COUNCIL AGENDA: 12/13/22
FILE: 22-1863
ITEM: 8.3

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand
Jim Shannon

SUBJECT: **SEE BELOW**

DATE: November 21, 2022

Approved Jennifer A. Maguire

Date **12/1/22**

COUNCIL DISTRICT: 3

SUBJECT: APPROVAL OF A FUNDING COMMITMENT FOR SECOND STREET STUDIOS DEVELOPMENT LOCATED AT 1144 SECOND STREET

RECOMMENDATION

(a) Adopt a resolution:

(1) Approving a construction-permanent loan commitment of $13,000,000 to Second Street Studios, LP, (Developer) an affiliate of First Community Housing, for Second Street Studios Development located at 1144 South Second Street (Development);

(2) Authorizing the Director of Housing to negotiate with Developer for the refinance and payoff of the outstanding $12,000,000 senior Silicon Valley Bank loan to the Development and fund $1,000,000 to pay for other operating expenses of the Development; and

(3) Authorizing the Director of Housing to negotiate and execute either the amendment of existing loan documents or new loan documents and all other documents regarding an increase to the City of San José construction and permanent financing for the Development or a new construction and permanent financing commitment in the amount of $13,000,000, including any amendments or modifications thereto.

(b) Adopt the following 2022-2023 Appropriation Ordinance amendments in the Low- and Moderate-Income Housing Asset Fund:
(1) Decrease the Housing Project Reserve by $13,000,000; and
(2) Increase the Housing Loans and Grant appropriation to the Housing Department by $13,000,000.

OUTCOME

Approval of the recommended actions will enable the Developer to receive $13,000,000 in additional financing from the City for the Development to pay off its senior loan with Silicon Valley Bank (Bank), and to pay operating costs that have caused the Development to run out of funds and continue to support the residents living in this community.

BACKGROUND

Second Street Studios, consisting of 135 units in a five-story residential building, was completed and fully leased in August 2019. The City has made a total of $20,158,673 in loan commitments to the development. Below is a history of the City's loans.

- June 17, 2014 – City approved a $8,000,000 construction and permanent loan from the Low and Moderate Income Housing Asset Fund ("Low Mod"), which includes $500,000 for predevelopment. Total $8,000,000.
- September 15, 2015 – City approved a $6,452,000 increase to the construction/permanent loan from Low Mod funds. Total: $14,952,000.
- December 12, 2016 – Director, through her Delegation of Authority, approved an increase to the project's construction and permanent loan amount from $14,452,000 to $16,915,713, an increase of $2,463,713 in Low Mod funds.
- June 1, 2018 – City Council approved an increase of $1,500,000 in HOME funds to the construction and permanent loan commitment reflecting a total up to amount of $18,415,713.
- September 7, 2021 – Director, through her Delegation of Authority, approved an increase to the project's construction and permanent loan amount from $18,415,713 to $19,158,673, an increase of $742,960 in Low Mod funds.
- June 7, 2022 – City approved a $1,000,000 increase in Low Mod funds to the construction and permanent loan: Total $20,158,673.

Subsequent to the lease-up of the development, the County of Santa Clara Office of Supportive Housing (OSH) and the Housing Department assessed that additional safety measures and services were needed at the building. The Housing Department, OSH and the project sponsor First Community Housing (FCH) have worked together to monitor and stabilize the operations of the Development. As a result of OSH's assessment, $204,665 in additional funding was required to increase the number of security guards at the site and improve the coordination of services by the service providers and property management team.

In June 2022, staff began its discussions with the Bank to learn more about the Development's financial position and ability to pay its monthly loan repayment obligation. Consequently, staff worked with key lending partners and FCH to better understand the larger operational issues and financial stresses impacting the Development. As a result, staff is recommending additional funding to pay off the Bank loan to the Development to stabilize operations and eliminate short-term unpaid financial obligations. The results of staff's review of the project are presented in this memorandum.

