COUNCIL AGENDA: 04/27/21
FILE: 21-885
ITEM: 3.7

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand
Julia H. Cooper
Nanci Klein

SUBJECT: SEE BELOW

DATE: April 16, 2021

Approved [signature] Date **4/16/2021**

SUBJECT: PUBLIC PURPOSE BONDS ISSUED BY A JOINT POWERS AUTHORITY FOR MODERATE-INCOME RENTAL HOUSING

RECOMMENDATION

Accept the staff report on public purpose bonds issued by a joint powers authority (JPA) for moderate-income housing, and direct the Administration not to move forward with releasing a term sheet in order to pursue membership in one or more JPAs for moderate-income housing at this time.

OUTCOME

With the approval of the staff recommendation, the City would not issue a Request for Proposals and would not join any JPAs that use the new financing model for moderate-income housing. However, Housing Department staff would continue to pursue other opportunities and strategies for both affordable and moderate-income housing that make more efficient use of City funds and resources.

EXECUTIVE SUMMARY

Staff has conducted additional analysis of this new financing strategy for moderate-income housing. Larger cities in California, such as Oakland and San Francisco, have chosen not to join any of the JPAs. Further analysis by staff raised significant concerns, and while staff is eager to advance housing affordability, staff believes that the risks and costs of joining such JPAs outweigh the potential benefits. Especially given the low likelihood of success in having JPAs agree to all of the City's terms, the City Council's recent de-prioritization of the Moderate-Income Housing Strategy, the considerable staff time involved, and most importantly, the use of public subsidy and debt to produce little improvement in affordability but large fees, the Administration recommends against issuing an RFP and proceeding with this work. Staff has provided two alternatives. One

alternative is to create a Bay Area JPA in combination with our peer cities that can create a model that would address the concerns identified by our staff and our peer cities. The second alternative, not recommended by the Administration, is to release a Request for Proposals and include a term sheet as directed by the City Council in December 2020 before Councilmembers were made aware of all the information now available to staff.

BACKGROUND

On June 25, 2019, the City Council received an update on the Housing Department's moderate-income housing strategies. Included in that memorandum and presentation was a brief description of a moderate-income housing program proposed by the California Community Housing Agency (CalCHA), a newly formed JPA established by Kings County in 2019. This information was also presented to the City Council's Committee on Community and Economic Development on May 20, 2019.

In 2019, Housing Department staff led a team with the Department of Finance, the Office of Economic Development, and the City Attorney's Office that met several times with representatives of Catalyst Housing and the CalCHA team. The City team also consulted with its external advisor who did preliminary analysis on the CalCHA product. By November 2019, staff had identified structural questions and concerns that would require significant additional effort to resolve, and in early 2020 was beginning to work through selected issues to possibly bring the product to the City Council for further direction. However, the onset of the COVID pandemic and key Housing Department staff turnover redirected the focus of Housing's Policy and Production Teams that prioritized other time-sensitive work items.

On October 28, 2020, Councilmembers Khamis and Diep authored a memo to the Rules and Open Government Committee (Rules Committee) recommending the City join CalCHA. At that Rules Committee meeting, staff provided feedback that the requested actions would require additional staff time from within the Housing Department and other departments, including Finance and Office of Economic Development, and would need to be prioritized through the next Council Priority Setting Session. However, following further discussion, staff committed to providing an update at the Rules Committee meeting on December 2, 2020, with the help of staff from the Office of Economic Development.

In late August and early November 2020, staff met with representatives from the California Statewide Communities Development Authority (CSCDA) to learn more about their newly formed affiliate JPA and its program for moderate-income housing structured similar to CalCHA that uses a JPA to issue tax-exempt bonds to purchase and provide moderate-income housing.

On December 2, 2020, the Rules Committee received a report[1] that summarized staff analysis and work to date on the two unsolicited proposals for the City to join a JPA to provide moderate-income housing. Staff suggested that rather than sole sourcing this tax-subsidized program to one

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[1] https://sanjose.legistar.com/View.ashx?M=F&ID=8954795&GUID=DBE8A2A7-3985-4E78-BEF2-9BEBA5E2D800

entity working with a single developer, the most appropriate way to compare these programs would be to issue a request for responses. This would allow all interested parties to submit information to the City about their programs and would provide a transparent way for staff to negotiate the terms of entering one (or more) JPAs. The Rules Committee referred the item to the December 15, 2020, City Council meeting for further discussion.

On December 15, 2020, the City Council received the referral from the Rules Committee. Staff released a supplemental memo[2] prior to the Council meeting that included a detailed discussion of the items and areas where staff had further concerns and questions related to the structure of the financing model involved in both JPAs. The City Council accepted the staff report and directed staff to return to the City Council in April 2021 with a further evaluation of the model and with proposed terms that could be used as part of a request for proposals (RFP) issued shortly after the April City Council meeting.

ANALYSIS

Staff has had an opportunity to do additional analysis of the financing structure since the December Council meeting and has had conversations with other cities looking at the model. This additional analysis has confirmed staff's concerns surrounding this new financing model. In short, the program as it has worked in other locations would present risks and costs to the City, while providing only modest affordability gains.

Although staff is now recommending the Council not move forward with an RFP, the previous direction from the City Council in December was to bring forward a set of proposed business terms in April.[3] If the City Council elects to move forward in pursuit of joining one or more of these JPAs, despite the concerns raised by a consensus of the departments, staff would release a Request for Proposals (RFP) that would include the City's desired terms within the scope of the RFP. These are terms that the City would stipulate for project underwriting and product structure as a condition to joining any one of the JPAs and would be incorporated into the agreement that would be approved by the City Council. These terms can mitigate some of the concerns outlined further below, but do not completely eliminate many of them.

Following is a short summary of the product structure, and new information from other municipalities considering this structure.

Structure Summary

As a reminder of the basic mechanics of the model, the City would have to elect to become a member of a JPA as a non-voting alternate member. The JPA structure allows for the issuance of tax-exempt public purpose bonds, these bonds are used to purchase multifamily properties, and because they are government owned, they are not subject to property taxes. The structure relies on

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[2] https://sanjose.legistar.com/View.ashx?M=F&ID=9016977&GUID=3EA0D528-80EA-4124-A1E6-92B29DC294C8
[3] Draft business terms will be submitted as a supplemental memorandum to this memo.

two sets of bonds, one for the purchase and the other "B" series, to pay the manager and other parties. The approving city commits existing property taxes from the existing apartments to the project by approving the project. This property tax exemption is the key to enabling income-restricted units without any additional funding. Income restrictions on transactions are completely flexible under use of this product; however, cities have elected income mixes including a significant number of units priced for moderate-income households at 120% of Area Median Income (AMI), a portion for moderate-income households at 100% AMI, and some at 80% AMI for low-income households. In these models, the corresponding rents are intended to include some at nominally affordable levels (usually about 30% of the units) such as 35% of 80% of AMI, but others are essentially market-rate. Rent limits are not enforced by the City in this model. Rent increases may also be capped at no more than a 4% per year. Conceptually, the model could be used to finance new construction or to acquire and rehabilitate older apartment buildings, but to-date has been used for the acquisition of existing newer market-rate apartments. Between years 15 and 30, the City has a right of first refusal to purchase the property for the amount of debt then on the property. If bondholders on either set of bonds foreclose on the property, this right is lost. Also, the City has no control as to how much debt is amassed by the project in its first 15 years. If the City declines to purchase, the JPA must sell the property and distribute any net sales proceeds remaining after paying off debt. CalCHA started this model in 2019, and CSCDA and reportedly other JPAs are entering the market using the same model.

A more in-depth overview of the financing model is included in staff's December 2, 2020, memo to the Rules Committee.[4]

Few Large Cities Have Joined these JPAs

Cities that have larger finance and housing departments that have taken the time to analyze the product have declined to join these JPAs. Since the December City Council meeting, staff has learned that the City of Oakland has declined to join, citing similar concerns as have been raised by San José staff. San Francisco has also indicated it will not be joining and is focusing on other products for this income group as well as subsidizing deeper affordability options. The City of San Mateo reportedly is also not interested in this product for similar reasons as San José staff have cited. Staff has not had the capacity to survey additional cities.

Of the 10 largest cities in California, two cities have joined these JPAs. Long Beach (7) has joined CSCDA on a pilot basis to do one transaction and has joined CalCHA, while Anaheim (10) has joined CSCDA. The next largest cities to join CalCHA are Chula Vista (15) and Glendale (24). Carson (90) has also done a transaction with CSCDA. By far, most of CalCHA's members are small jurisdictions.[5] CalCHA's website shows a total of seven transactions closed since April 2019,[6] and CSCDA's shows a total of five transactions closed since December 2020.[7]

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[4] https://sanjose.legistar.com/View.ashx?M=F&ID=8954795&GUID=DBE8A2A7-3985-4E78-BEF2-9BEBA5E2D800
[5] https://www.calcha.org/general-information/members/
[6] https://www.calcha.org/.
[7] https://cscda.org/workforce-housing-program/.

HR&A Noted Many Concerns in its Analysis of a CSCDA Long Beach Transaction

For the Oceanaire transaction in Long Beach, the City of Long Beach hired HR&A Advisors[8] to analyze the transaction and the proposed financing product. HR&A is a well-respected real estate and economic development consulting firm that San José currently has under contract for analysis of the Diridon Station development. (HR&A's February 4, 2021, memo for the City of Long Beach is included as **Attachment A**.)

Note that the HR&A memo is highly cautionary, focusing on HR&A's concerns about the structure that remained *even though* the following terms were negotiated and changed in the favor of the City of Long Beach:

- Deepened affordability for moderate-income apartments
- Sped up conversion of units from market-rate to moderate-income
- Provided an updated market study
- Increased capital maintenance reserves
- Reduced some transaction fees
- Paid the City an annual monitoring fee
- Reimbursed the City's costs for review of the transaction.

Staff concurs with HR&A's assessment that there are several key areas of concern that must be weighed carefully when considering this new financing model. These areas are discussed further below. Proponents of the JPA structure argue that there is no risk to the City, little staff work needed by the City, and no subsidization required by the City. While it is true that the City is not directly liable for the debt, it would join a JPA that would issue non-rated bonds subject to Federal securities laws and antifraud provisions and would be associated with any bonds that fail or encounter difficulties. The developer and the JPA also are not liable for repayment of the bonds and the developers provide no equity or capital, despite collecting fees that would seem to suggest otherwise. Moreover, while the projects no longer contribute property taxes, the City would continue to serve them and if the project deteriorated or failed, the residents are City residents. As a result, there are still certain implied responsibilities that the City assumes for these transactions. Additionally, while the City does not award a cash subsidy to help acquire the properties, the ongoing property tax exemption is a significant voluntary tax subsidy by the City, and a significant involuntary contribution by the County, local school districts and other overlapping tax entities, including the State of California through its funding formula backfilling property tax for school districts.

