

Conceptual Proposal for New Student Housing in San Luis Obispo

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This real property development project walked through the steps and procedures that are typical for real property development. The project focused on a conceptual multi-unit student housing project located near Cal Polys campus. The rental market in San Luis Obispo is very competitive and through market and financial analysis, it was determined that there is a demand for projects like the one proposed. The project walked through the processes associated with the financial analysis of a potential construction project in San Luis Obispo. The project identifies a site, creates a budget both for construction, development, and design costs, then analyzes them in a Pro Forma. The information is then compiled into a spreadsheet that produces cash flows, net operating income and a rate of return. The goal of the project was to create a product that had at least a 10% rate of return, which is the lowest rate generally acceptable to financial stakeholders on this type of project. This project cleared that mark with a 10.7% rate of return, with a potential to increase the rate if the purchase price of the property could be negotiated down or if the project team could increase net operating income.

Key Words: Pro Forma, Development, Finance, Housing, Rentals

Introduction

San Luis Obispo has a housing shortage that is caused by the high density of Cal Poly students and a finite level of student housing options. This project looked to solve that problem by proposing a new student housing development. Completion of this project required learning about the methods and practices owners/developers use to evaluate property and determine the feasibility of a construction project. Construction management education focuses primarily on the processes of successfully managing and executing a wide range of construction projects. The course work focuses very little on what occurs prior to the issuance of construction documents or after final completion. This project walked through the entire building process including, site acquisition, zoning, design constraints and construction type, preliminary construction estimating and financial analysis of a potential project. The construction aspect of the project only accounted for a fraction of the research as most time and resources were spent on financial analysis and preliminary design criteria necessary to accurately reflect the financial viability of a new construction project. The end goal was to produce a pro forma that showed a levered rate of return at or greater than 10%.

Market Research

The first step in real estate development is to conduct basic market research. Research in the San Luis Obispo community found that there is a need for more student housing in San Luis Obispo. Cal Poly has roughly 20,000 total students and only provides 7744 beds on campus as of Fall 2018. The University is in the process of adding more student beds and taking pressure off the local market, but even with the new on campus housing options, roughly 12,200 students still require housing in the local community. The university master plan also predicts the number of enrolled students will increase to 25,000 by the year 2035, further increasing the pressure on the local housing market (California Polytechnic State University-SLO, 2020). These numbers do not account for the additional students at Cuesta college, who also potentially impact the housing supply in the area.

The rental market in San Luis Obispo is interesting because many of the student tenants are technically qualified as low-income, but due to parental financial support, can sign leases atypical with low-income tenants. Cal Poly students also tend to pool rent together with multiple students living in rental units, which allows them to out compete typical single family residence tenants (County of San Luis Obispo, 2020). The area around the Cal Poly campus is home to numerous apartment complexes and buildings that provide a good gauge for standard rental rates in the area. The Academy at Chorro is a building with almost identical location and purpose to the proposed project and it was used as a model, both for conceptual design and the determination of rental rates for student housing in the area. Their website shows a typical room rents for roughly \$1300 a month (Academy Chorro, 2020).

Soft Costs and Development Consideration

The development costs are known colloquially as project soft costs (as opposed to construction hard costs). These are the costs associated with preparing the project documents, satisfying all the city zoning requirements and regulations, and any other cost associated with development that do not fall under the umbrella of construction costs (Figure 1). These costs can vary, and like many costs in the development process, they are often represented as a percentage of construction hard costs for the purposes of financial analysis. The most significant assumption is the 23% soft cost allocation that was determined through meetings with local developers. This is to say that the soft costs will be roughly 23% of the hard costs of construction. This number was well below the originally assumed 30%.

Development Costs	
Land Cost	\$ 6,000,000
Construction Cost	\$ 251
Gross SF	60,000
Efficiency	85.0%
Net SF	51,000
Hard Cost	\$ 15,060,000
Soft Cost %	23.0%
Soft Cost \$	\$ 3,463,800
Total Development Cost	\$ 24,523,800

Figure 1. Development Cost Assumptions

Entitlements typically are the most difficult aspect of this phase of development. Proposing a development like this to the city planning commission and receiving their approval all depends on how they believe it will impact the community around the development. As stated above, San Luis Obispo's housing market is overburdened with student renters from both Cal Poly and Cuesta and the city has even stated their intent to streamline the process of entitling developments like the one proposed that increase the rental housing supply in the city of San Luis Obispo (San Luis Obispo Council of Governments, 2008).