ANALYSIS

Second Street Studios was the first 100% permanent supportive housing development funded by the City. As such, it was created to make progress toward solving homelessness by housing an estimated 150 formerly homeless individuals. FCH accepted the challenge of expanding their mission to include providing permanent supportive housing as part of their work in San José. Second Street Studios challenges have created opportunities for FCH and their partners to better understand the physical needs of the building, as well as the services needed to create a safe, healthy community for residents. The frequency of floods and fires within the building led to unplanned financial investments to prevent these incidents from occurring. Security measures were increased to address safety concerns. Many of these lessons have been addressed in subsequent permanent supportive housing developments.

Over the last year, operating expenses exceeded the rents collected. FCH was forced to lend the development funds from the FCH organization to pay critical partners (property managers, contractors, and service providers). Staff has determined that there is a need to increase cash flow to support and pay for the unanticipated and expensive operating expenses related to this 100% permanent supportive housing development. The solution is two-fold. First, restructure the senior debt to eliminate the Bank's monthly payment of $84,579 and second, redirect those funds to the project for payment of Current Liabilities, as defined below, and then to the City.

FCH's Commitment to Affordable Housing in San José

FCH owns and controls 16 properties in San José, of which, nine properties are LEED certified (Gold or Platinum). In addition, FCH has one property under construction and two vacant parcels held for future development. The City has invested nearly $87,000,000 in 15 of FCH's projects to create 1,992 affordable apartments in San José. Also, FCH is the City's only Department of Housing and Urban Development designated Community Housing Development Organization, which allows it to receive federal HOME Investment Partnerships Program funding for the development of affordable housing.

Challenges Faced by FCH in Building its Affordable Housing Pipeline

Historically, FCH has produced on average one development a year. Through a strategic planning process completed in 2017, FCH decided the best way to remain a financially viable organization was to increase production of affordable housing properties and build a pipeline of projects to be developed. This decision was based on the rising costs associated with development and the lower fee percentages associated with the tax credit program. FCH set a target to initiate three new construction projects annually.

In order to meet the goal to increase the development pipeline, FCH began investing more funds into predevelopment activities. Typically, these costs are reimbursed at the time of construction loan closing. The financial challenge arises when the timing of construction loan closing is delayed due to the inability of a proposed affordable housing project to secure the much needed public sector subsidy. The end result is that timing and the ability to "hold" properties is expensive while the financial resources needed to start and complete an affordable housing development are secured.

To build its development pipeline, FCH began to increase its predevelopment and acquisition expenses, which ranged from $2,000,000 up to $9,000,000 per project. Much of this expense was covered by FCH directly.

Because FCH did not have the financial resources to absorb delays in starting construction, FCH has become financially over-extended and unable to meet all of its financial obligations regarding two of its proposed developments (i.e., McEvoy/DuPont whose $29,000,000 predevelopment/acquisition loan is now in default and Pacific North in Santa Cruz which has incurred a loss of $2,500,000 in initial investment).

In regard to operational properties, FCH has two properties located in San José that are losing money: (1) Second Street Studios (approximately $30,000 per month) and (2) Curtner Studios (approximately $20,000 per month). While both project's ongoing losses are concerning, it is the losses associated with the proposed developments that have the greatest financial impact and represent the greatest financial challenge to the organization.

FCH has provided a plan to the Housing Department that addresses its long-term sustainability. The plan contemplates a strategy to partially repay McEvoy loans through the sale of the property and considers the FCH's portfolio of fully owned properties for capital by refinancing. Maintaining affordability and high-quality housing for FCH's low-income residents will remain the priority throughout this process.

Second Street Studio Financing

City of San José

Currently, the City has a construction and permanent loan in the amount of up to $20,158,673 to the Developer with a 4% simple interest per annum for a term of 55 years repaid from residual receipts. This loan amount includes $742,960 used for improvements to reduce damages from flooding caused by fire incidences. City's loan is in second position to the Bank's loan to the Project among the various lenders.

