

## MEMORANDUM

**To:** Chris Keffalos

**From:** Greg Jones

**Date:** May 14, 2014

**Re:** PotterView Development Scenario

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GCI owns through its subsidiary, Potter View Development Company (PVD) 96 acres of developable real estate in south Anchorage. This is hill side property with spectacular views of Anchorage, Cook Inlet and the Kenai Peninsula. It also has significant development risks and issues. It is GCI's goal to dispose of this asset and harvest the market value of the real estate. There is no urgency or corporate mission imperative driving this decision. It is based on a desire to focus corporate staff and resources on mission critical activities. That said, it is presumed that GCI would prefer gain as much for the property as possible.

There are several methods or strategies for disposing of this type of real estate. Before analyzing these, it is important to understand the property, especially in the context of the current Anchorage real estate market and the permanent changes that have occurred therein.

It is almost a cliché to say that Anchorage is out of land. It is situated on a peninsula with water on two sides and mountains on the third. Where there is a gap between the mountains and water on the north, the land is inviolate government property (military and park) that will never be available for use for community growth. Planners have been predicting the day that Anchorage runs out of land for 40 years – an easy call. It appears that that day has come.

To the real estate community, Anchorage always seemed to have development opportunities. In terms of physical features, there are three basic types of land in the Anchorage Bowl. In the early days, the focus was on the area north of Chester Creek – downtown and the immediately surrounding area. This is a high, level plateau with good to excellent soils near the surface. Portions are underlain by a dense blue clay, but for the most part that has always been ignored.

The area south of Chester Creek is characterized generally by a series of glacial deposits called moraines. These are long low hills that are mostly oriented east/west. Between the moraines are swampy deposits resulting from dying or dead drainage basins and ponds.

Finally, there is the Anchorage Hillside. Located on the foothills and lower slopes of the Chugach Mountains, these are among the most developed slopes in the US. Developed for the most part without the benefit of public sewer and water, this area has been singled out as one of the most dense concentrations of on-site septic systems and private wells in the world.

At the end of WWII, the developed portion was concentrated in and around the downtown area. As the area grew, especially after the earthquake of 1964, residential subdivision activity was concentrated south of Chester Creek on the moraines, in the Sand Lake area where gravel was plentiful and on the hillside. By the 1990s, as Anchorage pulled out of a post pipeline economic bust, the moraines in the lowlands were all subdivided. The hillside became more sought after for upscale housing. The demand for housing drove the price of lots up enough that the swampy areas between the moraines began to be economical to develop. In order to build streets and foundations for houses in these areas it was necessary to excavate all of the swampy and silty soils and replace them with compactable, non-frost susceptible gravels. This process began in earnest in the 1990's and has continued until the present day. During that period, all of the commercial gravel in the Anchorage Bowl was used up and the pits themselves were subdivided into lots. Gravel suppliers began importing gravel to Anchorage from pits in the Palmer/Wasilla area via trains. The demand for lots continued to support higher and higher prices which paid for the expensive gravel. Now, almost all of the swamps are filled, those initial pits in the Mat Su Valley are running out and new ones are being developed further out. The price of lots in Anchorage, if any can be found, are now four times what they were in the 1980's and early 1990's.

Throughout this period, developers began to see the handwriting on the wall – residential development in Anchorage as they knew it was coming to an end. They began to focus on projects in the Valley, where land was plentiful, soils were good and the cost of commuting was less than the premium paid for an Anchorage home.

By 2005, the Mat Su Borough was the fastest growing area of the state and was well established as a bedroom community for Anchorage. Developers and builders moved there to stay in business. Residential development in Anchorage began to focus on redevelopment of small parcels with greater and greater density. Anchorage was urbanizing. The price of Anchorage homes rose steadily. Residential land developers disappeared and were replaced by boutique entrepreneurs who were willing to take the time to do small complicated projects involving demolition, repurposing or redevelopment of older projects. This type of development is done in small bites and usually take several years to accomplish. They are generally high cost projects with challenging economics.

