Downtown High-Rise
Fee Exemption and Tax Reduction Program

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Downtown High-rise Program

2007: Parks Fee Reduction

2012: Parks Fee and Construction Tax Reduction

2016: Parks Fee and Construction Tax Reduction

- Planning application on or before December 31, 2017
- Obtain a Building Permit on or before July 31, 2018, and
- 80% of the residential units have a final inspection scheduled on or before December 31, 2020

2017: Parks Fee set to reflect unique high-rise characteristics

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Affordable Housing Impact Fee

2014: AHIF Adopted

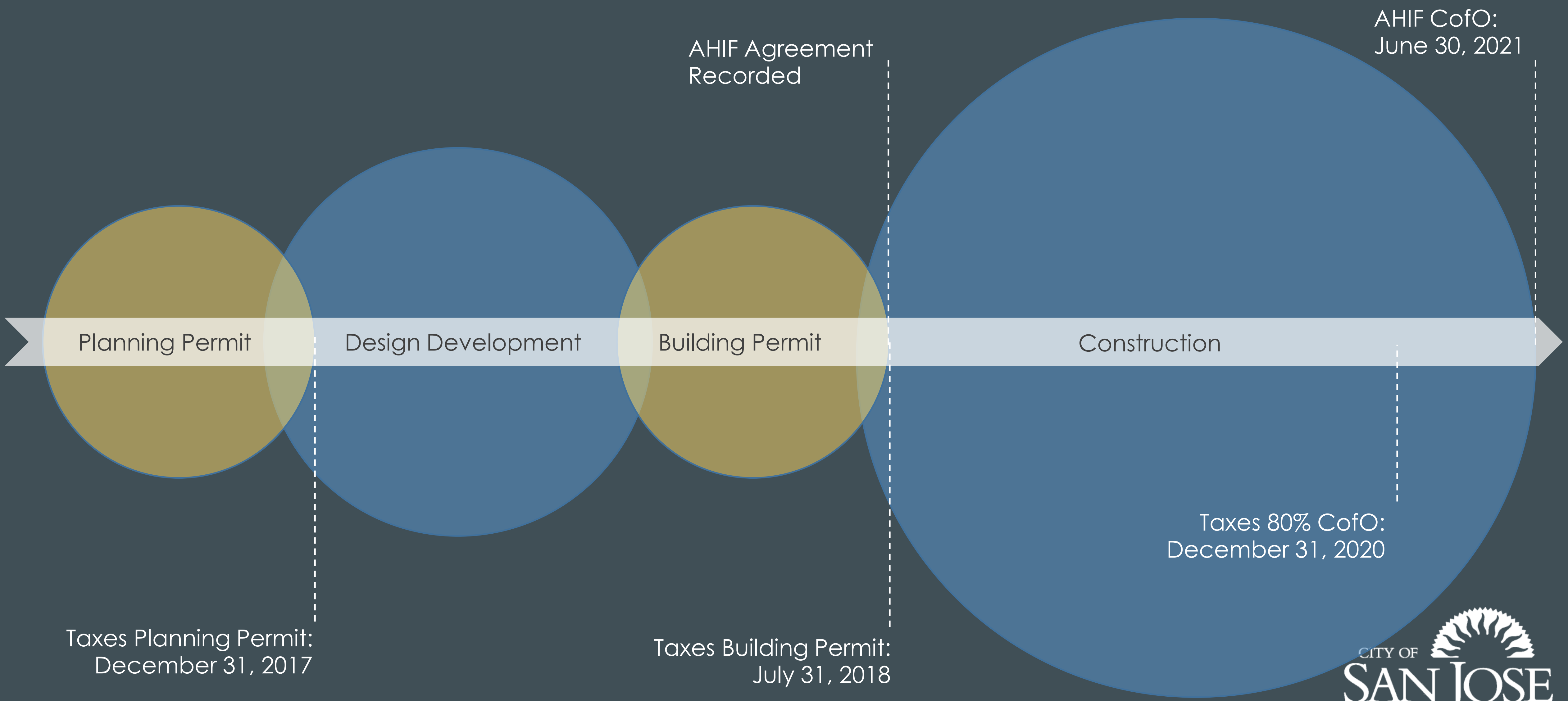
Included time limited exemption for Downtown High-Rise rental projects:

