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# MEMORANDUM

for

## THE CITY OF CAMBRIDGE

Regarding Financial Analysis for the BMR Zoning Petition

Final Memo 12/15/2020

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### ● EXECUTIVE SUMMARY

**ZONING PETITION.** On March 11, 2020, BioMed Realty, L.P. (BMR), submitted a rezoning petition to amend the Zoning Ordinance and the Zoning Map to create a new Planned Unit Development District entitled “Canal District Kendall” (PUD-CDK) located along Third Street in Kendall Square, between Linskey Way and the Broad Canal. The proposed zoning would enable the development of the vacant lot at 585 Third Street, either alone or combined with the adjacent gas transfer station (GTS) owned by Eversource at 330 Third Street.

As requested by a recent City Council Policy Order, an economic analysis was conducted to assess the potential change in property value from this rezoning petition and estimate the value of public benefits to be delivered in tandem with the new development allowed by the petition. Since many factors impact the final project value – factors that may change before the final project is complete - the estimates used in this memo are indicative of the magnitude of the zoning petition’s impact and not be construed as a precise determination of this impact.

**METHODOLOGY.** The analysis herein presents the results of a financial model used to estimate the project value to a developer under (a) the development scenarios that could occur under current zoning and (b) the scenarios that could occur with the zoning petition. Six development scenarios were analyzed: (a) four scenarios under current zoning with residential or office/lab alternatives at 585 Third Street with and without the GTS; and (b) two scenarios for the alternative development outcomes enabled by the zoning petition at 585 Third Street with and without the GTS site. Since the analysis indicated that the residential scenarios were not financially viable, the impact of the zoning petition was only considered in comparison with the existing zoning office/lab development scenarios.

**IMPACT ON PROJECT VALUE.** The increase in allowable office/lab development under the zoning petition will result in an increase in the net value of real estate that could be built. This net value increase represents (a) the change in total project value between scenarios under current zoning and the zoning petition (b) minus the increase in their respective development costs. Using developer investment return requirements, the zoning petition would result in an estimated \$88 million net value increase without the GTS site, and an estimated \$98 million in net value increase with the GTS site.

**DEVELOPER COST FOR BENEFIT COMMITMENTS.** BMR has committed to multiple benefits in conjunction with the zoning petition, including a new arts and cultural center, relocation of the Eversource GTS site, a new indoor public space and several free or subsidized services. The estimated value of the public benefits is \$19.4 to \$30.3 million for development without the GTS site and \$66.9 to \$80.7 million with the GTS site, based on projected costs to the developer of fulfilling the proposed commitments.

## ● INTRODUCTION

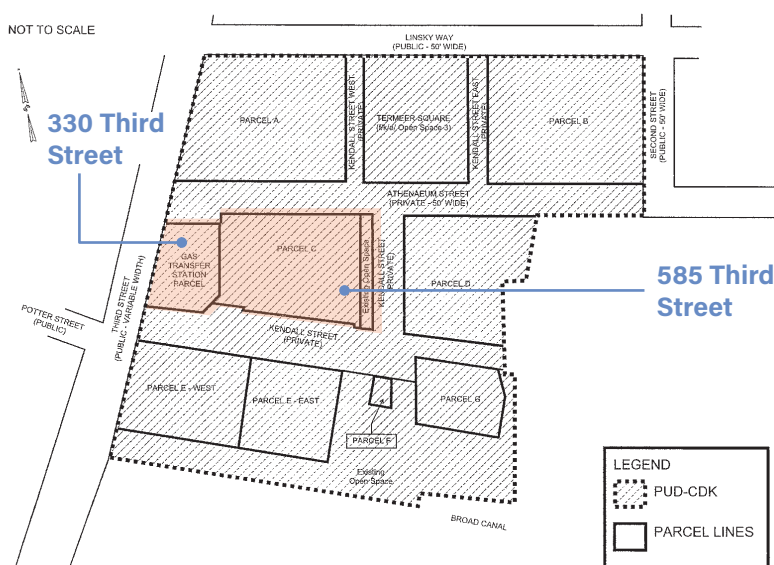
In 2019, the City Council adopted a Policy Order requesting an economic analysis of rezoning petitions that increase the development potential of sites by more than 50,000 square feet (SF). The goal of this analysis is to assess the potential change in property value from the zoning petition and estimate the value of public benefits to be delivered in tandem with new development allowed by the petition. In 2020, Cambridge hired Karl F. Seidman Consulting Services and Karp Strategies (together, the Consulting Team) as an independent third-party to prepare this analysis.

