

MEMORANDUM

To: Ronald Munekawa, Chief of Planning

From: Darin Smith and Ashleigh Kanat

Subject: Non-Conforming Use Analysis - 501 North San Mateo Drive;
EPS #121124

Date: October 24, 2012

The Economics of Land Use



The property at 501 North San Mateo Drive located in the City of San Mateo is zoned for multifamily residential use (R4). However, the site was developed and operated as a legal non-conforming food service retail use (a food market/deli) for several decades. The business ceased operation and the property was sold at the end of 2010 and again in August 2012. The new property owners have completed some non-structural improvements to the property and now intend to lease the property to a convenience store retailer (7-Eleven). The City is considering termination of the "legal non-conforming" status and requiring future uses to be in compliance with the R4 zoning requirements.

In this memorandum, Economic & Planning Systems, Inc. (EPS) assesses the economic implications of the potential continuation or termination of the legal non-conforming use status, according to the criteria established in Section 27.72.050 of the City's Municipal Code (attached for reference as **Appendix A**). Our evaluation is not focused on 7-Eleven as the particular tenant. Rather, it is EPS's understanding of the City's Code that future uses should be considered categorically (e.g., "food market") rather than with respect to a specific tenant (e.g., 7-Eleven). As such, we are assessing the implications of the continued use of the property by a food market retailer, generally, though we do refer to findings regarding convenience stores that operate similarly to 7-Eleven. The following findings reflect EPS's professional opinion, which the Planning Commission and City Council can consider in their own assessment of the effects of terminating the property's legal non-conforming status.

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Summary of Findings

- 1) "Food market" retail uses, as a general category, are not expected to cause or contribute to impairment of property values or economic stability of the surrounding area.**

There is no clear indication that the previous food market business caused negative impacts or diminished property values in the surrounding neighborhood, and letters submitted to the City from neighbors suggest the previous market was a desirable use. Moreover, research indicates that proximity to retail and services can have *positive* effects on neighborhood property values. As such, EPS believes that a "food market"—as a general use category—should not be considered to be a clearly de-stabilizing feature of a neighborhood.

- 2) The specific operations and design of the food market use can be a significant factor in determining its impact on its surrounding neighborhood.**

Some neighbors are understandably concerned that the food market will operate in such a way as to attract criminal acts or nuisance behavior. In particular, alcohol sales and late night operations typical of convenience stores have been shown to be correlated with such incidents and subsequent reductions in property value. These problems are more prevalent in areas of lower socio-economic status, while the neighborhood around 501 North San Mateo Drive appears to be of "average" socio-economic status within San Mateo County. Though it is not *certain* to EPS that even a 24-hour convenience store selling alcohol would diminish this neighborhood's property values, these *potential* impacts can be mitigated or avoided through site design and the business's operational program.

- 3) The continuation of the non-conforming use will not inhibit the type of development contemplated by the General Plan in the area around the site.**

The City's General Plan indicates that this property is located in the R4 zoning district, which anticipates multifamily residential development. The surrounding parcels are already developed and occupied for residential use or seemingly viable businesses, and EPS does not anticipate that any adjacent or proximate parcels would be foreseeably developable for new R4 residential uses whether the "food market" use continues or is terminated.

- 4) The land is usable for the purposes permitted in the applicable zoning district; however, it is unlikely that the existing building would be converted to residential use.**

While conversion of commercial buildings to residential use is not unprecedented, in EPS's opinion the existing building at 501 North San Mateo Drive is not likely to be converted in this way due to its physical form and site plan and the limited market for such an unusual product type in this predominantly residential, suburban neighborhood. If the building were to be demolished, it is physically feasible and prospectively financially viable that a residential developer could build up to two dwelling units on the 6,375-square foot parcel, per the "minimum parcel area per dwelling unit," maximum floor-area-ratio, and yard setback requirements of the R4 district.

5) The termination of the non-conforming use is likely to result in economic hardship to the property owners.

