 3.89 years of oversupply of office space in the Silicon Valley and San Francisco Peninsula
- Current market conditions do not make the project feasible, today
- Overall improvement in real estate fundamentals (leasing, rents, financing) is needed

Cushman & Wakefield made the following assumptions about the office/retail portion of the project in performing its analysis:

- Approximately $4 million in entitlements to be spent by the developer is needed to coordinate, plan, and get approvals for office/retail portion
- Construction costs estimated at $250 million (excluding land, entitlements, and leasing commissions)
- Construction commencement in 2012 (estimated) with final completion in 2015 (estimated)
- Pre-leasing campaign of office space will be beneficial to the overall success of the project
- Absorption period for the office space is forecasted at 35 months (January 2014 thru December 2016)

Cushman & Wakefield reached the following conclusions:

- Land value of the office/retail portion of the project based on the proposed entitlements discounted back to 2010, best case is $51.2 million and worst case $15.8 million
- Financial projections indicate that the office/retail portion of the project would sell for approximately $341,250,000 in 2014 based on discounted cash flows assuming construction commenced in 2012 and no changes to construction schedule
- Project is economically feasible over the long-term, but the calculated Internal Rate of Return of approximately 12.68% is below an industry target return of 15%, and relies on sale of the project to achieve that return

Combined Financial Findings for Entire Project

Cushman & Wakefield prepared a Land Residual Analysis for the full project, which is included as Attachment I. This analysis shows the land residual analysis for both the office/retail portion of the project, as well as the hotel portion of the project. It also includes a residual land value for the property under its present zoning. This analysis concludes that the property currently has a value of $36.7 million under the "best case" and current value of $18.7 million under the "worst case" assumptions. The total residual land value of the combined project is estimated to be $60.5 million under the "best case" assumptions and $15.8 million under the "worst case" assumptions. This results in a value of the entitlements, i.e. increase in the residual land value of the fully entitled project, of $23.8 million under best case assumptions and no increase in value under the "worst case", i.e. the project would not be financially feasible and therefore the entitlements would add no value to the property.

Cushman & Wakefield also prepared a proposed construction pro-forma for the combined office and hotel project, included as Attachment J, based on assumed commencement of construction in 2012 showing cash invested in the project and cash flows from leasing/operations. This pro-forma projected net cumulative cash flow is potentially not positive until 2023 indicating a required long-term holding period for the developer and considerable risk, according to Cushman & Wakefield. Total capital investment over the first seven years, including real estate commissions, future tenant improvements, and contingency (but excluding the value of the land) is projected to be as much as $430 million over the estimated 11 year holding period (2024).

<u>Conclusion</u>

Given (1) the conclusions of the FIA and the financial analysis prepared by independent experts, (2) the requirement that the hotel be built first with potential for significant long-tern revenue with guarantees, (3) the extensive measures to minimize environmental impacts, and (4) other Development Agreement terms, such as public benefit funding, staff recommends that the City Council consider the proposed Term Sheet for the Menlo Gateway (Bohannon Hotel & Office) Development Agreement (Attachment A) and proceed with the review process according to the previously established schedule (Attachment E).

IMPACT ON CITY RESOURCES

The applicant is required to pay planning permit fees, based on the Master Fee Schedule, to fully cover the cost of staff time spent on the review of the project. The applicant is also required to bear the cost of the associated reviews by consultant. For the consultant review, the applicant deposits money with the City and the City pays the consultants.

The FIA itself provides projections of the potential changes in fiscal revenues and service costs directly associated with development of the proposed project, for both the City and associated special districts. The Draft FIA was released on July 23, 2009 for an extended public comment period that ended on October 19, 2009. The Final FIA, prepared in response to comments on the Draft FIA, was released on March 25, 2010 for a 26-day review period. Comments on the Final FIA are due on or before the Planning Commission public hearing scheduled for April 19, 2010. A presentation highlighting the findings of the Final FIA will be provided before the start of the regularly scheduled City Council meeting in the Council Chambers starting at 5:30 p.m. On April 6, 2010, handouts of the presentation will be posted on the City's website after the meeting.

POLICY ISSUES

The proposed project will ultimately require the Council to consider a policy decision whether to change the General Plan land use designation and the zoning classification for the property. The implications associated with this decision will be analyzed through the project review process.

Staff is not making a recommendation on the policy decision to approve a project of the proposed size at this location given the benefits and impacts, as this is a Council decision. The Planning Commission will be asked to make a recommendation on this policy decision at its meeting on May 3, 2010. The City Council would then need to consider all inputs, including comments from the community, in making the policy decision, which is currently scheduled for June 15. At each of those meetings, staff will ask the Commission and Council, respectively, to first focus on the larger policy issue before weighing in on the details of the specific proposal.

For the meeting of April 6, 2010, the Council should decide whether it is generally comfortable with the term sheet as proposed. If the Council is generally comfortable, then there may be some specific items that the Council would like refined further concurrently with public review process. Staff could then attempt to negotiate with the applicant on modifications or revisions to the term sheet. If the Council is not generally comfortable with the term sheet as proposed, then the Council could stop the process and ask staff to go back to the table or the Council could direct staff to finish processing the project based on the proposed term sheet with the intention of denying the project.

ENVIRONMENTAL REVIEW

The Draft Environmental Impact Report was released on July 23, 2009 for an extended 60-day public comment period that ended on September 21, 2009. The Final EIR, prepared with response to comments on the Draft EIR, was released on March 25, 2010 for an extended 26-day review period. Comments on the Final EIR are due on or before the Planning Commission public hearing scheduled for April 19, 2010. A presentation highlighting the findings of the Final EIR will be provided before the start of the regularly scheduled City Council meeting in the Council Chambers starting at 5:30 p.m. On April 6, 2010, handouts of the presentation will be posted on the City's website after the meeting.

Justin Murphy Development Services Manager	William L. McClure City Attorney
Kent Steffens Deputy City Manager	Glen Rojas City Manager

PUBLIC NOTICE

Public notification was achieved by posting the agenda, at least 72 hours prior to the meeting, with this agenda item being listed. In addition, the City sent an email update to subscribers to the project page for the proposal, which is available at the following address: http://www.menlopark.org/projects/comdev_iac.htm A postcard mailed Citywide announcing the future meeting dates is scheduled to be mailed on April 8, 2010.

ATTACHMENTS

A. Letter from David D. Bohannon II, dated March 24, 2010 with proposed Development Agreement Term Sheet
B. Menlo Gateway Area Plan
C. Project Meetings and Milestones
D. Approved City Council Minutes for the Meeting of November 17, 2009

E. Excerpt of Public Outreach and Development Agreement Negotiation Process, dated February 23, 2010
F. Summary of City Revenue and Expenditures from Fiscal Impact Analysis (FIA)
G. HVS Executive Summary
H. Cushman & Wakefield Executive Summary
I. Land Residual Analysis
J. Construction Pro-Forma for Office and Hotel

REPORTS AVAILABLE FOR REVIEW ON CITY WEBSITE AND IN CITY OFFICES

A. Final Environmental Impact Report (EIR), dated March 2010, distributed separately
B. Final Fiscal Impact Analysis (FIA), dated March 2010, distributed separately
C. Hotel Financial Analysis, dated March 2010, distributed separately
D. Office Financial Analysis, dated March 2010, distributed separately

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