

City of Palo Alto



Downtown Development Cap Evaluation Phase I Concluding Report: Development Capacity, Market and Financial Feasibility Assesment, and Preliminary Policy Concepts

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Executive Summary

The purpose of the Downtown Cap Evaluation is to understand and analyze existing and projected parking, traffic, and land use conditions in Downtown Palo Alto, in order to inform future policy direction. Due to growing traffic and parking concerns in the 1980s, the City conducted a Downtown Study in 1984. As a result of that study, the City implemented a series of new regulations for the Downtown district in 1986. As part of these new regulations, the City implemented a Development Cap in 1986 to limit future non-residential development in the CD district to a total of 350,000 square feet beyond what existed or was approved in May 1986. The Development Cap regulations stipulated that this growth limit be re-evaluated once the City approved 235,000 square feet of new development in the Downtown. This milestone has been recently reached, prompting this study.

This report serves as the final product of Phase 1 of the Downtown Development Cap Study. It assesses potential commercial development in Downtown Palo Alto from both a “supply” perspective (how much new development could, and is likely to, be built based on regulatory and physical factors) and a “demand” perspective (how much and what type of development will the market support, and what development types are financially feasible under current zoning and market conditions). It concludes with a discussion of potential policy ideas that decision-makers may want to consider in Phase 2, based on these analyses and conclusions.

CAPACITY FOR NEW COMMERCIAL DEVELOPMENT

The analysis finds that while a number of sites Downtown are “overbuilt” according to the current development standards, many sites have not been developed to their full allowable potential. The total amount of unused commercial area in the Primary Study Area, based on the allowable FAR under current zoning, and regardless of other factors that might limit likelihood of development, is about 491,000 square feet. Adding in the bonus square footage that could be garnered through use of the Transfer of Development Rights (TDR) program, the maximum increases to 612,000 square feet of additional commercial space. It is important to note that these numbers are *theoretical maximums* based on zoning capacity only, and do not take into account various factors that may limit the likelihood of development or redevelopment on a given parcel.

When these limiting factors are taken into account, the “realistic” commercial development potential in Downtown Palo Alto decreases significantly. Even if a site is not currently built to its full potential as permitted under the zoning ordinance, there are a number of factors that contribute to whether it is actually likely to expand/redevelop or not. These include:

- How much unused commercial development capacity there is – also known as Commercial Potential. *A site that is “underbuilt” by just 200 square feet is less likely to expand than one that is underbuilt by 10,000 square feet.*
- Age of the existing structure. *Very new buildings are less likely to be redeveloped, and buildings that are designated historic are also less likely to be redeveloped.*
- Existing land use. *Some land uses may be more likely to redevelop than others, based on market conditions, property history, and other factors. For instance, actively used religious institutions are not likely to change.*
- Value of existing structure versus value of the land. *Where the ratio of the value of improvements to the value of the land is low, a parcel may be a more likely candidate for redevelopment. Where the ratio is high, redevelopment is less likely.*
- Existing floor area ratio (FAR), as currently built. *If a building’s FAR is lower than what the zoning permits, it may be more likely to expand or redevelop. However, this varies depending on how much lower it is. See discussion of Commercial Potential.*
- Parking requirements. *Providing required parking on-site might be a physical or financial challenge, especially for small parcels.*

The analysis contemplates two scenarios of future commercial development in Downtown Palo Alto, which apply these factors in varying degrees to the subset of parcels that have the potential to support additional commercial square footage. The scenarios reduce the theoretical maximum capacity (491,000 square feet) to a more reasonable range (53,400 to 146,000 square feet) of potential new development that is sensitive to site conditions and constraints. This translates to an annual expected range of 5,340 to 14,600 square feet; for comparison, the city has averaged 8,400 square feet of commercial development per year in the Downtown Study Area since the cap was established. Table E-1 summarizes these scenarios’ characteristics.

Table E-1: Commercial Buildout Scenarios Summary

	<i>Scenario 1: Higher Development Potential</i>	<i>Scenario 2: Lower Development Potential</i>
Number of Parcels that Meet Criteria for Redevelopment or Expansion	31	16
Potential Additional Commercial Development (square feet)		
Total	146,000	53,400
Average Annual over 10 Years	14,600	5,340
Percent Reduction from Theoretical Maximum New Development	70%	90%
Parking Spaces Required under Current Zoning	580	214

Source: Dyett & Bhatia, 2014

In fact, the amount of on-site parking that is required to support this potential new development could reduce buildout even further, as providing parking on-site is expensive and sometimes

physically challenging or impossible given site configurations. Palo Alto does have an in-lieu fee provision, which allows developers to pay a fee rather than provide the required parking on-site; however, some recent developments have come under increased pressure from the community to provide on-site parking anyway given the current difficulties with parking downtown.

REAL ESTATE MARKET DEMAND AND FINANCIAL FEASIBILITY OF NEW COMMERCIAL DEVELOPMENT

Real Estate Market Trends and Development

Real estate market data reveal an extremely favorable environment for commercial and residential development in Downtown Palo Alto. Values are robust and new development projects have surged in recent years. Downtown Palo Alto, while not immune to market cycles, is likely to remain a particularly sought-after office location, given the competitive factors that have driven this market to the value and occupancy highs and that are currently exhibited. In addition, retail and residential uses also are in high demand and likely will be included in new Downtown projects in the future. Given the limited amount of development that can be accommodated Downtown, the primary constraint faced by future development is not market support, but rather land supply, zoning, and project entitlement.

Development Feasibility

Illustrative pro forma analysis shows that single-use Downtown office development is financially viable in today's market. The analysis illustrates that a density increase of roughly 100 percent (i.e., redevelopment at twice the original size) on an office site may be sufficient to justify new development where there is an existing, functional office building. Redevelopment with a mixed-use project appears less financially feasible in today's market, but significant densification allowances (on the order of 200 percent) may justify a new project. These findings are generally confirmed by case study review of recent redevelopment projects in Downtown Palo Alto, in which a number of redevelopment projects resulted in significant site densification. In addition to full-scale redevelopment (demolition followed by new construction), additions and modifications to existing properties that add commercial space may be attractive to owners and developers seeking real estate investment opportunities.

Development Forecast

Over the next 20 years, historic absorption rates and market demand trends suggest that development projects might add roughly 100,000 to 150,000 square feet of net new commercial space Downtown over a 10 year period. The current development pipeline of about 28,900 net new square feet would then represent about two to three years of supply. While the forecast of 10,000 to 15,000 square feet per year on average may seem modest when compared to the major development projects have occurred Downtown in recent years, there are a variety of factors that explain this projection of net new commercial space, including the existing built environment, the regulatory landscape, and market cycles.

SUPPLY VERSUS DEMAND AND FUTURE POLICY DIRECTION

Comparing the projections of future commercial development in Downtown Palo Alto from both a supply (zoning capacity and site conditions) perspective and a demand (real estate market

trends and financial feasibility) perspective, it appears that the constraints associated with zoning and available developable parcels pose a greater limitation on future development than the economy. Extremely high office prices and lease rates are indicative of especially constrained supply and high demand. Now that the specified threshold for reexamining the development cap policy has been reached, the City has the opportunity to consider the role that both of these forces play in determining commercial development in Downtown Palo Alto in the future and set its policies accordingly.

Typically, cities are interested in controlling the amount, type, and timing of development in order to better control the impacts associated with development. Indeed, the original development cap policy (and associated growth management tools, such as the TDR program) was established primarily in order to address parking and traffic concerns. These concerns remain, and development pressure in Downtown Palo Alto has—at least during this current period of economic strength—increased. The second phase of the Development Cap study will consist of an in-depth policy-making process with community members and decision-makers. This report, which concludes Phase 1, considers some possible types of policies that the City could consider in Phase 2. Policy options could fall into several categories, including:

1. Changes to the Development Cap itself;
2. Changes to development standards that apply to Downtown zoning districts; and
3. Mechanisms to directly address the impacts associated with development, such as parking and traffic.

I Introduction

I.1 Project Purpose

The purpose of the Downtown Cap Evaluation is to understand and analyze existing and projected parking, traffic, and land use conditions in Downtown Palo Alto, in order to inform future policy direction.

Due to growing traffic and parking concerns in the 1980s, the City conducted a Downtown Study in 1984. As a result of that study, the City implemented a series of new regulations for the Downtown district in 1986. The City rezoned the Downtown district with a new designation, Commercial Downtown (CD). In the CD district, the City implemented more restrictive development regulations, limits to project size, and special development regulations for sites adjacent to residential zones. Additionally, the Downtown Parking Assessment District parking regulations were adjusted.

As part of these new regulations, the City also implemented a Development Cap in 1986 to limit future non-residential development in the CD district to a total of 350,000 square feet beyond what existed or was approved in May 1986. The Development Cap regulations stipulated that this growth limit be re-evaluated once the City approved 235,000 square feet of new development in the Downtown. This milestone has been recently reached, prompting this study.

The City anticipates a two-phase process for evaluation and planning:

- **Phase 1** (this process) consists of research and analysis of the development, parking, and traffic conditions in Downtown Palo Alto.
- **Phase 2**, which would be initiated following completion of Phase 1, will consist of planning and parking/transportation policy recommendations using the Phase 1 findings, additional analysis if necessary, and additional community input.

In addition to this existing conditions report, major Phase 1 tasks included:

- A Background Report covering development trends, parking, and traffic;
- A street intercept survey of the travel and parking behavior of Downtown residents, workers, and visitors; and
- A phone and online survey of Downtown businesses to determine current employment density.

The findings from the first two work efforts have been reviewed by City staff, stakeholders, and decision-makers. The Downtown business online and phone survey produced inconclusive results regarding the tech/software companies, as these were underrepresented in the survey responses, even when follow-up surveys were sent specifically to these businesses. Responses from retail, restaurants and other professional office sectors yielded better results. Staff anticipates that more robust and reliable collection of this data in future will be possible once the Business Registry program is put in place.

Together with this final report, which summarizes development capacity, development potential, and preliminary policy considerations, decision-makers will have the complete background research and summary findings from Phase 1 and preliminary policy ideas to use as a basis for developing new policy direction with the community in Phase 2.

1.2 Role of This Report

This report serves as the final product of Phase 1 of the Downtown Development Cap Study. It assesses potential commercial development in Downtown Palo Alto from both a “supply” perspective (how much new development could, and is likely to, be built based on regulatory and physical factors) and a “demand” perspective (how much and what type of development will the market support, and what development types are financially feasible under current zoning and market conditions). It concludes with a discussion of potential policy ideas that decision-makers may want to consider in Phase 2, based on these analyses and conclusions.

Following the introduction, this report is organized as follows:

- **Chapter 2: Development Capacity**, which describes the capacity for new development in Downtown Palo Alto, both at a theoretical maximum and at a more realistic level based on constraining factors.
- **Chapter 3: Market Assessment and Demand-Based Development Potential**, which describes real estate market trends, conducts a financial feasibility analysis of typical development types Downtown, and assesses commercial development potential from a market perspective.
- **Chapter 4: Policy Considerations**, proposes some potential policy ideas that decision-makers may wish to explore in Phase 2 of the Development Cap Study, based on the findings of this report and other background research, analysis, and surveys conducted in Phase 1.

In addition, Appendix A summarizes case studies of recent commercial developments in Downtown Palo Alto.

2 Development Capacity

2.1 Objective

As the City of Palo Alto considers whether to continue the policy of placing a cap on the amount of nonresidential development in the Downtown, an important consideration is how much development might reasonably be expected to occur based on the current development pattern and what existing zoning regulations allow.

The analysis of development capacity begins with an assessment of how much total nonresidential development could theoretically occur based on current zoning. Then, the analysis considers what a more reasonable expectation of development capacity might be based on a range of limiting factors. In other words, just because a parcel would be allowed to redevelop at a higher intensity, there are various factors—such as the age and use of the building, its value, parking requirements, and others—that might render redevelopment more or less likely or attractive to the owner. The analysis explores each of these factors, applies them to the parcels in the Downtown Primary Study Area, and arrives at a “realistic capacity” for new development that shows what Palo Alto might reasonably expect to see in the coming years.

Outlined here are the team’s procedures for collecting data on the parcels within the Primary Study Area and making a determination as to the likelihood of redevelopment on each parcel, as well as a determination as to the amount of new commercial development that each parcel would most likely see in the next 20 to 30 years. Integral to this analysis are the parking needs that correspond to future commercial development: this chapter summarizes how the team calculated the area that the potential commercial development would require for parking, and how parking needs would likely limit that development.

DATA AND METHODOLOGY

Data collection is an essential part of the study, as it involved looking at far more than the available data on each parcel, its existing structures, and its land use and zoning regulations. Economic & Planning Systems (EPS) provided a close look at local trends in the office and retail market and determined general development feasibility. EPS and Dyett & Bhatia together collected a range of information on each parcel, including physical constraints and qualitative observations about existing structures to develop a more robust and dynamic data set than was available in the preliminary data set. Using a variety of sources, the team tracked a broad range of information and observations about each parcel. These sources include:

- The County Assessor’s Data;
- Available maps and imagery, including GIS data, satellite images, and Google street view;

- On-line directories, where property addresses are available;
- Web-based real estate resources, including:
 - www.loopnet.com
 - www.propertyshark.com
 - www.prospectnow.com/property/santa-clara-ca
 - www.zillow.com
- Information provided by Palo Alto staff;
- City of Palo Alto permit listings; and
- On-line media reporting about development projects that are proposed or under construction.

By factoring in a combination of parcel data, site conditions, and observations about feasibility and developability, the team was able to visualize possible changes on each site.

The procedures outlined here established a comprehensive data set and set of procedures that enabled the team to consider all at once the relevant physical and regulatory factors that have an impact on future development, and to use this information to create informed pictures of how the Downtown may change in the future.

2.2 Current Zoning

This analysis is a straightforward look at the Primary Study Area’s total capacity for new commercial development based on current zoning regulations, regardless of any limiting factors. This analysis tells us the “outside envelope” of existing land use and zoning, as well as with the TDR/bonus. While this does not provide us with a realistic view of the redevelopment that is likely to occur, the analysis offers perspective as to what degree existing regulations truly limit redevelopment, and to what degree development is limited by other variables.

SELECTED PARCELS






The analysis commenced with a review and evaluation of the City’s initial data set, which includes 563 parcels within the Primary Study Area. The consultant team, with input from City staff, then narrowed the set to include only those parcels subject to the Downtown development cap. These “selected parcels” exclude public facilities and residentially-zoned areas, and include only those parcels that are zoned:

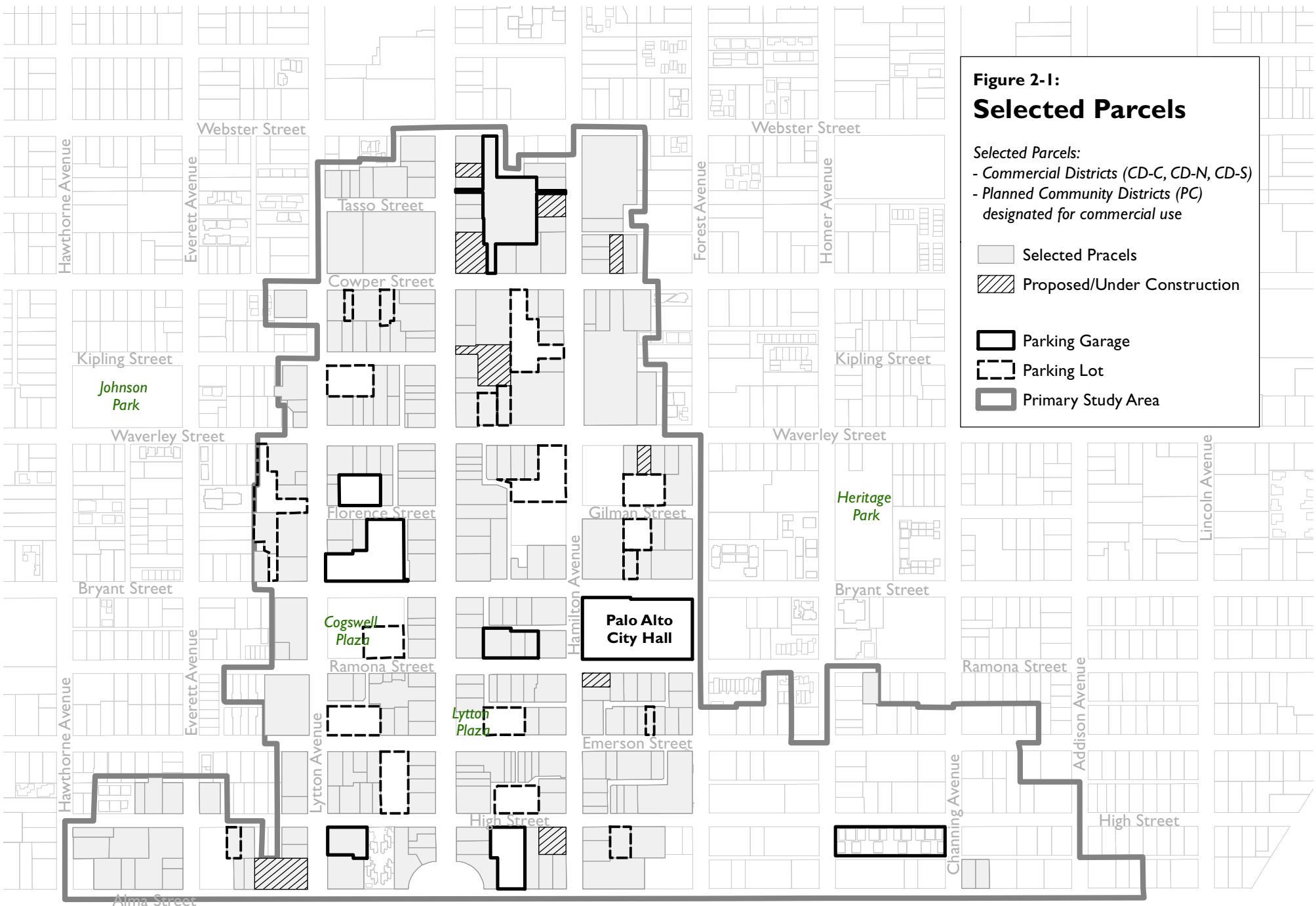
- **Commercial**, including CD-C, CD-N, or CD-S, and all applicable combining districts; or
- **Planned Community (PC)**, where the use is specified to be, or to include, commercial.

After the preliminary screening, 266 parcels records remained, for which the consultant team began to create a more robust data set. **Figure 2-1: Selected Parcels** identifies the complete set of selected parcels. None of these parcels are in the SOFA 1 or SOFA 2 areas. The corresponding data set identifies each parcel by its APN, and tracks all data relating to its development

**Figure 2-1:
Selected Parcels**

Selected Parcels:
 - Commercial Districts (CD-C, CD-N, CD-S)
 - Planned Community Districts (PC)
 designated for commercial use

-  Selected Parcels
-  Proposed/Under Construction
-  Parking Garage
-  Parking Lot
-  Primary Study Area



El Camino Park

 Palo Alto
Caltrain
Station

0 0.05 0.1 0.2



MILES

Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

constraints per zoning. It also tracks all data relating to improvements on the parcel, including the buildings' size, age, uses, and estimated value.