If the legal non-conforming use status of the property is terminated, the current property owners are not likely to recoup their investment. The current property owners purchased the property in August 2012 for \$1,009,000, anticipating that the property's continued use for retail would be permitted because the City had approved building permits for the proposed 7-Eleven. With this basis cost to the property owners totaling \$1,009,000, EPS does not anticipate that the rents received over the maximum five-year period for the phasing out of the non-conforming use, plus the value of the site as a residential parcel, will yield a reasonable return on the developer's investment. EPS estimates the financial difference to the developer between continuation and termination of the legal non-conforming use to be a loss of at least \$497,000 and more likely as much as \$620,000.

Economic Impacts of the Non-Conforming Use

The Municipal Code requires that the decision to terminate a non-conforming use consider whether the continuation of the non-conforming use will cause or contribute to impairment of property values or economic stability of the surrounding area. EPS has reviewed the neighbors' communications on this matter (dated through October 5, 2012), which suggest that a food market use similar to Hilltop Market or Stangelini's Deli would be considered an asset by many community members.

Their sentiments are supported by studies that indicate that successful retail uses provide goods and services that are desirable and convenient, and can have a positive influence on neighborhood stability and property values. More specifically, proximity to retail has positive effects on residential property values, although properties immediately adjacent to the retail uses (within 300 feet) may have some negative value impacts due to nuisances such as noise and traffic.¹ Also, the fact that the property was a food market for decades until just a few years ago suggests that the effects of a food market use have already been realized in the neighborhood. Based on these considerations, EPS believes that a "generic" food market would not be expected to have a deleterious effect on property values or neighborhood stability in this location.

However, the theme of the community's correspondence does not indicate concern about a "generic" food market but focuses instead on the very specific aspects of the proposed 7-Eleven tenancy. In particular, concerns cited include noise, traffic, and criminal and/or nuisance behavior associated with the potential 24-hour operation and sale of alcoholic beverages at 7-Eleven.² EPS correspondence with the City's Police Department reveals that that organization shares concerns about the potential 24-hour operation and alcohol sales of a convenience store in this location. A review of available data and literature suggests that these concerns have a basis in reality.

¹ Song, Y and J. Sohn. "Valuing spatial accessibility to retailing: A case study of the single-family housing market in Hillsboro, Oregon." *Journal of Retailing and Consumer Services* 14 (2007) 279 – 288. http://carbon.ucdenver.edu/~kkrizek/pdfs/Song_sohn_hedonic.pdf

² Other concerns expressed, such as the "corporate" ownership of 7-Eleven and the sale of certain unhealthy foods, are not considered by EPS to be relevant for this analysis of property value impacts.

Convenience stores are cited as a frequent target of criminal activity, particularly in the overnight hours.³ Convenience store clerks are among the employees most likely to be victimized by violent crime at work.⁴ Interestingly, some studies have found that independent stores less than two years old were at higher risk for robbery than older stores that are company-owned and operated (such as 7-Eleven).⁵ While national trendlines suggest that the incidence of such crimes has declined significantly,⁶ the September death of a convenience store clerk in Milpitas is a recent reminder of the concerns associated with crime at 24-hour convenience stores.

A 2012 national study shows that violent crime has been shown to affect residential property values negatively, so an increase in such incidents in this San Mateo neighborhood would be expected to result in some level of "impairment of property values."⁷ This same study suggests that even substantial changes in the incidence of violent crime have a relatively modest impact on urban property values, finding that "a 25 percent reduction in homicides should produce a 2.1 percent increase in (the ZIP code area's) housing prices over the next year." While this figure may seem surprisingly low, EPS believes it is reasonable to assume that the property value impacts are not evenly distributed throughout the ZIP code area, and that blocks with greater increases or decreases in crime levels will realize stronger localized effects. Still, EPS believes it is far from certain that a convenience store in this location would be victimized by violent crime. One study found that 79 percent of all convenience stores in the United States did not suffer a robbery in a year, and that 65 percent of all such robberies occurred in only 6.5 percent of all convenience stores (i.e., a few stores were victimized numerous times).⁸