## ● ZONING PETITION

On March 11, 2020, BioMed Realty, L.P. (BMR), submitted a rezoning petition to amend the Zoning Ordinance and the Zoning Map to create a new Planned Unit Development District entitled “Canal District Kendall” (PUD-CDK) located along Third Street in Kendall Square, between Linskey Way and the Broad Canal. The proposed zoning would enable the development of the lot at 585 Third Street, either alone or combined with the adjacent gas transfer station (GTS) owned by Eversource at 330 Third Street. Several proposed revisions to the original petition were made following the Planning Board public hearing held on September 14, 2020. In the petition’s current form, the anticipated new development would include up to 525,000 SF of office and/or laboratory space and would be required to provide an arts and cultural use on the site.

This memo summarizes the methodology and results of the economic analysis conducted to assess new development enabled by the zoning petition, inclusive of development on 585 Third Street only (without the GTS site) and on a larger combined parcel with the GTS site (See Figure 1).

**Figure 1. Map of Properties Considered in this Memo**



## METHODOLOGY + DATA SOURCES

### Process

To complete its analysis, the Consultant Team employed the following four-step methodology:

**STEP 1** In conjunction with the Cambridge Community Development Department, **the development scenarios that could occur under current zoning and with the zoning petition were determined.** These scenarios are presented in the next section. The changes in the type and scale of development *with* the petition, along with the resulting differences in development revenue and costs between current zoning and petition scenarios, formed the basis for estimating the petition's economic impact on project value. This initial step also identified the relevant public benefits expected to occur with the zoning petition that required valuation.

**STEP 2** **The key financial parameters needed to complete the economic analysis of development scenarios were identified and estimated.** Examples of these parameters included rental and vacancy rates for the new construction housing and office/lab space in Kendall Square, construction and other development costs, the cost of capital and financial returns for comparable development projects, and costs associated with providing public benefits. To estimate these parameters, the consultants reviewed real estate market reports from Costar and other firms, City of Cambridge reports, analyzed building permit construction cost data for comparable projects and conducted twenty interviews. These 20 interview sources included the Biomed Realty Trust/Redgate development team for the project site, commercial real estate brokers and developers with experience in Kendall Square, general contractors with local experience, operators of arts and cultural centers and theaters, developers and contractors, and a winter market operator in Cambridge. Detailed information on the financial parameters used in the analysis are provided in an appendix.

**STEP 3** **A financial model was prepared** and used to estimate the net operating income, project development costs ("development costs") and resulting project value under six development scenarios (four with current zoning and two under the zoning petition).

- **Project Value:** The project value for a scenario was estimated based on dividing its projected net income by a required rate of return threshold for the type of project. A developer will only undertake or buy a project if it meets their standard for an investment return and they will fund a project based on this rate of return. For example, a developer with a 10% annual rate of return threshold will invest \$10 million to build a project that is expected to generate \$1 million in net income annually ( $\$1 \text{ million} / .10$ ) since the project will provide the developer income equal to 10% of its total investment each year. More explanation of these return thresholds is provided below.

- **Development Costs:** In addition to the project value, the total project development costs for each scenario were estimated based on data about construction and project soft costs (i.e., legal, engineering, design, insurance, taxes, fees, etc.) gained for comparable projects and from interviews.<sup>1</sup>
- **Net Value Increase:** The net impact of the zoning petition was calculated as the difference between the change in project value and the change in total project development costs between current zoning and petition scenarios.

## STEP 4

**The cost for developer benefit commitments were estimated** using information and financial parameters obtained from BMR and other sources.