For parcels with projects that are in the development pipeline or are under construction, the team has identified the data for *the future or proposed project* and included it as part of the “existing” data. While pipeline projects are not yet approved and/or constructed, they are included in the “existing” dataset because there are already detailed development proposals associated with them, which constitute reasonable buildout assumptions for the purposes of this exercise.

EXISTING DEVELOPMENT ON SELECTED PARCELS

The analysis finds that the City's current zoning program would allow a total of approximately 2.3 million square feet of commercial space in the Downtown's commercially-zoned areas, given allowable base commercial FAR. In other words, if every commercially-zoned parcel were built to exactly what the zoning allows (by right, without bonuses), there would be 2.3 million square feet of commercial development in the Downtown. However, there is currently *more* commercial development than this on the ground right now. This is because a number of existing structures predate these regulations and already include more commercial space than the City code would allow to be built today. The site-specific analysis estimates that roughly 2.8 million square feet currently exist in the Downtown commercial zones.

The estimated 2.8 million square feet of commercial space is based on the data set described in Section 2.1. The analysis first identified sites that contain commercial space (mixed use [commercial only], office, restaurant, commercial, hotel, light industrial/warehouse) and tallied the built square footage. The five residential mixed-use properties, which include some existing commercial space, are treated differently. Without the benefit of data concerning the actual commercial space usage within these properties, the analysis assumes that commercial uses occur in the same proportion as what the zoning code allows. For example, a building with zoning that allows an FAR of 1.0 for commercial and FAR of 1.0 for residential is assumed to be built and used as 50 percent commercial and 50 percent residential.

CAPACITY OF SELECTED PARCELS UNDER CURRENT ZONING

Despite potentially containing more commercial space than zoning allows in aggregate, the consultant team conducted an analysis of potential additional commercial development capacity on the selected parcels. To determine the overall redevelopment capacity of the Primary Study Area over the long term, the consultant team started by assessing “Commercial Potential” of the selected parcels—a calculated metric that is described in detail below. In sum, this method estimates aggregate Downtown commercial development potential by considering existing site-specific zoning allowances and comparing these development allowances to the built commercial space that exists today.

Commercial Potential

We have defined Commercial Potential as *the ratio of Unused Commercial Area to Built Commercial Area*, where Unused Commercial Area is the amount of commercial development that is allowed per the existing maximum FAR, minus the amount of commercial that is currently built on the parcel. The calculation is as follows:

$$\text{Commercial Potential} = \frac{\text{Unused Commercial SF}}{\text{Built Commercial SF}}$$

where

$$\text{Unused Commercial SF} = \text{Allowable Commercial SF} - \text{Built Commercial SF}$$

This calculation tells us, in short, how underutilized a given parcel is on the basis of its commercial build-out.

Figure 2-2: Commercial Potential based on Allowable FAR categorizes the Selected Parcels based on “Commercial Potential.” Categories shown on Figure 2-2 range from less than 25 percent, where the unused commercial area is less than a quarter of the built commercial area, to over 200 percent, where the unused commercial area is more than twice the built commercial area. The total amount of unused commercial area in the Primary Study Area, based on the allowable FAR under current zoning, and regardless of limiting factors, is about **491,000 square feet**. Table 2-1 summarizes the breakdown, by category, of Commercial Potential on the selected parcels.

Table 2-1: Commercial Potential of Selected Parcels Based on Allowable FAR

<i>Commercial Potential</i>	<i>Number of Parcels</i>	<i>Total Unused Commercial Square Footage</i>
< 25%	191	31,199
25% - 50%	14	38,611
50% - 100%	16	181,290
100% - 200%	19	97,165
> 200%	26	143,046
Total	266	491,312

1. Existing square footage of parking structures is not counted as built commercial square footage.

Source: Dyett & Bhatia, *Economic & Planning Systems, and City of Palo Alto, 2014*

Bonus Square Footage Under TDR Program

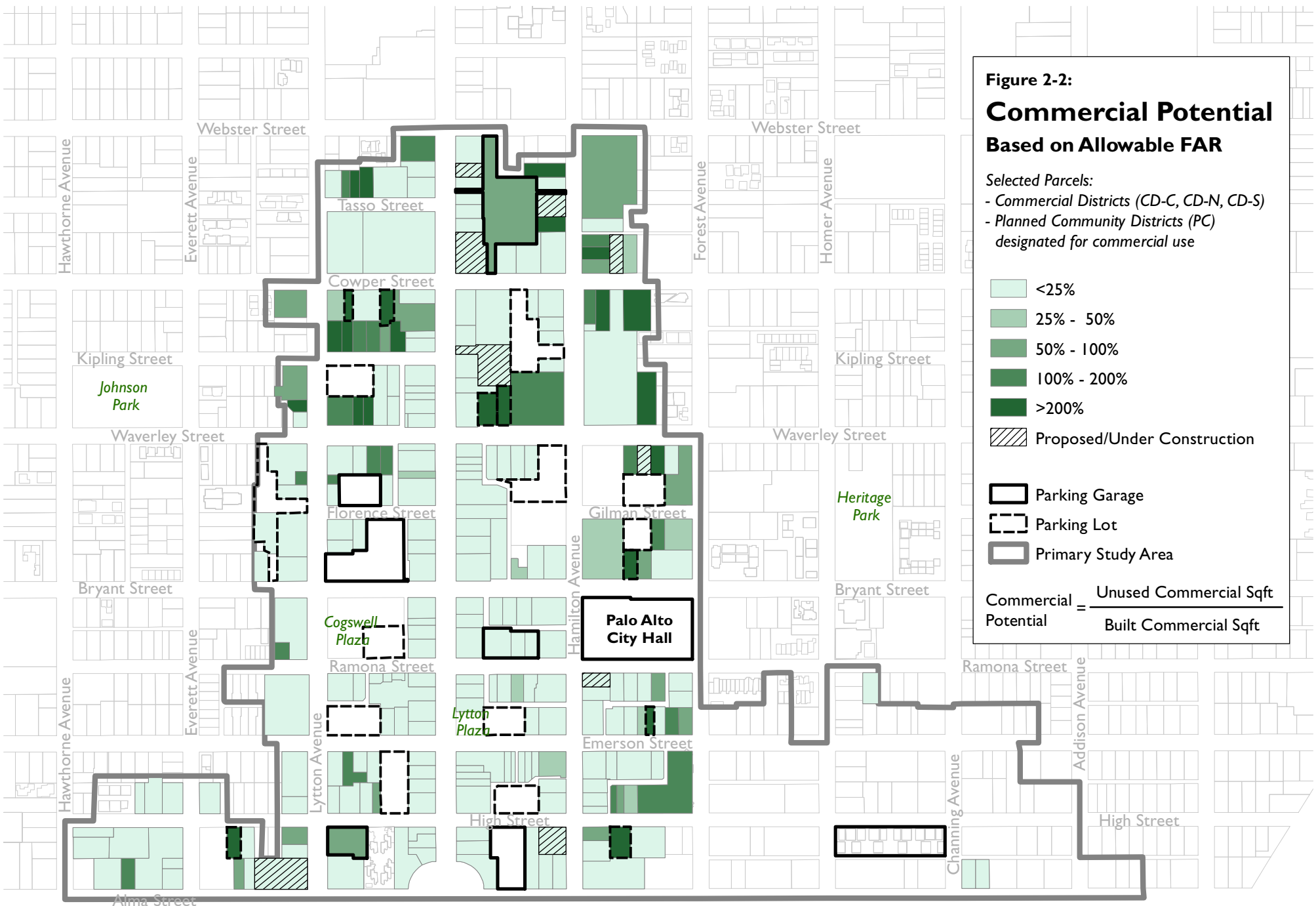
To provide incentives for historic and seismic rehabilitation of private property in the Downtown, the City of Palo Alto created a Transfer of Development Rights (TDR) program in 1986. The regulations for the program are in Section 18.18.080 of the Municipal Code. The program provides a floor area bonus for the qualified rehabilitation of certain eligible historic buildings (“sender” sites), which may then be transferred to eligible sites in the Downtown commercial district (“receiver” sites). The use of TDR is one of the only ways in which most buildings in the Downtown can expand beyond the base allowable floor area. Using bonus square footage from the TDR program, the majority of the Selected Parcels are able to build up to 3.0 FAR with TDR/bonus. **Table 2-2** summarizes the breakdown of existing zoning of Selected Parcels, their allowable FAR, and FAR with TDR/bonus. The TDR program functions in the Downtown market

**Figure 2-2:
Commercial Potential
Based on Allowable FAR**

Selected Parcels:
 - Commercial Districts (CD-C, CD-N, CD-S)
 - Planned Community Districts (PC)
 designated for commercial use

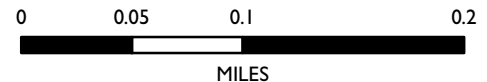
- <25%
- 25% - 50%
- 50% - 100%
- 100% - 200%
- >200%
- Proposed/Under Construction
- Parking Garage
- Parking Lot
- Primary Study Area

$$\text{Commercial Potential} = \frac{\text{Unused Commercial Sqft}}{\text{Built Commercial Sqft}}$$



El Camino Park

**Palo Alto
Caltrain
Station**



Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

by ensuring that there is potentially more demand for development rights than supply; in other words, there are more receiver sites in the Downtown than sender sites. A total of 244,378 bonus square feet could be generated by sender sites under the program.

Table 2-2: Zoning Designation and Allowable FAR of Selected Parcels

Zoning	Number of Parcels	Allowable FAR	Allowable FAR with TDR/Bonus
CD-C	236	2.0	3.0
CD-N	16	0.9	2.0
CD-S (P)	1	1.0	2.0
CD-S (P); CD-C (P)	1	2.0	2.0 ¹
PC	12	2.0	2.0 ²
Total	266	-	-

1. On parcels with more than one zoning designation, the more restrictive limits apply.

2. TDR/Bonus does not apply in PC zone.

Source: Dyett & Bhatia, *Economic & Planning Systems, and City of Palo Alto, 2014*

The commercial potential of properties in the Primary Study Area increases if we take the potential for TDR bonus floor area into account. In other words, if all of the parcels downtown achieved their maximum FAR with TDR/bonus, how much additional square footage would be possible? In **Figure 2-3**, a variant of Figure 2-2, the Unused Commercial Area is defined as the amount of commercial development that is allowed per the existing maximum FAR *with TDR or Bonus*, minus the amount of commercial that is currently built on the parcel. For residential mixed-use properties, we have assumed the entire additional area to be built out as commercial space. The total amount of unused commercial area in the Primary Study Area, based on the allowable FAR with TDR/bonus, and regardless of limiting factors, is about 1,814,000 square feet.

Table 2-3 summarizes the breakdown, by category, of Commercial Potential with TDR/Bonus on the Selected Parcels.

Table 2-3: Commercial Potential of Selected Parcels Based on Allowable FAR with TDR/Bonus

Commercial Potential	Number of Parcels	Total Unused Commercial Sqft
< 25%	76	50,067
25% - 50%	20	74,635
50% - 100%	35	423,167
100% - 200%	74	565,873
> 200%	61	700,090
Total	266	1,813,832

1. Existing square footage of parking structures is not considered as built commercial square footage.

Source: Dyett & Bhatia, *Economic & Planning Systems, and City of Palo Alto, 2014*

While this is an interesting theoretical exercise, it is not representative of reality. This figure is not actually attainable, as remaining TDRs are very limited. As of October 2013, just 128,930 “bonus” square feet remain for potential use out of the 244,378 square feet originally created under the program.

SUMMARY

The analysis finds that while a number of sites Downtown are “overbuilt” according to the current development standards, many sites have not been developed to their full allowable potential. **Table 2-4** presents estimates of zoning allowance, built commercial space, and Commercial Potential on the selected parcels. The final column adds the remaining TDR bonus square footage to the base.

Table 2-4: Summary of Downtown Theoretical Development Potential in Commercial Zones, on Selected Parcels

<i>Aggregate Commercial Zoning Allowance (Square Feet)</i>	<i>Actual Built Commercial Space (Square Feet)</i>	<i>Potential Additional Commercial Zoning Allowance, or “Commercial Potential” (Square Feet)</i>	<i>Base Commercial Potential Plus Available Bonus under TDR Program (Square Feet)</i>
2,267,000	2,723,000	491,000 ¹	620,000 ¹

1. These estimates of potential additional commercial square footage are theoretical maximums. They do not take into account the constraints and site-specific conditions that will necessarily limit the amount of new commercial development that may actually be constructed. See Section 2.3, Realistic Development Capacity.

Source: Dyett & Bhatia, Economic & Planning Systems, and City of Palo Alto, 2014

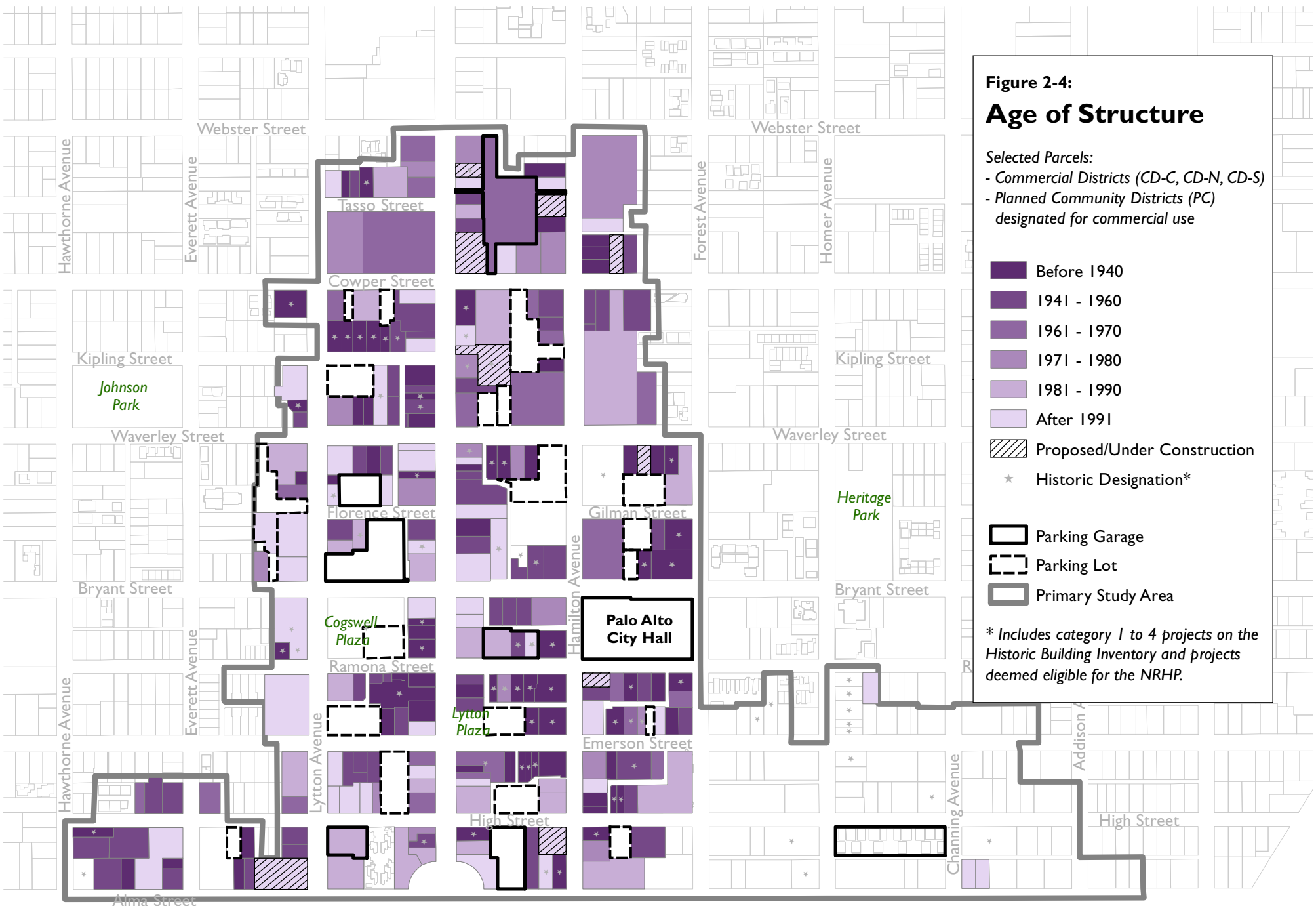
2.3 Realistic Development Capacity

There are many factors that contribute to whether sites will actually develop or redevelop, especially in largely built out, infill areas such as Downtown Palo Alto. These factors may reduce the total theoretical capacity under zoning to a more reasonable, realistic amount. Below is a summary of some of the factors and criteria the team tracked and evaluated, in an effort to arrive at more reasonable projections of future non-residential development in the Downtown Primary Study Area.

AGE OF STRUCTURE

The age of a structure may play a role in determining its redevelopment potential. New and recent construction is less likely to undergo major changes. And at the same time, an area’s oldest structures, which are often valued for their historic character or may be otherwise historically significant, are often also the least likely to see redevelopment or demolition. In general, post-war structures more than 30 years old that are in poor repair or are underutilized are often the most likely candidates for redevelopment.