Similarly, a study found that overall "the opening of new outlets (selling alcohol) have no statistically significant effect on the price of residential property transactions," although the characteristics of the local neighborhood play a significant role in determining the local impacts.⁹

³ [Altizio, Alicia and Diana York, "The Problem of Robbery of Convenience Stores," Community Oriented Policing Services, US Department of Justice, April 2007. \(<http://www.cops.usdoj.gov/>\)](#) and Community & Environmental Defense Services. <http://ceds.org/convenience.html>

⁴ C.F. Wellford, et al. "Multistate Study of Convenience Store Robberies." Justice Research and Statistics Association, October 1997. (<https://www.ncjrs.gov/pdffiles1/nij/grants/173772.pdf>)

⁵ Altizio and York.

⁶ FBI statistics cited by the National Association of Convenience Stores indicate decreases in violent crime at convenience stores each year from 2008 through 2011. <http://www.nacsonline.com/NACS/News/Daily/Pages/ND0921112.aspx>

⁷ Shapiro, Robert J. and Kevin A Hassett, "The Economic Benefits of Reducing Violent Crime: A Case Study of 8 American Cities" Center for American Progress, June 2012. <http://www.scribd.com/doc/97451505/The-Economic-Benefits-of-Reducing-Violent-Crime>

⁸ Schreiber, F. Barry, Ph.D, 1991 *National survey of Convenience Store Crime and Security*. Cited on <http://www.nacsonline.com/NACS/Resources/Research/Pages/ConvenienceStoreSecurity.aspx>

⁹ Teh, Bing-ru. "Do Liquor Stores Increase Crime and Urban Decay? Evidence from Los Angeles." University of California, Berkeley. 2007. http://websv03b.colgate.edu/portaldata/imagegallerywww/2050/ImageGallery/teh_jobmktpaper.pdf

The presence of stores that sell alcohol is correlated with higher crime rates and reduced property values in neighborhoods of lower socio-economic status (census tracts with median household income in the bottom two quintiles of the overall County), though higher socio-economic neighborhoods do not show the same significant effects and may even have *increased* property values after the opening of a store that sells alcohol. The local neighborhood area around the subject site (defined for data gathering purposes as Census Tracts 6059, 6060 and 6062—see **Figure 1**) has average household incomes similar to the Countywide average. Within the census tracts, average household incomes range from \$76,000 to \$82,000 compared with \$87,100 in the County—well within the middle quintile for the County (roughly \$65,000 to \$100,000, according to the 2011 American Community Survey from the US Census Bureau). These indicators suggest that the immediate neighborhood does not have a markedly lower socio-economic status and may not be as affected by the convenience store operation as would a less stable area.

While EPS recognizes the concerns associated with convenience store crime and alcohol sales and 24-hour operations, it is not *certain* that the operation of a convenience store at 501 North San Mateo Drive would result in such impacts and reduced property values. Still, a convenience store at this location may address the concerns of the neighborhood through a variety of approaches. According to analysts, appropriate approaches may include limited hours of operation or having more than one clerk during overnight shifts, appropriate lighting that provides safety but does not impact residences, physical or landscaped buffers for sight and sound, safety-oriented interior store layout, frequent trash pick-up, etc. ¹⁰

Viability of Conforming Uses

The Municipal Code requires that a decision to terminate a legal non-conforming use consider whether the property is usable for a conforming use and whether continuation of the non-conforming use will inhibit the type of development in the surrounding area as contemplated by the General Plan.

The property is located in the City's R4 Zoning District which permits multifamily residential uses with total unit counts based on site sizes, and this 6,375- square foot parcel is allowed to be redeveloped for two (likely attached) residential units. In theory, the existing 2,100-square foot building could be converted to this conforming use. However, in EPS's opinion, the existing building on the site does not easily lend itself to residential conversion given how and where the structure is sited on the parcel, commercial versus residential automobile and pedestrian access considerations, and commercial versus residential aesthetic considerations. As such, at the end of the commercial lease, EPS anticipates that the existing structure would need to be demolished to prepare the site for residential development.