- Provides evidence that development is not for-sale development

- Records an Affordable Housing Impact Fee Agreement prior to issuance of Building Permit, and

- Final Certificates of Occupancy ready to issue on or prior to June 30, 2021

Development Timeline:



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AHIF Eligible Projects

Project Name	Developer	Building Permits Issuance Date	Number of Units	Status	Meet Taxes Deadline	Meet AHIF Deadline
The Graduate Amcal	AMCAL Housing	12/19/17	260	Under Construction	Likely	Likely
Miro SJSC Towers	Bay View Development	12/22/17	630	Under Construction	Unlikely	Likely
Aviato	KT Urban/StarCity	N/A	302	Entitled	Unlikely	Unlikely
Greyhound	Z & L Properties	N/A	708	Entitled	Unlikely	Unlikely
Gateway Tower	The Core Companies	N/A	300	Entitled	Unlikely	Unlikely
4th Street Metro Station	Caruso Designs	N/A	218	Not Entitled	Unlikely	Unlikely
The Carlysle	Insight Realty	N/A	220	Not Entitled	Unlikely	Unlikely
Post & San Pedro	Simeon Properties	N/A	228	Added Units	Unlikely	Unlikely
27 West	Alterra Worldwide	N/A	374	Entitled	Unlikely	Unlikely

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Prior Council Direction

June 2018: Housing Crisis Workplan

- Align Construction Tax reduction with the end date of the AHIF exemption

June 2019: Workforce Standards

- Move forward with a unique services agreement for a consultant to perform the required financial feasibility assessment of Downtown high-rise residential Sub-Category – return on August 6, 2019.

- 14.10.060 Financially Infeasible: "Financially Infeasible" means that the **typical** Private Construction Projects, as that term is defined in Section 14.10.090 of this Chapter 14.10, in a Subcategory of Use, as that term is defined in Section 14.10.100 of this Chapter 14.10, are not likely to be built absent a reduction in fees and/or taxes applicable to the Projects.

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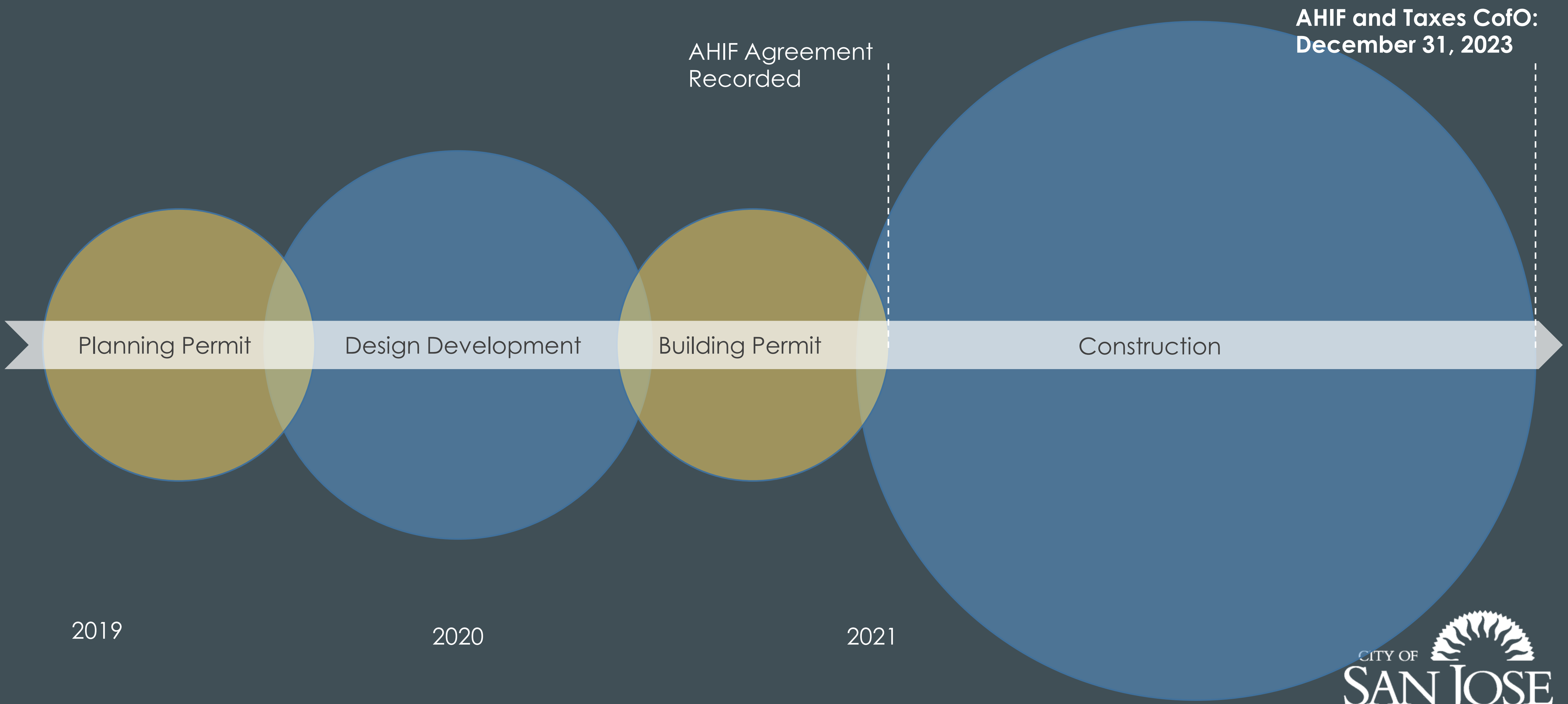
Proposed Extended Timeline:



