

MEMORANDUM

TO: Thomas F. Galligani, Jr.
Mayor's Office of Strategic Planning & Community Development
City of Somerville

FROM: Barry Abramson

SUBJECT: Evaluation of Ability of Union Square D2 Block Development to Support the
Additional Cost of Alternative 1 Design Concept

DATE: May 15, 2019

EXECUTIVE SUMMARY

This memorandum summarizes our evaluation of the ability of Union Square Associates, LLC's (US2's) D2 Block development project to support the cost of incorporating underground parking and other design changes called for in a community-driven concept known as Alternative 1.

The cost premium of Alternative 1 (the costs of the underground garage and other design and program changes as well as costs to the overall D2 project caused by a delay of anywhere from 12 to 20 months less the cost of the proposed above-ground garage) is estimated at approximately \$14,00,000 to \$25,000,000. Applying more conservative assumptions to certain components of the cost premium asserted by US2 could increase both ends of this range by as much as \$10,000,000. The foregoing does not account for the possibility of an economic/market downturn during the delay period.

Based on our review and evaluation of the financial pro forma and other information provided by US2 and the City and input from other sources, and the market risk associated with delay, we consider it very unlikely that the project would be able to support the additional cost of Alternative 1 and that the alternative would significantly increase the risk of the development not being able to proceed in the near term (even if that is defined as including the above-noted delay).

PROJECT FRAMEWORK

As the first phase of its Union Square master development, US2 proposes to develop a lab/office building (anticipated to be geared to life science tenants) on the D2.1 parcel and a multi-family residential project (mid-rise and tower buildings) on the D2.2 and D2.3 parcels. Each building would include ground floor retail and arts/creative economy space and 20% of the residential units would be affordable. US2's proposed parking approach is a three-level

above-grade garage with 269 spaces which would be lined with retail/arts and residential on the D2.2+3 site. US2 currently anticipates a construction start in October of this year. As part of a community review process, an alternate design concept (Alternative 1) has been proposed. This concept shifts parking to a four-level underground garage on the D.1 parcel (noted on the Talun/Tate concept sketch as accommodating 295 spaces). The concept also increases the amount of finished (non-parking) building area and open space and reconfigures buildings to open a view corridor.

Abramson & Associates, Inc. was engaged by the City of Somerville to evaluate the ability of the project to support the additional cost and the implications for financial feasibility of Alternative 1. This evaluation entailed the following major elements:

- Review and evaluation of the conceptual plans and estimated development costs associated with the two alternative parking approaches and the other program and design changes to determine the cost premium of Alternative 1
- Review and evaluation of pro forma information, provided on a confidential basis by US2, along with information from other sources, to determine the ability of the project to support the additional cost of Alternative 1 while maintaining the financial feasibility of the project

To do this, Abramson & Associates, Inc. relied upon its experience (over 24 years for the firm and 35 years for its principal) in real estate development analysis, supplemented by interviews of industry sources knowledgeable about relevant development as well as review of other market information.

EVALUATION

US2 estimated its proposed above-ground garage to have a development cost of \$45,000 per space for a total of approximately \$12,100,000. This cost includes hard costs (based on design development stage construction cost estimation by a construction contractor), soft costs and construction interest. This cost estimate is considered to be within a range of reasonableness, based on input from industry sources experienced with such garages in the local market.

Vermeulens, a cost estimator engaged by the City, estimated the construction cost of the Alternative 1 underground garage at \$23,208,000 (\$78,671 per space). In order to facilitate an apples-to-apples comparison, and recognizing the very conceptual nature of the Alternative 1 design, the estimated cost per space is applied to the number of spaces in US2's plan – 269, for a construction cost of \$21,163,000.

Vermeulens' estimate includes disposal of hazardous soils estimated at \$4,315,000. Deducting the \$900,000 estimated by US2 for hazardous waste removal that would be required for this site with its proposed plan yields an adjusted estimated construction cost of \$20,263,000 (\$75,325 per space). US2 reports contractor input that the cost of

underground garages in the local market is typically in the range of \$95,000 per space, which would indicate a cost over \$5,000,000 more than that estimated by Vermeulens.

Additional costs specific to the underground parking garage are:

- Owner's hard cost contingency – estimated at 10%, given the conceptual level of design and the high variability of costs associated with deep sub-surface conditions
- Soft costs – conservatively estimated at 8% of hard cost
- Construction interest attributable to the garage extending over the overall D2 project construction period

Together these costs yield a total estimated development cost specific to the Alternative 1 garage of \$25,841,000 (\$96,064 per space) in \$2019.

Other adjustments are warranted to more fully understand the cost impact of Alternative 1.