At one point, the Anchorage market supported several large residential development companies. They included Carr Gottstein Properties, Quadrant Development Companies, Alaska Diversified Properties, Warren Hines, and Gamel Homes, among several others. All of those large players in the residential development business are gone. Lack of land is the primary reason they left. In 1984, the MOA issued permits for almost 8000 dwelling units. In contrast, 2013 yielded 365 permits.

The importance of all the history to Potterview and GCI lies in the demonstrated fact that Anchorage's development infrastructure is all but gone. There are no large developers in Anchorage that are capable of taking on this project.

With that as a backdrop, it is important to look at the PotterView Property from the perspective of a potential investor. While there may be several factors that would be important as an investor considers purchasing this parcel, at the end of the day, everyone (buyer/investor, bank and seller) wants to know the value of the real estate. However, value is not a finite term. It can be very different for each interested party. The first questions to answer in establishing the value to an investor are; 1) how much money can be returned from this property and , 2) how long will it take?

Most investors will be looking at this property as a real estate development opportunity. With that as a given, we need to look at some basic assumptions. First, there is the "third/third/third" rule. Simply put, the rule means that the price of a finished lot in a subdivision is composed of three major parts. They are:

1. The cost of land
2. The cost of development
3. Revenue to the developer.

As you might expect, these three categories are a little more complicated than they look at first. Working backwards, let's look at them. The revenue to the developer includes profit, but it must also pay all of the development company's overhead, including the ongoing cost of looking for new projects, accounting, personnel, rent, etc. – the cost of running the company. Some argue that marketing costs come from this third as well. The cost of development third obviously includes construction cost for utilities and streets, but it also includes all of the planning, engineering, entitlements, permitting, design, community interaction and financing cost. The land cost is the simplest of the three to express, but is often the hardest to determine.

The developer is always most protective of the last third – revenue. So, the tendency is to let the first two thirds balance themselves. That means if development costs are projected to be low, then land cost will tend to be high. Conversely, if development cost is projected to be high, then land cost needs to be low. As you might expect, risk factors further exacerbate the vagueness of this calculation. If there is a risk of high development costs, the developer will try to assign a value to that risk and deduct it from the land cost. Generally, that risk cost will never knowingly be deducted from the developer's revenue.

So, to determine the value of the land, one has to begin to build a development scenario, assign development cost assumptions, determine where the risks are and try to put a value on those risks. To do so, let's make some development assumptions.

Utilities – It is safe to assume that this site will be developed with a full range of utilities, including sewer, water, gas, electric and telecommunications.

Lot Size/Density – Based on local experience, the best that can be expected in terms of the net number of lots on a large hillside property is going to be in the 2 units per acre range. That was the density achieved on the property to the south of this property in Potter Creek Subdivision. That does not mean that the lots are half acre. Approximately 25% to 30% of the land will likely be dedicated to access roads and internal streets – perhaps even more if this site is developed by itself. (More on this risk factor later.) Another measure will go to open spaces and physical features (parks, wetlands, bedrock). This could be as much as 15% on a hillside like this. This leaves us with a conceptual 20,000 to 25,000 sq. ft. of land per acre for housing. The topo undulates on this property, so locating a suitable building site on each lot is sometimes a challenge. Lot sizes may vary widely due to topo. That said, average lot sizes in the 10,000 to 12,000 sq. ft. would be expected.

Lot Value and Absorption - These would be very high value lots. In addition to the full range of utilities, they would have spectacular views, be protected by covenants that protected property values and would have convenient access to the Seward Highway. Lot sales next door at Potter Creek have demonstrated the value and desirability of these lots. For our analysis, we will assume that lots in this subdivision would sell for \$200,000 each and that up to 20 lots could be sold per year. This last assumption may be the most difficult to predict. Right now, the residential lot inventory in Anchorage is extremely low and the demand for new homes is on the rise, especially in the upper price ranges. If this condition persists for a few years, then 20 lots a year may be conservative. However, if more land is found in Anchorage (not likely), or the Knik Arm Crossing is built or if demand wanes due to a reversal of current economic trends, this assumption could be on the high side. This is another risk factor to be addressed shortly.