High-rise Prototype Development

Program	
Parcel Size (acres)	1.5
Parcel Size (sf)	65,340
Building Height (ft)	250
Building Area (gsf)	564,103
Building Efficiency*	78%
FAR (excl parking)	8.6
Residential Units	
Number of Units	550
Average Unit Size (nsf)	800
Unit Density (du/acre)	367
Parking	
Parking Ratio (parking spaces per dwelling unit)	0.80
Number of Spaces	440

* Building efficiency is the percentage of total rentable floor area (net square feet) divided by the gross building area.

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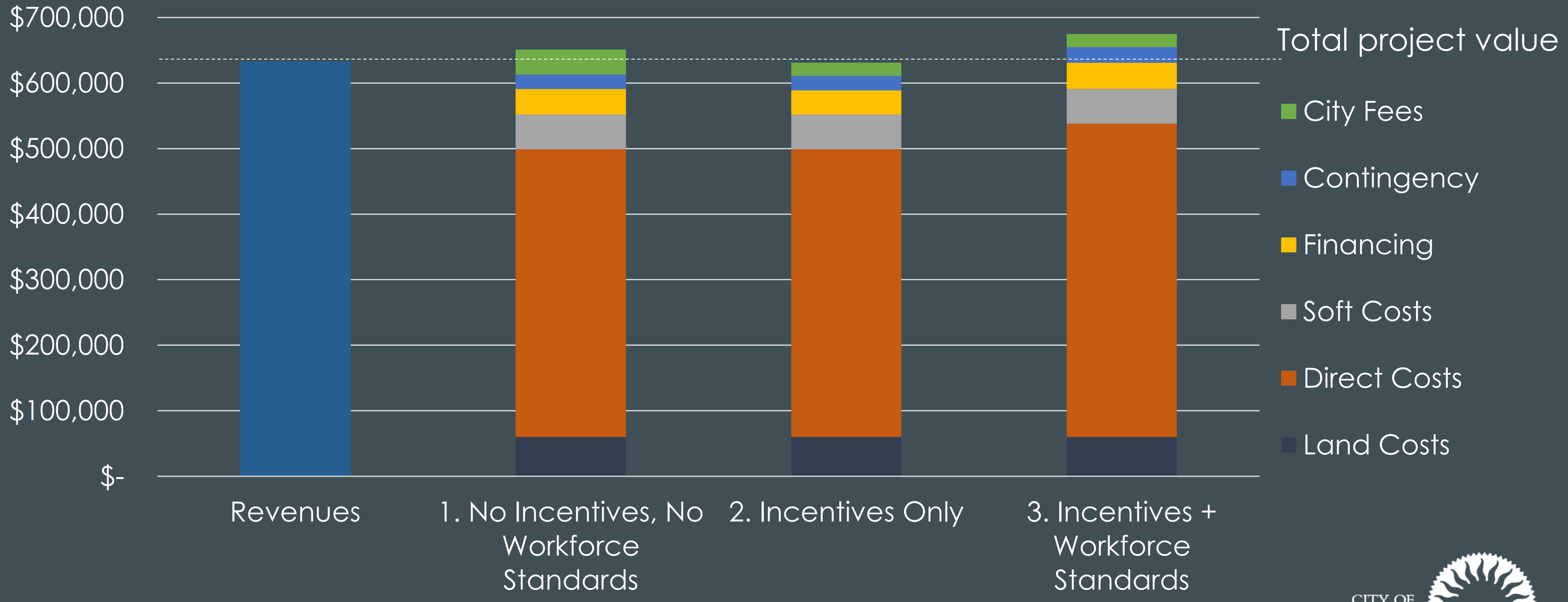
Cost versus Revenue (Per Unit)