### Return Thresholds

As noted above, return thresholds were used to estimate the project value for different development scenarios. Project developers face considerable financial risk when undertaking a project. Risks faced by developers include delays in obtaining project permitting, securing financing, and obtaining tenants for the project, which increase development costs and delay the receipt of income, all of which reduce investment returns. Another risk is unexpected changes in construction, financing or other costs which can increase development costs and lower actual returns. Finally, obtaining lower rents than expected due to changes in demand for space or increased competition from other developments will reduce project income and investment return.

Due to the time and risk involved in development, developers have a high return threshold, currently in the 6 to 7% range for Cambridge, depending on the development type and location. Investors, on the other hand, would acquire a property after it is built, leased and occupied, with the future income - at least over the lease terms - already established. Consequently, investors face less financial risk and have a lower return threshold, currently in the 4% to 5% range for Cambridge. The return threshold for a project developer was used for this analysis since it reflects the current status and risk for the project with BMR as the site developer still at an early stage of development in which it faces considerable risks to complete the project with the projected costs and rental income.

### Results

The results from this research and financial model analysis are presented below, beginning with an explanation of the development scenarios, and followed by the estimates for the zoning petition's impact on the financial value of the development and the value of proposed public benefits. All valuations and cost estimates are as of Third Quarter, 2020.

Since many factors impact the actual final project value, and they may change before the final project is completed, the estimates in this memo represent approximations based on current market and cost conditions. They are indicative of the general magnitude of the zoning petition's impact - not a precise determination of this impact.

## ● DEVELOPMENT SCENARIOS

### Current Zoning

The site is currently zoned Office 3A (O-3A) and is within the Planned Unit Development 3 (PUD-3) Overlay District. Current zoning permits a range of residential, office, and laboratory uses at a maximum floor area ratio (FAR) of 2.0 for non-residential uses and 3.0 for residential uses and with a maximum building height of 120 feet. Residential development would be subject to inclusionary housing provisions requiring 20% affordability, and allowing an increase in total density by 30%.

The 585 Third Street site is currently part of an approved 1.3 million square-foot mixed-use Planned Unit Development (PUD) project, which received a special permit in 1999 and has been fully developed with the exception of the 585 Third Street site. The site is permitted for development of an 85,000 square-foot performing arts center, but the presumptive developer (Constellation Center) has since sold the site, and thus it is unlikely to be completed. An alternative development plan for the site will require an amendment to the PUD special permit.

For the purpose of this analysis, four current zoning scenarios were analyzed under current zoning. These scenarios assume that the existing special permit would need to be amended and a new development plan permitted within current zoning limitations:

- Development at 585 Third Street without the GTS site:
  - 139,874 SF of residential development; or
  - 71,730 SF of office/lab space.
- Development at 585 Third Street with the GTS site:
  - 193,904 SF of residential development; or
  - 99,438 SF of office/lab development.

## Proposed Zoning

The following two scenarios represent the alternative development outcomes that would be enabled by the revised zoning petition:<sup>2</sup>

- Development at 585 Third Street without the GTS site: A new 435,000 SF mixed-use building with 420,000 SF of lab/office space and a minimum 15,000 SF community arts use.
- Development at 585 Third Street with the GTA site: A new 555,000 SF mixed-use building with 525,000 SF of office/lab space and a minimum 30,000 SF arts and cultural center, including a performance space.

Both of these options include 10,000 SF of ground floor public space.