Silicon Valley Bank Loan and Refinance

The Developer took out a senior note with Boston Private, which was purchased by the Bank, on December 23, 2019, for $13,000,000. The interest rate is 5.13% and the note is due in 20 years (January 1, 2040). The monthly debt service is $84,579 or $1,014,958 annually (principal and interest). However, the Developer is at risk of not being able to make payments for the following reasons related to the increase in operating costs.

- Flood and Fire Repairs - For the past three years, there have been up to $360,000 per year in unbudgeted repair costs primarily related to water damage from flooding and fire damage.
- Stable Revenue - Total annual revenue has remained relatively flat from $3,187,861 in 2020 to $3,164,238 projected in 2023.
- Security – Tenant-driven concerns of safety and security measures resulted in hiring a second guard on a 24-hour basis, which has increased security costs from $262,000 in 2020 to $460,512 projected in 2023.
- Property and Liability Insurance – Annual costs have increased from $87,231 in 2019 to $306,054 in 2023, partially due to a large fire in 2020.
- Resident Services - Costs have increased from $150,000 in 2019 to $217,294 in 2023 primarily from increased labor costs.
- Management Fee - Increased from $72,900 to $105,300 due to the intensive nature of the need at the site.
- Office Lease Space – Increased from $0 to $42,735 per year because the original office was only designed for two staff.
- Utility Costs - Electricity has increased from $120,000 to $239,295 because the site is covering all electrical costs,
- Janitorial Costs - Increased from $72,000 to $195,408 because the site initially budgeted one full-time employee five days per week instead of the current 2.0 full-time employee seven days a week,
- Staffing Costs - Payroll has increased from $304,894 to $469,619 annually due to increasing salaries and additional administrative and maintenance staff needed.

These unanticipated operating expenses have resulted in an annual additional cost of $966,000, which does not include unanticipated repair costs. FCH used its own funds in the amount of $558,451 to cover these unanticipated expenses and an additional $204,665 in security costs, covered by the County of Santa Clara.

Paying off the Bank's senior note will help the project pay for all operating expenses, including Current Liabilities, and reduce the risk of default. "Current Liabilities" include $544,883.79 in current accounts payable to the John Stewart Company (Property Management Company), $558,451.32 owed to FCH to cover FCH's advance to cover the unanticipated operating expenses and, $204,665 in additional security costs totaling $1,308,000.

Boston Private, predecessor of the Bank, initially sized their loan to the Project with a 1.15 Debt Service Coverage Ratio requirement. A Debt Service Coverage Ratio of 1.15 translates to a business being able to pay 100% of its debt at its current operating level with a 15% cushion. Due to the higher than anticipated operating costs detailed above, the project is currently operating at a 0.60 Debt Service Coverage Ratio which means that there is only enough net operating income to cover 60% of annual debt payments. In short, operating costs exceed revenues and the project does not support the Bank's loan. With the City as the new senior lender, the Project can be placed in a stronger financial position with terms that are suitable for a 100% Permanent Supportive Housing product.

While the property has continued to make its regularly scheduled monthly payments to the Bank, FCH as the project sponsor has needed to advance funds to the property on a monthly basis. Even with this advancement of funds, the property has incurred approximately $1,308,000 in Current Liabilities. Because the property has not been able to stabilize its operations (i.e., three consecutive months of better than break-even), Red Stone Equity, the investor and limited partner of this tax credit project, has not advanced its final pay-in equity amount to the property of approximately $785,000. By replacing the existing bank debt with a new City loan, the property will achieve the stabilization threshold within the first three months of the City's new loan which will enable the property to receive the final equity pay-in amount. FCH may then apply the final equity pay-in funds towards future operations of the property.