Figure 2-4: Age of Structure identifies the general age of each structure. Lighter colors are used for buildings that, based solely on age, are less likely to be redeveloped. These include the most



**Figure 2-4:
Age of Structure**

Selected Parcels:

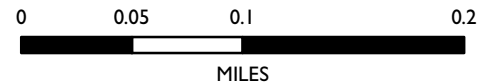
- Commercial Districts (CD-C, CD-N, CD-S)
- Planned Community Districts (PC) designated for commercial use

- Before 1940
- 1941 - 1960
- 1961 - 1970
- 1971 - 1980
- 1981 - 1990
- After 1991
- Proposed/Under Construction
- Historic Designation*
- Parking Garage
- Parking Lot
- Primary Study Area

** Includes category 1 to 4 projects on the Historic Building Inventory and projects deemed eligible for the NRHP.*

El Camino Park

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Station



Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

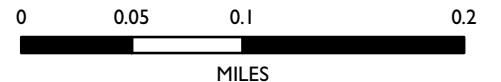
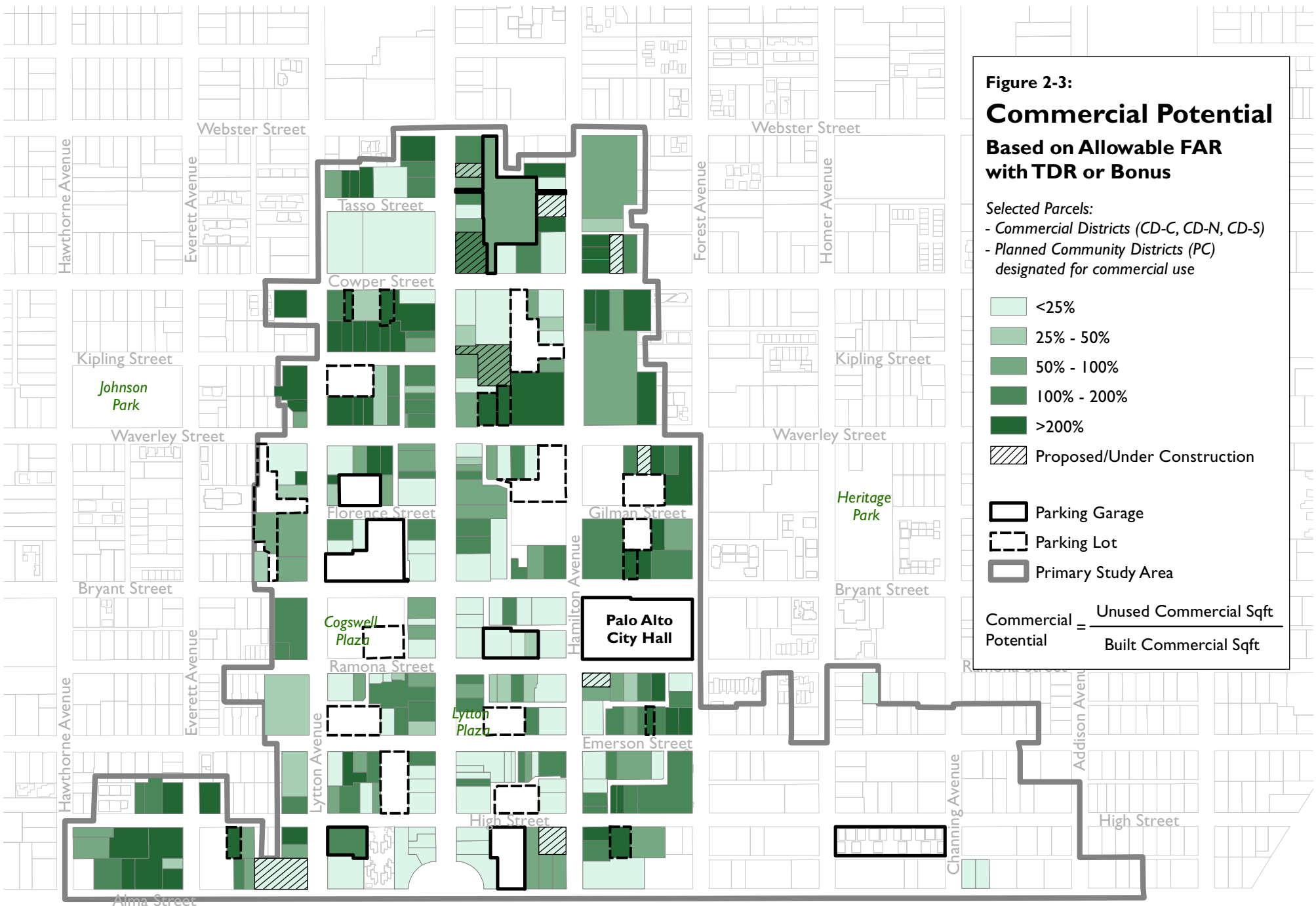
**Figure 2-3:
Commercial Potential**

Based on Allowable FAR with TDR or Bonus

- Selected Parcels:*
- Commercial Districts (CD-C, CD-N, CD-S)
 - Planned Community Districts (PC) designated for commercial use

	<25%
	25% - 50%
	50% - 100%
	100% - 200%
	>200%
	Proposed/Under Construction
	Parking Garage
	Parking Lot
	Primary Study Area

$$\text{Commercial Potential} = \frac{\text{Unused Commercial Sqft}}{\text{Built Commercial Sqft}}$$



El Camino Park

Palo Alto Caltrain Station

Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

recent construction as well as older/historic structures. Darker colored parcels are, therefore, more likely to be candidates for redevelopment. Building age figures are based on Assessor's data.

Table 2-5 summarizes the breakdown of Age of Structure of Selected Parcels.

Table 2-5: Age of Structure

<i>Age of Structure</i>	<i>Number of Parcels</i>	<i>Total Building Sqft</i>
Before 1940	78	487,850
1941 - 1960	61	357,867
1961 - 1970	24	500,326
1971 - 1980	19	339,773
1981 - 1990	25	773,310
After 1991	51	760,092
Total	258	3,223,218

I. Excludes parcels with only surface parking lots.

Source: Dyett & Bhatia, *Economic & Planning Systems, and City of Palo Alto, 2014*

EXISTING USE

A parcel's existing use may give us an indication as to the likelihood of redevelopment. Parcels with existing residential uses—whether residential only or residential mixed-use—are unlikely to change, regardless of zoning and the calculated commercial potential. Commercial developers will typically seek sites for redevelopment that are already used for commercial purposes; adding commercial space to existing residential or residential mixed use buildings is also uncommon. Similarly, actively used religious structures are unlikely to undergo a change to commercial. Of the selected parcels, 25 of them, or 9 percent, currently include residential or religious uses.

On the other hand, parcels zoned commercial that currently have industrial uses may be most ripe for change, as commercial uses are often more profitable than industrial uses in a downtown area. **Figure 2-5: Existing Land Use** identifies the existing land use for each parcel, separating out the various types of mixed-use and commercial development.

Table 2-6 summarizes the breakdown of existing land use of the Selected Parcels.

Table 2-6: Existing/Proposed Land Use

<i>Existing / Proposed Land Use</i>	<i>Number of Parcels</i>	<i>Total Building Sqft</i>
Residential	15	52,956
Residential Mixed Use	8	261,781
Commercial Mixed Use	30	528,700
Commercial	98	753,763
Office	101	1,465,543
Industrial	2	6,763
Religious	2	31,396

Table 2-6: Existing/Proposed Land Use

<i>Existing / Proposed Land Use</i>	<i>Number of Parcels</i>	<i>Total Building Sqft</i>
Parking Garage	2	144,200
Parking Lot	8	0
Total	266	3,223,218

Source: Dyett & Bhatia, Economic & Planning Systems, and City of Palo Alto, 2014

VALUE OF IMPROVEMENTS VERSUS VALUE OF LAND

One method to gauge the likelihood for change is by the improvement-to-land value, which is the value of the building(s) on a parcel divided by the value of just the land. An improvement-to-land value ratio lower than 1.0 indicates that the improvements are worth less than the land, and this is may be reason enough for an owner to decide to redevelop. A property may have a low improvement-to-land value ratio because the building(s) on the property may be old or dilapidated, or the structure may be small relative to the size of the parcel. A low ratio may also indicate that the value of the land has risen at a faster rate over time in relation to the improvement.

Figure 2-6: Improvement Value Over Land Value identifies the ratio for all the selected parcels. The data is based solely on the County Assessor’s data. Darker colors indicate a lower ratio, which may mean a greater potential for redevelopment.

Table 2-7 summarizes the breakdown of improvement value to land value of the Selected Parcels. The table shows that 84 parcels, or 32 percent of the selected parcels, have an improvement-to-land value ratio that is equal to or less than 1.0.

Table 2-7: Improvement Value over Land Value

<i>Improvement Value over Land Value</i>	<i>Number of Parcels</i>	<i>Percentage</i>
< 0.25	23	9%
0.25 - 0.5	23	9%
0.5 - 0.75	16	6%
0.75 - 1	22	8%
> 1	163	61%
Unknown	19	7%
Total	266	100%

1. Information is based on Santa Clara County Assessor’s Data in 2013; land and improvement values may have changed.

Source: Dyett & Bhatia, Economic & Planning Systems, and City of Palo Alto, 2014

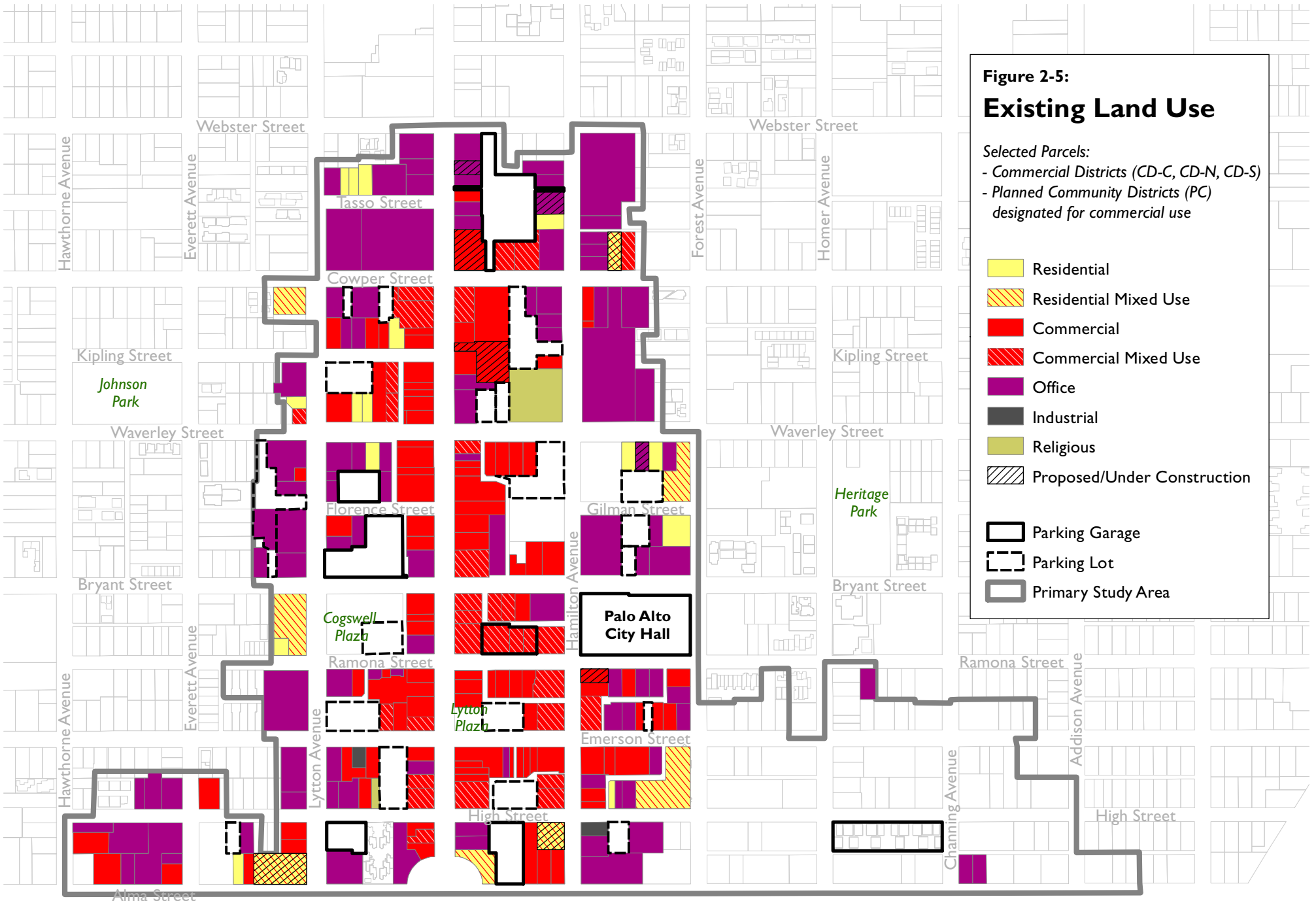
EXISTING FLOOR AREA RATIO

Floor area ratio (FAR) is a straightforward way to express how much development is on a given site; it is determined by dividing the gross floor area by the lot area. This calculation is independent of what the zoning would permit. If an entire lot were to be covered by a single-story

**Figure 2-5:
Existing Land Use**

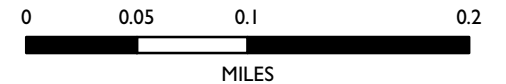
Selected Parcels:
 - Commercial Districts (CD-C, CD-N, CD-S)
 - Planned Community Districts (PC) designated for commercial use

-  Residential
-  Residential Mixed Use
-  Commercial
-  Commercial Mixed Use
-  Office
-  Industrial
-  Religious
-  Proposed/Under Construction
-  Parking Garage
-  Parking Lot
-  Primary Study Area

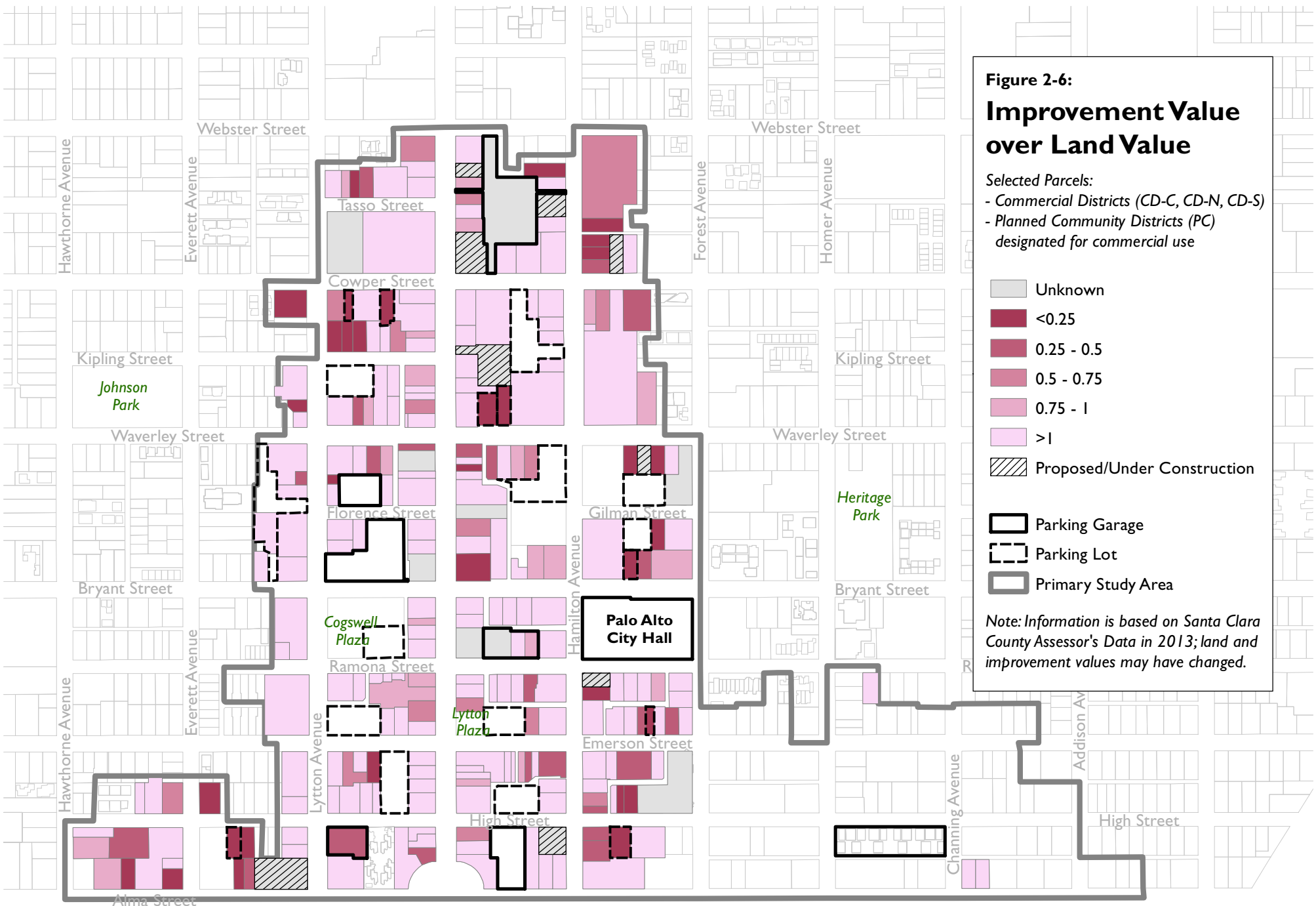


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Station



Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.



**Figure 2-6:
Improvement Value
over Land Value**

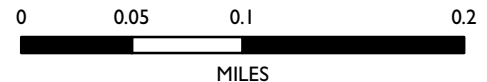
Selected Parcels:
 - Commercial Districts (CD-C, CD-N, CD-S)
 - Planned Community Districts (PC)
 designated for commercial use

- Unknown
- <0.25
- 0.25 - 0.5
- 0.5 - 0.75
- 0.75 - 1
- >1
- Proposed/Under Construction
- Parking Garage
- Parking Lot
- Primary Study Area

Note: Information is based on Santa Clara County Assessor's Data in 2013; land and improvement values may have changed.

El Camino Park

**Palo Alto
Caltrain
Station**



Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

structure, the FAR would be 1.0; if a two-story structure were to occupy exactly half a lot, the FAR would be 1.0. If a three-story structure were to occupy exactly half a lot, the FAR would be 1.5.

Figure 2-7: Existing FAR (As Built) identifies the FAR of existing structures as they are currently built—regardless of what the zoning would permit. The FAR includes both commercial and residential floor areas. As in Figure 3, the darker colors generally indicate a lower FAR, which may mean a greater potential for redevelopment. It should be noted that many buildings in the Primary Study Area, particularly the older ones, are built to an FAR that exceeds what the current zoning would allow.

Table 2-8 summarizes the breakdown of existing FAR (as built) of Selected Parcels.

Table 2-8: Existing FAR (As Built)

<i>Existing FAR (As Built)</i>	<i>Number of Parcels</i>	<i>Percentage</i>
<1	118	44%
1 - 2	96	36%
2 - 3	37	14%
3 - 4	11	4%
> 4	4	2%
Total	266	100%

Source: Dyett & Bhatia, Economic & Planning Systems, and City of Palo Alto, 2014

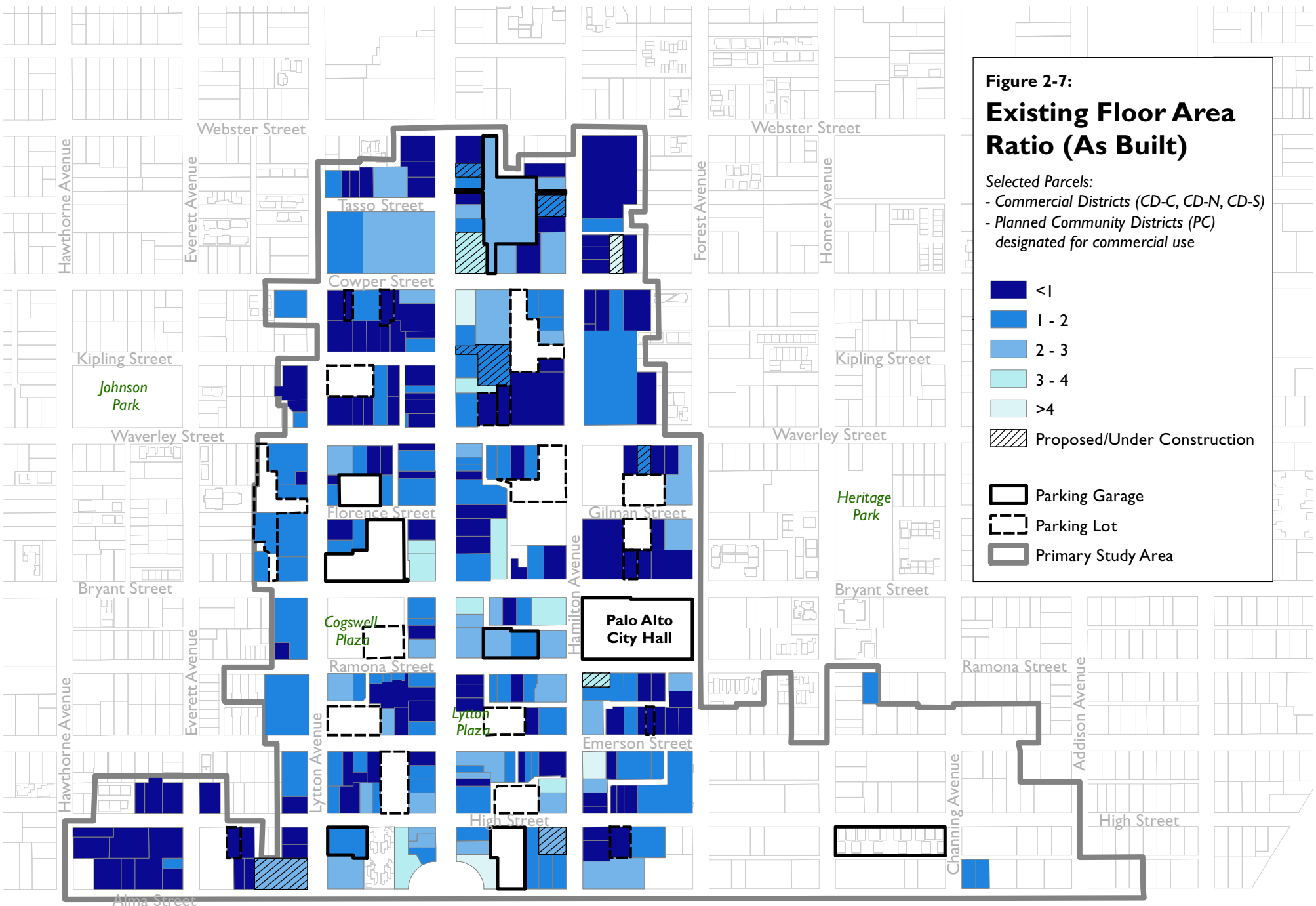
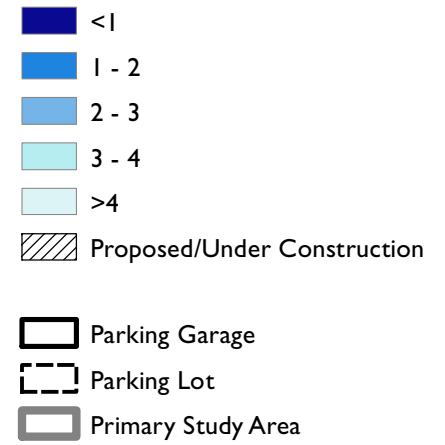
In the Downtown Study Area, the majority of commercial properties (those zoned CD-C) have a maximum allowable FAR of 2.0 (1.0 for the residential portion and 1.0 for the non-residential portion). Including a TDR or bonus, the maximum FAR increases to 3.0. Given an allowable commercial FAR of 1.0, a reasonable threshold for assuming a likelihood of redevelopment would be an existing FAR of less than 1.0. Table 2-8 shows that 118 parcels, or 44 percent of the selected parcels, have an existing FAR of less than 1.0.