**Figure 2. Development Scenarios Used for Analysis**

USES	GROSS FLOOR AREA	OFFICE/LAB	RESIDENTIAL	ARTS/CULTURAL CENTER
Current Zoning without Gas Transfer Station Site (Office/Lab Only, Maximum Potential SF)	71,730	71,730	N/A	N/A
Current Zoning without Gas Transfer Station Site (Residential Only, Maximum Potential SF)	139,874	N/A	139,874	N/A
Current Zoning with Gas Transfer Station Site (Lab Only, Maximum Potential SF)	99,438	99,438	N/A	N/A
Current Zoning with Gas Transfer Station Site (Residential Only, Maximum Potential SF)	193,904	N/A	193,904	N/A
Zoning Petition without Gas Transfer Station Site (Proposed SF)	435,000	420,000	N/A	15,000 (minimum)
Zoning Petition with Gas Transfer Station Site (Proposed SF)	555,000	525,000	N/A	30,000 (minimum)

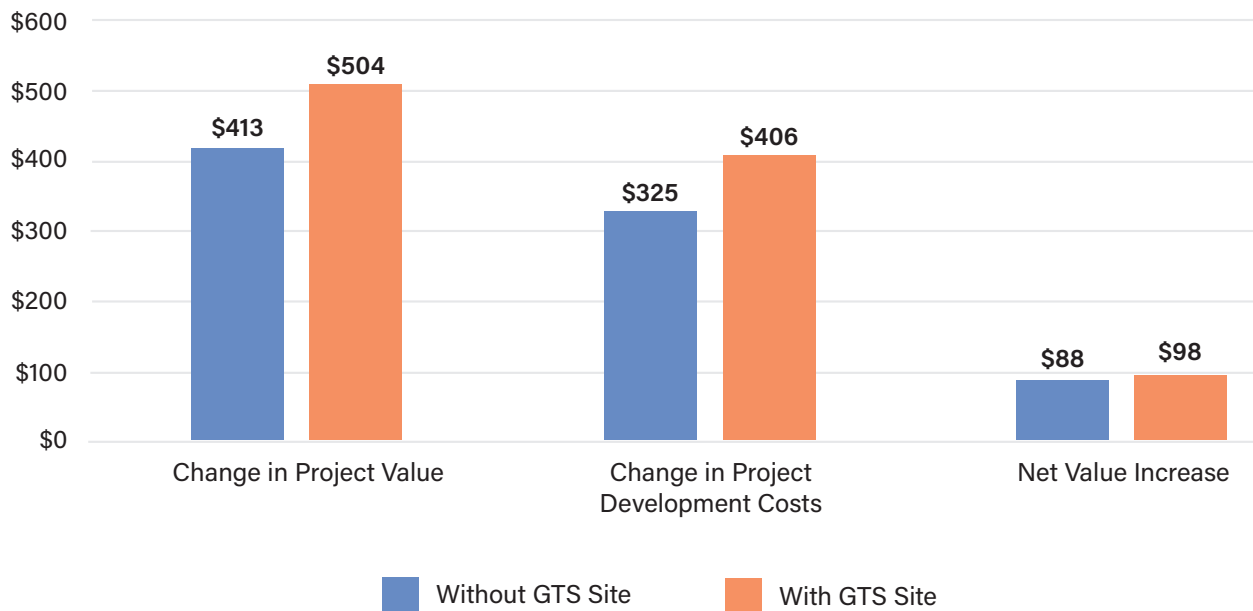
## ● ZONING PETITION IMPACT ON PROJECT VALUE

Financial analysis of the residential development scenarios under existing zoning options indicated that such projects were not financially viable, yielding negative land values and returns on total project cost below 3%. Consequently, these residential scenarios were omitted from the subsequent analysis and the impact of the zoning petition was only considered in comparison with the existing zoning office/lab development scenarios.

Under either development scenario, the increase in allowable office/lab development will result in a higher value for the real estate development that could be built. Two components determine the magnitude of this value increase: (1) higher rental income from the large addition of office/lab space; and (2) the increase in project costs to build the larger project and its component arts and cultural center. The combination of these two changes yields the estimated net value increase from the zoning petition.

Figure 3 shows the estimated increase in project value, increase in project costs and the resulting net value increase for development at the 585 Third Street site alone and with the GTS site under the developer return goals. Based on developer return requirements, the zoning petition results in an estimated \$88 million net value increase without the GTS site, and \$98 million in net value increase with the GTS site.