Site Identification

The site chosen for this project is the parcel at the corner of Meinecke and Santa Rosa streets in San Luis Obispo (See Figure 2). According to google maps, the site is a 20-minute walk to campus and a 5-minute walk to University Square, a local shopping center with grocery, convenience stores and restaurants. The parcel on the corner is much larger than any of the parcels in the area at almost 100,000 total square feet. The San Luis Obispo county parcel map estimates the property to be valued at \$3.7 million and the existing improvements to be valued at \$1.4 million dollars. The holistic analysis of the proposes project and its financial particulars will determine the accuracy of these estimates and give an idea of a fair acquisition price for the site (Bordonaro, 2020).

Site Plan and Conceptual Design

The next step in the process is developing a site plan and a conceptual design for the project. The idea for the project is to construction an apartment complex for students that will both serve to mitigate the effects of the student population on the local housing market and generate a profit for the investors and stakeholders. The city of San Luis Obispo has an extensive list of regulations and requirements that govern the basic design of a building. Through the development of the conceptual design, it was discovered that the regulations with the largest impact on conceptual design were density regulations, parking requirements, setbacks, and lot coverage.

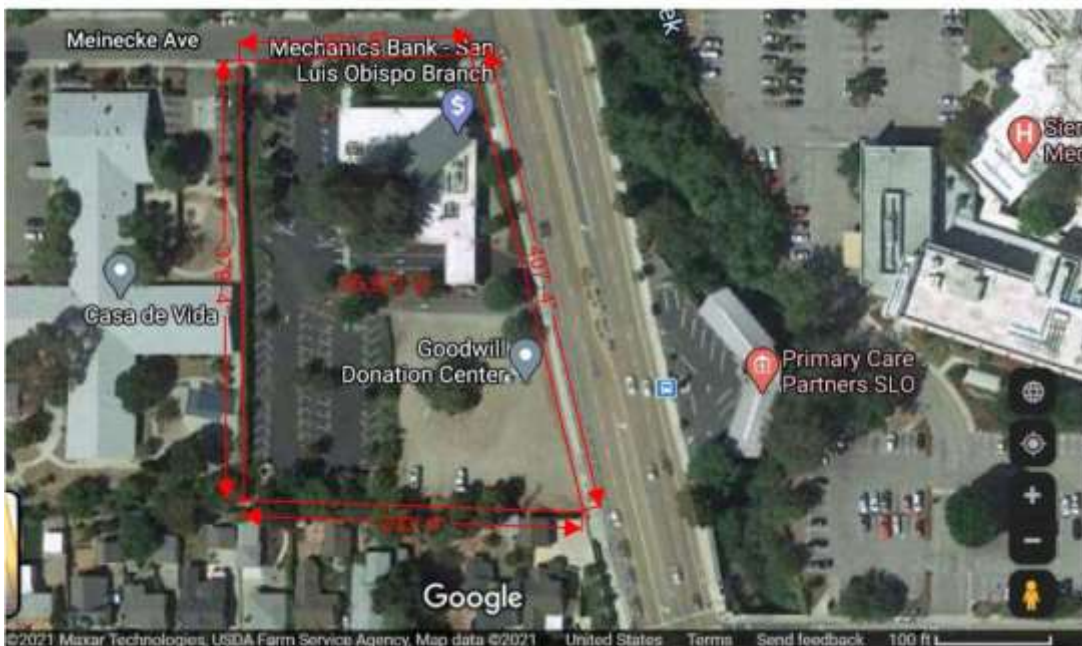


Figure 2. Site map and Location

The density regulation had the largest impact on the project both from a design standpoint and a financial analysis standpoint. The purpose of this project is to provide more student housing and generate a profit; the most efficient method of accomplishing these goals is to maximize the number of units and therefore tenants in the building. R-4 (High Density Residential) zoning regulations for the city of San Luis Obispo dictate that the maximum units per acre is 24 units (See Figure 3). The site for this project is just over 2 acres which allows for 48 units in the building. 1 unit is defined as containing two or less bedroom which places the total occupant capacity at 96 occupants.