Development Feasibility

$$\text{Yield on Cost} = \frac{\text{Net Operating Income}}{\text{Total Development Cost}}$$

Target Yield on Cost = 5.25%

	1. No incentives, no workforce standards	2. Incentives only	3. Incentives + workforce standards
Net Operating Income	$27,000	$27,000	$27,000
Total Development Cost	$651,000	$632,000	$675,000
Yield on Cost	4.15%	4.27%	4.00%

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AHIF Projects Impact

Project Name	Developer	Number of Units	Status	If Paying AHIF FY 22-23 ($19.61)	Program
The Graduate Amcal	AMCAL Housing	260	Under Construction	$ 5,126,760	Current
Miro SJSC Towers	Bay View Development	630	Under Construction	$ 11,525,346	Current
Aviato	KT Urban/StarCity	302	Entitled	$ 5,600,851	Proposed
Greyhound	Z & L Properties	708	Entitled	$ 13,833,286	Proposed
Gateway Tower	The Core Companies	300	Entitled	$ 4,614,331	Proposed
4th Street Metro Station	Caruso Designs	218	Not Entitled	$ 3,876,289	Proposed
The Carlysle	Insight Realty	220	Not Entitled	$ 3,763,453	Proposed
Post & San Pedro	Simeon Properties	228	Added Units	$ 3,511,504	Proposed
27 West	Alterra Worldwide	374	Entitled	$ 5,354,628	Proposed

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Meeting the Ordinance Requirements

	Requirement	Consultant Analysis
a.	Whether construction of the Private Construction Projects in the specified Subcategory of Use is Financially Infeasible;	*Under current conditions, a typical high-rise development in downtown San José is not financially feasible.*
b.	The reason(s) for any conclusion that construction of the Private Construction Projects in the specified Subcategory of Use is Financially Infeasible;	*The yield-on-cost for Scenario 1 is 4.13%, short of the target return of 5.25%. This is mainly due to the escalating cost of construction in the current market environment, currently estimated at $651,000 per unit for a development of this type.* *With the current high level of development costs, average rents would need to increase by 20 percent (to $4.80 per net square foot or $3,840 per unit monthly) for the development to be feasible given current costs.*

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Meeting the Ordinance Requirements

	Requirement	Consultant Analysis
c.	The anticipated duration of any condition(s) making construction of the Private Construction Projects in the specified Subcategory of Use Financially Infeasible;	*As rental rates over the last ten years have averaged 4.6 percent annual growth (see Figure 5), it may require a few years of favorable conditions (strong rental market combined with flat development costs) to reach feasibility.*
d.	The estimated size of the financial gap between the Private Construction Projects in the specified Subcategory of Use being Financially Infeasible and financially feasible;	*A 21 percent reduction in total development costs (or $138,000 reduction per unit) would be required for a development of this type to be feasible.*

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Meeting the Ordinance Requirements

		Requirement	Consultant Analysis
e.		Options for making construction of the Private Construction Projects in the specified Subcategory of Use financially feasible, including the following:	
	i.	Providing the proposed fee or tax reduction without requiring the payment of prevailing wages;	*Extending the incentives improves the financial picture slightly but is not sufficient for the development to reach feasibility.*
	ii.	Providing the proposed fee or tax reduction along with requiring the payment of prevailing wages; and	*Including workforce standards increases development costs by 4%.*

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Meeting the Ordinance Requirements

		Requirement	Consultant Analysis
e.		Options for making construction of the Private Construction Projects in the specified Subcategory of Use financially feasible, including the following:	
	iii.	Any additional options, other than the proposed fee or tax reduction, that would make construction of the Private Construction Projects within the specified Subcategory of Use financially feasible, provided that any such options must comply with all applicable laws and regulations, including the City's current general plan.	*Other policy solutions that could improve feasibility include relaxing building codes and participating in workforce training efforts.* These options would not make construction of the Private Construction Projects within the specified Subcategory of Use financially feasible. The three variables that were directly explored in the report were: • No incentive and no workforce standards • Incentives only • Incentives and workforce standards implemented

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Responding to Concerns

I. The study does not provide a single independent source for any data points or assumptions used in its pro forma analysis.