Historically, San Mateo has had a strong housing market, and multifamily and attached residential units are prevalent in the neighborhood. Immediately adjacent to the subject property, six townhome condominiums were built in 1990 and are currently valued at over \$400,000—prices that require roughly \$100,000 annual household incomes to afford. Though current price points in the real estate market may or may not support the costs of new construction (including land value expectations), over the longer term EPS considers new residential development conforming to the General Plan to be a viable option for the subject site,

¹⁰ Altizio and York.

if the site were vacant. Thus, EPS concludes that this site is usable for a conforming use of "R4" housing development.

EPS does not believe that continuation of the legal non-conforming use at 501 N. San Mateo Drive will inhibit conforming residential development more broadly in the surrounding neighborhood. For example, if adjacent sites were underutilized and ready for a desired R4 development "but for" the fact that the subject site is in retail use, it might be determined that the continuation of the non-conforming use is inhibiting a larger, conforming development opportunity. This is not the case on the subject property; although a larger parcel would accommodate more units and likely improve the development economics of the subject site, the adjacent residential uses (six townhomes at 503 through 513 North San Mateo Drive, and single-family homes at 253 and 257 East Bellevue Avenue) are occupied and in good, habitable condition. As such, they do not appear to be available for parcel assembly, nor do they represent residential development opportunities that would be lost if a retail use remains on the subject site.

Beyond the adjacent parcels, there also does not appear to be significant opportunity for new development of R4-compliant uses in the greater neighborhood. Most of the surrounding parcels are *already* developed as higher density housing, and those that are not residential are used for commercial businesses (professional and personal services, clothing sales, etc.). There is little or no undeveloped land within several blocks of the subject property, so most new development would require the de-occupation and demolition of existing buildings—a prospect EPS considers unlikely given the ongoing cash flow represented by these occupied buildings. With these physical and economic constraints, EPS considers significant new development compliant with R4 zoning to be unlikely *with or without* the continuation of the legal non-conforming use at 501 N. San Mateo Drive. Thus, EPS concludes that the legal non-conforming use's continuation is not likely to inhibit development as sought under the General Plan.

Economic Hardship of Termination

As required under the Municipal Code, EPS evaluated the extent to which the termination of the non-conforming use would create an economic hardship for the property owners by assessing the property owners' going-in investment and land use expectations and comparing them to potential revenues over time. If the legal non-conforming use status of the property is terminated, EPS projects that the current property owners will not be able to recoup their investment within a five-year period, the maximum allowed by code.

The current property owners purchased the property at the end of August 2012 for \$1,009,000, following the City's approval of building permits for the proposed 7-Eleven. To achieve a return on cost of 7.5 percent per year as a typical commercial property owner in current market conditions (\$75,600/ year), the property owner would need to realize triple-net rents of roughly \$3.00 per square foot per month for the 2,100 square foot building— within but at the top of the range of prevailing retail lease rates in San Mateo, which typically fall between \$1.50 and \$3.00 per square foot.¹¹ This is important because it indicates that the property owner's level of investment was reasonable under the assumption that the owner would be allowed to continue to have a retail tenant on the site.

¹¹ Based on an October 2012 review of 16 San Mateo retail lease listings posted on loopnet.com

Table 1 shows the expected financial returns, expressed as an Internal Rate of Return (IRR) for the property if it achieves rents at \$3.00 per square foot per month. This simple table assumes the developer paid \$1,009,000 in acquisition costs, leases the building for five years at \$75,600/year, and at the end retains the full \$1,009,000 value of the site as a continuing legal non-conforming use.¹² Under this scenario, the IRR for the developer is 7.5 percent—within the range that EPS would expect for commercial property.¹³