**Figure 3. Estimated Zoning Petition Impact on Project Value and Cost, in Millions**



Several factors impact, and may ultimately change, the net increase in project value that actually occurs:

- **One factor is the actual rent achieved in project leases.** This analysis assumes \$93 per SF in rent, which is based on having one tenant occupying a large portion of the project, and one that is able to negotiate a lower rent than current peak rents in Kendall Square, partly aided by competition from space available at other planned development projects in the neighborhood. If stronger demand for Kendall Square lab space occurs and delays with other projects result in higher rents at the BMR project, then the gain in project value from the petition will be higher. Alternatively, if demand for space in Kendall Square declines, and the BMR project achieves lower rents, the net value increase will be lower.
- **A second factor impacting net value are development costs.** If construction or other development costs are higher than estimated due to unexpected costs incurred, accelerated construction cost growth, delays in securing development approvals, financing or leasing up the completed project, then actual development costs will be higher, resulting in a lower net value increase. Savings in development costs, on the other hand, will result in a higher increase in net project value.
- **Additionally, capital market changes may alter required returns for developers and potential future investors** – and, ultimately, how the increase in rental income with the zoning petition is valued by developers and investors. For example, continued low interest rates and low stock market returns may increase future investor interest in real estate assets and lower their return threshold. Within real estate assets, if other assets perform poorly and become less favored by investors, Cambridge lab space may become a more desirable asset with lower return thresholds than currently assumed. In these situations, future investors may be willing to pay more to acquire the completed project even if its income stream does not change. Similarly, developers may be able to raise capital at lower rate, reducing their return threshold.
- **Covid-19 impacts.** The future impacts of the Covid-19 pandemic are unknown at this time but could alter the project value and development costs. Long-term changes in the demand for office space and lab space may affect the rents achieved and the resulting project value. Changes in construction practices, material and labor costs could alter construction costs while new legal, regulatory or financial issues and processes can add to non-construction project soft costs.
- **Finally, the type of tenant and lease terms at the completed project alters its financial risks, and thus the desired return and value of the income stream.** If the project is fully or close to fully leased to financially strong tenants with 15-20 year leases, then investors will reduce their expected rate of return and pay more for the stabilized property than if it has financially riskier tenants and shorter leases.



## ● COST OF DEVELOPER BENEFIT COMMITMENTS

BMR has committed to provide multiple benefits in conjunction with the zoning petition, including a new arts and cultural center, relocation of the Eversource GTS site, a new indoor public space and a number of free or subsidized services. Table 3 summarizes the estimated value of these benefits with and without inclusion of the GTS site. Low and high cost estimates for several benefits were made based on information from comparable projects and cost figures provided by BMR. For operational support for the arts and cultural center, BMR indicated a commitment of \$12 million to ensure the long-term sustainability of the larger 30,000 SF arts and cultural center by covering initial years’ operating costs and providing a long-term endowment. In the case of the smaller arts center (in the “No GTS Site scenario), the Consultant Team used a range of \$6 million to \$12 million, as it is uncertain how the operating costs and endowment needs for the operating entity will change with a smaller footprint.

The estimated value of the public benefits is \$19.4 to \$30.3 million for development without the GTS site and \$66.9 to \$80.7 million for the larger project with the GTS site. Within the project that includes the GTS site, the public benefits are much greater due to the significant cost of relocating the gas transfer facility and the inclusion of a much larger 30,000 SF arts and cultural center with a full performing arts theater, compared to a smaller 15,000 SF center in the smaller project.