Proposed Actions to Address Second Street Operations

Proposed Actions to be taken by the City and the Bank:

- The City will loan Developer $13,000,000 to pay off the Bank loan in the amount up to $12,000,000 and approximately $1,000,000 for Current Liabilities of the Property;
- The Bank will defer three months in principal payment obligation;
- The Bank will forgive $1,611,899 in prepayment penalties; and
- The Bank will consent to withdrawal of funding from the Operating Reserve and/or Social Services Reserve to address short-term unpaid financial obligations.

Once the Developer pays off the Bank loan of $12,000,000 to the project and the City becomes the new senior lender, the City will contribute an additional $1,000,000 to help eliminate the Current Liabilities payment obligation to stabilize operations. Any Current Liabilities outstanding will be covered by a combination of an Operating Reserve and the Final Equity Pay-in. Finally, once Current Liabilities have been paid and operations are stabilized, remaining cashflow will be used to repay the City's loan. The table below lists the Current Sources to pay for Current Liabilities at the project.

Table 1: *Second Street Studios Current Liabilities Payment Sources (estimated)*

Current Liabilities	Amount Outstanding	Current Sources	Amount
John Stewart Company	$544,884	City of San José	$1,000,000
FCH Operating Expense Advance	$558,451	Operating Reserve	$300,000
Security Costs	$204,665	Final Equity Pay-in	$8,000
Total	**$1,308,000**	**Total**	**$1,308,000**

The Housing Department recommends that the City make a refinance loan from the Low- and Moderate-Income Housing Asset Fund to the Developer in order to pay off the Bank to stabilize and improve the operations of the Development. Stabilization is critical to the on-going operations of Development. More importantly, it is an investment in the health and wellbeing of the tenants living at Second Street Studios. The table below lists the current and proposed financing for the project.

Table 2: *Second Street Studios Capital Contribution (Current versus Proposed):*

Sources	Current	Proposed
Silicon Valley Bank	$12,000,000	$0
City of San José (First Position)	$0	$12,000,000*
City of San José (Second Position)	$20,158,673	$20,158,673
Infill Infrastructure Grant (IIG)	$4,000,000	$4,000,000
Affordable Housing Program (AHP) Loan	$1,340,000	$1,340,000
Total	**$37,498,673**	**$37,498,673**

*An additional $1.0 million will be loaned to FCH to help pay off Current Liabilities.

Loan Terms

The total new loan to Developer will be $13,000,000 including $12,000,000 to pay off the Bank loan and $1,000,000 to pay off the Current Liabilities. The new first position $13,000,000 loan from the City will have separate terms that are favorable to the Development and more importantly to the residents living at Second Street Studios. Initial terms will be structured to 1) pay off the Bank loan of $12,000,000 to the project; 2) infuse an additional $1,000,000 to the project to ensure all Current Liabilities are paid in full; 3) use the Social Services Reserve and Operating Reserve to address short-term unpaid financial obligations; and 4) secure repayment of the City's loan as the new senior lender.

As described above, Second Street Studios loses approximately $30,000 per month. While the City's loan with a lower interest rate and extended repayment horizon are anticipated to achieve a financially viable operation over the long term, final negotiations are in process subject to current budget analysis and future cashflow projects suitable for a successful outcome at Second

Street Studios. This action will result in the elimination of all hard repayments or monthly payments. Payments on the remaining debt will be repaid annually if rents are sufficient to pay for all of the operating expenses. The City loan will be structured to not require payment if revenue collected from rents are not sufficient to cover operating costs.

Finally, the City loan documents will require that Developer report out on key performance metrics set forth by the City that will measure building maintenance, operating costs including services, tenant satisfaction and turnover, as well as overall financial condition of the borrower and the Developer on an annual basis. This ensures that both the City and the Developer are tracking the habitability, resident experience, the financial performance of the building, and its ability to repay the loan. Failure of the Developer and the borrower to meet the performance metrics may be deemed a default under the new loan.