The following five concerns highlighted per HR&A's analysis and staff's other recent research continue to stand out as material in staff's recommendations. Of the five, one is a structural issue with no apparent mitigations, three can be only partially mitigated, and one can likely be mitigated. A high-level summary of these issues is as follows:

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[8] https://www.hraadvisors.com/

- No third party exists to oversee ongoing income compliance, which has no obvious mitigants, decreases the structure's public value, and escalates the structure's audit and reputational risks;
- Compensation is not directly tied to parties' performance or risk taken, which could be partially mitigated by capping fees and aligning incentives with property performance;
- Transaction fees are high relative to renters' benefits, which could be partially mitigated but not eliminated by cost/benefit forecasting, capping fees, possibly deeper affordability mixes, and defining rents per the State Health and Safety Code;
- Foregone revenue of property tax and transfer tax revenues could be significant over time, including reducing revenues specifically for affordable housing and homelessness, which could be limited by controlling the number of transactions under this product; and,
- High purchase offers made possible by local tax subsidies may crowd out private investment, alter submarket property prices, and limit the City's ability to acquire the buildings from JPAs later, which could likely be mitigated by requiring appraisals and other prudent underwriting parameters for sizing debt.

Following is a more in-depth discussion of these issues. Note that this information builds upon the information presented in previous memos.

No third party to oversee ongoing income compliance – Under this structure, the JPA is responsible for overseeing its acquired property, including its effective management as the property owner. The JPA also receives ongoing fees from the B bonds for this oversight function, as its contracted property management companies do the actual management work. However, staff is concerned that could be a perverse incentive for the JPA as property owner to increase revenue and rents in order to repay its debt in the Series B bonds, rather than adhere to the affordability restrictions that they themselves oversee. City staff do not oversee annual compliance, as it does with its affordable housing portfolio and the City's tax-exempt bond issuances. There are no other funders, or financing participants, that can incent compliance. There is no regulation that clearly requires adherence to income restrictions within a given timeframe. While this flexibility can help to manage a development, it may erode the value of the promised affordability. The City, as only an "Alternate Member" of the JPA, does not have the ability to enforce in the case of non-compliance. There is a requirement in the terms that the JPA and asset manager provide annual reporting to the City. However, staff has not identified a clear enforcement mechanism within the terms should a non-compliance issue arise. On the contrary, City staff could receive reports indicating non-compliance, and therefore have new, potentially negative implications for the City (reputational risk, and potential State audit risk) that would realistically require it to review and issue letters acknowledging noncompliance even though it is powerless to enforce.

> No obvious mitigants: *This concern about inability to enforce compliance is inherent to the structure of the product, has no obvious mitigation, and has the potential for increased reputational and audit risks for the City.*

<u>Compensation is not tied to performance or level of risk taken</u> – Both the HR&A memo and other industry professionals that staff met with recently advised that financial incentives for this product should be changed to better align with property performance. These transactions are typically structured with a Series A of non-rated tax exempt bonds which need to be place with sophisticated investors due to the risk of the bonds, and a Series B which is, in essence, a deferred developer fee and generates no equity or cash for the project. The Series B bond is primarily paid from net cash flow after mandatory operating expenses are paid. As a result, there is an incentive to operate the property with low expenses. However, HR&A's analysis notes that in addition to significant upfront fees, ongoing fees paid to the JPA as property owner and to the asset manager (developer role) are fixed and are not tied to any performance in the property. Fees also escalate automatically at 3% per year, and there are reserves funded to ensure that these payments can be made in years of negative cash flow.

In addition, interest payments on the B bonds, which HR&A calls "preferred equity payments," carried a 10% interest rate in the Long Beach Oceanaire transaction described above, in the event a property's cash flow cannot support payment on B bonds in a given year. While this is below private mezzanine debt interest rates of 14% or higher, public interest rates are typically far lower. As a comparison, the City charges 1% to 4% interest or uses the Applicable Federal Rate, a rate recognized by the Internal Revenue Service (IRS) as appropriate for a public entity, when it restructures its residual receipts loans for affordable housing transactions. The current long-term AFR compounding annually is 1.98%,[9] approximately one-fifth the interest rate on the B Bond for this structure. Finally, it is important to note that the compensation paid to the public JPA owner and the asset manager is not tied to any development risk (presuming no rehabilitation is done on a property), and generally no upfront equity is being contributed by the property owner or asset manager. As stated, the only new revenues to the transaction are the foregone public agency property taxes. And because these projects are acquiring large multifamily properties, this means the public agencies immediately forego existing annual property taxes for the promise of future nominal affordability. Due to the short track record of the existing projects, and the difficult pandemic economy, the existing projects cannot demonstrate a pattern of meeting even those low expectations.

> <u>Potential partial mitigants</u> – In the attached Term Sheet, staff modified the compensation structure so that it would better align financial incentives with property performance. Escalation of fees at 3% per year could be allowed if performance targets were met, such as vacancy rates under 5%, but higher vacancy rates would earn escalation of 2% or 1%. Interest rates on the B bonds, so-called "preferred equity payments," should be lowered to the extent that fees relative to public benefit need to be lowered (see item below). Staff also proposes limiting the size of the B bonds and, therefore, its ongoing payments, in order to lower the overall debt on the property and to offer more affordability within each project.
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> *This concern about misalignment between performance and risk can be partially mitigated by limiting and aligning compensation and capping the B piece debt.*

[9] IRS, Applicable Federal Rates, Apr. 2021, https://www.irs.gov/pub/irs-drop/rr-21-07.pdf.

Transaction fees are high relative to public benefit to renters – The public JPA that purchases and owns a property and the asset manager that puts the transaction together both receive fees at both closing and annually. In the HR&A analysis done for the Oceanaire transaction in the City of Long Beach, the total fees exceeded the affordability benefit of the project for the first 14 years. The affordability benefit was quantified by the dollar amount of rent reduction compared to market-rate. Over the 30 years, the fees totaled 65% of the cumulative affordability benefit. These fees are reportedly high relative to other market-rate transactions, and they limit the affordability benefit that a project is able to offer.

The purpose of the public tax subsidy should be to convey value to residents more than to the seller of the private property and the asset and program managers. Therefore, the ongoing affordability relative to fees paid must be carefully weighed for each project. In the Long Beach Oceanaire transaction, as an example, the forgone property tax on the purchased property was approximately $1.53 million annually, while the annual rent reduction for the project was roughly $1 million. In other words, by this comparative measure, the cumulative foregone taxes exceeded the total reduction in rents achieved through the purchase. In other words, the City could have produced 1.5 times more affordability by not getting involved with the JPA and finding a way to return the property taxes to the original apartment building owner.

> Potential partial mitigants – The Term Sheet indicates that each project must demonstrate through a City-engaged third-party analysis prior to City Council approval of the transaction that the projected rent reduction is expected to meet or exceed forgone property tax revenue. To convey real affordability through market cycles and to ensure that units are rented promptly, staff included a minimum rent rule that all rents be at least 10% below market-rate rents for that submarket at all times. Affordability definitions must adhere to State law, using a 30% income standard and defining rent as net of a standard set of utility payments, and requiring deeper affordability income mixes will convey more value to tenants, even though it is highly unlikely Regional Housing Needs Allocation credit can be given for these properties. Finally, lower transaction fees will allow more of the value in transactions to benefit tenants in the form of affordability rather than benefitting the JPA and its partners.
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> *This concern about the value of tax subsidy relative to affordability can be mitigated but not fully eliminated, as the performance of the property is over the long-term for 15 to 30 years, and projections may not come to fruition. Further, there is uncertainty over affordability enforcement, as discussed above. In that respect, a City-sponsored JPA eliminating profit motive and subjecting all procurement to competitive processes would come closer to fully mitigating the concern.*

Cumulative impact on property tax and transfer taxes – Because the acquisitions from these projects typically involve large, newly-built multifamily housing complexes the approval of several or even one large transaction can have a significant impact to property tax revenues. The cumulative effect of many large new multifamily buildings receiving tax exemptions every year could represent a significant cumulative fiscal impact. In addition, the City would also forego collection of property transfer tax under the City's Measure E, as public entities such as a JPA are

not subject to pay this tax. During a sample 30-year period, a large residential property may change ownership several times. The resulting forgone transfer tax revenue would reduce the Measure E funds available for deeply affordable deed-restricted affordable housing, housing preservation, and homelessness strategies.

> Potential partial mitigants – The impacts of foregone property and transfer taxes can be mitigated by the City's hiring a consultant to carefully review each transaction for City Council consideration and requiring the City Council approve each transaction. It can also be limited by capping the number of transactions approved under this structure, and by ensuring that an amount equal to foregone revenues is repaid in higher priority at the time of property disposition if the City declines to purchase a property and it is sold at the end of the 30-year period. This could take the form of a Payment In Lieu of Taxes obligation.
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> *The amount of foregone tax revenues can be limited through analysis, terms and conditions, and caps on the number of buildings able to be purchased through this product.*

High purchase offers may alter the San José real estate market – Staff is concerned about the price impact that these transactions could have on the overall market within San José. Staff has heard from those in the investment community that the JPAs are already pursuing deals in San José with prices offered that may exceed typical market-rate offers and could crowd out other private investment. Overpayment for properties, made possible by the property tax exemption and JPA tax-exempt bond issuance, also would increase the amount of debt on each property / transaction, thereby limiting the City's ability to exercise its purchase option in years 15 to 30.

> Mitigants: In order to mitigate this risk of high purchase offers impacting the market, the term sheet requires a third-party appraisal to validate purchase prices. Requiring a third-party appraisal may slow a transaction down slightly, but appraisals are a prudent real estate practice that should not be foregone to size a reasonable amount of debt on the property. The terms also include a requirement for studies assessing the physical needs of each property to properly size capital replacement reserves needed over time, which also right sizes the amount of debt that can be serviced annually.
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> *The risk that public tax subsidy unintentionally alters the local real estate market can be mitigated, but not eliminated, by requiring prudent underwriting practices.*

Finally, in addition to these five issues, staff continues to be concerned about the potential focus by the State and/or the IRS on this new type of conduit financing.[10] The risk that the City as a JPA member could be pulled into audits or have to spend time addressing reputational attacks appears real, particularly given early reports about the transactions conveying limited public benefits relative to fees.

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[10] A fuller discussion of this issue is found in staff's December 2, 2020, memorandum to the Rules Committee, heard by the City Council on December 15, 2020.
https://sanjose.legistar.com/View.ashx?M=F&ID=8954795&GUID=DBE8A2A7-3985-4E78-BEF2-9BEBA5E2D800

CONCLUSION

It is highly likely that no interested party will agree with all the City's terms and will wish to negotiate modifications extensively. Further, there is a significant amount of staff work involved in finalizing and issuing a Request for Proposals (RFP) and term sheet, evaluating proposals, and entertaining potential follow-ups from applicants. Directing staff to undertake this time-consuming endeavor would be contrary to the City Council's de-prioritization of a Moderate-Income Housing Plan in its March 2021 roadmap exercise and would distract staff time away from projects that generate deeper affordability to the San José community.

Based on further analysis and information, it is not at all clear that the benefits of the products outweigh the risks and costs to the public. The product may convey some value to some renters in these buildings and to the City in the long-term. However, early evidence on the few transactions done to date indicates that foregone property tax revenues have garnered only modest affordability benefits. Also, there is little advantage to joining the JPAs on a pilot basis, as the model relies on 30-year bond financing; thus, any problems or issues may take many years to present themselves and longer to unwind.

For these reasons and the information contained in this memo as well as the previous staff memos, the Administration recommends against moving forward with issuance of an RFP with the possible intention of joining one or more JPAs.

EVALUATION AND FOLLOW-UP

With the staff recommendation, no further work would be done related to this financing model or the associated JPAs and staff diverted to this project would rededicate energies to prioritized projects that produce more tangible benefits to City residents.

CLIMATE SMART SAN JOSE

The recommendation in this memo has no effect on Climate Smart San José energy, water, or mobility goals.