- Massachusetts Brownfield Tax credit is estimated at \$726,000 based on the net \$3,415,000 hazardous waste removal cost attributed to the underground garage at an 85% net market resale yield on the 25% credit.
- Land-/hard-scape cost for the larger open space in the Alternative 1 plan is estimated at \$330,000 based on a net additional open space area of 11,000 square feet at \$30 per square foot. This estimate does not include the cost of the water feature shown in the Alternative 1 concept plan.
- Project-wide redesign and re-permitting would be required beyond the costs specific to the garage in the above soft-cost estimate. Alternative 1 would entail major changes to the buildings on both sites as well as the open space, and much of the permitting would need to be redone. US2 estimates redesign and re-permitting costs at \$2,850,000. As a conservative measure, the analysis assumes an allocation of half that amount – \$1,425,000.
- Value of the additional 30,000 GSF of building area created in the Alternative 1 plan – 24,000 SF (approx. 19,000 net rentable) residential and 6,000 square feet retail/arts. This evaluation does not constitute an appraisal. Accordingly, for purpose of this evaluation, we have used the \$1.7 million estimate presented in a prior estimate by Northstar which was included in the City's March 5th presentation. This equates to \$57 per gross building square foot. The actual valuation could vary significantly, though not to an extent that would materially impact the overall conclusions of the evaluation. It is noted that, while economies of scale could benefit the value of such additional buildable space, there are factors which could lead to a significantly lower value. The additional residential space on the first and second floors facing the rear alley likely would command lower rent than that on upper floors. Some rentable space in the lab building (estimated by US2 at 3,500 square feet) could be lost to ramping systems for the garage and the non-rectangular floor plate in that building could negatively impact utility and attainable rent.

After factoring in the above considerations, the total cost of Alternative 1 is estimated at \$25,170,000 (\$93,569 per space) in \$2019.

Subtracting the \$12,105,000 (\$45,000 per space) estimated cost of US2's above-ground garage from the above amount indicates the cost premium of Alternative 1 at \$13,065,000 (\$48,569 per space) in \$2019.

Redesign and re-permitting could significantly delay the construction start from the current schedule of October of this year. US2 estimates the delay at 20 months based on the CDSP and DSPR permitting processes required by zoning and the actual durations of those processes experienced to date. With costs escalating at an estimated annual rate of 5%, such a delay could result in an escalated cost premium of approximately \$15,200,000. If the delay were to be limited to 12 months, the escalated cost premium would be approximately \$14,300,000.

Additionally, delay could significantly increase the cost of the overall D2 project, which may well not be matched by corresponding increases in rents and income, resulting in a substantial increase in the financial impact of Alternative 1. The general expectation in the construction and development sectors is that, barring an economic slow-down, construction costs will continue to escalate at the recent annual rate of approximately 5% for the next year or two, whereas market participants are generally reluctant to anticipate annual rental rate growth of more than 3%.

If this disparity in growth rates were to hold, the overall D2 project's development costs would need to be reduced in order to maintain the acceptable financial return estimated for US2's proposed project. This required cost reduction is preliminarily estimated to be on the order of \$500,000 per month – approximately \$10,000,000 for a 20-month delay or \$6,000,000 if the delay were to be 12 months. These amounts would effectively constitute additional cost premiums of the Alternative 1. If rental rate increases were to track with construction cost increases, then there would be no additional cost premium on this account, thus setting the lower end of the range, but this would be considered an optimistic assumption.

Adding the project-wide delay cost premium to the above-estimated direct premium would yield a total cost premium of approximately \$14,300,000 to \$20,300,000 if the delay were to be 12 months and approximately \$15,200,000 to \$25,200,000 for a 20 month delay.

As previously noted, US2's estimates of the underground garage's hard cost and redesign/re-permitting cost are higher than the estimates used in this evaluation and there are factors that could result in the value of additional occupiable building area being considerably lower than the assumption used in the analysis. If US2's estimates and a lower valuation of additional building area were to be borne out, both ends of the Alternative 1 cost premium range could be increased by as much as \$10,000,000.