PARKING REQUIREMENTS

Parking requirements are a critical component of the potential build out analysis. As documented in the Downtown Development Cap Evaluation Background Report, on- and off-street parking occupancy within the Primary Study Area regularly reaches over 77 percent during the weekday and 78 percent in the weekday evening. For public lots, occupancy exceeds 90 percent during peak times, and on some residential streets parking occupancy exceeds 100 percent (i.e. there are more vehicles parked on the street than the street is designed to accommodate). Notably, these figures reflect the use of residential neighborhood streets by employees and visitors, and for residents who live closer to the commercial core, it is sometimes difficult to find parking in front of their homes during the day. The City is proposing a Residential Preferential Parking program which would regulate non-resident parking within the Downtown neighborhoods and shift parking to the lots and garages, effectively limiting the parking supply within the neighborhoods, so adequate parking and transportation services for new developments will become even more crucial.

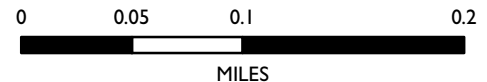
**Figure 2-7:
Existing Floor Area
Ratio (As Built)**

Selected Parcels:
 - Commercial Districts (CD-C, CD-N, CD-S)
 - Planned Community Districts (PC)
 designated for commercial use



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Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

Per Chapter 18.52 of the Palo Alto Municipal Code, all new uses and additions or enlargements of existing buildings or uses within the Primary Study Area are required to provide off-street parking and loading space, or to pay an in-lieu fee. Even with the in-lieu fee as an option, community members are increasingly putting pressure on developments to provide parking on site because of the perceived parking shortage in Downtown overall. This requirement, however, effectively prohibits the expansion of many properties in the Downtown. Without constructing a structured parking facility on-site, it is unlikely that existing parking structures would be able to support the additional parking required to accompany new development. Moreover, size and access constraints would prohibit creating structured parking on a number of the smaller underutilized parcels. Likewise, where projects are currently surfaced parked, it is unlikely that additional square footage could also be surface parked. Where a structure would likely be replaced in the event of redevelopment, lot size and access would limit the feasibility of a structured garage.

In order to show a conservative estimate of development capacity, this analysis assumes that new development will provide parking on-site. The team also used the City's existing parking ratio for development within the Parking Assessment District—one space per 250 square feet of commercial area—to determine the number of parking spaces that would be required under the potential redevelopment scenario discussed in the following section.

POTENTIAL REALISTIC DEVELOPMENT CAPACITY SCENARIOS

Individually, each of the factors described above will not necessarily dictate whether one site or another develops, nor can they be used with certainty to arrive at a definitive development scenario for the future. However, they can be combined to show how much future development in Downtown Palo Alto might occur given present conditions, both physical and regulatory.

In order to arrive at a realistic development capacity, we developed two possible build-out scenarios: Scenario 1 is a “high” scenario that is more liberal in identifying sites as having development potential, and Scenario 2 is a “low” scenario that is more restrictive. Each scenario reduces the theoretical maximum 491,000 square feet of Unused Commercial Floor Area of the selected parcels to a more realistic potential buildout, but by different amounts.

Scenario 1 (Higher Development Potential): Methodology and Assumptions

To determine the potential build out of Scenario 1, we eliminated all parcels that satisfy the following criteria:

- Existing Land Use = Residential only
- Unused Commercial < 250 SF
- Commercial Potential ≤ 25%
- Ratio of Improvement Value to Land Value ≥ 1.0
- Structure built in the year 2000 or later
- Development proposed or under construction on parcel
- Existing Improvement = Religious structure

All parcels that did *not* meet any of the above criteria were considered to be candidates for redevelopment. The total number of parcels that are candidates for redevelopment or expansion under this scenario is 31, or 12 percent of the 266 selected parcels.

Adding up how much additional commercial square footage could be built on this “redevelop” subset of parcels, the total is **146,000 square feet**. In other words, 146,000 square feet is the difference between how much development is on these parcels currently, and how much more might be built on them, assuming that they are built out to the maximum allowable FAR permitted by right (without bonuses). This scenario represents a 70 percent reduction from the theoretical maximum zoning allowance of 491,000 square feet.

While it is true that existing zoning regulations limit maximum building size to 25,000 square feet of gross floor area and expansions to 15,000 square feet above the existing floor area, these restrictions would have little impact on this projected commercial floor area. Less than 1 percent of the added square footage would result in buildings over 25,000 square feet or expansions that are more than 15,000 square feet over the existing floor area. Limitations to site coverage set by existing zoning may also further reduce the total commercial floor area; however, the effects of this limitation factor in building design and would have to be worked out on a parcel-by-parcel basis.

Scenario 2 (Lower Development Potential): Methodology and Assumptions

To determine the potential build out of Scenario 2, we eliminated all parcels that satisfied the following criteria:

- Existing Land Use = Residential only
- Unused Commercial < 250 SF
- Commercial Potential ≤ 50%
- Ratio of Improvement Value to Land Value ≥ 0.5
- Structure built in the year 2000 or later
- Development proposed or under construction on parcel
- Existing Improvement = Religious structure

All parcels that did *not* meet any of the above criteria were considered to be candidates for redevelopment. The total number of parcels that are candidates for redevelopment or expansion under this scenario is 16, or 6 percent of the 266 selected parcels.

When we look at how much additional commercial square footage could be built on the “redevelop” subset of parcels in this second, more restrictive, scenario, the total is **53,400 square feet**. In other words, 53,400 square feet is the difference between how much development is on these parcels currently, and how much more might be built on them, assuming that they are built out to the maximum allowable FAR permitted by right (without bonuses). This scenario represents a 90 percent reduction from the theoretical maximum zoning allowance of 491,000 square feet.

Existing zoning regulations that limit maximum building size to 25,000 square feet of gross floor area and expansions to 15,000 square feet above the existing floor area would not have any impact on the projected additional commercial floor area of Scenario 2.

Parking Calculation

For all properties we identified as potential development opportunities, we determined the most realistic on-site parking scenario. We first determined whether the structure would most likely be expanded or replaced in the event of redevelopment, and whether parking for the Commercial Potential square footage would most likely be provided through structured or surface parking. We made these determinations based on a variety of factors including the age and value of the structure; the lot size and configuration; and the nature of existing parking facilities. We then made the following assumptions:

- On lots that would likely be redeveloped with structured parking, we assumed 400 square feet per required parking stall. This ratio is typical for efficiently-designed parking garages.
- On lots that would likely provide new required parking in a surface lot, we assumed 325 square feet per parking stall. This ratio is typical for efficiently-designed surface parking lots.

Figures 2-8 and 2-9 identify the area, in square feet, that would be required to fully park each parcel under each potential redevelopment scenario, given the City’s current requirement of one parking space per 250 square feet of commercial floor area. It should be noted that for many developments throughout the study area, the existing commercial square footage is underserved by parking, based on the existing parking requirement. The areas indicated in figures 2-8 and 2-9 do not reflect this deficiency; rather, they reflect only the parking that would be required of the Commercial Potential. In total, Scenario 1 would require about 580 new parking spaces, or about 230,000 square feet of new parking, and Scenario 2 would require about 214 new parking spaces, or about 85,500 square feet of new parking.

Buildout Scenario Summary

Table 2-9 summarizes and compares the two scenarios, illustrating a high and a low end of potential additional commercial development in Downtown Palo Alto, based on allowable zoning and site characteristics. Over the next 10 years, reasonable assumptions for new development range from around 53,000 to 146,000 additional square feet of non-residential floor area, or an average of 5,300 to 14,000 square feet per year. For purposes of comparison, it should be noted that since the establishment of the cap in 1986, Palo Alto has averaged 8,400 square feet of commercial development in the Downtown Study Area per year.

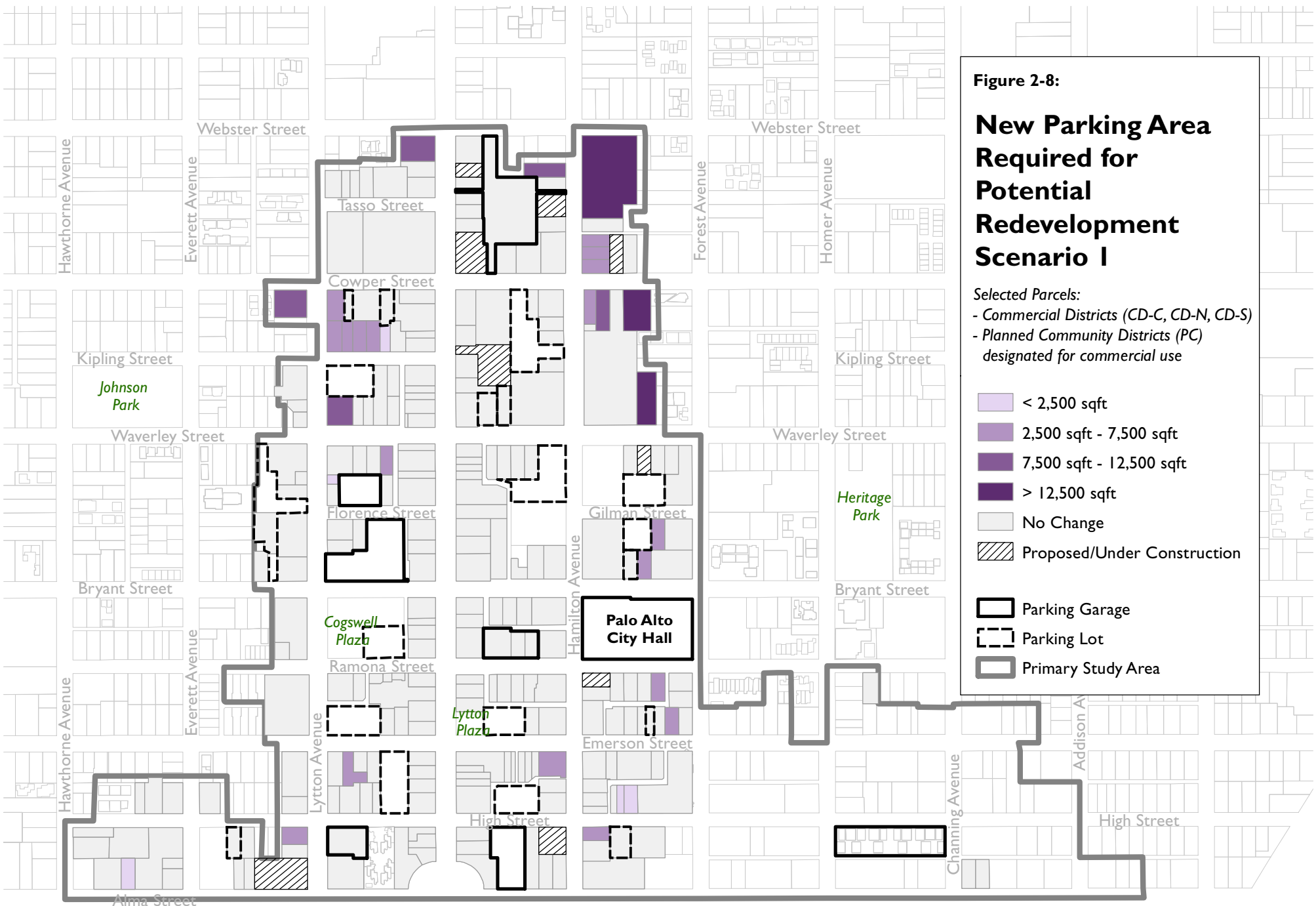
Again, these projections are based on a “supply-side” approach, considering land availability, site characteristics, and development regulations. The next section of this report examines the real estate market conditions, or the “demand-side” of the equation, which is equally important in determining the amount and type of nonresidential development likely to occur in Downtown Palo Alto in the coming years.

Figure 2-8:

New Parking Area Required for Potential Redevelopment Scenario I

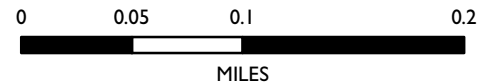
Selected Parcels:
- Commercial Districts (CD-C, CD-N, CD-S)
- Planned Community Districts (PC) designated for commercial use

- < 2,500 sqft
- 2,500 sqft - 7,500 sqft
- 7,500 sqft - 12,500 sqft
- > 12,500 sqft
- No Change
- Proposed/Under Construction
- Parking Garage
- Parking Lot
- Primary Study Area



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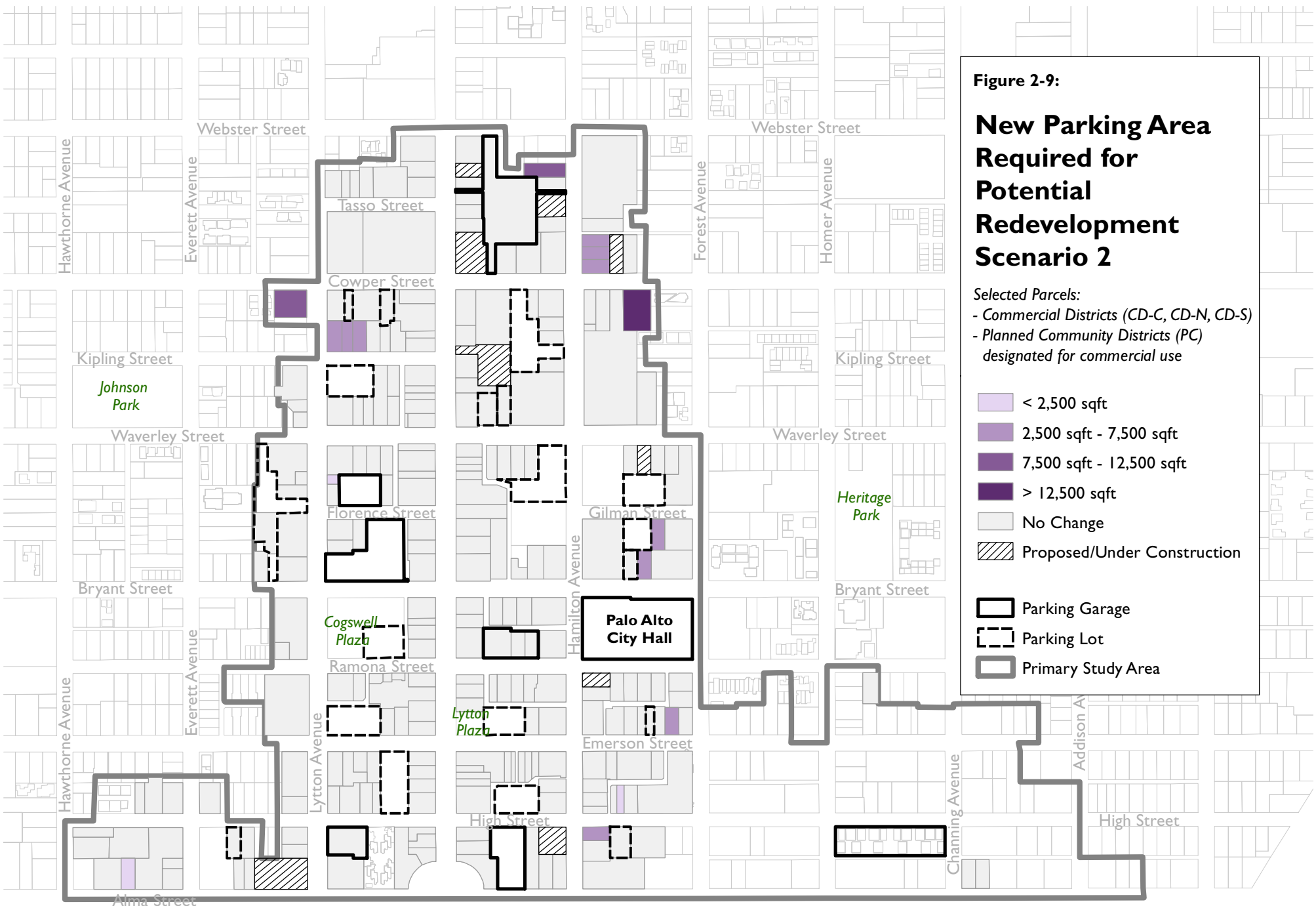
Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

Figure 2-9:

New Parking Area Required for Potential Redevelopment Scenario 2

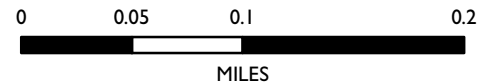
Selected Parcels:
- Commercial Districts (CD-C, CD-N, CD-S)
- Planned Community Districts (PC) designated for commercial use

- < 2,500 sqft
- 2,500 sqft - 7,500 sqft
- 7,500 sqft - 12,500 sqft
- > 12,500 sqft
- No Change
- Proposed/Under Construction
- Parking Garage
- Parking Lot
- Primary Study Area



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Source: City of Palo Alto, 2014; Dyett & Bhatia, 2014.