POLICY ALTERNATIVES

Alternative #1: Direct staff to issue a Request for Proposals (RFP) with term sheet before the end of the fiscal year. It would take several months to select any respondents that met the criteria and to negotiate and agree on final terms. If all City terms are accepted by one or more respondents, staff would negotiate the required joint powers agreement amendments and return with proposal(s) and the necessary amendments and agreements to join one or more JPAs. If not, staff would report back on results and end the work.

Pros: Issuing an RFP would enable the City to determine if it is possible to use this structure and have all of its objectives met at this time. It is a good time in the real estate market cycle to pursue use of a product that could help to reposition Class A properties suffering from high vacancies.

Cons: It is quite unlikely that the City will receive positive responses to all its terms, while issuing an RFP and evaluating responses involves a considerable amount of staff work. Staff has significant concerns about this execution, and it is virtually certain that respondents will want to enter into time-consuming negotiations with staff on terms less acceptable to the City. In addition, the City Council recently deprioritized the Moderate-Income Housing Plan, it having received only one vote in the City Council's March 2021 roadmap exercise.

Reason for not recommending: This alternative's drawbacks outweigh its advantages; therefore, staff does not recommend this alternative.

Alternative #2: Direct staff to work with the Bay Area Housing Finance Authority to create a Bay Area JPA to issue this type of bond.

Pros: The Bay Area Housing Finance Authority (BAHFA) was created through legislation in 2019[11] specifically to serve the affordable housing needs of the Bay Area through production, preservation, and protection strategies. It has the power to issue bonds to raise revenues for financing, and has a focus on innovation and creativity, with an objective to "craft innovative approaches to overcome persistent challenges the region has faced, including creative financing…"[12] It is governed by the Association of Bay Area Governments and Metropolitan Transportation Commission, which has local elected officials on their governing boards (including those from the City). San José's Director of Housing sits on the BAHFA Technical Advisory Committee. It is an appropriate and promising local organization to reflect local conditions and policy priorities, with a local office that City staff or elected officials could go to in case meetings were necessary regarding problem properties. Further, as BAHFA has not yet formed a JPA, it could be constructed from the start with different tiers of members, with some members having greater levels of control than others as desired.

Cons: While BAHFA is ideally positioned for this work, its leadership first would have to agree this is an endeavor it wants to undertake, and it would need to obtain resources to do this work. It also would take time and effort for City staff to work with BAHFA to develop a JPA structure for moderate-income housing that meets the City's needs and addresses the City's concerns. An adequate level of effort unfortunately is not possible at this time while COVID response – the eviction moratorium, rent increase moratorium, the Emergency Rental Assistance Program rollout,

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[11] AB 1487 (Chiu, 2019), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB1487.
[12] "New Report Charts Course Tackling Bay Area's Chronic Housing Affordability Problems," Feb. 25, 2021, https://abag.ca.gov/news/new-report-charts-course-tackling-bay-areas-chronic-housing-affordability-problems; Association of Bay Area Governments and Metropolitan Transportation Commission, *Momentum for Lasting Solutions: Launching the Bay Area Housing Finance Authority and the Expanded Regional Housing Portfolio*, Feb. 2021, p. 9, https://abag.ca.gov/sites/default/files/documents/2021-02/Launching%20BAHFA-Regional%20Housing%20Portfolio_2-24-21_v6.pdf.

new stimulus funding to address homelessness, and several anti-displacement strategies – remains the top priority for the Housing Department.

Reason for not recommending: While staff recommends pursuit of BAHFA as a highly promising partner as a longer-term strategy, staff lacks adequate resources in the short-term to develop this product given COVID response priorities.

PUBLIC OUTREACH

This memorandum will be posted on the City's Council Agenda website for the April 27, 2021 City Council meeting.

COORDINATION

This memorandum was coordinated with the City Attorney's Office.

FISCAL/POLICY ALIGNMENT

The creation of moderate-income housing options is consistent with the City's obligation under its State-certified Housing Element 2014-2023 to meet its Regional Housing Needs Allocation production goals for affordable housing, including those for moderate-income households. It is also consistent with the Housing Crisis Response Workplan and the FY 2020/21–FY 2020/23 Affordable Housing Investment Plan. Focusing staff work on moderate-income housing strategies at this time is misaligned with the City Council's FY 2021-22 Roadmap from March 2021, which de-prioritized this work in favor of COVID response and more important enterprise initiatives.

COMMISSION RECOMMENDATION/INPUT

The San José Housing and Community Development Commission's focus is to review policies, programs and strategies for affordable housing and community development, rather than specific financing products or transactions; therefore, a review of this specific product is beyond the scope of the Commission's duties. However, the Commission heard an update on moderate-income strategies at its May 9, 2019, meeting. Commissioners' comments relevant to the JPA-issued bond product included support for lowering fees (costs) to support creation of affordable housing, and the importance of producing housing at all levels of affordability.

CEQA

Not a Project, File No. PP17-007, Preliminary direction to staff and eventual action requires approval from decision-making body.

/s/	/s/	/s/
NANCI KLEIN Director, Office of Economic Development	JACKY MORALES-FERRAND Director, Housing	JULIA H. COOPER Director, Finance

For questions, please contact Jerad Ferguson, Office of Economic Development, Housing Catalyst, (408) 535-8176; Kristen Clements, Housing Department, Division Manager, at (408) 535-8236.

Attachments:

Attachment A: HR&A, Analysis of a Proposed Moderate-Income Housing Transaction for the Oceanaire Property, Feb. 4, 2021

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MEMORANDUM

To:	Oscar Orci, City of Long Beach
From:	HR&A Advisors, Inc.
Date:	February 4, 2021
Re:	Analysis of a Proposed Moderate-Income Housing Transaction for the Oceanaire Property

Introduction

Purpose of the Analysis

HR&A Advisors, Inc. ("HR&A") was engaged by the City of Long Beach (the "City" or "Long Beach") to conduct detailed and independent programmatic and financial review of a proposed project to convert an existing 216-unit Class A multifamily building called the Oceanaire and located at 150 West Ocean Boulevard in the City, to moderate-income housing using a tax-exempt bond financing structure, which also qualifies the Oceanaire for *ad valorem* property tax abatement during the term of the financing (the "Transaction"). The Transaction proponents, California Statewide Communities Development Authority's Community Improvement Authority ("CSCDA") and Waterford Properties ("Waterford") brought the proposal to the City in October 2020. At a meeting on November 17, 2020, the City Council directed Long Beach Development Services staff to provide a detailed review and recommended action for City Council consideration. HR&A's analysis supports the City staff analysis by reviewing the terms of the Transaction, potential benefits and risks, and provides recommendations if the City Council is inclined to proceed with the Transaction.

HR&A's analysis included several approaches to fully understand the scope and implications of the Transaction. HR&A first conducted a detailed review of draft Transaction documents provided by CSCDA to City staff and available related documentation a similar transaction that recently closed its financing in Anaheim. HR&A also met with Transaction proponents several times to better understand their assumptions, expectations, and projections within the Transaction underwriting process. In addition, HR&A conducted independent research using third party sources, including CoStar real estate data, HUD databases, interviews with California Department of Housing and Community Development ("HCD"), and city staff reports related to other similar proposals in Anaheim, Carson and San José. Finally, HR&A also drew on its 40 years of experience advising cities and other public agencies across the U.S. on affordable housing programs and finance, and other consulting experience for the City.

HR&A completed an initial evaluation of the proposed Transaction in a memorandum dated January 13, 2021, which City staff shared with the Transaction proponents. On January 19, the Transaction proponents provided comments on HR&A's initial analysis along with a new market study and an updated financial model, which they further updated on January 21. They also agreed to make several changes to the Transaction including an increase to the percentage of units at the lower end of the moderate-income affordability range; increasing the financial commitment to property maintenance capital expenditures; a faster pace to conversion of all units to moderate-income; reducing some Transaction fees; making payment of the City's annual monitoring fee; and reimbursing City costs to review the proposed Transaction. This memo considers the new information provided to HR&A and the revised and new Transaction commitments.

The analysis in this memo provides perspective on several critical topics focusing on the City's potential benefits from the Transaction and, the recent improvements notwithstanding, how the deal structure could be adjusted to better protect the City's interests. These topics include further enhancing the affordability benefits of the Transaction; market conditions that could reduce the City's affordability and fiscal benefit; and the financial benefits to the Transaction proponents.

Summary of Findings and Conclusions

Although the new information provided by the Transaction proponents includes some improvements recommended by HR&A and City staff, particularly by increasing the number and percentage of units affordable to households at the lower end of the specified income range, most of HR&A's original concerns remain. More specifically, the Transaction's modest affordability benefits, a financial structure that is misaligned with City interests, and a return on public investment that does not provide clear justification for participation. The Transaction would immediately lead to an annual reduction in *ad valorem* property taxes of $1.48 million, for all the tax entities involved, including the City and local school districts. This suggests caution before the City agrees to participate in the Transaction without obtaining further changes in all three areas, as summarized below and presented in more detail in the balance of this memo.

The affordability benefits provided by the Transaction are modest for the following reasons:

- **Limited increase in affordability on a small number of units:** According to Waterford, approximately 40 percent of the units are already occupied by moderate-income households, although paying market rent. The affordability restriction eventually placed on all 216 units, rents will only be meaningfully decreased on the 87 units designated for 80 percent of Area Median Income ("AMI") households, which have a 28 percent discount to market rents,[1] or $853 on average. The 100 percent AMI units have a 10.0 percent discount to market and the 120 percent units have rents that are at par with market.
- **Inconsistent with State Income Limits affordability definitions:** The Transaction's restricted rents are based on a schedule derived from the Low-Income Housing Tax Credit ("LIHTC") program, which are higher than another California affordable housing program income and rent limits schedule applicable to other programs, and allows for rents (not including utilities) to account for 35 percent of household income, rather the more typical limit of 30 percent for rent <u>and</u> utilities. The Transaction's restricted rents are 11 percent to 19 percent above the affordable rents if calculated with the more typical 30 percent household income affordability definition, such that tenants would be paying rent and utilities accounting for more than 37 percent of their income.
- **No RHNA benefits**: The Transaction does not provide the City with any Regional Housing Needs Allocation ("RHNA") benefit, because: (1) state law limits the counting of existing unit conversions for RHNA to only those serving very low- and low-income households; (2) only units with at least a 55-year covenant on restricted rents, as opposed to the 15 to 30 year term of the Transaction; and (3) the rents must use the lower-priced State Income Limits rent limits schedule.
- **Does not address the City's highest priority for affordable housing:** Although there is clearly a need for more moderate-income housing in the City, both need and RHNA requirements are most significant for affordable housing at lower income levels. Current market conditions indicate that while 20 percent of moderate-income renters are cost-burdened (i.e., paying more than 30% of income for housing costs), this is much lower than the share of cost-burdened lower-income households in the City (43%).

The financial structure of the Transaction does not appropriately align the interests of the City and the parties to the Transaction and may not yield the asserted future benefits for the City due to the following:

- **Complicated financial structure with numerous associated fees:** The purchase price, proposed fee and debt schedule put a heavy financial burden on the Transaction leaving high debt leverage throughout the proposed term. The Transaction proponents receive approximately $7.2 million in fees at closing as well as approximately $1.0 million annually. This includes an annual $500,000 payment on one of the bonds, which is a form of Waterford preferred equity. These fees reduce the cash available to provide more affordable units. The result is that the on-going fees exceed the

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[1] "Market rents" are defined herein as those achieved at the property in the last three months which are above the average market rents shown in the Concord Group market study provided by the Transaction proponents.

affordability benefits for the first 14 years of the Transaction and account for 65 percent of cumulative affordability benefits at year 30.