Using these assumptions, we see the possibility of 192 lots at \$200,000 each or potential revenue of \$38M over a 10 year period! Entitlements are not a problem on the PotterView tract. The current R-3SL zoning would allow the type of development envisioned above. So, what is holding back the demand for this land?

First of all, the assumptions are based on best case scenarios. Any credible investor will discount those right off the bat. Lot prices could vary, but are probably the least risky factor. Even so, a prudent buyer will discount them to at least 75% of current assumed value. Also, there are always some lots that are not as good as the prototype lot in the subdivision (the dogs). They will drag down the average. So let's put the lot values at \$150,000 average for an investor pro forma analysis. We can talk about an escalator later.

There is probably more risk associated with density. This issue is also intertwined with access. Several factors are in play here. First, the topo is steep, but roads in the MOA can only have so

much slope. In Potter Creek, the main road was required to average no more than a 6% grade, with no portion of the road exceeding 8%. Consequently, there are five major switchbacks, all held up with very large retaining walls, on Potter Valley Road. Four of those switchbacks are above the bridge. The land there is comparable to PotterView and we have to assume that a similar road would be required to develop Potterview in a similar manner. Potter Valley Road cost approximately \$14M to build in 1984.

There are further difficulties associated with access. Potter Valley Road was made even more expensive by the fact that it was not allowed to have lot frontage and driveways. Every lot in the subdivision had to have another interior road fronting on it for access. This was partially offset by the fact that the MOA, through a now defunct matching program, paid for just over half the cost of Potter Valley Road. Finally, Potter Valley Road could not maintain the 6% average grade within the boundaries of the land it owned and the developer had to acquire adjoining land for road needs. The first switchback past the bridge is actually built on what was at the time Chugach State Park land. In PotterView's case the same would be necessary, probably more than once. That would take the cooperation of the adjoining property owner to the north. That presents a major risk factor. These design issues and the need to work within the boundaries of this parcel make a connector road from top to bottom of the parcel both physically and fiscally not feasible.

What all this means is that development of the Potter View tract would probably have to be done as two projects – one accessed from the top at the end of Goldenview Drive and one accessed from the bottom off of Potter Valley Road. The two would not interconnect from top to bottom. That could mean that a portion of the property, between the two projects could end up a “never never land” where development would be impossible due to lack of access. This means that a potential buyer will assign a high risk factor to the density. It is not farfetched to think that the density could be cut in half as a result of the access issues. Now we have the possibility of 96 lots at \$150,000 each for revenue of just over \$14M.

A note here on the MOA's position. As indicated above, the zoning generally allows this type of development. Even so, the plat has to go through an entitlement and permitting process. The MOA has placed a very high priority on the need of a connection between Potter Valley Road and Goldenview Drive. This priority is backed up by many studies and engineering standards. They have allowed Goldenview to develop into what is, in essence, a very long and very populated cul-de-sac, with no back door for emergencies and traffic relief. Thus, approval of a plat that does not include such a connection may be difficult represents another major risk factor.

Development costs for this project end up being the catch all risk factor. Depending on how the issues discussed above are resolved, then development costs could vary greatly. That said, let's look at our scenario. We now have \$14M of revenue to work with. Two thirds of that is \$9.5M. Now we have to begin to guess what the cost of constructing roads and utilities might

be. One common way to do that is on a per linear foot basis. If we assume that we have high end lots in the 12,000 sq. ft. range it will be necessary for those lots to be relatively wide, both for the house to take advantage of the views and to accommodate the larger houses that populate this end of the market. It is reasonable to assume an average lot width of 100 feet. So that means that for each lot, there will have to be 100 feet of onsite streets and utilities. Hillside conditions, including perched water, bedrock and retaining walls will likely run the cost of those improvements to a combined \$600 per linear foot. We have to assume that most of the streets would be single loaded to the downhill side due to the slopes, so the full frontage is borne by only one lot. That takes another \$5.8M out of the land and development cost two thirds, leaving \$3.7M.