**Figure 4. Estimated Value of Developer Committed Public Benefits**

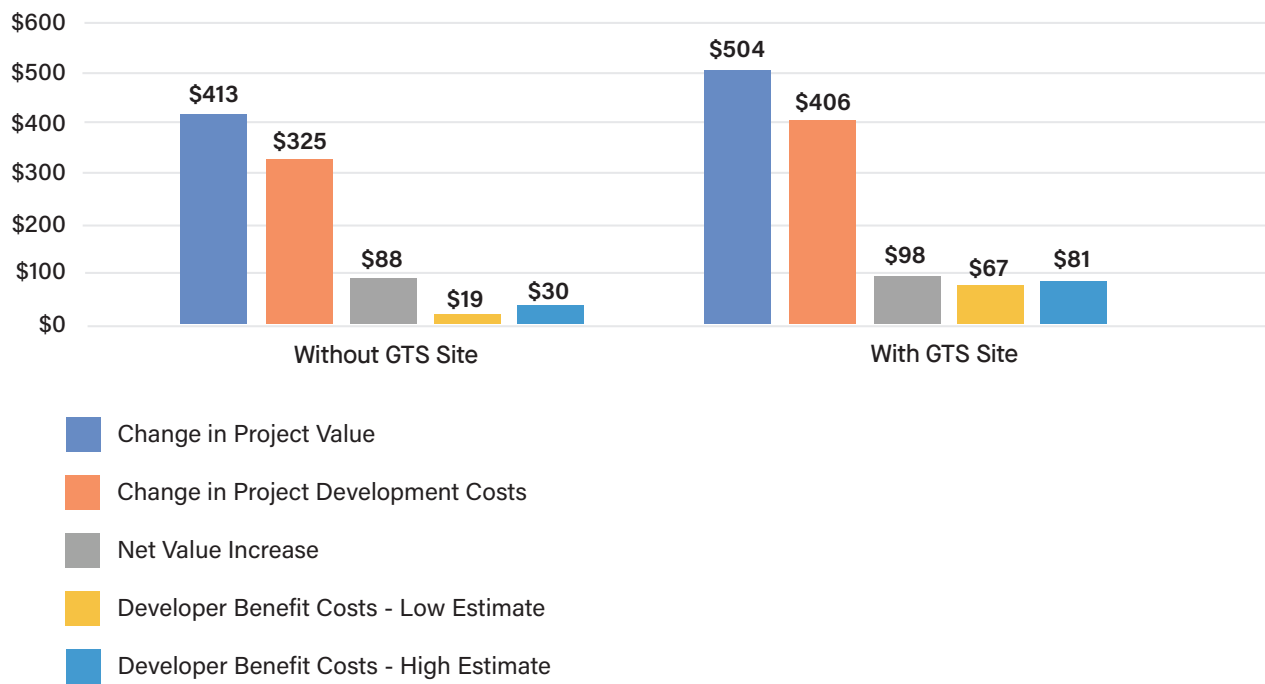
PUBLIC BENEFIT ITEM	NO GTS SITE		WITH GTS SITE	
	LOW ESTIMATE	HIGH ESTIMATE	LOW ESTIMATE	HIGH ESTIMATE
Arts/Cultural Center Development Cost	\$11,250,000	\$15,000,000	\$22,500,000	\$30,000,000
Arts/Cultural Center Facility Costs	\$240,000	\$337,500	\$480,000	\$667,500
Operational Support for ACC Entity	\$6,000,000	\$12,000,000	\$12,000,000	\$12,000,000
GTS Relocation	\$0	\$0	\$30,000,000	\$35,000,000
Winter Market	\$20,000	\$75,000	\$20,000	\$75,000
Free Kayak	\$100,000	\$100,000	\$100,000	\$100,000
Free Ice Skating	\$26,000	\$26,000	\$26,000	\$26,000
Ice Skating Rink Use	\$10,000	\$10,000	\$10,000	\$10,000
Indoor Public Space	\$1,800,000	\$2,800,000	\$1,800,000	\$2,800,000
Total	\$19,446,000	\$30,348,500	\$66,936,000	\$80,678,500

## ● CONCLUSION

Approval of the BMR zoning petition will enable an increase in the net value of projects built at both the 585 Third Street site alone and at the 585 Third Street combined with the adjacent Eversource GTS site. The estimated net value increase for development on 585 Third Street alone is \$88 million and the estimated net value increase for development on the larger site is \$98 million. These estimates reflect the risk and investment return thresholds for a developer undertaking the project from conception through completion. That value is subject to variability based on how market rents, development costs and other factors change between 2020 and the project’s completion and occupancy.