- **Compensation is not closely tied to performance:** The Transaction proponents' returns are all but guaranteed and front-loaded, creating a misalignment with the City's goals for long-term affordability and potential financial benefit after 15 to 30 years. The annual asset management fee increases three percent per year without reference to performance. There is also a reserve fund with five years of fees for both Waterford and CSCDA and the fee is paid even if the Oceanaire performs poorly. Finally, the preferred equity returns accumulate annually even if the Oceanaire's cash flow cannot support immediate payment.

- **Public fiscal benefits are contingent on sales price:** The City's potential proceeds are at the bottom of the sale proceeds distribution waterfall leaving the City open to significant market risk at time of sale or refinancing between the 15th and 30th years.

- **Aggressive rent assumptions put public fiscal benefits at risk:** The Transaction proponents assume that rents will grow annually at three percent per year for 30 years. Over the last 20 years, rents in Long Beach only increased at or above three percent from 2015 to 2018, when a significant number of new Class A properties were delivered. Therefore, in the likely event that market rents grow more slowly, a large share of the affordable rents will not be competitive because they are priced above market rents, potentially creating a cash flow issue and eroding affordability benefits and reducing the public fiscal benefit.

The public fiscal benefit return on the City's foregone *ad valorem* property tax revenue is low unless the City is able to recoup significant value from sale of the Oceanaire, which is uncertain. Small variations in operational performance of the Transaction could jeopardize the City's public benefits position due to the following:

- **Minimal public benefit for foregone property tax**: When fully converted to moderate-income rents, the foregone annual *ad valorem* property tax (i.e., $1.53 million), is higher than the projected annual reduction in rents (i.e., $1.0 million). In other words, the Transaction does not create significant additional benefit despite CSCDA's efforts to lower capital costs and Waterford efforts to achieve asset management efficiencies.

- **A precedent setting transaction that may be difficult to modify for any future transactions**: Approval of the proposed Transaction structure could set a precedent for any similar future transactions, even though each one would be considered by the City individually. The cumulative effect of full property tax exemptions for multiple transactions could have a significant fiscal impact, considering there are nine Class A multifamily buildings with 50 or more units, according to CoStar, that could be candidates for similar transactions.

HR&A recommends the following actions that could mitigate these issues and make the Transaction more beneficial to the City:

1. **Reduce rents to an affordable level:** Rents should be lowered to equate with 30 percent of income net of utility costs rather than the current cost burdened definition of 35 percent of income plus utilities.
2. **Tie affordability to tax abatement:** Achieving affordability gains should be more closely tied to property tax abatement so that if the Transaction does not achieve expected conversion, then the Transaction is liable for property tax payment to the City.
3. **Lower transaction fees**: The closing fees, annual fees and preferred equity structure put financial stress on Oceanaire cash flow that forces higher moderate-income rents and reduces potential repayment of foregone property taxes.
4. **Align incentives to repay the City:** At sale, move the City property tax reimbursement ahead of the payment of the Series B Bond to increase the chance that the City will be made whole.
5. **Require annual reporting to the City.** The Transaction proponents should be required to provide final financial transaction and annual financial reporting to the City, along with information about

property conditions and the capital expenditure plans, particularly after the 10th year of Oceanaire operation.

The City should also make broader determinations about these type of moderate-income preservation projects so that it is easier and more transparent to evaluate similar opportunities:

6. **Make moderate-income housing preservation policy decisions:** about how to preserve moderate-income housing that maximizes public benefit and is open to a wider set of stakeholders.
7. **Determine a viable exist strategy:** City staff should initiate more detailed evaluation of alternative exit strategies for the proposed Transaction to be prepared for decision making between the 15th and 30th year when the City is permitted to require re-financing or sale of the Oceanaire.

Structure of the Memo

This memo next describes where "moderate-income" housing in general and in Long Beach specifically fits into the affordable housing spectrum, then reviews the terms of the proposed Transaction. Then it presents the Transaction's potential benefits to the City and risks related to affordability, financial structure and return on investment. A final section provides more detail on the recommendations.

Background on Moderate-Income Rental Housing in Long Beach

Defining Moderate-Income Limits

Moderate-income households are those at the upper end of the spectrum of incomes that define "affordable housing." More specifically, moderate-income households are defined as those who earn between 81 percent and 120 percent of AMI for each county. **There are two approaches in California to calculating AMI and associated maximum rents, and the Transaction uses the higher of the two.** The first approach, referred to as State Income Limits, prepared by the California Department of Housing and Community Development ("HCD"), uses calculations prepared by the U.S. Department of Housing and Urban Development ("HUD") that results in an AMI of $77,300 for a four-person household in Los Angeles County in 2020.[2] The other approach is used for LIHTC projects through HUD's Multifamily Tax Subsidy Project ("MSTP") and results in an AMI of $112,600 for a four-person household.[3] The Transaction utilizes the MSTP approach to calculating AMI with the resulting income brackets displayed in Figure 1. Note that neither the LIHTC program nor HUD publishes moderate-income MSTP values for 120 percent AMI limits, so the Transaction uses a multiplier to establish upper limit incomes and associated rents, rather than referencing a published standard.

Figure 1. Proposed Income limits by the Transaction

AMI	80%	100%	120%
1 PERSON	$63,120	$78,900	$94,680
2 PERSON	$72,080	$90,100	$108,120
3 PERSON	$81,120	$101,400	$121,680
4 PERSON	$90,080	$112,600	$135,120
5 PERSON	$97,360	$121,700	$146,040
	MTSP income limits	MTSP income limits	100%AMI*1.20

Sources: Waterford Cash Flow for Loan Sizing, January 20, 2021; HR&A Advisors, Inc.

Long Beach Multifamily Housing Market Overview

The City of Long Beach's multifamily rental market has experienced wide variation in performance by product quality class. According to Costar, in 2020 the average rent for all market rate multifamily rental buildings with more than 50 units was $2,177 per unit per month with an overall vacancy rate at 7.9 percent.

[2] https://www.hcd.ca.gov/grants-funding/income-limits/state-and-federal-income-limits/docs/income-limits-2020.pdf

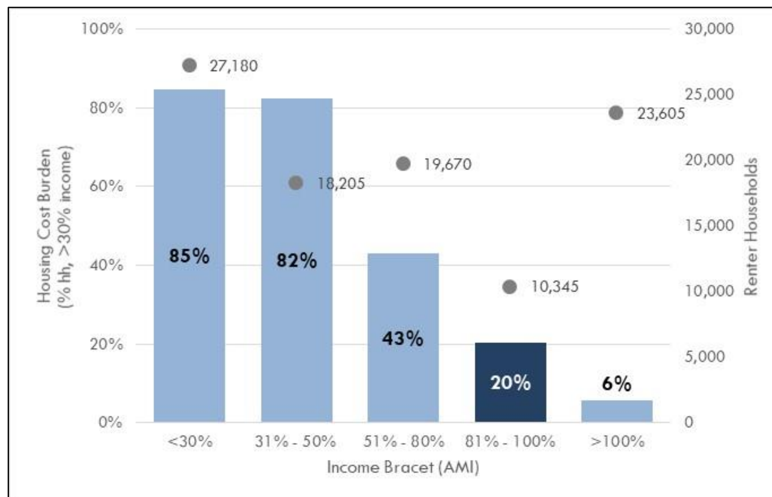
[3] The MSTP Income Limits are used for projects financed with tax-exempt housing bonds by HUD and the California Tax Credit Allocation Committee ("TCAC"). Given that these programs do not apply to households with 120 percent of AMI there is no officially published income and maximum rent schedule for this moderate-income category.

These overall statistics mask the difference in performance by product class over the last five years. For example, in 2016 there were only two Class A properties in Long Beach. Since then, seven new buildings were delivered increasing the supply to 1,477 units.[4] Many of these buildings had not stabilized before the onset of the COVID-19 pandemic and have struggled to maintain occupancy, leading to a 6.8 percent decline in rents and a vacancy rate of 17.4 percent. In contrast, rents for Class B and Class C buildings continued to grow throughout 2020 at 2.3 percent and 0.6 percent, respectively. Vacancy also remained at historic levels of 5 percent. The historic compound annual growth rate ("CAGR") over the past 20 years for Class A properties was 1.44 percent, compared to 2.75 percent for Class B and 3.07 percent for Class C. The implication of these trends is that the upper end of the Long Beach rental market has been struggling to maintain rents and occupancy. This implies that there is an on-going correction that could make market rate rental housing, at least temporarily, more affordable to moderate-income households in Long Beach.

Rental Housing Cost Burden

The result of the rental housing market dynamics is that a relatively small share of moderate-income households is cost burdened, particularly compared to lower income households. Figure 2 shows that 20 percent of the 10,345 renter households that have an annual income between 80 percent and 100 percent of AMI spend more than 30 percent of the income on housing costs, which includes rent and utilities.[5] Households in lower income brackets have a significantly higher rates of being housing cost burdened. The implication is that although there is room for improvement, the City's moderate-income households are not experiencing an affordability crisis on par with other income brackets in Long Beach. This is not to suggest that moderate-income renters do not deserve policy attention, but rather that the current intervention might not be the most effective use of scarce City resources.

Figure 2: Long Beach Renters Housing Cost Burden, 2013-2017



Sources: HUD, 2013-2017 CHAS Data, released August 2020; HR&A Advisors, Inc.

Housing Production Gap

Like housing markets across the state, the market in Long Beach has struggled to supply new moderate-income rental housing leading to a production gap. Nonetheless, since 2014, the City moved closer to meeting its RHNA allocations for a "fair share" of regional housing need than in the past. For the 4th Cycle RHNA, Long Beach added only 2,060 housing units between 2006 and 2014 leaving 78.5 percent of its allocation

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[4] Data obtained from CoStar

[5] Data based on HUD's Comprehensive Housing Affordability Strategy ("CHAS") Data which does not breakout households with 120 percent of AMI. https://www.huduser.gov/portal/datasets/cp.html#2006-2017_query

unfulfilled.[6] Furthermore, most of these units were single family housing with a net loss of multifamily units. The situation has improved for the current 5th Cycle RHNA where the City was allocated 7,048 housing units. By 2019, the City approved 3,830 units leaving 54.3 percent unfulfilled, as summarized in Figure 3. Although many of these units are multifamily, more than 80 percent were for Above Moderate-Income (i.e., market rate) households creating a widening gap between supply and demand for moderate-income housing. Only 39 units, or 1.0 percent, of the new units were for moderate-income households, which met only 3.0 percent of the 5th Cycle RHNA allocation. The estimated allocations for moderate-income housing in the pending 6th Cycle RHNA are more than three and half times larger than the last cycle, suggesting that the gap between supply and demand for moderate-income housing will continue to grow, yet this is tempered by the low share of households that are housing cost burdened as mentioned above.

Figure 3: Housing Production Gap

	Very Low-Income (<50% AMI)	Low-Income (50-80% AMI)	Moderate-Income (80-120% AMI)	Above Moderate (>120% AMI)	Total
5th Cycle RHNA					
RHNA Long Beach, 2013-2021	1,773	1,066	1,170	3,039	7,048
Building Permits Issued 2014-2019	410	177	39	2,592	3,218
Housing Production Gap	**1,363**	**889**	**1,131**	**447**	**3,830**
6th Cycle RHNA					
RHNA Long Beach, 2021-2029	7,122	5,038	4,149	11,131	26,440

Sources: City of Long Beach, 2020;[7] HR&A Advisors, Inc.