Table 2-9: Commercial Buildout Scenarios Summary

	<i>Scenario 1: Higher Development Potential</i>	<i>Scenario 2: Lower Development Potential</i>
Number of Parcels that Meet Criteria for Redevelopment or Expansion	31	16
Potential Additional Commercial Development (square feet)		
Total	146,000	53,400
Average Annual over 10 Years	14,600	5,340
Percent Reduction from Theoretical Maximum New Development	70%	90%
Parking Spaces Required under Current Zoning	580	214

Source: Dyett & Bhatia, 2014

2.4 Conclusions

Various factors, including age of structure, existing use, existing FAR, and improvements-to-land value ratio, can reasonably be expected to reduce the capacity for new commercial development. As illustrated in Section 2.3, these factors would likely reduce potential buildout of the Downtown Study Area by 70 to 90 percent of its theoretical maximum, to an expected range of 53,400 to 146,000 square feet (without bonuses). However, if all required parking were to be provided on-site to serve this new development, approximately 85,500 to 230,000 required square feet of parking area for the additional commercial floor area would be needed.

It is unrealistic to expect that this amount of parking could actually be provided on-site, and most developers/property owners would choose to pay the in-lieu fee rather than provide on-site parking. It is reasonable to assume, at the very least, that developments on parcels of a very small size would likely pay the in-lieu fee rather than provide parking on-site. Drawing a line at a parcel size of 5,000 square feet, or 0.11 acres, this would exclude 10 of the 31 parcels identified as reasonable redevelopment candidates in Section 2.3.

Of the remaining 21 sites, a good portion could theoretically provide on-site parking and still be financially feasible, particularly in a very strong market such as what Palo Alto is currently experiencing (see pro forma analyses in Section 3.3). However, the provision of parking may realistically be limited by a number of factors, including unworkable lot configurations, limitations to access, and/or prohibitively high initial costs of construction of structured parking compared with the potential new commercial square footage. Furthermore, in a weaker market, when lease rates or sale prices are less likely to cover the additional expense, more properties would likely choose to pay the in-lieu fee or not develop at all.

While parking reductions may currently be granted for projects that include community benefits or joint use/shared parking, the majority of potential development in the Primary Study Area would not be eligible for such exemptions or reductions. And while paying in-lieu fees is a

legitimate option, there has been increasing pressure from the community on developers to provide parking on-site rather than pay the fee, due to the parking shortage that many may experience or perceive. **Therefore, based on the figures presented here, the greatest limitation to buildout of unused commercial square footage lies with provision of parking on-site.**

The limitations described here also suggest that that City's standard parking ratio could be reexamined. The single ratio of one stall per 250 square feet of commercial floor area is not sensitive to the various types of uses that will occur as the area builds out, and it is likely that a more efficient ratio would suffice for retail uses and certain types of office uses. Looking at comparable districts in peer cities may help lend some insight as to ratios that achieve a balance between parking needs and commercial demand. Some cities require lower parking ratios for office uses than for retail or restaurant use: comparable districts in Santa Clara and Mountain View require one space per 300 square feet, while retail and restaurant uses have a higher ratio. Santa Cruz maintains the one-per-300 square feet ratio for offices as well as retail, and demands a higher ratio only for restaurant uses (one-per-100 square feet). Alternately, some cities require parking only above a specified floor area. In Oakland, for example, office uses in comparable districts require one space per 900 square feet for projects over 10,000 square feet of floor area, and retail uses require one space per 600 square feet for projects over 3,000 square feet of floor area.

The findings presented here advise the team and staff, as the Downtown Development Cap Evaluation proceeds to the next phase, to use the data set and analysis tools to focus on policy recommendations for parking management and requirements as well as other growth management tools. See policy discussion in Chapter 4.

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3 Market Assessment and Demand-Based Development Potential

This chapter provides a high-level analysis of the real estate market and new development trends as well as a projection of future commercial development in Downtown Palo Alto. The initial findings described below are based on a review of real estate data, development feasibility analysis, and case studies of Downtown commercial sites.

3.1 Market Trends

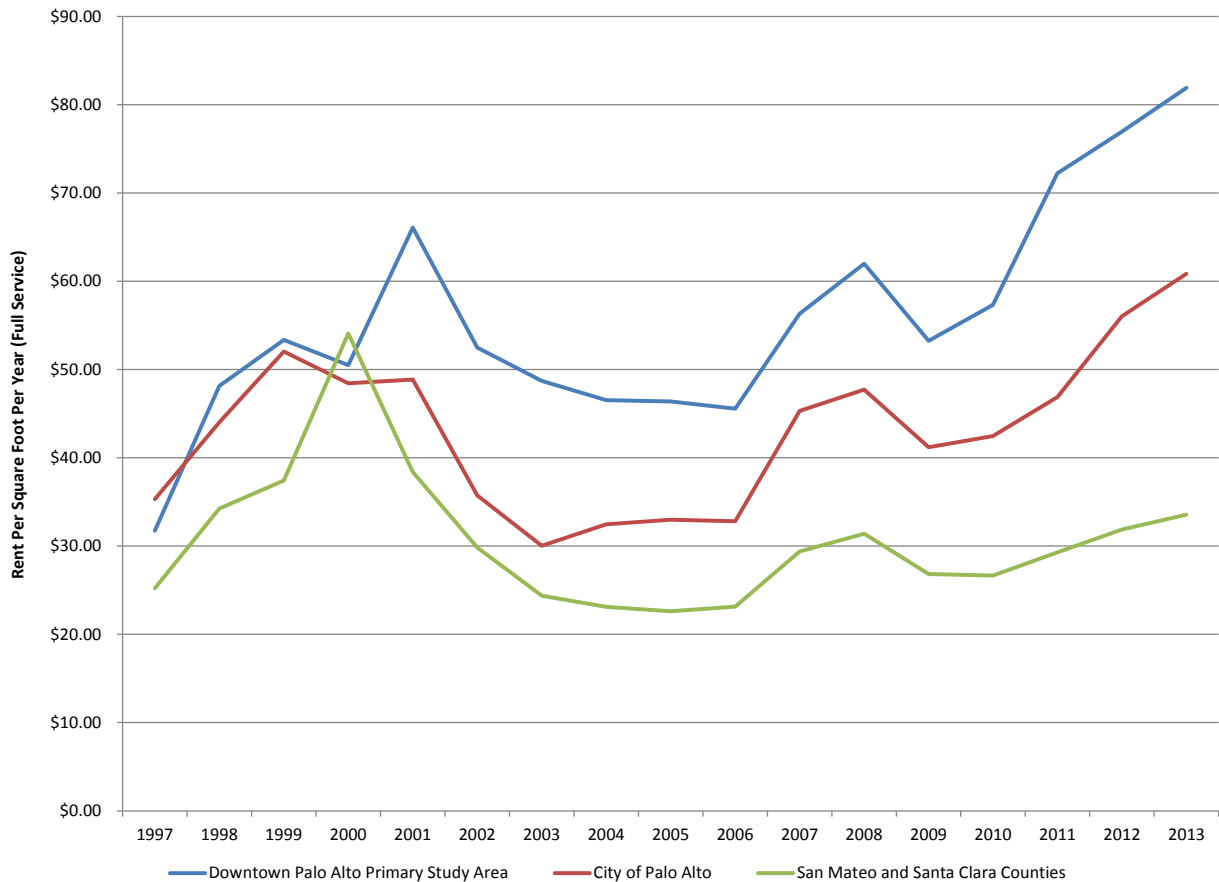
An analysis of real estate market conditions and trends Downtown, citywide, and in the region provide critical insight into the level and type of development that is likely to be demanded in Palo Alto's Downtown in the future. The analysis relies on a variety of data sources, though the commercial real estate data referenced are predominantly from CoStar Group, a well-regarded national provider of real estate industry data. CoStar data were deemed the best and most comprehensive available, providing records for all major commercial buildings (tenant and owner occupied) in the study area.

OFFICE MARKET TRENDS

Technology firms ranging from small start-up companies to well-established international firms like Google have been in expansion mode, fueling an office market rebound in Silicon Valley. While office lease rates within the broad Peninsula and South Bay markets have climbed to just above their 2008 peak, rents in Palo Alto, particularly Downtown, have surged upward and are now well above those prior highs.

The office market in Downtown Palo Alto is making headlines, with rents and sale values that are on par with the most sought-after office locations in the country. Downtown Palo Alto is the most highly-desired office submarket in Silicon Valley. Office rents in Downtown Palo Alto surpassed previous dot-com era highs in 2010 and are now at record levels. The average office lease rate in the Downtown Primary Study Area cleared \$80 per square foot per year (\$6.67 per square foot per month) in 2013. By comparison lease rates averaged about \$60 citywide and about \$35 across San Mateo and Santa Clara Counties more broadly (see **Figure 3-1**).

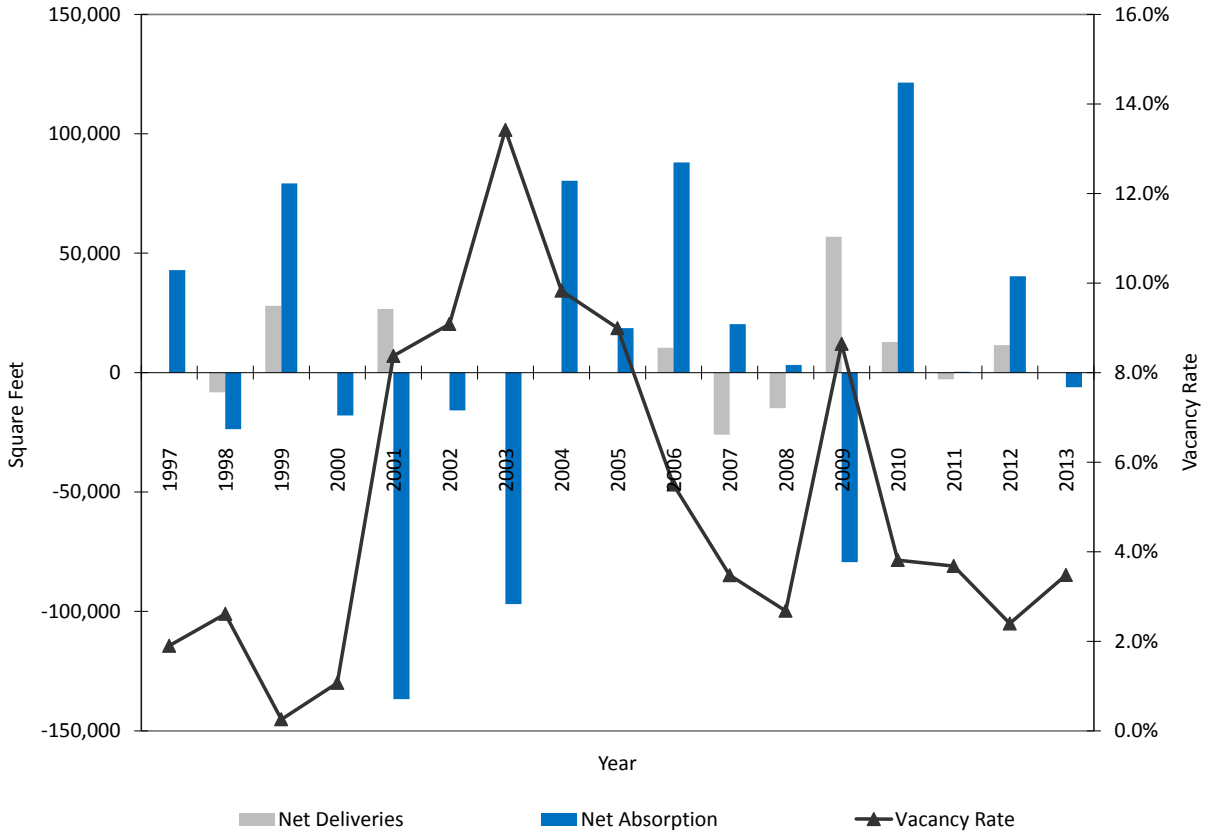
Figure 3-1: Office Lease Rate Trends



Source: CoStar Group

Despite offering more than 2.35 million square feet of office space, vacancies Downtown are scarce. While new office projects (e.g., 101 Lytton, 101 Forest) have recently added to the inventory of office space Downtown, the modest quantity of new supply has done little to satisfy unmet demand. The average vacancy rate in 2013 was below 4 percent (and Q1 2014 data suggest that vacancy has fallen to only 2 percent). **Figure 3-2** reveals that while there was a spike in vacancy during 2009, a surge in net absorption during 2010 resulted in a tight market. The Downtown Palo Alto market has maintained low, single-digit vacancy since 2010.

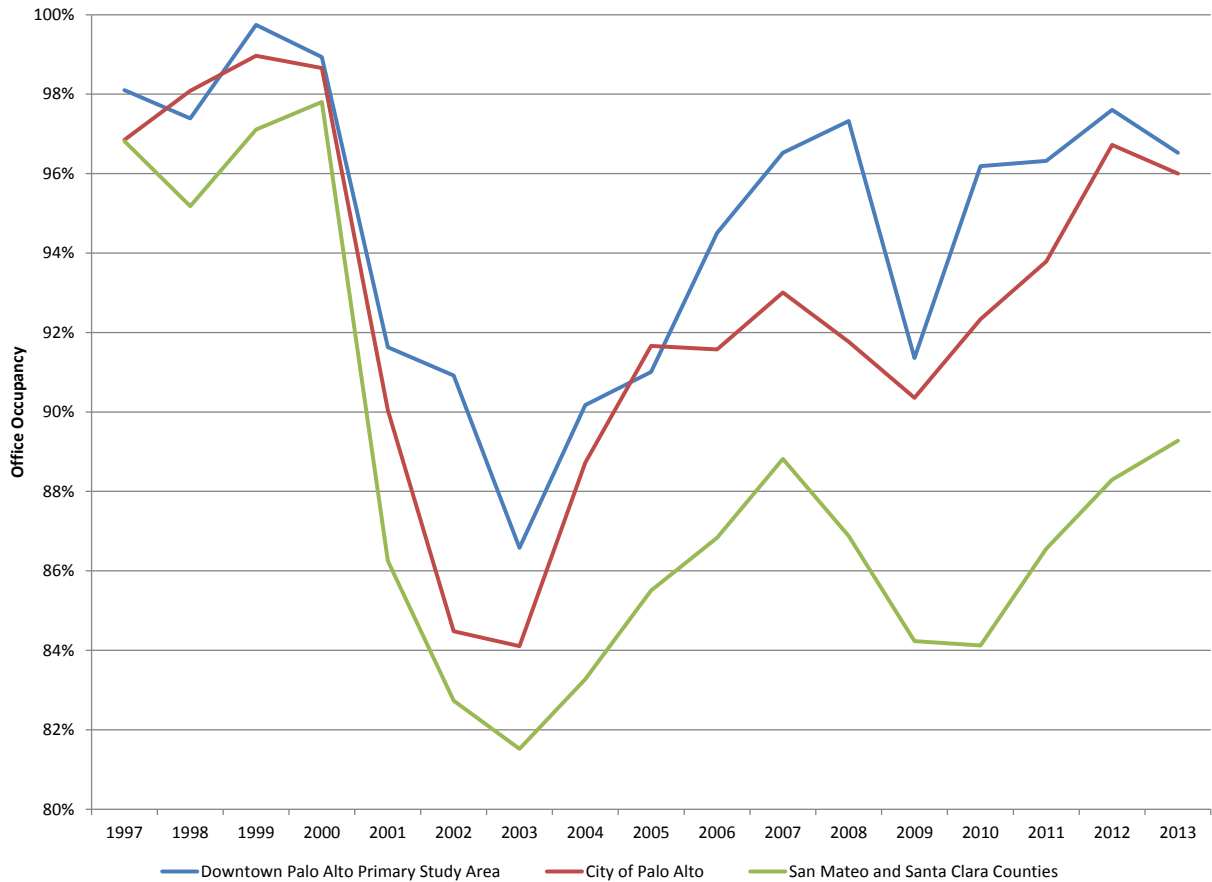
Figure 3-2: Downtown Palo Alto Office Market Trend



Source: CoStar Group

Citywide, vacancy is only slightly higher than Downtown. However, space availability in the broader market (San Mateo and Santa Clara Counties) is considerably better, with office vacancy of about 10 percent (roughly 7 percentage points higher than Downtown) during 2013 (**Figure 3-3**).

Figure 3-3: Office Occupancy Trend

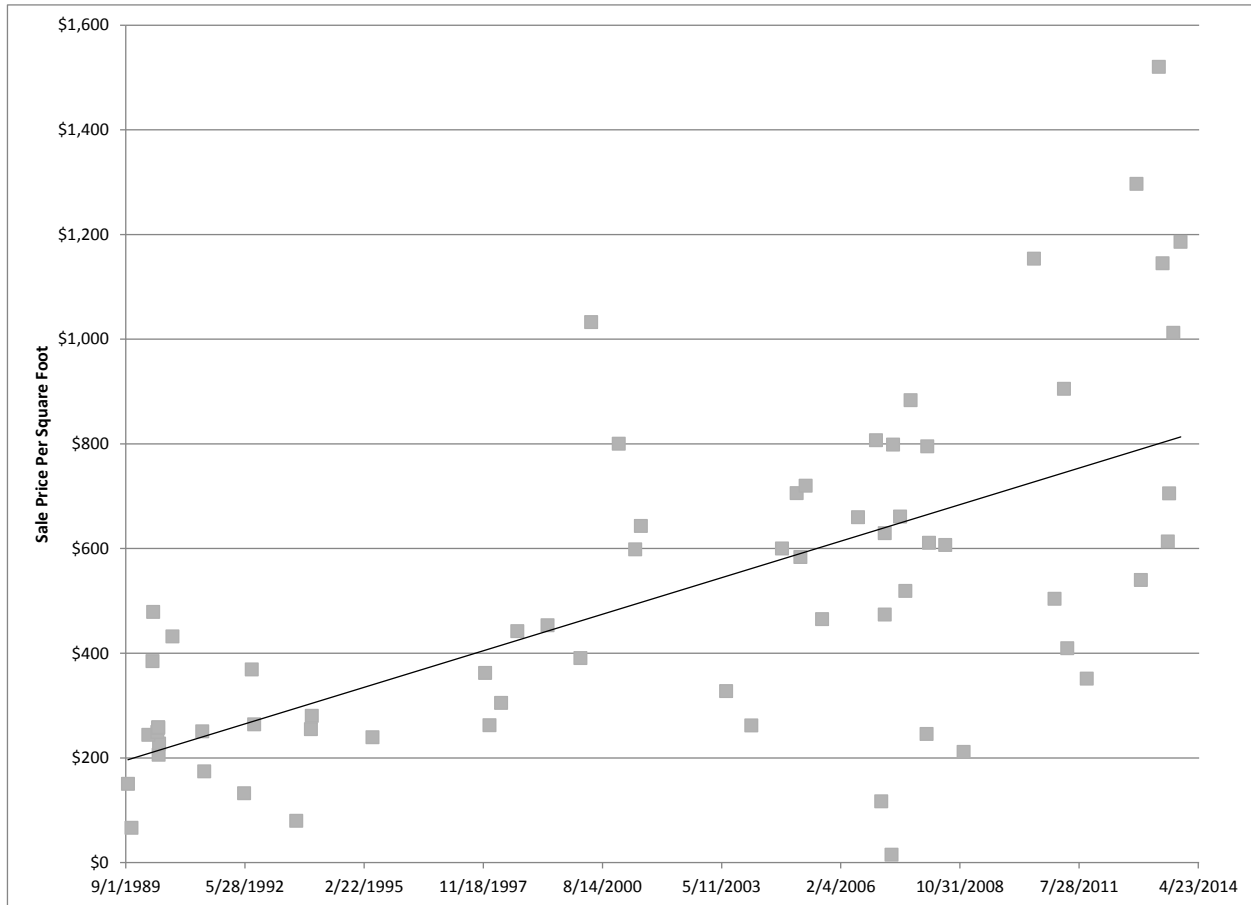


Source: CoStar Group

Office building sales prices in Downtown Palo Alto reflect the relatively steady escalation of rents (**Figure 3-4**). While pre-recession sales never topped \$1,000 per square foot, available data reveal six recent transactions in which pricing was above that threshold. In 2011, a 72,000-square-foot downtown Palo Alto office building (100 Hamilton) sold for about \$900 per square foot. At the time, the deal was one of the most expensive sales of a U.S. office building over 15,000 square feet. More recently, in mid-2013, a 10,350-square-foot office building (335 Bryant) sold for over \$1,500 square foot. Across six major office building transactions that occurred in 2013, the unweighted average price per square foot exceeded \$1,000.