Estimated Cost and Cost Premium of Alternative 1

Estimated Cost of Alternative 1 Specific to Garage and Directly Effected Project Elements (\$2019)		<u>total</u>	<u>\$/space</u>
Est. Garage Constr Cost @ US2 proposed # spaces	269	\$21,162,522	\$78,671
less est. portion of hazardous waste removal cost that would be incurred at D2.1 without UG garage		<u>(900,000)</u>	<u>(\$3,346)</u>
Estimated Construction Cost		\$20,262,522	\$75,325
Owner's HC Contingency	10%	<u>\$2,026,252</u>	<u>\$7,533</u>
Total Hard		\$22,288,774	\$82,858
Soft Costs	8%	<u>\$1,783,102</u>	<u>\$6,629</u>
Subtotal Hard & Soft Costs		\$24,071,876	\$89,487
Constr Interest		<u>\$1,769,283</u>	<u>\$6,577</u>
Total Development Cost		\$25,841,159	\$96,064
Adjustments			
Brownfield Tax Credit		(\$726,000)	(\$2,699)
Additional Land-/Hard-scape Cost		\$330,000	\$1,227
Project-Wide Redesign and Re-Permitting		\$1,425,000	\$5,297
Credit for Value of Additional Building Area		<u>(\$1,700,000)</u>	<u>(\$6,320)</u>
Net Adjustments		<u>(\$671,000)</u>	<u>(\$2,494)</u>
Adjusted Cost		\$25,170,159	\$93,569
Above-Ground Garage D2.2+3 - in \$2019		<u>(\$12,105,000)</u>	<u>(\$45,000)</u>
Cost Premium Alternative 1 Versus Above Ground Garage (\$2019)		\$13,065,159	\$48,569
Cost of Delay if 12 Months			
Adjusted Cost of Alternative 1 Specific to Garage and Directly Effected Project Elements escalated 12 months		\$26,428,667	\$98,248
Above-Ground Garage D2.2+3 - in \$2019		<u>(\$12,105,000)</u>	<u>(\$45,000)</u>
Cost Premium Alternative 1 Versus Above Ground Garage		\$14,323,667	\$53,248
Project-Wide Impact of Delay of 12 months		<u>\$0 - \$6,000,000</u>	
Total Effective Cost Premium/Impact of Alternative 1		\$14,300,000 - \$20,300,000	
Cost of Delay if 20 Months			
Adjusted Cost of Alternative 1 Specific to Garage and Directly Effected Project Elements escalated 20 months		\$27,267,672	\$101,367
Above-Ground Garage D2.2+3 - in \$2019		<u>(\$12,105,000)</u>	<u>(\$45,000)</u>
Cost Premium Alternative 1 Versus Above Ground Garage		\$15,162,672	\$56,367
Project-Wide Impact of Delay of 20 months		<u>\$0 - \$10,000,000</u>	
Total Effective Cost Premium/Impact of Alternative 1		\$15,200,000 - \$25,200,000	

Note:

Above estimates do not include higher costs estimated by US2
Future dollar costs escalated at annu 5%

As previously noted, US2's estimates of the underground garage's hard cost and redesign/re-permitting cost are higher than the estimates used in this evaluation and there are factors that could result in the value of additional occupiable building area being considerably lower than the assumption used in the analysis. If US2's estimates and a lower valuation of additional building area were to be borne out, both ends of the Alternative 1 cost premium range could be increased by as much as \$10,000,000.

Also note that the estimates do not account for the impact of delay on the cost of US2's investment capital accruing over the master-development period, nor the timing at which the City and community would receive project fees and other benefits.

To determine whether the D2 project can afford the additional cost of Alternative 1 while maintaining financial feasibility we reviewed and evaluated pro forma information provided by US2 on a confidential basis. This pro forma indicates the project, as currently planned, achieves a financial return marginally sufficient to attract investment and achieve financial feasibility. Our evaluation of the pro forma and its underlying assumptions, based on our experience and research, supports its overall reasonableness and indication that the project would not be able to support significant additional development cost.

If efficiencies could be found in the project, it might be able to support some of the Alternative 1 cost premium, but we consider it very unlikely that any such efficiencies would enable the project to absorb more than a relatively minor portion of the premium and it is also possible that the project, even as proposed by US2, could see costs or revenues move in a direction diminishing prospects for feasibility.

In addition to the estimated cost premium, a major potential impact of the delay caused by Alternative 1 which could significantly jeopardize the financial feasibility of the D2 project is market risk. The local multi-family market has been on a strong prolonged run and there is no guaranty how long this will continue. The market for life science lab space expanding beyond East Cambridge has grown considerably in recent years. It is possible this will continue or even accelerate over the next few years. However, this market tends toward clustering and delay in bringing space to market in Union Square will increase the opportunity for other areas, some of which already have a head start, to gain critical mass, strengthening their competitive appeal vis a vis Union Square. Relative to both the residential and lab markets, the possibility of a general economic slowdown within the next year or two compounds the market risk of delay. Missing the market could delay the project for an unknown period of time, possibly exceeding the delay estimated for redesign and re-permitting of Alternative 1.

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