HR&A Analyze. Advise. Act.
700 South Flower Street, Suite 2995, Los Angeles, CA 90017
T: 310-581-0900 | F: 310-581-0910 | www.hraadvisors.com

MEMORANDUM

To:	David Martin, Director of Planning, City of Santa Monica
From:	HR&A Advisors, Inc.
Date:	August 21, 2020
Re:	**Financial Feasibility Review of the Miramar Hotel Redevelopment Project**

INTRODUCTION

At your request HR&A Advisors, Inc. ("HR&A") performed an expedited independent review of a confidential financial feasibility analysis and supporting documentation provided to HR&A by The Athens Group (the "Developer") for the proposed Miramar Hotel Revitalization Project (the "Project") in the City of Santa Monica (the "City"). The Project includes an expansion of facilities and services in the existing Miramar Hotel, plus 60 new luxury condominiums, new open space amenities, and the potential for up to 48 units of affordable housing to be developed on a Second Street site now used for hotel surface parking. As we understand it, the financial feasibility analysis provided by the Developer represents information that figures in negotiations between the Developer and City staff about "community benefits" that City decision makers may use in supporting the scale and range of community benefits recommended for the Project.

The financial feasibility analysis provided by Developer, even without the specified community benefits, shows a profit margin that is well below the minimum acceptable real estate industry benchmark for a development of this type. As further discussed below, HR&A's independent review of the Developer's financial feasibility analysis supports a higher profit margin investment return threshold than portrayed by the Developer.

BACKGROUND

The Developer's confidential financial feasibility analysis takes the form of a static pro forma financial model (the "Financial Model"), or snapshot of Project development costs, revenues and operating costs and net sale value for all aspects of the Project and generates the resulting profit margin measured in the Project's fifth operating year, by which time it is expected to have achieved stabilized hotel operations, initial sale of all condominiums and stabilized occupancy of the affordable housing units. The Financial Model includes detailed construction and related "soft costs," financing costs and projected revenues and annual operating cost for the revitalized hotel, new condominiums, hotel retail components, and resulting net sale value as compared with total development cost. It was prepared in two versions: first without and then with proposed land and other financial contributions to help fund a minimum of 42 affordable housing units, along with costs for certain additional community benefits that emerged from negotiations as of the date of HR&A's analysis in early August (i.e., historic preservation components, publicly accessible open space, and environmentally sustainable design). The confidential supporting documents contain analysis for key program, cost and revenue assumptions used in the Financial Model, including detailed construction cost estimates for all Project elements.

In addition to reviewing all supporting documentation provided by the Developer, HR&A validated all Financial Model calculations and performed, within the time available, independent review of certain real estate financial metrics used in the Financial Model. The Developer was responsive to all HR&A questions and requests for additional information during the course of our review.

FINDINGS

The Developer's Financial Model utilizes a developer profit margin threshold as the key investment return metric to determine Project feasibility, which is suitable for this type of real estate development (i.e., net sale value of the completed Project hotel and condos, minus total development cost, divided by total development cost). The Financial Model without the specified community benefits shows a profit margin of 6.7 percent that is well below the applicable minimum acceptable real estate industry benchmark of 12.0 percent. The Developer notes that ownership is willing to accept a relatively low profit margin because of the uniqueness of the Project and a long-term vision for the property, but that the even lower profit margin after accounting for the costs of the identified community benefits (i.e., 2.2%) may not be acceptable.

While we do not take issue with the construction cost estimates provided by the highly experienced Morley construction company and Community Corporation of Santa Monica, we do have concerns about certain other factors reflected in the Financial Model that have a significant impact on the low profit margin results. These issues are discussed below.

- ***Including a Current Asset Valuation as a Development Cost.*** The Financial Model includes an estimate of the current market value of the existing hotel as a "development cost," which has a very large impact on the profit margin calculation. This would be appropriate if the Project site were being acquired by a new owner/developer, but this is clearly not the case here, since the existing hotel has been under the same ownership that proposes to now undertake the Project, since 2006. The Developer determines the value for the existing hotel by taking an average price per key (or room) of luxury hotel sales for 14 recently-completed or renovated projects sold between 2015 and 2019 in markets that include San Francisco, West Hollywood, Beverly Hills, and Malibu, and multiplying by the existing 301 hotel keys. The resulting asset value estimate is $356 million.

  If some value for the existing hotel is included in the Financial Model as an equity contribution to the Project, we believe there are other values that may be more appropriate for this Project. One would be a capitalized value, as opposed to a sales comparables approach, considering that there is specific data available about the operating revenues and costs of the existing hotel. If an income capitalization approach is used, even using a very aggressive 4.5 percent cap rate derived from the cited hotel sale comps, and the existing hotel's average annual net operating income over the last few years (i.e., pre-COVID-19 pandemic), we estimate the valuation of the current asset would be 13 percent lower than the Financial Model value (i.e., about $309 million). The Financial Model also ignores the fact that a potential buyer would need to account for significant capital reserves to undertake any renovation or deferred maintenance needed, likely further depressing the current valuation.