Lot coverage, parking and building height were also key considerations when producing preliminary site plan/design. The maximum building height was limited to 35 feet which allows for 3 stories of building construction. Each bedroom required .75 parking spaces and 1 bike rack space per bed. The building is only allowed to cover 60% of the lot and must be setback from the property line by at least 10 feet. Parking space ended up being one of the most influential factors on preliminary design as well as lot coverage (Davidson, 2019).

Development Standard	R-4 Zone	Additional Regulations
Maximum Residential Density	24 units/net acre	See also Section 17.70.040 (Density). Regardless of the density calculation, at least four density units shall be allowed on each parcel; except this shall not apply to common interest subdivisions.
Minimum Setbacks		
Front	10 feet	See also Section 17.76.030 (Front Yard Paving)
Interior Side and Rear	See Section 17.22.020.B, Table 2-11: R-4 Zone Minimum Interior Side and Rear Setbacks.	
Corner Lot - Street Side	10 feet	
Maximum Building Height	35 feet	See also Sections 17.22.020.B (Interior Side and Rear Setback Standards) and 17.70.080 (Height Measurement and Exceptions).
Maximum Lot Coverage	60%	See also Section 17.70.120 (Lot Coverage)
Minimum Lot Area	5,000 square feet	See also Section 16.18.030 (Subdivisions: Lot Dimensions)
Edge Condition Requirements	See Section 17.70.050 (Edge Conditions)	

Figure 3. Regulations for high density residential

Construction Budget

The development of a construction budget with just a concept and without any design documents is difficult. The developer often requests the costs at this stage to be stipulated in a per square foot basis to input this into the pro forma. Specialty Construction Inc. (SCI) was the local company used for this project to determine the construction budget. They cautioned against the use of simple square foot estimates citing their inaccuracy, and instead presented a breakdown of various assembly costs per square foot or lump sum costs for various aspects of the project. Contractors use their own historical data and their knowledge of the local construction market to determine these prices.

The data given by SCI was compiled into a per square foot cost, as that is the unit of input for the financial calculations. Due to the proprietary nature of the company's historical cost data, the breakdown of line items and assembly costs will not be included. In lieu of historical data, rough assumptions have been made regarding the assumed cost of large work packages (Figure 4) The estimate ended up coming to \$15.06 million, which was under the price \$22.8 million that was assumed for construction hard costs at this project's inception. The cost per square foot also includes the demolition of the existing structure and the necessary site improvements and parking area construction, as well as building construction. Construction budget was the largest and final piece of costs data needed to create the development cost breakdown.

Budget Items	Estimated Cost
Demolition	\$ 200,000
Site Work (Clearing, Grading etc.)	\$ 150,000.00
Foundation/Concrete	\$ 3,750,000.00
Framing (Type V)	\$ 5,250,000.00
MEPs	\$ 4,500,000.00
Finishes	\$ 1,210,000.00
Total Cost	\$15,060,000.00

Figure 4. Cost Breakdown

Financial Analysis

The final deliverable for this project is a pro forma that accounts for all the potential costs, risk and revenue potential associated with this conceptual development (Appendix A). The purpose of the market research, development analysis and construction budget are to determine the values of the inputs for the pro forma spreadsheet and produce the relevant financial metrics to present to potential investors for the project. The process of financial forecasting requires developers to use previous knowledge and existing data to make assumptions regarding various inputs to the spreadsheet. This pro forma breaks down the project cash flow year by year. The major assumptions for this document were that the construction period would take 2 years and there would be no revenue in those years. The property is assumed to be fully operational and generating revenue by the beginning of year 3.

Unit Mix

The primary source of revenue from this project will be rental income from tenants. The template used for financial analysis on this project allowed experimentation with different unit mixes. The final determination was to use all 48 units as 2 bedroom and rent for \$2800 per unit. The primary influence on this unit mix determination was city zoning laws. This project was limited to 24 units per acre, which allowed 48 units for this project. The problem with inserting 3-bedroom units is that they count as 1.5 units and there was no obvious benefit from a financial analysis perspective to include them in the unit mix.