Figure 3-4: Downtown Palo Alto Office Sales



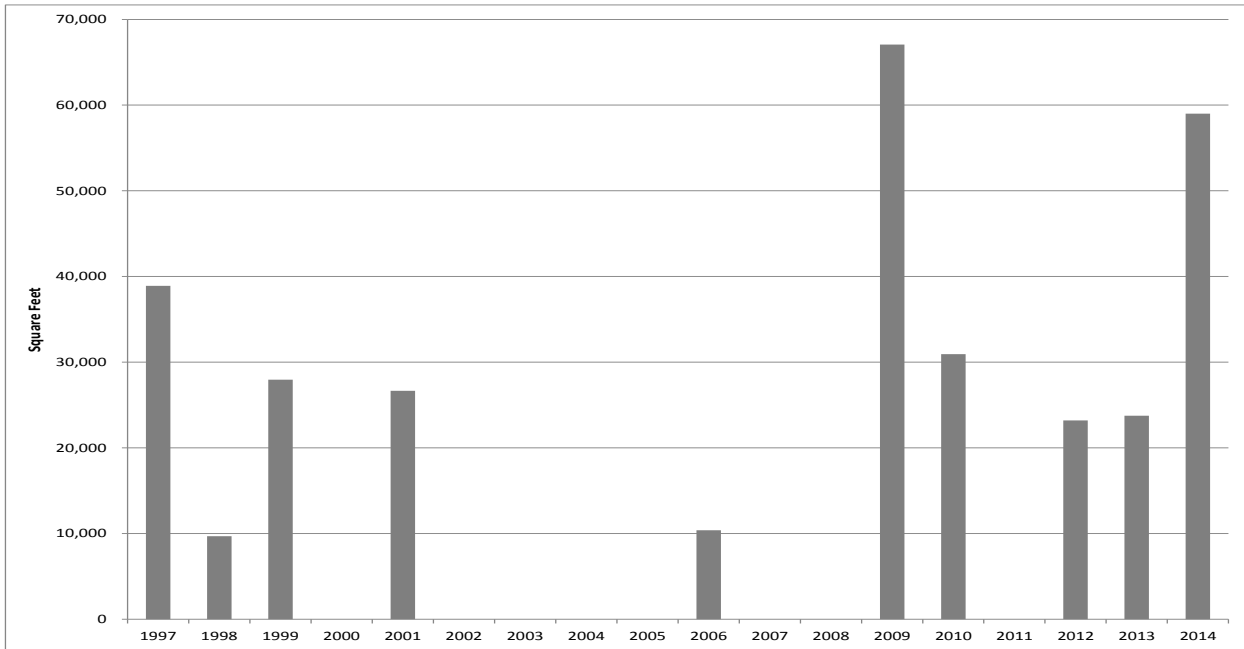
Source: CoStar Group

Over the years, the high value of commercial real estate in Downtown Palo Alto has generated significant interest amongst developers pursuing new office projects. Since 1997, developers have constructed approximately 320,000 square feet in office-anchored buildings in the Downtown Primary Study Area (an office stock increase of about 15 percent).¹ Interestingly, more than half of this total, over 200,000 square feet, was completed since the end of the recession (i.e., since Q2 2009). However, demolitions occurred to make way for some of these new development projects, thereby reducing the overall net addition of space achieved by new development. CoStar data indicate that about 56,000 square feet of office space was demolished or repurposed to provide for the 204,000 square feet of office space delivered since the recession ended (**Figure 3-5**).²

¹ Development quantity is reported as gross leasable square footage (or Rentable Building Area), which includes common areas. Note that the Downtown cap tracks net commercial space, which excludes common areas and other non-usable floor area.

² CoStar data reveal that between Q2 2009 and QTD 2014 (as of 5/6/2014) 204,000 square feet office space was constructed while the total rentable office inventory increased by about 148,000 square feet.

Figure 3-5: Downtown Palo Alto Office Construction



Source: CoStar Group

Address	Year Built	Stories	Rentable Building Area
480 Cowper St	1997	3	19,404
180 Lytton Ave	1997	2	4,650
428-432 University Ave	1997	4	14,856
909 Alma St	1998	4	9,700
411 High St	1999	1	7,400
390 Lytton Ave	1999	3	20,564
200-228 Hamilton Ave	2001	3	26,657
164 Hamilton Ave	2006	3	10,395
325 Lytton Ave	2009	3	31,688
820 Ramona St	2009	2	5,084
310 University Ave	2009	3	30,289
101 Forest Ave	2010	2	15,861
102 University Ave	2010	4	15,077
524 Hamilton Ave	2012	2	7,404
317-323 University Ave	2012	4	15,799
278 University Ave	2013	4	23,752
101 Lytton Ave	2014	4	59,000
Total			317,580

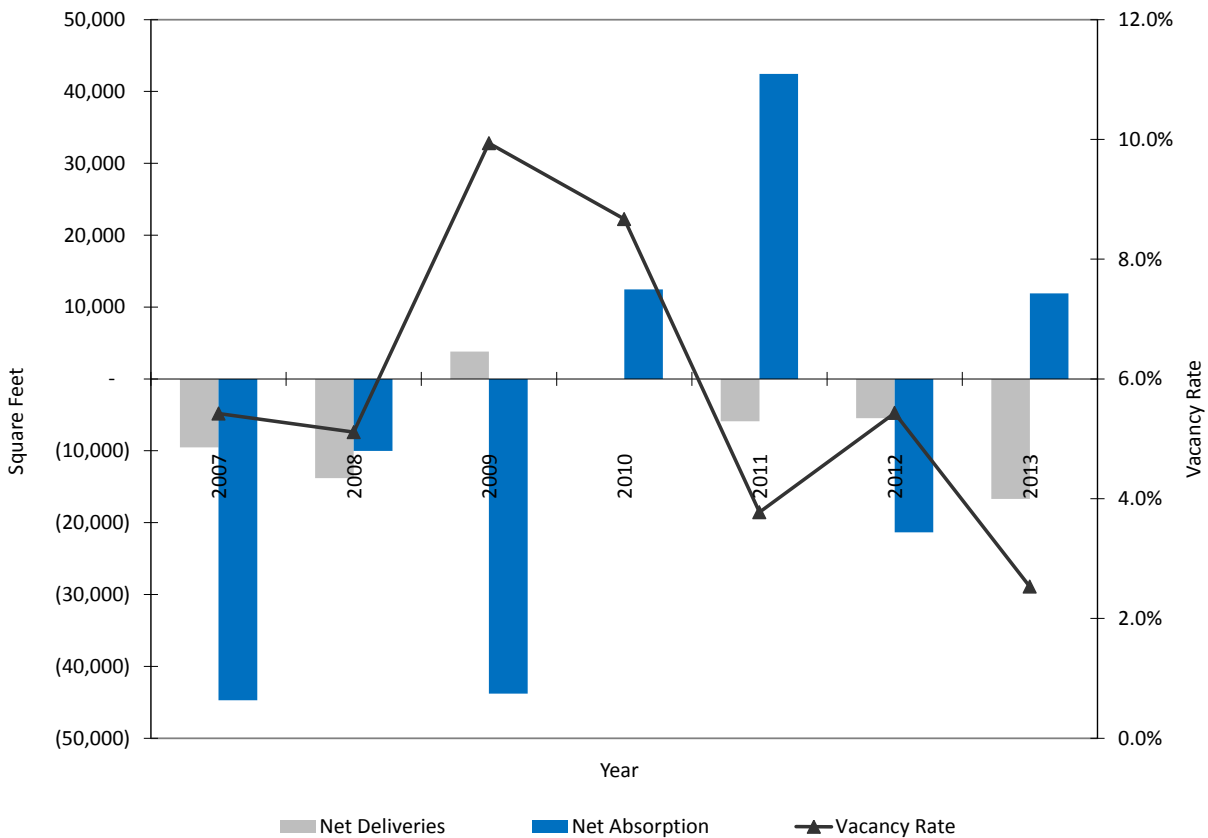
Overall, the market data reveal an extremely favorable environment for commercial office development in Downtown Palo Alto. Values are robust and new development projects have surged in recent years. Downtown Palo Alto, while not immune to market cycles, is sure to remain a sought-after location for workspace, given the competitive factors that have driven the market to the value highs and vacancy lows that are currently exhibited. The Downtown market is likely to experience significant and continued pressure for the redevelopment of underutilized sites (e.g., properties currently developed well below the allowable FAR) over the long term.

RETAIL MARKET TRENDS

Palo Alto's Downtown features a vibrant shopping district centered on University Avenue. Consisting of a wide variety of shops and restaurants, the district bustles daily but is particularly lively on Friday and Saturday night and during the weekday lunch hour. Many shops maintain extended hours to take advantage of bar- and restaurant-driven business during the evenings.

Based on data from CoStar, retail vacancy in the Downtown Primary Study Area is extremely scarce, with only about 2.5 percent available during late 2013 (roughly 24,000 square feet out of the 954,000-square-foot retail inventory). The low vacancy rate is attributable to positive net absorption and the declining quantity of retail space (which according to anecdotal accounts is at least partially attributable to the conversion of retail space to office uses), as shown in **Figure 3-6**.

Figure 3-6: Downtown Palo Alto Retail Market Trend



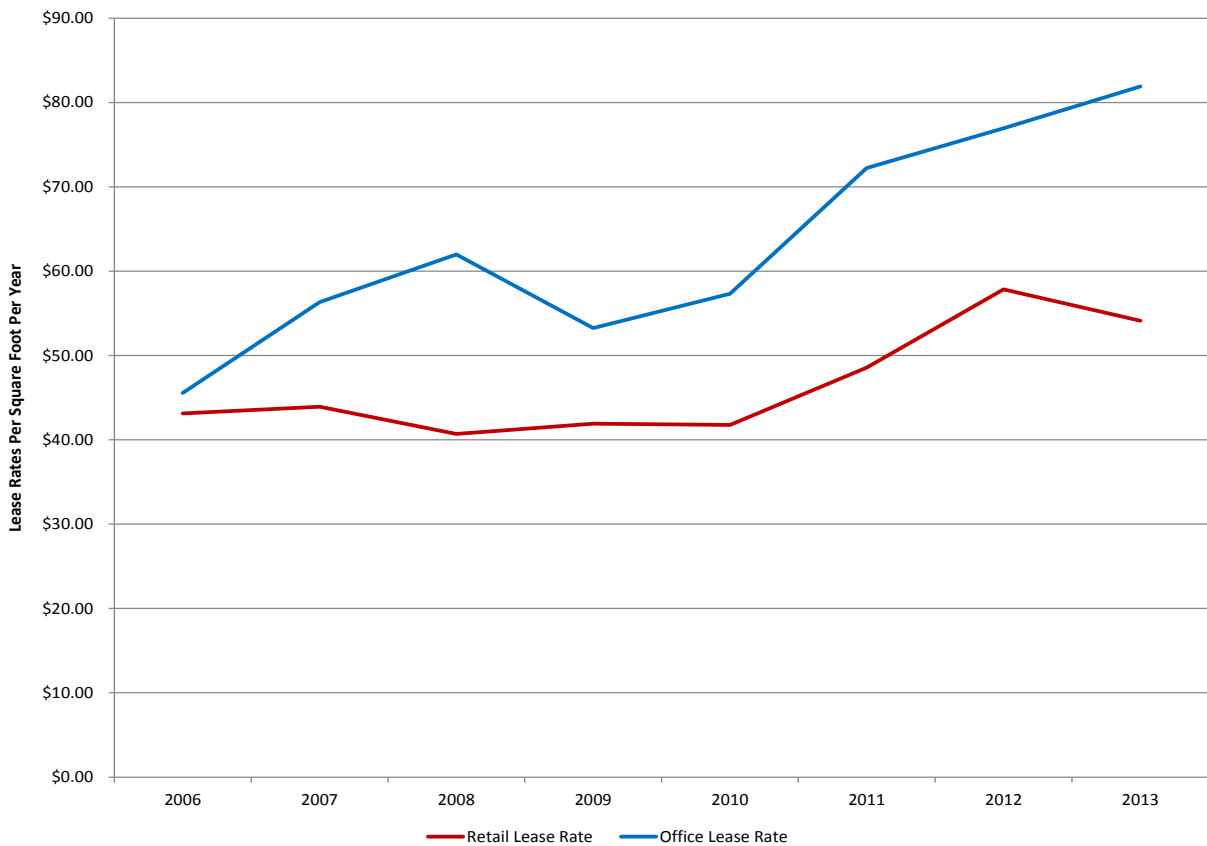
Source: CoStar Group

Retail rental rates in the Downtown range broadly, from about \$36 to \$90 NNN (excluding taxes, insurance, and maintenance) per square foot per year. The Downtown market-wide average was about \$58 NNN during the first quarter of 2014. While these are strong lease rates for a historic downtown with relatively small-format spaces, retailers commonly pay more for space at the nearby Stanford Mall. By comparison, lease rates at the Stanford Mall are typically in the range of \$70 NNN. Stanford Shopping Center is an open-air super regional shopping center anchored by five major department stores (Neiman Marcus, Nordstrom, Bloomingdale's, Macy's, and Macy's

Men's Store). Development of the Center occurred in phases beginning in the mid-1950s and today it comprises over 1.3 million square feet of gross leasable area.³

Despite the strength of the Downtown Palo Alto retail market, office rents have grown more dramatically in recent years. Retail (NNN) and office (full service) rates were both about \$45 per square foot in 2006, but office rates have increased to more than \$80 per square foot while retail rates remain below \$55 (Figure 3-7). The market strength of office relative to retail space is further confirmed by the number of office tenants currently occupying former retail sites. With the exception of prime locations along University Avenue office tenants are willing to pay higher rents than retailers.

Figure 3-7: Comparison of Retail and Office Rates Downtown



Source: CoStar Group

Despite the growing value disparity between retail and office uses downtown, retail remains an economically viable use in Downtown Palo Alto, with optimally-located retail properties capable

³ Simon Property Group, Inc.

of achieving rents that rival office uses. However, retailers have strong preferences concerning location and sub-optimal retail sites are unlikely to be value-competitive with office uses under current market conditions.

RESIDENTIAL MARKET TRENDS

While residential uses are excluded from the Downtown development cap policy, this analysis considers the market and potential of residential uses, primarily to inform analysis of mixed-used projects and to better understand potential competition amongst uses for a limited supply of development sites in the Downtown. This section commences with an overview of citywide housing, focusing in on the Downtown market to the degree that readily available data allow.

According to the US Census Bureau's American Community Survey, there are about 27,800 housing units in the City of Palo Alto (2008-2012), about 40 percent of which (42 percent of occupied units) were rental units. Approximately 62 percent of the city's dwelling units are single-family homes, while about 19 percent of units are in small- to mid-size apartment or condominium buildings (2-19 units), and 18 percent are in large buildings with 20 or more units. Data from RAND California statistics puts the average for-sale home value citywide in 2012 at \$1.8 million while more recent data from Redfin.com suggest that home transactions have averaged about \$2.2 million during the first half of 2014.

Rental Units

Market data concerning major apartment complexes (50 units or more) indicate that the average rent in Palo Alto is \$3,035 per month for an 868 square foot apartment, approximately \$3.50 per square foot per month.⁴ Available data from CoStar Group identify 310 multifamily rental units in the Downtown Primary Study Area. Of these, available data reveal that 157 units in two projects are designated affordable. The 50-unit 801 Alma is an affordable project completed by Eden Housing in 2013. Other notable apartment complexes in Downtown Primary Study Area include Alma Place (107 affordable units) and the historic Hotel President Apartments (75 market rate apartments). Hotel President units rent for about \$1,340, roughly \$3.66 per square foot per month.

Just outside the Downtown Primary Study, the Marc (located at 501 Forest Ave.) better exhibits the high residential rental rates that are achievable in the Downtown vicinity (**Figure 3-8**). This 118-unit, 12-story project built in 1965 currently achieves over \$5 per square foot per month. Units rent for between \$4,500 for a 1 bed/1 bath unit and \$8,250 for a 2 bed/2.5 bath unit per month.

⁴ RealFacts data for Q1 2014 that includes 14 properties offering 2,750 units.

Figure 3-8: The Marc

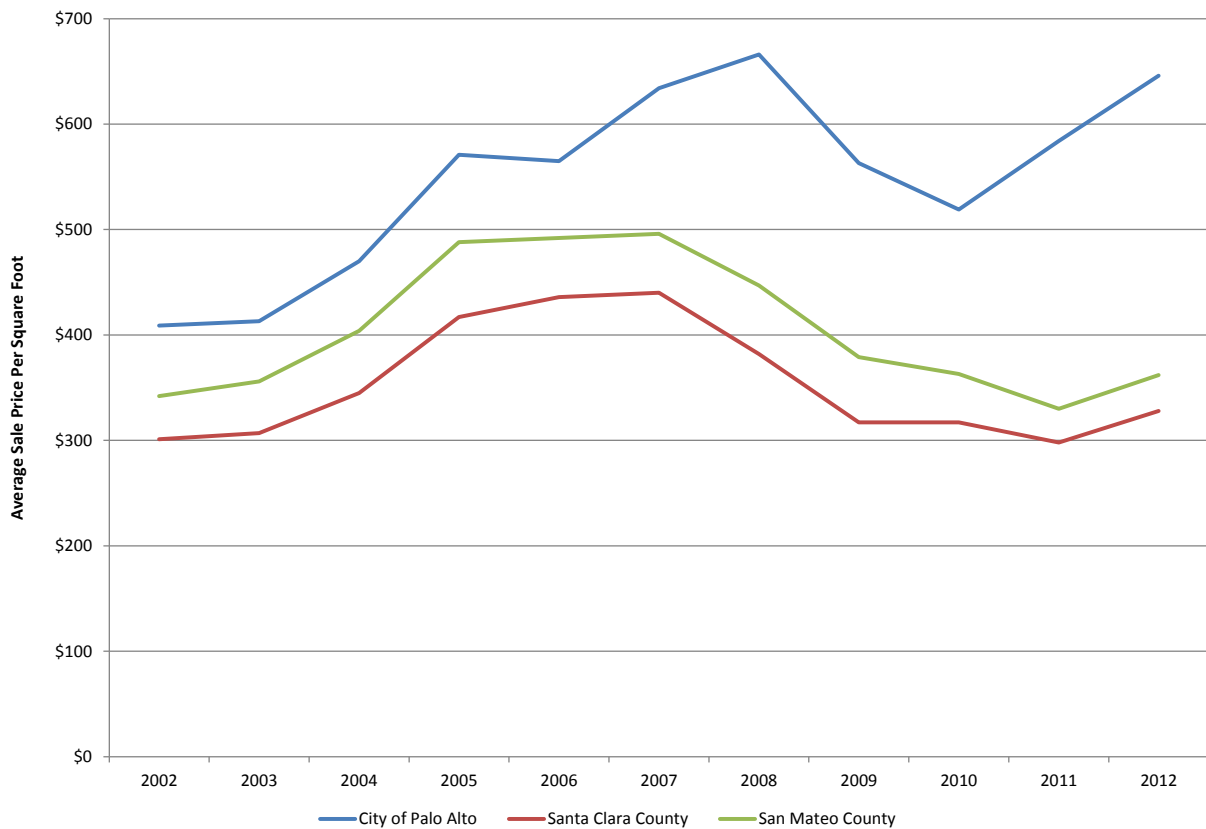


Source: Google Maps Street view

Condominium and Townhome Units

Condominiums and townhomes in the City of Palo Alto trade at a significant premium over similar homes in the broader Santa Clara County and San Mateo County markets. In 2012, pricing of condominiums and townhomes in Palo Alto was about \$650 per square foot, as compared with about \$350 and \$325 in San Mateo County and Santa Clara County, respectively. **Figure 3-9** presents recent trends in condominium and townhome sales prices, based on data from RAND California Statistics. As shown, the Palo Alto condominium and townhome market has exhibited very strong price appreciation since 2010 relative to the Peninsula and South Bay.