Moderate-Income Rental Housing Programs

Despite the growing gap, there are no public financing tools or funding programs to increase the production of moderate-income units in Long Beach or elsewhere in the state. Affordable housing financing and funding sources are generally restricted to households under 80 percent of AMI, including federal and state Low Income Housing Tax Credits, housing revenue bonds, a variety of HCD assistance programs and various local affordable housing programs. The limited 39 moderate-income units produced in the City during the current RHNA cycle were negotiated through the sale of Redevelopment Successor Agency-owned sites. The City's recently enacted mandatory inclusionary housing policy will help to produce a limited number of moderate-income units. The policy includes a 10 percent set-aside dedicated to moderate-income for new condominium development. For multifamily rental, it requires 12 percent of total units to be income-restricted with 50 percent dedicated to moderate-income. The policy will apply to all new development with 10 more units that require discretionary approval in the Downtown and Midtown areas with a phased implementation starting January 1, 2020 and full requirements by January 1, 2024. In other words, there are no existing means of supporting developers or property owners converting existing market-rate rental housing to moderate-income housing. Moderate-income housing supply remains very difficult to supply because rents are too low to justify high construction costs, and household incomes are too high to attract government subsidies. This reality explains the limited progress the City has made in meeting its RHNA allocations for moderate-income housing.

In response to the lack of public resources to provide moderate-income rental housing, CSCDA recently launched a new statewide program to leverage tax exempt public purpose bonds to increase the supply of moderate-income housing. CSCDA is a joint powers authority ("JPA") founded and sponsored by the League of California Cities and the California State Association of Counties. It was created in 1988 to enable local government and eligible private entities to access low-cost, tax-exempt financing for projects that provide

[6] https://downtownlongbeach.org/wp-content/uploads/2018.02.16_DLBDCReport_Final-1.pdf

[7] https://longbeachca.maps.arcgis.com/apps/opsdashboard/index.html#/a35a7e756777479f9f2593659d5b7669

public benefit. CSCDA has more than 530 cities, counties and special districts as "members" and has issued more than $65 billion through more than 1,700 transactions. A newly established JPA, CSCDA Community Improvement Authority[8], is focused on supporting moderate-income housing production. CSCDA Community Improvement Authority currently has two members, City of Anaheim and City of Carson, each with one moderate-income project similar to Oceanaire. Three such projects have closed financing since December. Although the new JPA has a limited operating history, CSCDA and its program partners are in discussion with 13 other cities, which like Long Beach, are in different stages of reviewing the program in general or specific conversion projects.

Under its moderate-income housing program, CSCDA will issue public benefit tax-exempt bonds to acquire and convert newly constructed multifamily properties to moderate-income restricted properties. Properties will then be governed by a Regulatory Agreement and Declaration of Restrictive Covenants with a specific income restriction and affordability mix for any units that become vacant. The key to making these projects work financially is that because CSCDA is as a public agency, it is not required to pay *ad valorem* property tax, which saves annual building operating cash flow that can used to pay the bond debt. And, other than securing local government approval of a Resolution authorizing a joint exercise of power, agreeing to become a "member" of CSCDA, the form of a separate Public Benefit Agreement (through which it receives any surplus revenues from future sale of the property after at least 15 years) and approval for CSCDA to issue the bonds, no other project approvals are required, and the local jurisdiction is exempt from any liability related to the project financings and the operation of the converted multifamily building for between 15 and 30 years (as discussed further below). CSCDA is working with multiple project asset management partners (e.g., Plenary Americas, the Waterford Group, and Manatt Housing Solutions), property management firms (e.g., Greystar), legal counsel which has standardized all program documents, and bond underwriters (e.g., Goldman Sachs).

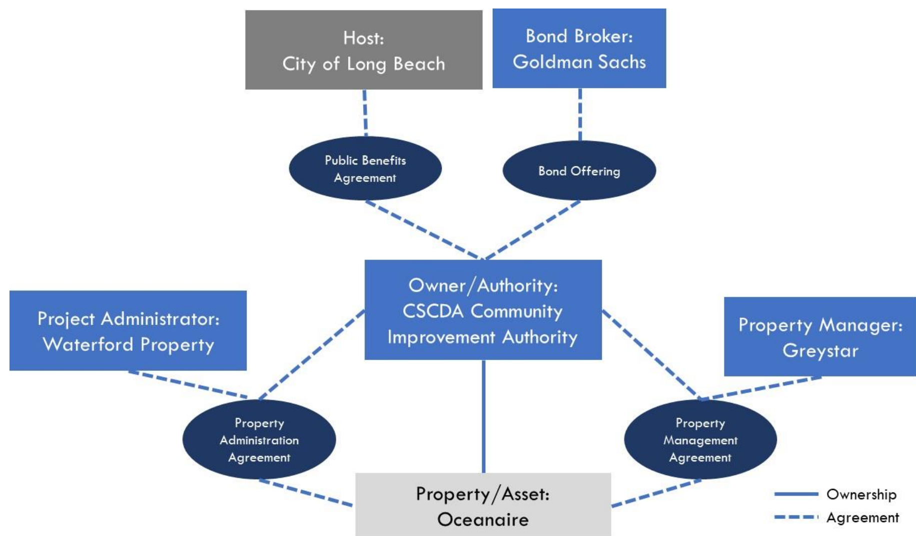
CSCDA is not alone in setting up a program to utilize tax-exempt bonds to increase the supply of moderate-income rental housing. For instance, a similar moderate-income bond financing program has been developed by California Community Housing Agency ("CalCHA"), also a newly formed JPA established by Kings County and the Housing Authority of Kings County in January 2019. Additional cities, counties, and other local government entities have since joined, including City of Carson, Glendale, and Mountain View. CalCHA is currently working with Catalyst Housing Group as its asset manager.

Summary of the Proposed Oceanaire Transaction

As part of its new moderate-income financing program, CSCDA and Waterford presented an opportunity to the Long Beach City Council to convert the Oceanaire to moderate-income housing. As shown in the organizational chart in Figure 4, CSCDA will purchase the Oceanaire from Waterford who is simultaneously purchasing from Lennar, the current owner and developer of the building.

[8] All memo reference to "CSCDA" is to this entity.

Figure 4: Oceanaire Transaction Organizational Structure



Sources: Government Purpose Regulatory Agreement Relating to CSCDA Community Improvement Authority Housing Revenue Bonds Series 2020A; HR&A Advisors, Inc.

CSCDA will partner with Waterford, a value-add real estate developer based in Newport Beach and active in the Long Beach market, to act as the project administrator or asset manager. The relationship between CSCDA and Waterford will be governed by a Regulatory and Property Administration Agreement. Greystar, a large, well-regarded property management company, will act as the property manager pursuant to a Property Management Agreement with CSCDA with oversight by Waterford.

The City would join CSCDA as a "member" and act as the host for purposes of the tax-exempt bond issued by CSCDA. The City's participation allows the CSCDA JPA to enjoy the same level of property tax exemption as if the property is owned by the City, therefore the Oceanaire would forgo paying the City and all other taxing entities *ad valorem* property taxes for between 15 and 30 years (i.e., the term of the bond financing). Full property tax exemption is rarely available to other public financing mechanisms and property tax welfare exemption is typically only available to properties restricted to low income households that provides deeper affordability. Based on the Oceanaire sales price, the total foregone property taxes and voter-approved indebtedness are approximately $1.5 million per year as shown in Figure 5. The City forgoes 21.66 percent of the one percent General Levy, or $264,252. The cumulative net present value loss of property tax revenue to the City would be as much as $7.8 million as shown in Figure 6 assuming a 2 percent discount rate.

Figure 5: Estimated Foregone Property Tax Revenue, FY2021-22

Estimated Foregone Property Tax, FY2021-22		
Projected Oceanaire Sale Price		$122,000,000
General Levy (1% Assessed Value)		
City of Long Beach	**21.66%**	**$264,252**
Long Beach Unified School District	17.10%	$208,620
Long Beach Community College	2.58%	$31,476
County of Los Angeles	28.78%	$351,116
Other County of Los Angeles Authorities	2.71%	$33,062
Other Education Authorities	26.05%	$317,810
Other Authorities	1.12%	$13,664
Total General Levy	**100.00%**	**$1,220,000**
Voted Indebtedness		
Unified Schools	0.143%	$174,876
Metro Water	0.004%	$4,270
Community College	0.063%	$76,964
Total Voted Indebtedness		**$256,110**
Total Foregone Property Tax		**$1,476,110**

Sources: Los Angeles County 2019-20 Oceanaire Property Tax Bill; Los Angeles County Auditor-Controller Tax Rate Area Lookup; HR&A Advisors, Inc.

Figure 6: Projected Foregone Property Tax Revenue on the Oceanaire

Oceanaire Projected Property Taxes				
Year	1	15	20	30
All Taxing Entities				
Annual	$1,476,110	$1,924,646	$2,116,795	$2,563,169
Cumulative (Inflation Adjusted)		$21,582,873	$28,716,363	$42,908,033
City of Long Beach				
Annual	$264,252	$348,675	$384,965	$469,271
Cumulative (Inflation Adjusted)		$3,886,059	$5,181,412	$7,772,118

Note: Cumulative are based on a 2% discount rate and property tax increases of 2%/year as per Prop 13.
Sources: Los Angeles County 2019-20 Oceanaire Property Tax Bill; Los Angeles County Auditor-Controller Tax Rate Area Lookup; HR&A Advisors, Inc.

The relationship between CSCDA and the City is governed by a Public Benefit Agreement that ensures that the City will not be liable for Oceanaire financing or operations during at least the first 15 years of the Transaction. Between year 15 and 30, the City will have the option to trigger a property refinancing or sale whereby any surplus sales proceeds after paying off remaining bond debt and fees could be used to reimburse itself and other taxing entities for the foregone property tax revenue and any other public purpose. The Public Benefit Agreement does not specify the terms of the future refinancing or sale except to ensure that the minimum price repays all outstanding debt and property fees. However, CSCDA and Waterford provided HR&A and City staff with an estimate of potential sale proceeds, which is discussed in a subsequent section of this memorandum.

The Oceanaire is a Class A, 216-unit apartment building delivered in 2019 in downtown Long Beach. The Oceanaire was developed by an affiliate of the national homebuilder, Lennar Corporation ("Lennar"). Waterford secured the right to purchase the Oceanaire in an off-market competition for $122.0 million or $564,00 per unit. Waterford paid a transaction broker an additional $1 million in fees. The Oceanaire was 71 percent occupied in December 2020 with a Net Operating Income ("NOI") of approximately $620,000 over the trailing 12 months. The implied income capitalization rate is less than 1.0 percent, but could be up to 1.5 percent if the trailing three months of actual rent is used to calculate NOI. For the appraisal commissioned as part of the Transaction, the Oceanaire was valued using a stabilized NOI of $8.0 million with 95 percent occupancy leading to a 4.25 percent cap rate. Among the comparable sales set utilized in the appraisal, the cap rates ranged between 3.51 percent and 4.60 percent indicating that the appraisal cap rate is within the market range. Over a four-year period the building is projected to converted to income restricted units for households earning 80 percent, 100 percent, and 120 percent of AMI. The conversion period is dependent on current market rate tenants moving out of the building and therefore is not guaranteed. Initially, Waterford and CSCDA suggested that one-third of the units will be dedicated to each income bracket. Currently, Waterford has dedicated 40.5 percent, to 80 percent AMI, 20.0 percent to 100 percent AMI, and 40.0 percent to 120 percent AMI, as indicated in

Figure 7. Without subsidies, 40 percent of the existing tenants already qualify for these income bracket restrictions. These households may pay more than 30 percent of their income in rent but their incomes were still high enough to meet Oceanaire leasing requirements.