There is also some consideration by the city for below market rate units. San Luis Obispo, like many municipalities, will grant bonus units if some of the units provided are offered at below market rate. There is a minimum number of below market or affordable units to receive this bonus, and the bonus allows the developer to exceed the standard 24 units/acre limit set by the city. This project did not account for any affordable units, but it is worth noting that their addition could benefit the developer/owner by allowing more total units and there for create a more profitable venture.

Construction Loans

Construction loans and the terms of financing a new apartment complex are case specific and often depend on a multitude of factors. In the interest of keeping the scope of this project manageable, several assumptions regarding the terms of a potential loan for this project were made (Figure 5).

The first assumption in the loan section of the pro forma is that it will be a 30-year fixed rate loan. Realistically the interest rate could change year by year depending on the terms of the loan, but for simplicity's sake the loan was assumed to be a fixed rate of 3.5%. This is an aggressive estimate for interest an interest rate, but the assumption is that the demand for housing and location of the project will entice the lending agency to offer a more favorable rate.

The next assumption is the I/O or interest only period. This is the period where the borrower only repays the interest on the loan and not the principal. This period is assumed to last two years which is the projected length of construction. The reasoning for this is that there will be no revenue during construction and the principal can be repaid once tenants begin to move in and the project begins to generate revenue.

Finally, the most significant portion from a financing perspective is the LTC section or loan to credit. This determines how much of the total loan amount must be a down payment. The more financial risk in the project will lead lending agencies to require a larger down payment. The reason this is the most significant factor in the loan calculations is that it will determine how much cash the developer must acquire to begin the project. There are various ways in which these funds can be raised from personally financing the project, to asking investors to assist with project financing. As stated above, this project did not dive into the details of the terms of a potential loan, however it is worth noting the assumptions made and the significance of each assumed item.

<u>Loan</u>	
Amortization	30 yrs
Interest Rate Yr 1	3.50% 6 Mo. Libor + 2.5%
Interest Rate Yr 2	3.50%
Per Financing	3.50%
I/O	2 yrs
LTC	75%
Loan Amount	\$ 18,392,850
Equity	\$ 6,130,950

Figure 5. Loan Assumptions

Net Operating Income

Net operating income (NOI) is the gross revenue minus the operating costs of the building and repayment of construction loans. The construction period is assumed to take the first two years of the project. These two years will see only expenses as construction loans are paid back and no income is recorded, as there will be no tenants to pay rent. Year 3 and 4 will be the first year that income will be recorded, and this is known as the stabilization period. This period has a higher vacancy rate than years 4-10, as the assumption is not all the units will have tenants immediately. For this project, we assumed the vacancy during the stabilization period would be lower than the typical 10% assumption due to the high demand for student housing.

Net operating income accounts for the operating costs associated with maintaining and operating an apartment building from an ownership perspective. The template used to analyze this project broke down operating costs as a percentage of total revenue. The percentages used were a ballpark estimate and included items such as: repairs and maintenance, management fees, utilities, insurance, and taxes (Figure 6). The operating expense input also accounted for potential income from laundry machines in the buildings and potential vacancies. As stated above, the only assumption changed from the template provided by a local developer was the vacancies, and the assumption is the demand for student housing will drive vacancy lower than what is typical for multi-family residential development.

Operating	
% Rent Increase YOY	3.0%
Vacancy	5.0%
Stabilization Vacancy Year 3	5%
Stabilization Vacancy Year 4	5%
Operating Expenses	30.0%
Laundry	1.25% % of Net Rent
Property Mgt. Fee	5.0% % of Gross Potential Rent
Utilities	3.5% % of Gross Potential Rent
Repairs & Maintenance	3.5% % of Gross Potential Rent
Payroll	3.5% % of Gross Potential Rent
Marketing	3.5% % of Gross Potential Rent
General Administrative	3.5% % of Gross Potential Rent
Real Estate Taxes	3.5% % of Gross Potential Rent
Insurance	3.5% % of Gross Potential Rent
Replacement Reserves	3.5% % of Gross Potential Rent

Figure 6. Operating Cost Assumptions

Capitalization Rate and Sale

The template used for this project assumed that the property would be sold in year 10 at what is known as a “5 cap”. A “5 cap” or 5% capitalization rate is used in real estate to determine the sale value of the property. The capitalization rate is determined by dividing the NOI of the property by its market value. In this case, the template works backward from a predetermined cap rate at sale to determine the market value and therefore sale price of the property. The sale value is determined by dividing the net income in the sale year by the cap rate. This project at a 5 cap has a sale value of \$24.9 million dollars.