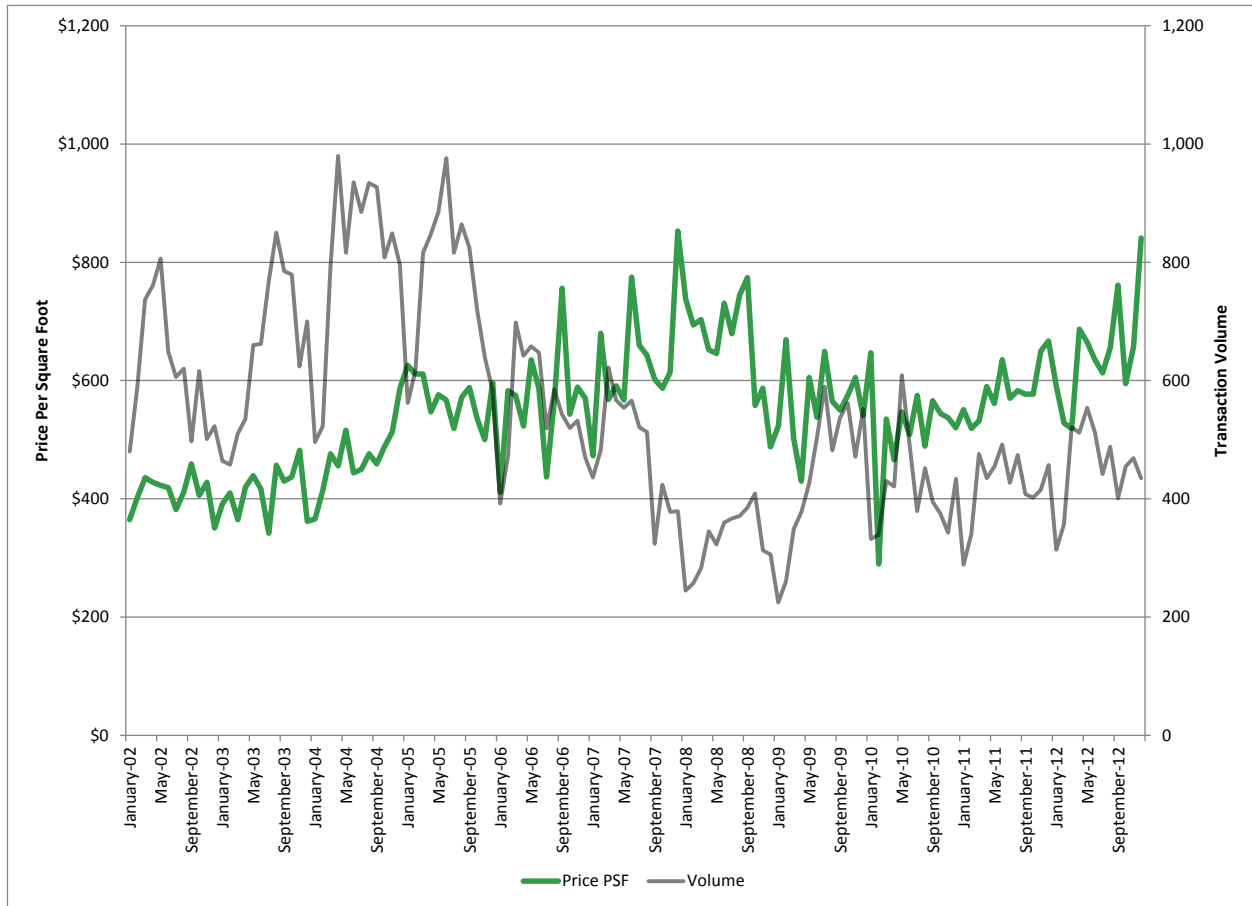
Figure 3-9: Condominium and Townhome Sales Trend



Source: RAND California Statistics

Figure 3-10 provides additional detail concerning the City of Palo Alto market, revealing that by the end of 2012 average sale pricing had exceeded \$800 per square foot on monthly transaction volume of 435 units.

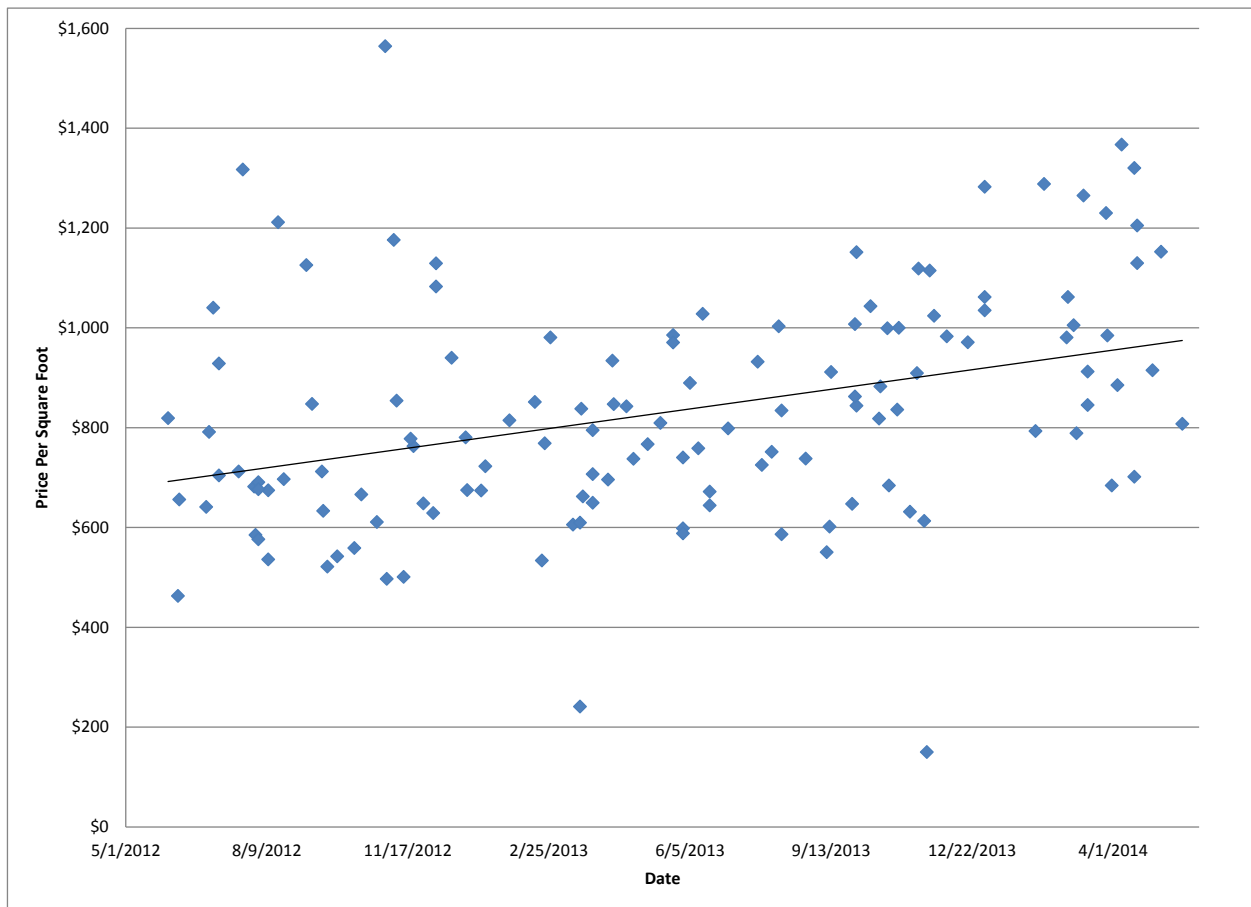
Figure 3-10: Palo Alto Condominium and Townhome Pricing and Transaction Volume



Source: RAND California Statistics

A sample of residential transaction data from the Downtown Palo Alto vicinity reveals that recent sales commonly have been well over \$1,000 per square foot, with a number of recent transactions over \$1,200 per square foot. **Figure 3-11** presents condominium and townhome sales data for the Downtown vicinity, including transactions occurring during 2012 through April 2014. A simple trend line reveals the overall rate of price escalation observed in the data. As shown, the price of typical Downtown condominiums and townhomes has increased from about \$700 per square foot in 2012 to nearly \$1,000 in recent months.

Figure 3-11: Downtown Palo Alto Vicinity Condominium and Townhome



Sales

Source: Redfin

Downtown Palo Alto condominium and townhome sales prices appear to be only slightly below office prices, potentially making this use appealing to developers. However, developers seeking to construct income-producing assets (as opposed to for-sale products) likely will prefer to build office spaces, since residential rents are notably lower than office rents. However, this analysis did not identify any recently constructed residential rental comparables (i.e., 50-unit+ major projects for which data are available) that exhibit the upper-end potential of residential rents Downtown.

It is possible that a new residential apartment project could achieve rental rates on par with office uses if well positioned in the marketplace.

3.2 Financial Feasibility Analysis

This study relies on an illustrative pro forma financial analysis to evaluate the potential development feasibility of new development projects. The pro forma analysis approximates the cash-flow (i.e., costs and revenues) of generic office and mixed-use projects Downtown, to evaluate land value and redevelopment potential.⁵ The analysis finds significant value associated with buildable Downtown sites, particularly where single-use office projects may be developed.

The high-level pro forma analysis provides an illustration of redevelopment potential in the Downtown. By comparing the estimated value of a hypothetical existing office building to the pro forma value of new, higher-density buildings (office and mixed use), the analysis evaluates what range of density increases may be needed to justify full redevelopment of an existing building. The hypothetical existing building considered in the pro forma analysis is a 10,000-square-foot office building with average rent of \$5.00 per square foot. The value of this existing building is estimated at about \$6.5 million (about \$650 per square foot), as shown in **Figure 3-12** and detailed in **Figure 3-13**. **Figure 3-12** also summarizes the resulting value estimates for three distinct redevelopment alternatives as a basis for comparing the likelihood of various intensification scenarios. As shown, redevelopment of an existing 10,000 square foot office building with a 20,000 square foot office building appears financially attractive. However, the financial viability of redevelopment is less likely when the replacement project is mixed use, particularly when office is excluded from the program.

⁵ Residual Land Value considers the market value of a built project and subtracts out the total cost of development (excluding land) to estimate land value.

Figure 3- 1 I: Summary of Pro Forma Scenarios

Pro Forma Scenario	Square Feet	FAR	Total Value	Land Value
Existing Office Building	10,000	1.0	\$6,500,000	N/A
New Office Building	20,000	2.0	\$23,803,800	\$6,524,059
Office/Residential/Retail Mixed-Use Building	30,000	3.0	\$29,603,014	\$5,881,171
Residential/Retail Mixed Use Building	30,000	3.0	\$25,441,714	\$5,081,122

The first feasibility comparison test analysis considers a test case where a new 20,000-square-foot office space with rent of \$6.75 (per square foot per month) replaces an existing 10,000-square-foot office building. Characteristics of the hypothetical existing office building are described in **Figure 3-12**. In this example, preliminary pro forma analysis of the new building suggests a residual land value of about \$6.52 million, greater than the total value of the existing building (see **Figure 3-13**).⁶ In cases where the residual land value of the new project is greater than the total value of the existing property, there is economic rationale for the current owner to redevelop the property or sell the property to a developer (though, of course property owners have a variety of investment goals as well as non-financial motivations).

In the second feasibility test, we evaluate the potential value of a 30,000-square-foot mixed-use project with an average rental rate of \$6.13 (a blended average of office rent at \$6.75 and retail and residential rents at \$5.50 full service). In this example, the preliminary analysis estimates the value of the mixed-use project at nearly \$30 million, with a residual land value of about \$5.9 million. In this example, because retail and residential rents are anticipated to be below office rents, even with an additional 1.0 FAR over a single-use office project the residual land value does not quite exceed the value of the hypothetical existing office building valued at \$6.5 million (see **Figure 4-14**). However, higher-value condominiums (versus rental units) or other improvements to the financial performance of the new building could make up the value differential shown here.

⁶ Note that the capitalization rate for a new building is assumed to be lower than an existing building, due to the risk of obsolescence associated with the older structure.

In the third test, we evaluate the potential value of a 30,000-square-foot residential/retail mixed-use project with average rent of \$5.50 (retail and residential rents at \$5.50 full service). In this example, the preliminary analysis estimates the value of the mixed-use project at about \$25 million, with a residual land value of about \$5.1 million. Again, because retail and residential rents are anticipated to be below office rents, an additional 1.0 FAR over the single-use office project is insufficient to achieve a residual land value that exceeds the value of the hypothetical existing office building valued at \$6.5 million (see **Figure 3-15**).

Given pro forma assumptions that run proportionally with building size, the analysis is scalable (i.e., in general, a developer may be willing to buy a functional existing building and demolish it or adaptively reuse it to construct a new higher-value building that is two to three times the size of the original structure). However, it is important to note that the hypothetical cash-flow analyses are designed as illustrative examples based on highly generic projects. Actual development outcomes on specific sites will vary widely depending on a variety of unique and unknown factors, including but not limited to the entitlement process, property attributes (e.g., size, condition, geometry, and location), ownership considerations, existing uses, and other factors.

Figure 3-12: Valuation of Hypothetical Existing Office Building

DEVELOPMENT PROGRAM ASSUMPTIONS			
Site (Square Feet)			10,000
FAR			1
Rentable Area (Square Feet)	100%	of GBA	10,000
BUILDING VALUE			
Gross Potential Rent (FS)	\$5.00	per SF/Month	\$600,000
Losses to Vacancy	5.0%	of GPR	-\$30,000
Collection Losses	0.0%	of GPR	\$0
Losses to Concessions	0.0%	of GPR	\$0
Gross Revenue			\$570,000
Operating Expenses	\$1.50	per SF/Month	-\$180,000
Net Operating Income			\$390,000
Income Capitalization	6.00%	Capitalization Rate	\$6,500,000
Building Value			\$6,500,000

Figure 3- 13: Residual Land Valuation of Hypothetical New Office Building

DEVELOPMENT PROGRAM ASSUMPTIONS			
Site (Square Feet)			10,000
FAR			2
Rentable Area (Square Feet)	100%	of GBA	20,000
Parking Spaces			80
BUILDING VALUE			
Gross Potential Rent (FS)	\$6.75	per SF/Month	\$1,620,000
Losses to Vacancy	5.0%	of GPR	-\$81,000
Other Revenue (Parking)	\$50	per Space/Month	\$48,000
Gross Revenue			\$1,587,000
Operating Expenses	\$1.50	per SF/Month	-\$360,000
Net Operating Income			\$1,227,000
Building Value	5.00%	Capitalization Rate	\$24,540,000
Disposition Cost	3.0%	of Building Value	-\$736,200
Net Building Value			\$23,803,800
DEVELOPMENT COSTS			
Construction Costs			
Basic Site Work	\$20	per site SF	\$200,000
Building Direct Cost	\$240	Cost/SF (GBA)	\$4,800,000
Parking Direct Cost	\$60,000	per Space	\$4,800,000
<i>Total Construction Cost</i>			<i>\$9,800,000</i>
Soft Costs			
Architecture and Engineering	10.0%	of Construction Cost	\$980,000
Entitlement	\$20	Cost/SF (GBA)	\$400,000
Other Professional Services	5.0%	of Construction Cost	\$490,000
Permits and Fees	\$40	Cost/SF (GBA)	\$800,000
Taxes and Insurance	2.0%	of Construction Cost	\$196,000
Tenant Improvements	\$40	Cost/SF (GBA)	\$800,000
<u>Financing</u>	4.0%	of Construction Cost	<u>\$392,000</u>
<i>Total Soft Costs</i>			<i>\$4,058,000</i>
Developer Costs			
Marketing/Leasing	3.0%	of 10-yr. lease value	\$461,700
Developer Fee (overhead)	3.0%	of Hard and Soft Costs	\$415,740
<u>Developer Contingency</u>	5.0%	of Hard and Soft Costs	<u>\$692,900</u>
<i>Total Developer Costs</i>			<i>\$1,570,340</i>
Total Development Cost			\$15,428,340
LAND VALUE			
Developer Return Requirement	12%	of Development Cost	\$1,851,400.80
Residual Land Value	\$326.20	per square foot (GBA)	\$6,524,059
	\$28,418,802	per acre	