Figure 7: Oceanaire Proposed Affordability Mix at Stabilization

	Income Bracket			
	80%	**100%**	**120%**	**Total**
Studio	6	3	6	15
1 bed	40	20	40	100
2 bed	38	19	37	94
3 bed	3	1	3	7
Total	**87**	**43**	**86**	**216**
Share of Units	**40%**	**20%**	**40%**	

Sources: Waterford Cash Flow for Loan Sizing, January 20, 2021; HR&A Advisors, Inc.

The acquisition will be fully financed by a tax-exempt Essential Housing Revenue Bond issued by CSCDA, which will become the owner, as well as a subordinate Series B bond providing preferred equity to Waterford. The Transaction's total sources and uses of funds are shown in Figure 8. The $139.8 million Series A 30-year bond would be sold to institutional investors with a $134.9 million principal and $4.5 million issuance premium. The Series A bond will be priced at closing. This instrument covers the $122.0 million purchase price[9], $8.4 million in reserve funds, $5.5 million in fees and fee reserves for Waterford and CSCDA, $6.4 million in transaction fees for Goldman Sachs and others. The property cash flow is projected to support interest payments in the first year with principal beginning to pay down in year 4. The financing structure includes a subordinate Series B bond that acts as a preferred equity grant of $5.0 million to Waterford. According to the language in a Bond Offering Memo on a comparable deal in Anaheim, the Series B bond compensates for "the sale and assignment of certain assets to the Authority, including its purchase rights to the Project, a business plan for the Authority, and certain intellectual property." It is important to note that no cash is exchanged at closing, but it is included in the sources and uses table because Waterford immediately begins earning 10 percent annual interest on the Series B bond. As currently sized,

[9] The purchase price is based on the purchase and sale agreement. The $1 million broker fee is included in the issuance and broker fees. This contrasts with the Transaction bond underwriting included the broker fee as part of the purchase price.

the Oceanaire's cash flow fully supports these interest payments in year 4 when the outstanding liability peaks at $6.0 million, according to data provided to HR&A.

Figure 8: The Transaction's Sources and Uses of Funds

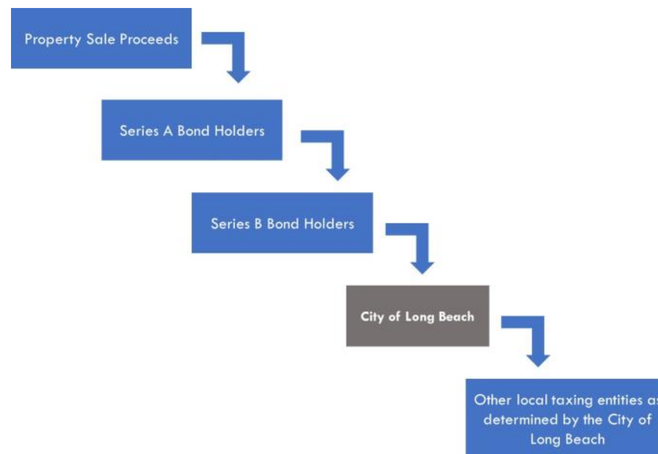
Sources of Funds	Total	Per Unit
Series A	$134,934,001	$624,694
Series A Issuance Premium	$4,499,095	$20,829
Series B	$5,000,000	$23,148
Total	**$144,433,096**	**$668,672**

Uses of Funds	Total	Per Unit
Purchase Price	$122,000,000	$564,815
Reserve Funds	$8,161,389	$37,784
Project Administrator Fees & Reserves	$4,012,005	$18,574
Project Administrator Preferred Equity	$5,000,000	$23,148
Issuance & Broker Fees	$5,259,701	$24,350
Total	**$144,433,096**	**$668,672**

Sources: Waterford Cash Flow for Loan Sizing, January 20, 2021; HR&A Advisors, Inc.

The City's option to force a sale between years 15 and 30 is contingent on repaying all outstanding bonds putting the City at the bottom of the sale proceeds distribution waterfall. In other words, as shown in Figure 9, the Series A bondholders, Waterford and the Series B Bond are above the City in receiving payment. Neither the Series A nor the Series B Bonds are fully amortizing, implying that under any scenario there are always debt obligations to be repaid at the 30th year. The City has the option to determine how and which taxing authorities share in the proceeds. The project proponents suggest that the proceeds be split between the City, the County, Long Beach Unified School District and Long Beach Community College. The City's position in the waterfall and the implied guarantee of Waterford's preferred equity creates direct interest by the City in the financial structure of the Transaction, the condition of the property over time, and the degree of affordability achieved by the Transaction.

Figure 9:The Oceanaire Sales Proceeds Waterfall



Sources: Form of Public Benefit Agreement CSCDA 4134-7659-4982 Section 6; HR&A Advisors, Inc.

Potential Transaction Benefits

Participation in the proposed Transaction has several potential benefits for the City. The primary benefit is the conversion of existing market rate housing units to income restricted units targeted at moderate-income households. Potential affordability gains are measured by comparing the proposed rents to the trailing three months ("T3") of actual rents according to the rent roll provided by Waterford and Lennar, by income bracket and unit size. These rents are lower than those assumed by Waterford but higher than the market analysis by the Concord Group.

The largest affordability gains are for the 87 units targeted at 80 percent AMI households, but are very modest for the 100 percent AMI and 120 percent AMI. Market rents at the property, as represented by actual leasing comps in the building in the T3, are higher than all of the 80 percent AMI rents, as shown in Figure 10. These higher market rents lead a weighted average rent that is 28 percent lower than the market weighted average. The 100 percent AMI weighted average rents are 10 percent lower than market in contrast to the 120 percent AMI that are at par with market rent. In Figure 10 rents with a positive discount rate are above T3 actuals implying that 103 units, or 46 percent of all units, are priced above actual market rents. When income qualified existing tenants' leases expire, they would be offered the below-market rents if their current rents are higher than the restricted rents. Tenants whose household incomes do not qualify for restricted rents will not be displaced, but rather allowed to stay until they voluntarily leave. Accordingly, there will be no displacement impact. When units are vacated, they will be rented to income-restricted households. Due to a combination of tenant circumstances, it is difficult to exactly determine when full affordability benefits will be achieved. Given that occupancy at closing is expected to be 68 percent, Waterford has estimated that the Oceanaire will convert quickly to moderate-income households within four years.

Figure 10: Rent Discounts to Market by Income Bracket and Unit Type

Unit Type	Market Rent	80% AMI			100% AMI			120% AMI		
	(T3)	CSCDA	Discount ($)	Discount (%)	CSCDA	Discount ($)	Discount (%)	CSCDA	Discount ($)	Discount (%)
Studio	$ 2,327	$1,841	($486)	-21%	$2,301	($25)	-1%	$2,381	$54	2%
1 bed	$ 2,564	$2,102	($461)	-18%	$2,628	$64	3%	$2,676	$113	4%
2 bed	$ 3,529	$2,366	($1,163)	-33%	$2,958	($571)	-16%	$3,549	$21	1%
3 bed*	$ 5,530	$2,627	($2,903)	-52%	$3,284	($2,246)	-41%	$3,941	($1,589)	-29%
Weighted Average	**$ 3,063**	**$2,218**	**($853)**	**-28%**	**$2,766**	**($276)**	**-10%**	**$3,075**	**$10**	**0%**
Units Above Market Rent (#)				**-**			**20**			**83**
Share of Total Units				0%			9%			38%

Sources: Lennar Rent Roll, December 2020; Waterford Cash Flow Loan Sizing January 2021; HR&A Advisors, Inc.

An additional benefit is the potential surplus conveyance proceeds that are made in one lump sum to the City when the Oceanaire sells sometime between years 15 and 30. The City has discretion to determine the distribution of sales proceeds between local taxing authorities. The magnitude of the lump sum is dependent on a variety of assumptions that will be discussed below that make it difficult to accurately quantify the potential financial sale benefit. Besides the foregone property tax revenue, these financial benefits come at relatively limited expense to the City, because the City is not financially responsible for the bond financing or operations of the Oceanaire, and only a limited amount of staff time will be required to monitor the Transaction each year.

Potential Transaction Risks

There are several risks with the Transaction that can be grouped into three broad categories: level of affordability benefits, financial structure burden and return on the City's foregone property taxes. The City should consider and fully understand the risks noted below before proceeding with the proposed Transaction. Many of them could be compounded if the proposed Transaction sets a precedent for additional future transactions of this type.

1. Limited Affordability Benefits

The Transaction claims to be supplying unmet housing demand that will help the City meet affordability targets and support moderate-income households, but a close analysis of the Transaction's mechanics and definition of affordability reveals only modest affordable housing gains by several measures.

Limited Increase in Affordability on a Small Number of Units

While there will be an affordability restriction placed on all 216 units, rents will only be meaningfully decreased on the 87 units designated for 80 percent of Area Median Income ("AMI") households, which have a 20 percent discount to market rents[10], or $620 on average as shown in Figure 10. The 100 percent AMI units have only a 4.0 percent discount and the 120 percent units have a 3.0 percent discount.

Not Following HCD or City Definition of Affordability

The Transaction calculations of affordable rents do not conform to the traditional definition, because they are above the typical affordable housing cost burden ratio. The Transaction documents require that rental payments shall not exceed 35 percent of the relevant income limit "for the County, adjusted for household size, as published annually by HUD and utilized by the California Tax Credit Allocation Committee ("CTCAC").[11] The 35 percent of income limit exceeds California State law's definition of "affordable housing cost" for lower-income households as not more than 30 percent of gross household income.[12] Furthermore, "housing cost" also traditionally include an allowance for utilities. When accounting for both the lower share of income, 30 percent, and the Housing Authority of the City of Long Beach's published utility allowance schedule the net rents are on weighted average $404 to $581 per month, or 17 percent to 19 percent, lower than assumed in Transaction underwriting. Figure 11 demonstrates the difference in the calculation of rents between CSCDA and affordable for a studio apartment for household with 80 percent of AMI. Figure 12 then compares the CSCDA rents to affordable rents for all income brackets and unit types. The difference column shows the delta between CSCDA and affordable rents. This implies that the Transaction provides limited affordability benefits compared to the standard maximum rent definitions used by HUD and HCD.

Figure 11: CSCDA vs Affordable Monthly Rent Calculation

80% AMI Studio		
	CSCDA	**Affordable**
Annual Income (1 Person Household)	$ 63,120	$ 63,120
Share of Income (%)	35%	30%
Share of Income ($)	$ 22,092	$ 18,936
Monthly Share of Income	$ 1,841	$ 1,578
Utility Allowance	$ -	$ 89
Monthly Rent	**$ 1,841**	**$ 1,489**

Sources: Affordable Tax Credit Cash Flow Bond Sizing Oceanaire January 21, 2021; The Housing Authority of the City of Long Beach Utility Allowance Schedule 2020; HR&A Advisors, Inc.