  It should also be noted that the existing hotel will immediately lose most of its current value once Project construction commences, since all of the existing improvements, other than the Palisades Building will be demolished, and even that remaining building will be substantially rehabilitated. Accordingly, we believe that any allowance for equity contribution for the existing hotel should be limited to implied land value or no more than a hotel valuation based on capitalized net operating income. Although an appraised land value is not available, using the City-commissioned opinion of value for the Second

Street parking lot (i.e., $850/land square foot) and increasing it by, say, 17 percent (i.e., to $1,000 per square foot) to account for its Ocean Avenue/Wilshire Boulevard location and much larger land area, would produce an estimate of about $191 million, which is about 46 percent lower than the value used in the Financial Model.

Either alternative existing asset valuation approach would improve the resulting Project profit: 12.4 percent using the capitalized NOI approach and 30.0 percent using the approximated land value approach, without the specified community benefits; with the specified community benefits the resulting profit margin would be 7.5 percent using the capitalized NOI approach and 23.5 percent using the approximated land value approach.[1]

- ***Including Lost Net Operating Income as a Development Cost.*** The Developer has also included an estimate of $35 million in foregone net operating income (NOI) during three years of Project construction as a Project "development cost," in addition to the Hotel Contribution Value discussed above. Including this cost would only be appropriate if the Hotel Contribution Value is reduced to implied land value. Otherwise, any other approach to including a Hotel Contribution Value already accounts for near-term NOI, so including both double-counts consideration of foregone existing hotel NOI. Eliminating this smaller assumed development cost would also improve the profit margin results, although to a lesser degree than adjusting the existing asset value assumption (i.e., 10.5% without the specified community benefits and 5.8% with the specified community benefits).
- ***Potentially Higher Condominium Sale Prices.*** The Developer's stated condominium sales price projection per square foot is based on a survey of 2019 luxury condominium sales along Ocean Avenue. The resulting average price (i.e., $1,700) is then increased by 35 percent to reflect a premium for hotel services that will be available to condominium buyers, and then escalated by three percent per year to the year of initial sales in 2026 (i.e., $2,746 per square foot). While this clearly results in average pricing well above most sales on Ocean Avenue to date, the unique features of the Project, its location facing the ocean across Palisades Park, all the other attributes of a Santa Monica location, and the unique financial profile of likely buyers for the Project's condos, suggests that average pricing could be higher. This view is based on three currently listed condo sales along the length of Ocean Avenue that are in the $2,000 to $3,000 per square foot range, which is similar to closed sales transactions during the past year for some luxury condominiums in and around Beverly Hills. Applying the same assumed hotel services premium and inflation factors to a base price of $2,000 per square foot today (and a resulting $3,224 per square foot value in 2026), for example, would improve the Project's profit margin result to 14.0 percent without the specified community benefits, and 9.3 percent with the specified community benefits. But we acknowledge that the reverse is also true: inability to achieve the Developer's projected price would reduce profit margins below the results reported by the Developer.
- ***Conservative Hotel Cap Rate Used in the Completed Project Value Calculation.*** The Financial Model uses a "terminal" cap rate that we regard as very conservative in calculating the value of the completed Project, which figures in the profit margin calculation. While it is customary for feasibility analysis to use a higher cap rate to estimate the value of a sale at the end of a holding period in the future, as compared with a cap rate derived from a sale today, to account for a variety of risks and uncertainty over that time period, we find that the spread between current cap rates for a comparable luxury hotel sold today (i.e., 4.5%) and what the Financial Model uses in calculating a sale value in the Project's fifth operating

[1] All profit margin changes also include associated reductions in Project financing costs, which are based in part on including the Hotel Contribution Value as a financed development cost.

year (i.e., 5.25%) is overly conservative. Although the Project assumes a higher level of financial performance and a higher service quality rating than has ever been achieved by a luxury hotel in Santa Monica, it does so based on a long history of successful hotel performance at the Project site, and in what will likely return to being one of the strongest hotel markets in the Los Angeles region. In our view, this mitigates some of the risks supporting the Developer's assumed terminal cap rate. Therefore, if even a somewhat lower terminal cap rate, of say, 5.0 percent is used, the completed Project value will increase and so will resulting profit margins (i.e., 9.8 percent without the specified community benefits and 5.3 percent with the specified community benefits).

In conclusion, revising any one of the questionable assumptions discussed above, which either reduces total development cost or increases net Project value, would result in profit margins without and with the specified community benefits costs included that are moderately to much higher than the results in the Developer's Financial Model (i.e., 6.7% and 2.2%, respectively); in some cases the changes would result in profit margins that exceed the minimum industry profit margin threshold (12.0%) for this type of luxury hotel and condominium development.