As an alternative calculation, EPS has prepared **Table 2** to illustrate the developer's return if the non-conforming use is terminated at the end of five years—the longest term allowed under the Municipal Code if the City opts for termination. On this table, EPS has assumed that the retail space would lease for \$100,000 annually—a figure that reflects a prevailing rate for 7-Eleven leases throughout the country, according to data gathered by EPS from an online commercial real estate source.¹⁴ This lease rate would equate to \$3.97 per square foot per month—significantly above the prevailing rates for retail leases in San Mateo. As such, EPS considers this to be an aggressive assumption intended to represent an optimistic revenue projection, from the perspective of the property owner. This scenario also requires an accounting of the net value of the parcel for a conforming use at the end of the five-year period. Based on residential land value data shown on **Table 3**, EPS has estimated that the 6,375-square foot site would be worth \$407,000, although the cost to demolish existing structures and parking lots would reduce the site's net value to roughly \$389,000.¹⁵ In this scenario—which is intended to show the maximum potential revenues by extending the non-conforming lease as long as possible and using above-market-rate rents—the property owner realizes a -3.2 percent return, meaning they will have lost roughly \$120,000 on the transaction over the five-year period.

Comparing the net cash flow over five years from **Tables 1 and 2**, these scenarios suggest that the property owner would suffer a net loss of over \$497,000 if the non-conforming use is terminated. It is worth noting that EPS considers it unlikely that a retail building known to be available for a maximum of five years would be able to achieve even market-rate rents, let alone premium rents. As such, the economic hardship to the property owner may be substantially greater than is estimated herein. A more conservative approach would be to compare the \$1,009,000 property acquisition cost (confirmed as having been reasonable) to the \$389,000 value of the site for development of a conforming use, without assuming that any

¹² Note that EPS has assumed that the commercial building will be viable for many years after the 5-year period of this analysis. With investment of over \$100,000 to a building that was occupied by a viable business within the past few years and that has not sustained fire or other significant damage, EPS foresees no near-term end to the building's remaining useful life.

¹³ Note that for both **Table 1 and Table 2**, EPS has *not* included inflation of lease rates or the reversion value of the property. In this way, we are expressing our findings in constant (Year 2012) dollars.

¹⁴ 1031comex.com as of 10/12/12 showed a range of lease rates for 7-Eleven's nationwide, but most were around \$100,000/year.

¹⁵ Note that this assumed land value equates to roughly \$195,000 for each of the two allowed units on the site. The attached townhomes on the adjacent parcels have assessed land values ranging from \$70,000 to \$166,000 per unit.

rent revenue would be generated by the site prior to its disposition for residential development. In this case, EPS estimates that the quantified economic hardship to the property owner is \$620,000.¹⁶

As a point of comparison, EPS has created **Table 4** to show how long a lease term may be required to achieve comparable financial returns while still “sunsetting” the legal non-conforming use. As shown, EPS has assumed that the retail tenant would pay premium rents of \$100,000 annually for 15 years, after which the use would be terminated and the land made available for R4 development. Under this scenario, the developer could achieve a 7.2 percent IRR—similar to that achievable if the legal non-conforming use is *not* terminated and more typical market rents are achieved (as shown on **Table 1**). Though the Municipal Code requires that a terminated use be discontinued in not more than five years, EPS concludes that it would take at least 15 years of premium rents for the property owner to receive a financial return comparable to what might have been reasonably expected when the property was purchased and improved.

¹⁶ EPS has reviewed the letter from the developer’s attorney to the City, dated October 23, 2012. That letter conducts its own analysis of the developer’s and tenant’s economic hardship, comparing the site’s value for residential development to the full value of the building’s rent, taxes, and other revenues as well as 7-Eleven’s expected profits, franchising fees, and interior improvement and equipment costs over 30 years. EPS believes it is more appropriate to estimate the hardship based on the site’s value for residential development versus actual costs incurred to date rather than speculative “opportunity costs” of future revenues. Note that this reflects EPS’s economic opinion, and may or may not be supported by case law on estimating the economic impacts of terminating uses.

Table 1
Property Owner Hardship Assessment -- Continuation of Non-Conforming Use
501 North San Mateo Drive Non-Conforming Use Analysis; EPS #121124

Item	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Property Owner Investment	(\$1,009,000)	(\$1,009,000)	\$0	\$0	\$0	\$0	\$0
Lease Revenue (Market Estimate: \$75,600 per year for 5 years) [1]	\$378,000	\$0	\$75,600	\$75,600	\$75,600	\$75,600	\$75,600
Remaining Property Value	\$1,009,000						\$1,009,000
Net Revenues	\$378,000	(\$1,009,000)	\$75,600	\$75,600	\$75,600	\$75,600	\$1,084,600
IRR	7.5%						

[1] Using rent estimate based on 7.5% return on cost annually, which also falls within the upper range of current San Mateo retail lease rates at \$3.00/SF (NNN).