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[10] Market rents are defined as those achieved at the property in the last three months which are above the average market rents shown in the Transaction provided market study by the Concord Group.

[11] Draft Regulatory Agreement and Declaration of Restrictive Covenants

[12] https://www.hcd.ca.gov/grants-funding/income-limits/index.shtml

Figure 12: Underwritten Rents Compared to Affordability Adjusted Rents by Income Bracket

Type	80% AMI			100% AMI			120% AMI		
	CSCDA	Affordable	Difference	CSCDA	Affordable	Difference	CSCDA	Affordable	Difference
Studio	$1,841	$1,489	($352)	$2,301	$1,884	($418)	$2,381	$2,278	($103)
1 bed	$2,102	$1,707	($395)	$2,628	$2,158	($470)	$2,676	$2,608	($68)
2 bed	$2,366	$1,911	($455)	$2,958	$2,418	($540)	$3,549	$2,925	($624)
3 bed	$2,627	$2,109	($518)	$3,284	$2,672	($612)	$3,941	$3,235	($706)
Weighted Average	**$2,218**	**$1,795**	**($423)**	**$2,766**	**$2,265**	**($501)**	**$3,075**	**$2,743**	**($332)**

Sources: Waterford Cash Flow for Loan Sizing, January 20, 2021; The Housing Authority of the City of Long Beach Utility Allowance Schedule 2020; HR&A Advisors, Inc.

No RHNA Benefits

The proposed Transaction will not count towards the City's Regional Housing Needs Allocation ("RHNA"). As mentioned above the City has struggled to meet the moderate-income housing delivery goals in its RHNA. Unfortunately, the units converted to moderate-income housing through this Transaction will not help meet the City's RHNA goals for that income category, because they do not meet the standards of California Government Code Section 65583.1(c) in four important areas. First, for moderate-income units to count they must generally be new construction which is not the case with the proposed Transaction. Second, to the extent that converted moderate-income units can be counted, they must be restricted to low-income or very low-income rents. Furthermore, RHNA income brackets are defined in terms of the California Official State Income Limits which have substantially lower income limits for moderate-income[13] than the MTSP rents assumed for the Transaction. For the City to receive RHNA credit, for example, the income of a 4-person household moderate-income household cannot exceed $92,740, which is much lower than the income limits $132,120 proposed by the Transaction underwriting using TCAC-based assumptions. Finally, the units must be income restricted for 55 years, but the Transaction provides for only a 15- to 30-year limitation. CSCDA reports to HR&A that they are working with the League of California Cities to sponsor state legislation and that State Senator Lena Gonzales has requested to be the author of this bill. But at this time, no such benefit for the City from the Transaction is available and no detailed information on how to address the above issues have been provided.

Not Meeting City's Highest Priority for Affordable Housing

The housing cost burden data show that most moderate-income households are not heavily cost burdened, but other lower income categories continue to face heavy burdens and continue to need support. In other words, more than 80 percent of extremely low- to low-income households are housing cost burdened in Long Beach. These income brackets have the highest need and struggle the most in obtaining affordable housing. In comparison, 20 percent for moderate income households are housing cost burdened as shown in Figure 2. The housing cost burden for moderate income households in Long Beach is much lower than in the rest of Los Angeles County or California more generally. Although moderate-income households also deserve support, the direct benefit being supplied by the Transaction is not likely the most effective means of supporting this income group. A pending HR&A memo on this subject will explore other means of supporting increased housing affordability for moderate-income households.

2. Financial Structure Misalignment with City Fiscal and Policy Goals

The financial structure of the Transaction limits the potential affordability and long-term upside for the City. As mentioned above, the proposed Transaction is fully financed with a Series A Bond and a Series B Bond that leaves very little excess cashflow from the Oceanaire to direct towards increased affordability or reducing bond principal. The current debt structure does not provide excess cash flow in the initial years that

[13] https://www.hcd.ca.gov/community-development/housing-element/docs/housing-element-annual-progress-report-instructions-2019.pdf

would allow for more affordability. The financing structure is non-traditional creating a long-term financial burden that makes it difficult to provide deep rental discounts and potentially reduces surplus proceeds.

Complicated Financial Structure with Numerous Associated Fees

The complicated financial structure leads to numerous upfront transaction costs and on-going fees that reduce the Transactions ability to provide more affordability. That is, Waterford and CSCDA take out a combined $3.5 million fee at closing in additional to several other fees that lead to $7.3 million in closing fees as shown in Figure 13.[14] On an annual basis there are also several fees that total more than $1.0 million. The annual fees include a $200,000 asset management fee for Waterford that inflates by 3.0 percent per year as well as a $500,000 interest payment on the Series B bonds which function as preferred equity payments. CSCDA also receives a $209,738 fee per year for their ownership stake. As a result, in the first 15 years there are $20.7 million in fees to the project proponents. In combination, these fees are high considering that there is neither cash equity nor development risk involved in the Transaction.

Figure 13: Total Fees Closing and Annual Fees for the Oceanaire

Fees	Closing	Annual On-going	Total at 15 years
City of Long Beach		$ 34,560	$ 518,400
Goldman Sachs (Bond Originator)	$ 2,091,496	$ 15,000	$ 2,316,496
Waterford (Property Administrator)	$ 2,000,000	$ 700,000	$ 11,477,699
Greystar (Property Manager)	$ -	$ 121,315	$ 2,581,105
CSCDA (Owner)	$ 1,399,340	$ 209,738	$ 2,097,381
Eastdil (Commercial Real Estate Broker)	$ 1,000,000		$ 1,000,000
Other Brokerage Fee	$ 768,865	$ -	$ 768,865
Total	**$ 7,259,701**	**$ 1,080,614**	**$ 20,759,947**

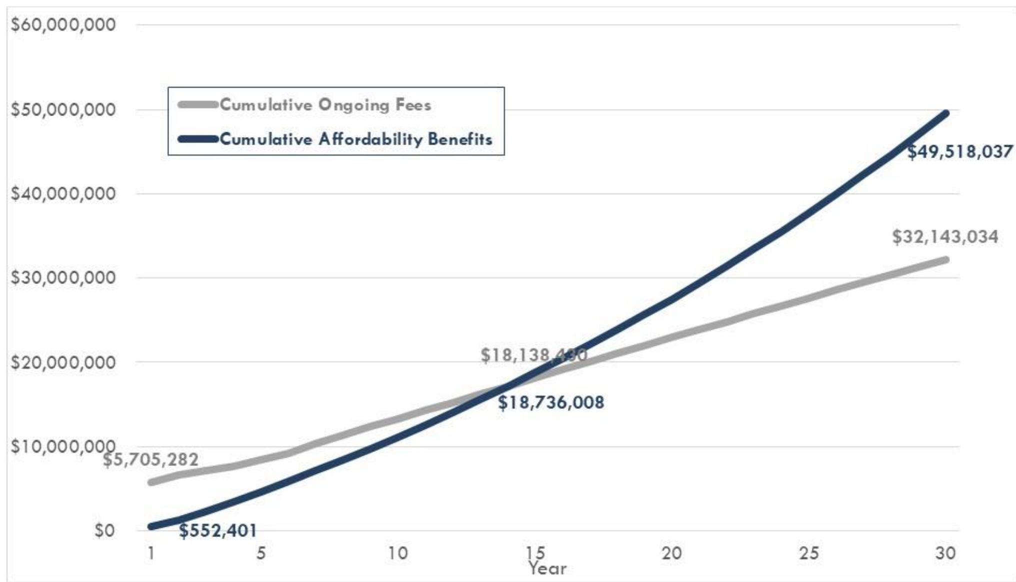
Sources: Affordable Tax Credit Cash Flow Bond Sizing Oceanaire January 21, 2021; HR&A Advisors, Inc.

Compensation is High and Not Closely Tied to Performance

Figure 14 compares the cumulative ongoing fees with the cumulative affordability benefits. The fees are higher than the benefits for the first 14 years of the Transaction. By year 30 the fees equate to 65 percent of the total benefits of the Transaction. This shows that CSCDA and Waterford's fee structure is very high compared to the public affordability benefit.

[14] Note that the Bond also includes an additional $2.0 million reserve account to ensure that there is sufficient funding for Waterford and CSCDA's administrative fee.

Figure 14: Cumulative Ongoing Fees Compared to Affordability Benefits



Sources: Affordable Tax Credit Cash Flow Bond Sizing Oceanaire January 21, 2021; HR&A Advisors, Inc.

Furthermore, the Transaction's financial and fee structure does not directly link the proponent's compensation to performance and provides significant cumulative benefit in the initial years of the Transaction. One important aspect is that Waterford's and CSCDA's fees are fixed and therefore its returns do not vary with the performance of the Transaction. In addition, there is a reserve fund that ensures that their annual fees are paid regardless of the Oceanaire's performance. Greystar's property management fees are related to performance and are consistent with industry standards.

Public Benefits Are Exposed to Market Risk

The potential size of the City's sale proceeds, or surplus conveyance proceeds, are also subject to several risks and assumptions that reduce the City's long term fiscal benefit. One of the most important assumptions in this analysis is that the property tax exemption will expire with the sale of the Oceanaire. The analysis assumes that the property will remain moderate-income housing but would not qualify for the property tax exemption conferred by the current financial structure. The result is that potential sales proceeds are much lower because net operating income ("NOI") would be adjusted to account for property taxes. Another important assumption is the exit cap rate which is assumed to be 50 basis points above the current market cap of 4.25 percent, or 4.75 percent. The result is **that small variations in rent growth and vacancy have the potential to dramatically reduce the surplus sale proceeds from the Transaction at year 15** as shown in Figure 15.[15] In Figure 15 if the values are negative there would not be sufficient value to proceed with a sale so the City would have to wait until there is a higher valuation to move forward with the disposition. If rent growth stays the same but vacancy increases to 10 percent then surplus proceeds disappear, meanwhile if rent growth drops to 2.5 percent or 2.0 percent then surplus proceeds disappear at all vacancy levels. While it is impossible to predict the probability of these outcomes, the historic performance of the rental market and AMI growth indicate that it is more likely than the Transactions projections. That is, as mentioned earlier, once the units are converted to income restricted households rent growth will be driven by AMI growth. AMI might be as high as 3 percent but according to CoStar the historic growth rate for Class A multifamily rental projects in the City for the past 20 years was 1.44 percent. This lower market rent growth indicates that the Oceanaire rents would be above market rents is AMI growth is applied. The result

[15] The analysis assumes that NOI is capped at 4.75% to account for income restriction on the property.

is that rents would either not be able to be raised as much as AMI growth or vacancy would increase as tenants move out to get better rents. The current market reflects this reality.

Figure 15: Sensitivity Analysis of Public Proceeds at Year 15 with Changes in Vacancy and Rent Growth

Rent Growth	Vacancy		
	5%	7%	10%
2.00%	($28,799,395)	($34,757,330)	($43,073,240)
2.50%	($10,371,260)	($17,067,777)	($26,886,196)
3.00%	$8,185,770	$987,465	($9,597,230)

Note: Sales proceeds are modelled with a 4.75% exit cap rate and NOI net of property taxes
Sources: Affordable Tax Credit Cash Flow Bond Sizing Oceanaire January 21, 2021; HR&A Advisors, Inc.