CONCLUSION

By replacing the permanent Bank debt, and lending Developer $13 million, the City will hold a first mortgage that will enable the property to achieve the following:

- In combination with the use of the property's Operating Reserve and Social Services Reserves, pay-off all Current Liabilities of the property.
- Allow the property to become qualified for and receive the final Equity Pay-in Amount as discussed above.
- Allow for the property to stabilize operations through the rightsizing of ongoing Operating Expenses.
- Allow the property, over a period of time, to fully fund the Operating and Social Services Reserves, as may be needed.

The recommendation is to approve the requested funding which will stabilize operations of the property that is serving formerly homeless households with needed services.

EVALUATION AND FOLLOW-UP

The Housing Department produces periodic information memoranda regarding the use of the Director of Housing's Delegation of Authority under the Municipal Code; therefore, any additional actions would be summarized in those memoranda. In addition, the Housing Department posts to its website, www.sjhousing.org, periodic reports on the status of its affordable properties undergoing rehabilitation or construction.

CLIMATE SMART SAN JOSE

This recommendation has no effect on Climate Smart San José energy, water, or mobility goals.

POLICY ALTERNATIVES

To arrive at this proposal, staff considers the following options:

Alternative # 1: Deny the requested funding commitment

Pros: The additional funds requested could be used for other affordable housing developments within the City of San José.

Cons: The City will lose an opportunity to meet the financial obligations and operating costs that would cause a disruption to the residents living at Second Street Studios.

Reason for not recommending: The proposal is a viable opportunity to support the needs of deeply affordable housing opportunity for vulnerable individuals in an inclusive setting.

PUBLIC OUTREACH

On February 10, 2022, FCH co-hosted a meeting with the Spartan Keyes Neighborhood Association to highlight and address the community's concerns and identify areas that would enhance the operations of the Second Street Studios Development. Monthly community meetings take place on the first Wednesday of every month at the property.

COORDINATION

Preparation of this report was in coordination with the Office of the City Attorney.

COMMISSION RECOMMENDATION/INPUT

This item was not heard by the Housing and Community Development Commission, as approvals of affordable development financing and acquisition do not fall under the functions, powers, and duties of the commission delineated in Section 2.08.2840 of the San José Municipal Code.

COST SUMMARY/IMPLICATIONS

1. AMOUNT OF RECOMMENDATION: $13,000,000

2. SOURCE OF FUNDING: Low and Moderate Income Housing Asset Fund (346).

3. FISCAL IMPACT: The recommended action in this memorandum will enable the Housing Department to provide financing to Developer in order to pay off a $12,000,000 senior bank loan for the Second Street Studios development and infuse $1,000,000 to the Development to remedy the cash flow situation caused by higher than projected operating costs. There is no additional ongoing budgetary impact resulting from the actions recommended in this memorandum.

BUDGET REFERENCE

The table below identifies the fund and appropriations to fund the actions recommended as part of this memorandum.

Fund #	Appn. #	Appn. Name	Current Total Appn.	Rec. Budget Action	Amt. For Commitment	2022-2023 Adopted Operating Budget Page	Last Budget Action (Date, Ord. No.)
346	8437	Housing Project Reserve	$15,245,000	($13,000,000)	$0	1009	10/18/2022 Ord. No. 30833
346	0070	Housing Loans and Grants	$81,019,444	$13,000,000	$13,000,000	1008	10/18/2022 Ord. No. 30833

CEQA

Not a Project, File No. PP17-003, Agreements/Contracts (New or Amended) resulting in no physical changes to the environment; and File No. PP17-004, Government Funding Mechanism or Fiscal Activity with no commitment to a specific project which may result in a potentially significant physical impact on the environment.

/s/
JACKY MORALES-FERRAND
Director, Housing Department

Jim Shannon
JIM SHANNON
Budget Director

The principal author of this memorandum is Isaac Orona, Development Officer. For questions, please contact Rachel VanderVeen, Deputy Director of Housing at Rachel.VanderVeen@sanjoseca.gov or (408) 535-8231.