Figure 3-14: Residual Land Valuation of Hypothetical New Mixed-Use

DEVELOPMENT PROGRAM ASSUMPTIONS			
Site (Square Feet)			10,000
FAR			3.0
Rentable Area (Square Feet)	100%	of GBA	30,000
Parking Spaces			98
BUILDING VALUE			
Retail (25% Program)	\$5.50	per SF/Month (FS)	\$495,000
Office (50% Program)	\$6.75	per SF/Month (FS)	\$1,215,000
Residential (25% Program)	\$5.50	per SF/Month (FS)	\$495,000
Gross Potential Rent	\$6.13	per SF/Month (FS)	\$2,205,000
Losses to Vacancy	5.50%	of GPR	-\$121,275
Other Revenue (Parking)	\$50	per Space/Month	\$58,500
Gross Revenue			\$2,142,225
Operating Expenses	\$1.50	per SF/Month	-\$540,000
Net Operating Income			\$1,602,225
Building Value	5.25%	Capitalization Rate	\$30,518,571
Disposition Cost	3.0%	of Building Value	-\$915,557
Net Building Value			\$29,603,014
DEVELOPMENT COSTS			
Construction Costs			
Basic Site Work	\$20	per site SF	\$200,000
Building Direct Cost	\$240	Cost/SF (GBA)	\$7,200,000
Parking Direct Cost	\$60,000	per Space	\$5,850,000
<i>Total Construction Cost</i>			<i>\$13,250,000</i>
Soft Costs			
Architecture and Engineering	10.0%	of Construction Cost	\$1,325,000
Entitlement	\$20	Cost/SF (GBA)	\$600,000
Other Professional Services	5.0%	of Construction Cost	\$662,500
Permits and Fees	\$40	Cost/SF (GBA)	\$1,200,000
Taxes and Insurance	2.0%	of Construction Cost	\$265,000
Tenant Improvements	\$40	Cost/SF (GBA)	\$1,200,000
Financing	4.0%	of Construction Cost	<u>\$530,000</u>
<i>Total Soft Costs</i>			<i>\$5,782,500</i>
Developer Costs			
Marketing/Leasing	3.0%	of 10-yr. lease value	\$625,118
Developer Fee (overhead)	3.0%	of Hard and Soft Costs	\$570,975
<u>Developer Contingency</u>	5.0%	of Hard and Soft Costs	<u>\$951,625</u>
<i>Total Developer Costs</i>			<i>\$2,147,718</i>
Total Development Cost			\$21,180,218
LAND VALUE			
Developer Return Requirement	12%	of Development Cost	\$2,541,626.10
Residual Land Value	\$196.04	per square foot (GBA)	\$5,881,171
	\$25,618,380	per acre	

Building

Figure 3-15: Residual Land Valuation of Hypothetical New Residential Mixed-Use Building

DEVELOPMENT PROGRAM ASSUMPTIONS

Site (Square Feet)			10,000
FAR			3.0
Rentable Area (Square Feet)	100%	of GBA	30,000
Parking Spaces			60

BUILDING VALUE

Retail (33% Program)	\$5.50	per SF/Month (FS)	\$660,000
Residential (67% Program)	\$5.50	per SF/Month (FS)	\$1,320,000
Gross Potential Rent	\$5.50	per SF/Month (FS)	\$1,980,000
Losses to Vacancy	5.0%	of GPR	-\$99,000
Other Revenue (Parking)	\$50	per Space/Month	\$36,000
Gross Revenue			\$1,917,000
Operating Expenses	\$1.50	per SF/Month	-\$540,000
Net Operating Income			\$1,377,000
Building Value	5.25%	Capitalization Rate	\$26,228,571
Disposition Cost	3.0%	of Building Value	-\$786,857
Net Building Value			\$25,441,714

DEVELOPMENT COSTS

Construction Costs			
Basic Site Work	\$20	per site SF	\$200,000
Building Direct Cost	\$240	Cost/SF (GBA)	\$7,200,000
Parking Direct Cost	\$60,000	per Space	\$3,600,000
<i>Total Construction Cost</i>			<i>\$11,000,000</i>
Soft Costs			
Architecture and Engineering	10.0%	of Construction Cost	\$1,100,000
Entitlement	\$20	Cost/SF (GBA)	\$600,000
Other Professional Services	5.0%	of Construction Cost	\$550,000
Permits and Fees	\$40	Cost/SF (GBA)	\$1,200,000
Taxes and Insurance	2.0%	of Construction Cost	\$220,000
Tenant Improvements	\$40	Cost/SF (GBA)	\$1,200,000
Financing	4.0%	of Construction Cost	\$440,000
<i>Total Soft Costs</i>			<i>\$5,310,000</i>
Developer Costs			
Marketing/Leasing	3.0%	of 10-yr. lease value	\$564,300
Developer Fee (overhead)	3.0%	of Hard and Soft Costs	\$489,300
Developer Contingency	5.0%	of Hard and Soft Costs	\$815,500
<i>Total Developer Costs</i>			<i>\$1,869,100</i>
Total Development Cost			\$18,179,100

LAND VALUE

Developer Return Requirement	12%	of Development Cost	\$2,181,492.00
Residual Land Value	\$169.37	per square foot (GBA)	\$5,081,122
	\$22,133,369	per acre	

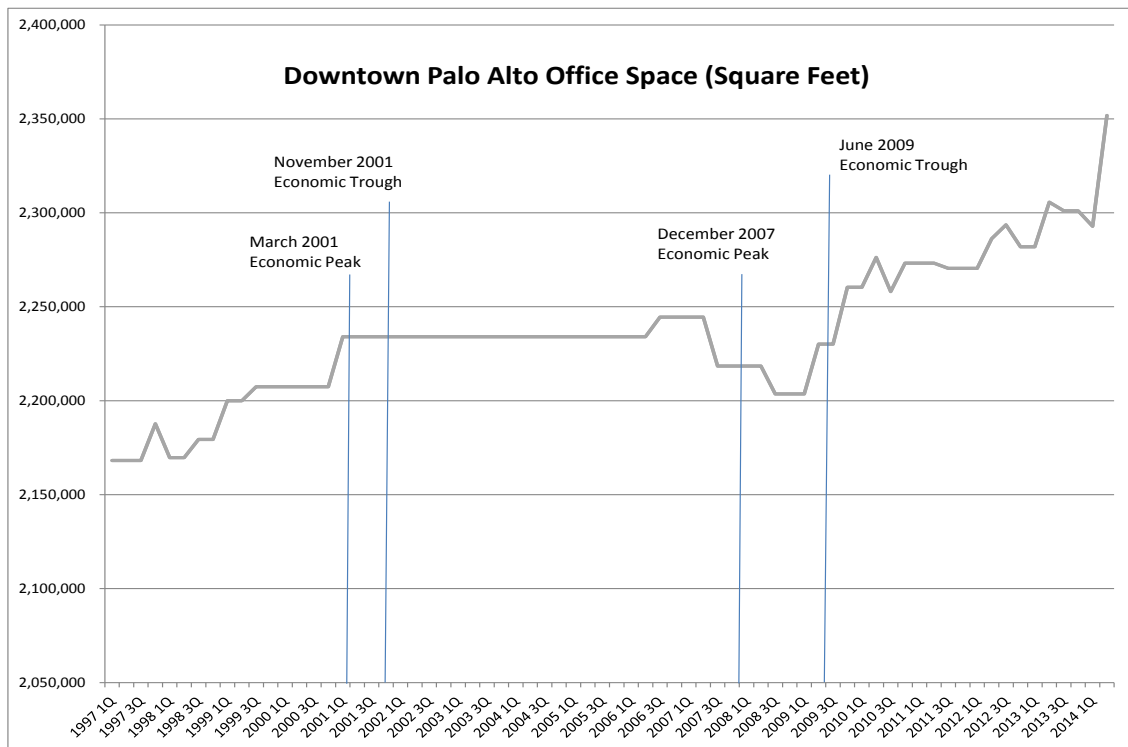
3.3 Development Potential

COMMERCIAL DEVELOPMENT OUTLOOK

Given current real estate market conditions, it seems likely that demand for office space will continue to drive demand for new development projects in Downtown Palo Alto for the foreseeable future, as evidenced by recent development projects, market trends, and the illustrative pro forma analysis presented above. Looking back at office-anchored development trends during the period from 1997 through 2014 (the period for which data are available) average annual net construction of office space was approximately 10,500 square feet. Further, considering macroeconomic cycles, including “peak-to-peak” cycles from 2001 and 2007 to today, office-anchored real estate construction averaged 8,900 square feet to 20,500 per year, respectively. These averages include both the lows and highs of past market cycles, providing a reasonable basis for forecasting.

Given historic market cycles and trends, it is reasonable to expect about 10,000 to 20,000 net new square feet of commercial development annually in the Downtown. However, given the phenomenal strength of the recent surge in development, it may be that the long run development outlook is closer to the lower end of the spectrum. **Figures 3-16** and **3-17** present the market data that comprise the basis for the commercial development projection.

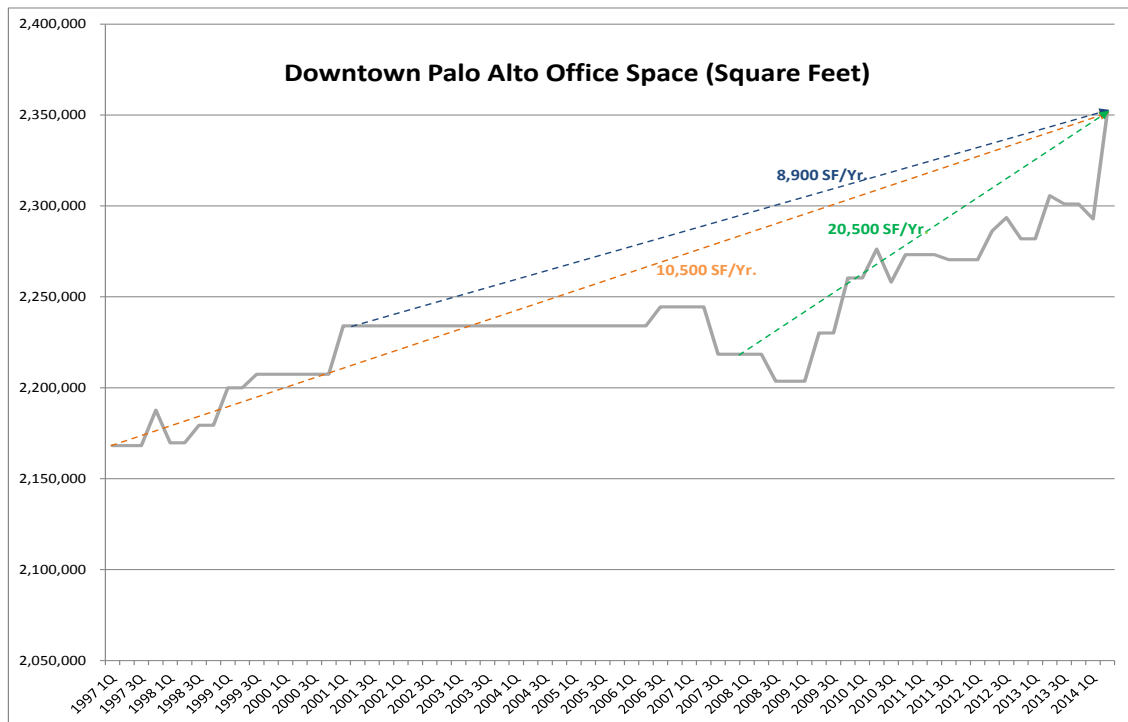
Figure 3-16: Office Market Historical Performance



Sources: Costar Group; NBER; and EPS

Figure 3-17: Office Market Performance/Forecast Basis

City of Palo Alto Downtown Development Cap Evaluation



Sources: Costar Group; NBER; and EPS

Assuming that office uses continue to drive development in Downtown Palo Alto and that space demand and development continue on the path charted during recent history, it appears reasonable to expect an average of about 10,000 to 15,000 square feet of additional commercial development annually in the Downtown area. Accordingly, about 100,000 to 150,000 square feet of new commercial space might be developed over the next 10 years. The current development pipeline of about 28,900 net new square feet represents about two to three years of supply.

While the forecast of 10,000 to 15,000 square feet per year may seem modest when compared to the major development projects that have occurred Downtown in recent years, there are a variety of factors that explain this projection of net new commercial space, including:

- **Existing Built Environment** – Downtown Palo Alto is essentially built out, with the best development opportunities found where there are underutilized sites (i.e., depreciated buildings and surface parking lots). There are very few unused sites for new development. Further, new development commonly replaces existing space, making the net addition of space less than the gross size of the new development project. In some years, major demolitions may occur prior to the completion of new projects.
- **Regulatory Landscape** - With commercial FAR typically limited to 1.0 in the Downtown, existing zoning limits the potential of commercial densification in the Downtown. While the TDR program allows for some additional bonus square footage to be gained, the remaining available TDR square footage pool is limited. Further, there is an active and engaged residential community, which increases the time, risk, and cost burden for new development projects, which slows the development of new space.

- **Market Cycles** – Real estate markets, like all markets, experience cycles of growth and decline. The development projection is calculated based on recent market cycles, and reflects average annual increases in commercial spaces during both periods of growth and decline.

There is some evidence that office users have, in some cases, sidestepped obstacles to office space development by converting retail spaces for office use (e.g., along Emerson St.). Indeed, this analysis finds that retailers are typically do not pay as much rent as an office tenant would. However, the City has some retail protection policies in place Downtown and in some locations retail may be more valuable than office. This analysis assumes that future office demand will be primarily met through new office development rather than through the conversion of existing space

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4 Conclusions and Policy Considerations

4.1 New Development: Supply versus Demand

An important conclusion from the research and analysis presented in the preceding chapters is that right now, as Palo Alto enjoys its position at the epicenter of Silicon Valley and the economic growth associated with it, the real estate market—particularly for office development—will support a very high amount of new development, even as redevelopment projects on currently built sites. **Appendix A**, which presents case studies of recent commercial development projects, shows that returns on investment are high enough that even a project that replaces an existing building with one that has just 10 percent more floor area is still profitable. While most redevelopment projects increase the floor area somewhat more than that, the general case can be made that the strong market has produced, and will likely continue to produce, viable redevelopment opportunities even in a largely built-out infill area like Downtown Palo Alto. Absorption trends (from the past several market cycles, not just this recent period of economic strength) indicate that Downtown could see an average of 10,000-15,000 square feet of new commercial development per year, or 100,000-150,000 square feet total over the next 10 years.

Therefore, if market conditions (the demand side of the equation) are not a significant barrier to new development, then capacity for new development (the supply side of the equation) may a better indicator of how much new development Downtown Palo Alto is likely to see in the coming years, especially if the economy remains strong. Development standards in place in Palo Alto's zoning ordinance limit the total floor area allowed on a given site. Not accounting for any constraints, the difference between how much floor area is allowed on commercially-zoned sites versus how these sites are developed today is 491,000 square feet. When possible "bonus" square footage (made available through the TDR program) is added, the total allowable increases to 612,000 square feet. However, various factors, including the age, use, and value of the current structure; parcel size; and remaining potential square footage allowed on a site-by-site basis, render the realistic development capacity in Downtown Palo Alto to be in the range of 53,400 to 146,000 square feet over 10 years, or 5,340-14,600 square feet annually. Having to provide on-site parking would likely reduce this number even further.

4.2 Potential Policy Categories

Just as in the 1980s, when the current development cap was established, it is within the City's power to "pull the policy levers" to control the pace, type, and/or location of development (and/or the impacts associated with that development) in Downtown Palo Alto to achieve a legitimate public purpose expressed by the community. This section presents several categories of possible

new policies for consideration, which decision-makers and the public may wish to explore in more depth in Phase 2 of this study.

ESTABLISHING/CONFIRMING THE POLICY OBJECTIVE

The original cap was established largely because of parking and traffic concerns. Before beginning to explore policy solutions, Palo Alto must answer: is that still the primary reason for controlling development Downtown? Then, if so, is a development cap the best way to address these concerns? If not, what might be better? If the community has a different objective, then other policies might be considered as well or instead.

The City should ensure that the public has had the opportunity to have this dialogue and that the policy objective has been clearly established before coming up with a recommendation. There have been a number of opportunities for key stakeholders and the public at large to weigh in on this issue through the various ongoing public processes such as the Comprehensive Plan Amendment/Our Palo Alto, improvements in parking management, debate regarding recent Downtown development projects, and dialogue surrounding the Downtown Cap Study itself. The community should have the opportunity to continue this dialogue during Phase 2 of the Downtown Cap study, to ensure that any policy solutions being considered reflect the public's priorities and desires.

POTENTIAL TYPES OF POLICIES FOR CONSIDERATION IN PHASE 2

This findings of this report, which concludes Phase 1 of the Downtown Cap Study, point to some broad categories of policies that the City Council and the community at large may explore in more depth in Phase 2 of the study. Policies that have the potential to shape the type, pace, location, and impacts of development in Downtown Palo Alto in the coming years can be grouped into the following categories:

1. Those that affect the Downtown Development Cap itself (for example, concerning the square footage limit, the timing, the uses affected, the area affected, or simply whether to retain the cap at all);
2. Those that affect development standards that apply to zoning districts in Downtown Palo Alto (for example, allowable FAR, allowable uses and changes of use, and bonus FAR); and
3. Those that affect the impacts associated with development (for example, parking, traffic, and community benefits).

There are a wide variety of possible policy mechanisms in each of these categories, which have the potential to impact the built environment in Downtown Palo Alto as well as the impacts—both desirable and undesirable—that accompany growth and change in any vibrant city center. Through the continuation of this effort, as well as the ongoing update to the Comprehensive Plan and other relevant planning and transportation studies, the Palo Alto community will have the opportunity to explore these in depth and arrive at an approach that will best serve the community's objectives for the Downtown.

Appendix A: Downtown Palo Alto Commercial Development Case Studies

Case studies of infill commercial development projects that have occurred in the Palo Alto Downtown in recent years help inform our understanding of current development economics. The case studies considered here were selected through a process that included identifying sites within the Downtown Primary Study Area where buildings had been demolished and redeveloped. Out of eight sites initially identified, six were selected for further analysis (102 University was redeveloped primarily as a residential use and 310 University was redeveloped due to a fire, and thus these two were excluded).

The case studies suggest that there is significant variability in the scale of redevelopment relative to the original magnitude of site improvements, ranging from 14 percent to about 12-fold increase in the building square feet. The average for all six projects is about a 315 percent increase in building square feet (this is reduced to 150 percent increase when the high and low outliers are eliminated) over the original structure, generally consistent with the pro forma examples above. **Figure A-1** summarizes the results of the six case studies, with further detail for each provided below. These case studies clearly indicate that developers will demolish and rebuild Downtown when additional site density can be accommodated.

Figure A-1: Summary of Case Studies

Case Study	Densification
<p>325 Lytton 31,688 SF built in 2009 Replaced 10,000 SF built in 1960</p>	217%
<p>101 Forest 15,861 SF built in 2010 Replaced 10,208 SF built in 1900</p>	55%
<p>265 Lytton (Webster Square) 30,754 SF built in 2012 (some historic structure retained) Replaced 18,161 SF built in 1948</p>	69%
<p>611 Cowper 30,000 SF under construction (delivery anticipated 2015) Replaced 2,208 SF built in 1989</p>	1259%
<p>537 Hamilton 17,150 SF under construction (delivery anticipated 2014) Replaced 4,560 SF built in 1960</p>	276%
<p>390 Lytton 20,564 SF built in 1999 Replaced 18,000 SF built in 1951</p>	14%
<hr/>	
Average	315%
Average (excluding tails)	154%

325 LYTTON



- 31,688 square feet built in 2009
- Replaced 10,000 square feet built in 1960
- Increase of 21,688 square feet (217%)

101 FOREST



- 15,861 square feet built in 2010
- Replaced 10,208 square feet built in 1900
- Increase of 5,653 square feet (55%)

265 LYTTON (WEBSTER SQUARE)



- 30,754 square feet built in 2012 (some historic structure retained)
- Replaced 18,161 square feet built in 1920/1948
- Increase of 12,593 square feet (69%)

611 COWPER



- 30,000 square feet under construction (completion anticipated 2015)
- Replaced 2,208 square feet built in 1989
- Increase of 27,792 square feet (1,259%)

537 HAMILTON



- 17,150 square feet under construction (completion anticipated 2014)
- Replaced 4,560 square feet built in 1960
- Increase of 12,590 square feet (276%)

390 LYTTON



- 20,564 square feet built in 1999
- Replaced 18,000 square feet built in 1951
- Increase of 2,564 square feet (14%)

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