To better understand the long-term implications to the City, Figure 16 shows the potential public proceeds under several different rent growth scenarios at years 15 and 30. In the resulting analysis, at year 15 with a 3.0 percent rent growth lead to a net present value of surplus conveyance proceeds are $8.1 million, but the net public fiscal benefit is negative because foregone property taxes exceed the surplus proceeds. At year 30 rents are projected to have grown sufficiently to expect $169.4 million surplus proceeds and a $48.8 million net fiscal benefit. In Scenario 1, a more modest rent growth, 2.5 percent, there would not be any surplus proceeds at year 15 and the City would be unable to trigger a sale as indicated by the negative surplus conveyance proceeds. At year 30, surplus proceeds would be approximately $93.8 million with a net fiscal benefit of $7.9 million. In Scenario 2, rent growth is reduced further to 2.0 percent leading to $27.3 million in surplus proceeds in year 30 yet the net public fiscal benefit is still negative. These scenarios imply that there is significant risk to the City obtaining a large and significant fiscal benefit that is larger than the foregone property tax collections.

Figure 16: Public Fiscal Benefits Sensitivity Analysis with Changes in Rent Growth

	Original: 3.0% Rent Growth		Scenario 1: 2.5% Rent Growth		Scenario 2: 2.0% Rent Growth	
Year	15	30	15	30	15	30
Exit NOI	$8,320,000	$12,970,000	$7,646,000	$10,872,000	$7,014,000	$9,041,000
Projected Property Tax	($1,925,000)	($2,563,000)	($1,925,000)	($2,563,000)	($1,925,000)	($2,563,000)
Adjusted Exit NOI	$6,396,000	$10,407,000	$5,722,000	$8,308,000	$5,089,000	$6,478,000
Projected Sales Proceeds	$134,645,000	$219,086,000	$120,457,000	$174,913,000	$107,142,000	$136,379,000
Interest Reserve Account	$5,397,000	$5,397,000	$5,397,000	$5,397,000	$5,397,000	$5,397,000
Series A	($126,123,000)	($49,272,000)	($130,048,000)	($80,247,000)	($134,009,000)	($107,129,000)
Series B	($5,779,000)	($5,779,000)	($6,221,000)	($6,221,000)	($7,365,000)	($7,365,000)
Surplus Conveyance Proceeds	**$8,140,000**	**$169,432,000**	**($10,414,000)**	**$93,843,000**	**($28,836,000)**	**$27,282,000**
Surplus Proceeds (inflation adjusted)	$5,930,000	$91,705,000	($7,586,000)	$50,792,000	($21,005,000)	$14,766,000
Foregone Property Taxes (inflation adjusted)	$21,583,000	$42,908,000	$21,583,000	$42,908,000	$21,583,000	$42,908,000
Net Public Fiscal Benefit	**($15,653,000)**	**$48,797,000**	**($29,169,000)**	**$7,884,000**	**($42,588,000)**	**($28,142,000)**

Note: Inflation adjusted assumes a discount rate of 2%
Sources: Affordable Tax Credit Cash Flow Bond Sizing Oceanaire January 21, 2021, HR&A Advisors Inc.

Aggressive Rent Growth Assumptions

Achieving the Transaction's business plan goals involves several risky assumptions related to rent growth and vacancy, particularly with the ongoing impacts of the COVID-19 pandemic on the multifamily sector. The Transaction is projected to have a net absorption of 10 units per month over the next seven months reaching a stabilized occupancy of 95 percent by June of 2021. There are likely to be more move outs over this period than expected, partially due to the impact of COVID-19. For instance, between October and

December of 2020 occupancy decreased by three percent for a net loss of eight units over the period. An additional 13 units are expected to be vacant by February further dropping occupancy to 68 percent. In fact, the property appraisal noted that rents will be flat through 2022. While the Transaction enables reducing rents to aid in lease up, as mentioned above the drops might not immediately attract moderate-income households and may take longer to stabilize. This is problematic because the Transaction depends heavily on leasing units to 100 percent and 120 percent AMI households to offset the larger discounts for 80 percent AMI households. More specifically, this condition may result in dropping rents on the 100 percent and 120 percent units to boost occupancy and cash flow to meet debt obligations, potentially drawing down on the interest reserve and further financially burdening the Transaction.

Furthermore, it is unclear from the materials provided how Waterford and Greystar plan to market the building and find moderate-income households. The Regulatory Agreement stipulates that units must be rented to households in one of the specific income brackets. If Greystar is unable to lease a unit to a targeted income bracket after 30-days they can lease to a lower or higher income bracket, but the households must meet one of the three moderate-income brackets. Absent a specific leasing strategy, there is risk is that Waterford and Greystar may not locate enough income qualified households to maintain appropriate occupancy levels.

Finally, rent assumptions are aggressive and may lead to much lower valuation at sale as well as reduced affordability benefits. According to the Regulatory Agreement, affordable rent should not exceed 35 percent of the relevant AMI level for Los Angeles County. Rent growth is then capped at the AMI growth rate for the County for a given year. In a traditional California affordable housing project, this assumption is reasonable because the discounts to market are so large that the affordable rents are nearly always below market rents. Yet, for a moderate-income transaction where 103 units are already priced above market the assumption becomes aggressive. Over the last 20 years, rents in Long Beach only increased at or above three percent from 2015 to 2018, when a significant number of new Class A properties were delivered. Therefore, in the likely event that market rents grow more slowly, a large share of the affordable rents will not be competitive creating a cash flow issue, eroding affordability benefits and reducing the public fiscal benefit.

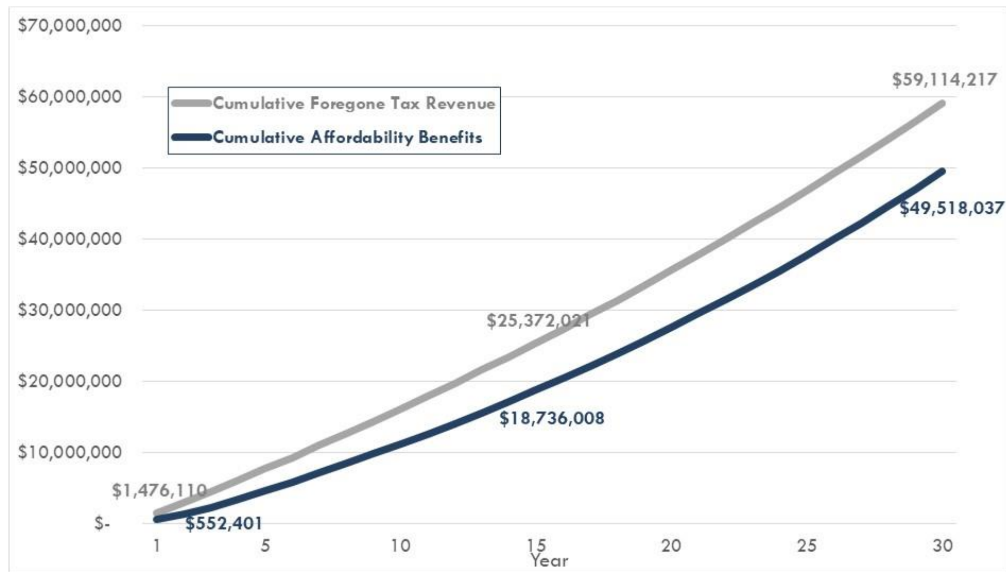
3. Justifying Return on Foregone Property Tax Revenue

The Transaction's potential returns on investment are susceptible to market conditions that include assumptions about rent growth and vacancy that may be difficult to meet. Given the potential variance in returns on investment both in terms of affordability and fiscal returns the Transaction poses risks.

Minimal Public Benefit for Foregone Property Tax

The affordability gains provide units for an underserved moderate-income bracket, but the total affordability benefits are relatively limited compared to the foregone property tax revenue. Figure 17 shows that the cumulative affordability benefits are always smaller than the foregone property tax with the different growing over time. The opportunity cost is likely larger because the City also loses the tax basis to issue bonds for other uses or pay for General Fund services. The City also loses the opportunity to increase property taxes by resetting the assessed property value when the property would have traded to other private buyers. For instance, over the course of 30 years it is likely that the building would trade three or more times, each at a higher price, further increasing property tax revenues. Finally, the City is also forgoing a small reduction in the cumulative sales tax revenue that results from lower household incomes. The combination of these factors shows that the affordability gains are relatively limited compared to the foregone property taxes that could be used for other public purposes. Furthermore, given that existing tenants cannot be displaced under the terms of the agreements, there is a chance that some of the units will never convert to income restricted rates. Partially due to the inability to displace existing tenants, Waterford assumes it will take at least six years to fully convert.

Figure 17: Estimated Cumulative Foregone Property Taxes compared to Cumulative Affordability Benefits



Sources: Waterford Cash Flow for Loan Sizing, January 21, 2021; HR&A Advisors Inc.

Require Annual Reporting To The City

The Transaction proponents should be required to provide final financial transaction and annual financial reporting to the City, along with information about property conditions and the capital expenditure plans. More specifically, this should include the Preliminary and Final Offering Statements, the quarterly and annual Continuing Disclosure Statements, an annual report on property condition and proposed capital expenditures, notice of any change in asset manager or property management company, an opportunity for City staff to periodically inspect the Oceanaire upon reasonable advance request to the property management company, and if the A Bond qualifies for designation as a "Social Bond " (i.e., a socially-responsible investment standard), as has been the case with at least one completed CSCDA transaction to date, copies of annual reports on whether the Transaction is meeting its Social Bond Framework standards.

Precedent Setting Transaction

For the City to fully realize the potential benefits of the proposed Transaction, it will be critical to clearly define an exit strategy and recognize that this transaction will set a precent. City staff should plan to explore each of the scenarios that could cause the City to want or need to take over the Oceanaire and ensure that it is not creating moral hazards by, in effect, guaranteeing projects that encounter operating or public safety difficulty, leaving the City with no other option but to assume control of the Oceanaire.

The first consideration is the expected year of sale. The sooner the Oceanaire sells the less property tax revenue is lost, but the affordability and fiscal benefits are also smaller. On the other hand, a shorter hold period has less depreciation and potential for significant deferred maintenance that could accrue if the building is held for 30 years.

The second consideration is determining, and clearly defining, the reimbursement to various taxing agencies when the Oceanaire is eventually sold. The language in the current Regulatory Agreement leaves some ambiguity about the compensation of taxing authorities. The City should further explore and decide exactly how, when, who and how much various entities will be reimbursed at future sale.

The third consideration is the type of sale as summarized in Figure 18. Selling the Oceanaire at market rate will have the largest public proceeds result because the opportunity for the buyer to mark to market is

largest, but the City will also be contributing to the loss of moderate-income housing. This scenario seems politically unlikely and implies that the surplus public proceeds will not be maximized from the Transaction. Selling the property to a non-profit developer would help maintain the affordability benefits, but there would be very minimal resulting public proceeds. The buyer would not qualify for tax exemption and may need some other public subsidy to maintain the discounted rents. The low-income scenario would lead to the largest affordability gains, but there would be no public proceeds. The buyer would qualify for property tax exemption and federal, state and/or local loan programs and may therefore not require additional public proceeds to operate the building.

Figure 18: Various Exit Strategy Scenarios

	Buyer	Affordability	Cap Rate	Public Proceeds	Tax Exemption	RHNA Credit
Market Rate	For-profit	None	Lowest	Highest	None	No
Moderate-Income	Non-profit	Moderate	Moderate	Minimal	None	No
Low Income	Non-profit	Significant	Highest	None	Yes	Yes

Source: HR&A Advisors, Inc.