Rate of Return and Final Analysis

The levered rate of return on a development considers the NOI, projected sale value and loan repayments to determine a rate of return on the project. Any positive rate of return suggests that the project is viable, however the larger the percentage the more profitable the project. The goal for this project was to get the levered IRR to at or around 10%, with all the assumptions and inputs mentioned above, this project’s levered IRR came out to only 10.7% (Appendix A). This is the minimum rate of return that is considered acceptable for this type of development and it would be interesting to see how investors would feel about this rate of return. Many of the inputs used in this Pro Forma were on

the conservative side, so there is also room to cut down on cost while maintaining a similar NOI, and therefore creating a more attractive rate of return for investors.

Conclusion

The most significant metric of a pro forma is the levered rate of return on the project. The goal for this project was to get the levered IRR to at or near 10%. The project with the given particulars above came out to a 10.7% levered IRR. This suggests that the project is viable with the current inputs and market conditions to the pro forma. The purchase price of the likely the primary governing factor on the viability of this project. The current purchase price is based on the city assessor's map which estimates lot values based on location and improvements. This price does not produce a desirable rate of return, however, reducing the purchase price to \$ 4 million dollars produced a rate of return of 13.6% which is a much more attractive rate of return for potential investors. That price point may or may not be acceptable to the current property owner but paying \$ 4 million would take this from a project that is somewhat desirable to investors, to a project that will easily raise funds for its implementation and execution. The final rate of return could also be increased if NOI for the project increased as well. The process of increasing NOI for this development would involve increasing rent prices and therefore revenue, and/or decreasing expenses such as construction hard costs, cost of entitlements, or obtaining a more favorable interest rate on the construction loan. There could also be consideration for changing the development from multi-family to mixed use to increase revenue. Any combination of these changes could increase the rate of return and create a more desirable investment opportunity.

References & Appendix

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Appendix A

Year	1	2	3	4	5	6	7	8	9	10
Land Cost	(\$6,000,000)									
Hard Cost	(\$7,530,000)	(\$7,530,000)								
Soft Costs	(\$1,731,900)	(\$1,731,900)								
Total Development Costs	(\$15,261,900)	(\$9,261,900)								
NOI	\$0	\$0	\$1,102,677	\$1,135,758	\$1,169,830	\$1,204,925	\$1,241,073	\$1,278,305	\$1,316,654	\$1,356,154
Multifamily Sale Amount	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$27,936,770
Unlevered Cash Flow	(\$15,261,900)	(\$9,261,900)	\$1,102,677	\$1,135,758	\$1,169,830	\$1,204,925	\$1,241,073	\$1,278,305	\$1,316,654	\$29,292,924
Unlevered IRR	5.8%									
Project Cash Flow	(\$15,261,900)	(\$9,261,900)	\$1,102,677	\$1,135,758	\$1,169,830	\$1,204,925	\$1,241,073	\$1,278,305	\$1,316,654	\$29,292,924
Add Back In Loan Draws	\$9,130,950	\$9,261,900								
Subtract Interest Payments			(\$638,123)	(\$625,569)	(\$612,568)	(\$599,104)	(\$585,162)	(\$570,724)	(\$555,772)	(\$540,288)
Subtract Loan Repay - Principal	\$0	\$0	(\$352,982)	(\$365,537)	(\$378,538)	(\$392,001)	(\$405,944)	(\$420,382)	(\$435,333)	(\$450,817)
Subtract Loan Repayment Final	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	(\$15,191,316)
Levered Cash Flow	(\$6,130,950)	\$0	\$111,572	\$144,652	\$178,725	\$213,820	\$249,968	\$287,200	\$325,549	\$13,110,503
Levered IRR	10.7%									