[2] Applies average residential land value of \$64 per square foot.

Sources: Loopnet.com; Economic & Planning Systems, Inc.

Table 2
Property Owner Hardship Assessment -- Termination of Non-Conforming Use
501 North San Mateo Drive Non-Conforming Use Analysis; EPS #121124

Item	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Property Owner Investment	(\$1,009,000)	(\$1,009,000)	\$0	\$0	\$0	\$0	\$0
Lease Revenue (Max. Estimate: \$100,000 per year for 5 years) [1]	\$500,000	\$0	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
Potential Sale Price for Conforming Use (Gross Site Value) [2]	\$407,176						\$407,176
less Demolition							
Building (at \$5/sq.ft.)	(\$10,500)						(\$10,500)
Site/ Paving (at \$15.50/sq.yard)	(\$7,363)						(\$7,363)
subtotal, Demolition	(\$17,863)						(\$17,863)
Net Site Value	\$389,313						\$389,313
Net Revenues	(\$119,687)	(\$1,009,000)	\$100,000	\$100,000	\$100,000	\$100,000	\$489,313
IRR	-3.2%						

[1] Using highest rent estimate represents upside scenario for Property Owner.

[2] Applies average residential land value of \$63.87 per square foot to the 6,375 square foot lot.

Sources: County of San Mateo; Green Building Square Foot Costbook, 2013; Economic & Planning Systems, Inc.

Table 3
Comparable Residential Land Values
501 North San Mateo Drive Non-Conforming Use Analysis; EPS #121124

Property	Land Value	Parcel Size	Land Value/Sq.Ft.
503 North San Mateo Drive	\$166,289	-	-
505 North San Mateo Drive	\$108,207	-	-
507 North San Mateo Drive	\$156,553	-	-
509 North San Mateo Drive	\$69,537	-	-
511 North San Mateo Drive	\$102,964	-	-
513 North San Mateo Drive	<u>\$125,432</u>	-	-
	\$728,982	12,375 sq.ft.	\$58.91 /sq.ft.
253 East Bellevue Avenue	\$165,970	3,000 sq.ft.	\$55.32 /sq.ft.
257 East Bellevue Avenue	\$218,866	3,000 sq.ft.	\$72.96 /sq.ft.
Former San Mateo Police Station [1]	-	-	\$68.30 /sq.ft.
Average			\$63.87 /sq.ft.

[1] Based on the appraisal of the former San Mateo Police Station parcel located on South Delaware Street in San Mateo (Parcel Number 035-320-120) by Hulberg & Associates, Inc. on January 29, 2011.

Sources: County of San Mateo; City of San Mateo; Economic & Planning Systems, Inc.

Table 4
Property Owner Hardship Assessment -- Amortization of Property Owner Investment with Termination of Non-Conforming Use
501 North San Mateo Drive Non-Conforming Use Analysis; EPS #121124

Item	Total	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 14	Year 15
Property Owner Investment	(\$1,009,000)	(\$1,009,000)	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Lease Revenue (Max. Estimate: \$100,000 per year) [1]	\$1,400,000	\$0	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
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subtotal, Demolition	(\$17,863)															(\$17,863)
Net Site Value	\$389,313															\$389,313
Net Revenues	\$780,313	(\$1,009,000)	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$489,313
IRR	7.2%															

[1] Using highest rent estimate represents upside scenario for Property Owner.

[2] Applies average residential land value of \$63.87 per square foot to the 6,375 square foot lot.

Sources: County of San Mateo; Green Building Square Foot Costbook, 2013; Economic & Planning Systems, Inc.

Figure 1. Map of Census Tracts 6059, 6060, and 6062