We have yet to address the cost of offsite improvements like extending the water line up Goldenview (up to \$1M), tapping into the sewer lift station at the Old Seward Highway (\$0.5M?) and all of the pre-development costs, such as engineering, platting and permitting costs, to name a few. This could easily add up to another \$2+M. This means that an "as is" sale right now will generate very little interest.

The point of this discussion is to address why this property, as a standalone project, has never been attractive to the investment and development community. It just doesn't work by itself. There are too many risks, both known and unquantified. Moreover, ever since this property was originally purchased from the State of Alaska in 1980 and privately held by Quadrant Development Company, and later, Alaska International Industries and GCI, it has been clear that successful development of the property would depend on working with the adjacent property to the north.

In the early 80's the MOA was the owner of the property to the north and it was for sale. That changed with the settlement of the Alaska Mental Health lawsuit and the establishment of the Mental Health Trust. The land was pulled back to the Trust and was for sale again. GCI made an attempt to buy it, but was outbid by a local developer, John Berggren. He then sold it on a note to a local realtor who wanted to try his hand at development. His plans for a senior housing condo project were unsuccessful. Berggren now has it back. He is suffering significant health issues and may be ready to sell it again.

Why does the addition of the Berggren property to PotterView make sense? It solves several issues. First, the combined properties make a road connection between Potter Valley Road and Goldenview Drive much easier. Due to the width of the combined properties, the number of switchbacks needed to gain the elevation necessary to traverse the property would be down to two. Since this road would be used to access lots directly, and since development costs per foot would be much less without the switchbacks, density would be up and costs per lot would be down. Add the fact that offsite costs and pre-development costs would be spread over many more lots, and the economic viability of the combined project is much improved.

What could it look like? The Berggren property is approximately 105 acres. Added to GCI 96 gives the investor the probability of working with 200 acres that stretches from 2500 to 3000 feet across the hillside (a key dimension for the purpose of gaining altitude at low grades). With 200 acres, let's assume a density of 1.5 units per acre, or 300 lots. Development costs would be lower, due to scale and the ability to accommodate the slopes and other natural features in the design. For discussion purposes, let's use 500, per linear foot. Also, at least half or more of the lots would be on double loaded streets, spreading the on-site construction costs over more lots. Offsite costs and pre development costs would be about the same.

That gives us \$45M in revenue from lot sales over 15 to 20 years. At \$500 per linear foot with 50% of the streets double loaded, the average cost per linear foot per lot would be closer to \$375. With 300 lots at 100 feet each, the cost of on-site development should be between \$11M and \$13M. Pre development and offsite costs should be between \$3M and \$4M. That would leave \$28M. The developer's third would be \$15M, leaving \$13M for both parcels of land and to accommodate the remaining predevelopment risk.

The question at this point would be how much is each parcel worth. An argument can be made that the GCI parcel is worth more simply because it has the proper zoning, immediate access to sewer and Potter Valley Road. That would be a whole separate analysis. Suffice to say, that \$13M should be enough to cover both parcels and a significant amount of risk.

The take home facts from the discussion above are these.

1. Anchorage is out of land. Large parcels are rare and the few large parcels left are owned by institutions and governmental agencies. None are developers.
2. Anchorage is out of developers. Consequently, the few owners of large parcels have to become developers to unlock the value of their parcels. (Mental Health Trust, U of A, MOA)
3. The value of this parcel is locked up pending resolution of development issues. Eliminating risk equates to value added. Increasing density both adds value and eliminates risk.

The best way to increase the value of the GCI PotterView parcel is to, first, combine it with the Berggren property. This adds density and spreads costs. The next step would be to set about reducing the risks associated with the development process. That would include rezoning the Berggren property to a classification similar to the GCI parcel, negotiating with the MOA to share costs on connector road, establishing the design and cost of offsite improvements. If these were accomplished and if the land were prepared and platted so that it could be sold off in bite sized chunks to the small builder/developers that are left in Anchorage, the bulk of the "land third" could accrue to the land holder over time.

GCI could take a passive or an active role in this process. That is to say, they can be the consolidator of the two parcels, or they can wait for another investor to decide to put the two parcels together and prepare them for development. It is clear that such an investor is going to minimize risk by paying as little as possible for the real estate going in.