BMR’s multiple public benefits commitments made with the zoning petition will provide considerable value to the City of Cambridge and its residents. Benefit commitments made if the 585 Third Street site is developed alone are estimated between \$19.4 and \$33.3 million, with the arts center construction and financial operating support accounting for almost 90% of the estimated value. The estimated value of benefit commitments made if the larger site is developed are \$62.6 to \$76.3 million; the arts/cultural center construction and financial operating support represent 56% of that total estimated value and relocation of the Gas Transfer Station accounts for 40% of the total estimated value.

**Figure 5. Comparison of Net Value Change and Developer Benefit Costs, in Millions**



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## ● ENDNOTES

1. Land costs, including site remediation were omitted since these costs would not change between projects built with current zoning and those built with the zoning petition.
2. These scenarios are based on the minimum SF size for the arts and cultural center under the zoning petition. The actual size in the final building may be larger, which would increase development costs.

● APPENDIX A | ASSUMPTIONS USED IN FINANCIAL MODELS

Figure A.1. Housing Development Assumptions for Existing Zoning Scenarios

PARAMETER	ASSUMED VALUE FOR ANALYSIS
<u>Development Costs</u>	
<b>Total Development Costs</b>	
Land Costs, including Site Clean-Up	Not included as it is constant across scenarios
Construction	\$375/PSF
Soft Costs	20% of Construction
<u>Revenue</u>	
<b>Rental Housing - Monthly PSF</b>	
Studio	\$5.50
1 BR	\$4.75
2 BR	\$4.25
3 BR	\$3.75
Annual Operating Costs/Unit	11,000
Vacancy Rate	5%
Leasable Dwelling Unit Space/GFA	80%
<u>Unit Mix - Market Rate Units</u>	
Studio	38.6%
1 BR	40.5%
2 BR	17.3%
3 BR	3.6%
<u>Unit Size - SF</u>	
Studio	500
1 BR	700
2 BR	900
3 BR	1,100
<u>Financing</u>	
Developer Return Threshold	6%

**Figure A.2. Office/Lab Development Assumptions for Financial Model:  
Existing Zoning and with Petition**

PARAMETER	KENDALL SQUARE/BMR PETITION
<b>Development Costs</b>	
<b>Total Development Costs</b>	
Land Costs including Site Clean-Up	Not included as it is constant across scenarios
Construction - Core Building	\$490 per Rental SF
Construction - Tenant Improvement Allowance	\$20 per Rental SF
Construction - Arts/Cultural Center Improvements	\$700 per SF
Soft Costs	30% of Construction
Financial Carry Costs	\$110 per Rentable SF
<b>Revenue</b>	
Lab Rent, NNN Annual PSF	\$93
Vacancy Rate	5%
Leasable Space/GFA	0.95%
Building Annual Operating Costs	\$20 PSF for Public and Arts/Cultural Space
District Association Fees	\$2.25 PSF for Public Space and Arts/Cultural Center
<b>Financing</b>	
Developer Return Threshold	6.75%

## ● APPENDIX B | FINANCIAL MODEL RESULTS

ESTIMATED AMOUNT (\$ MILLION)	CURRENT ZONING WITHOUT GAS TRANSFER STATION SITE (OFFICE/LAB ONLY, MAXIMUM POTENTIAL SF)	ZONING PETITION WITHOUT GAS TRANSFER STATION SITE (PROPOSED SF)	CURRENT ZONING WITH GAS TRANSFER STATION SITE (OFFICE/LAB ONLY, MAXIMUM POTENTIAL SF)	ZONING PETITION WITH GAS TRANSFER STATION SITE (PROPOSED SF)
Net Operating Income	\$6.02	\$33.89	\$8.35	\$42.34
Project Value, Developer Return	\$89.20	\$502.07	\$123.60	\$627.19
Construction Costs	\$45.98	\$284.59	\$63.74	\$364.16
Soft/Other Development Costs	\$16.82	\$102.79	\$23.32	\$128.54
Total Development Costs	\$62.80	\$387.38	\$87.06	\$492.70