- Strategic Economics reviewed recent high-rise construction and development proposals in the Bay Area, collected market data for apartment rents and land costs in the Downtown, and interviewed a range of developers and general contractors experienced with high-rise development in San José.
- Strategic Economics also reviewed two feasibility analyses for San José high-rises conducted by Keyser Marston Associates in 2018 and 2019.
- In reviewing the impact of the workforce standards, the report cites studies from both the Berkeley Planning Journal and Industrial and Labor Relations Review

Responding to Concerns

II. The value assumed for land costs appears to be significantly higher then both the actual land costs incurred by the majority of projects in the subcategory, and higher than typical land values in downtown. Other values assumed without independent sources may have similar problems.

- Some recent projects in the Downtown have lower land costs because the land was purchased in the past, however the analysis assumed that a typical project moving forward would need to pay current land prices, and land prices have been increasing in the Downtown.
- The land cost assumption also includes site costs, which can be an additional $10 – 25 per square foot of land.
- This assumes that the current owner is intending to develop in person. As with recent construction, the developer has either partnered with another entity or sold the development opportunity subsequent to entitlement.
- The most recent transactions available are most relevant as they account for the significant investment in public infrastructure coming into the Downtown (BART), and in commercial development by both Google and other speculative commercial developers.
- Staff analysis of the reduced land value shows that the pro forma still doesn't meet the Yield on Cost threshold for feasibility.

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Responding to Concerns

III. The study fails to analyze the range of different project characteristics within the specified subcategory; instead, it assumes all Downtown high-rises are exactly the same in size, structure, efficiency and financing. It also fails to perform a sensitivity analysis.

- Per the ordinance, "Financially Infeasible" means that the **typical** Projects, are not likely to be built absent a reduction in fees and/or taxes applicable to the Projects. Size or shape of lot, height restrictions, adjacent neighborhoods or historic structures, high water table, or other factors can affect the individual feasibility of a project.

- If assessed as an individual project, the proposed development would not qualify for the exemption from the workforce standards – not a sub-category.

- The feasibility assessment cannot anticipate all outcomes and therefore the feasibility model cannot be used as a calculator or dynamic model to benchmark individual project feasibility against a single project. More accurately it is a measure of feasibility across the subcategory based on a "typical" development project.

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Responding to Concerns

IV. The estimate of workforce standards impacts is based on faulty analysis, including failure to separate out construction worker wages & benefits from all other construction costs, failure to ground-truth results against industry baseline data, and possible conflation of terms. As a result, the estimated impact of the workforce standards in the study is 3 to 9 times higher than if it were calculated properly.

- Goal was to estimate the cost of the prevailing wage requirement specifically for high rise residential construction in the specified geography. Consultant found that the impact of prevailing wage on high rise projects is actually lower in Downtown than for other residential product types, because the majority of construction labor on high rise projects are usually union workers.

- The cost differential between prevailing wage and non-prevailing wage costs is not just the difference in payroll. The difference also includes additional fees and markups that subcontractor firms charge general contractors.

- Staff and consultant asked a variety of stakeholders for additional data or credible sources to help verify the cost differential – other than those cited in the report, none were provided.

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Responding to Concerns

V. No opportunity was provided for stakeholder review of the analysis, followed by the consultant providing written responses to stakeholder feedback.

- Staff prioritized Council direction to return on August 6, or as soon as possible.
- Stakeholders were asked for feedback on the scope and workforce analysis, and provided the opportunity to meet with the consultant directly.
- Study was intended to be objective and staff has focused on not presupposing the outcome or attempting to influence the consultants findings.
- Staff received the report two days before it was posted, and as soon as it was available it was provided to stakeholders.

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Responding to Concerns

VI. The study does not, as required by ordinance, provide a quantitative analysis of additional options, other than the proposed fee or tax reduction, that would make construction of the projects within the subcategory financially feasible, beginning with an opportunity for stakeholders to propose additional options for analysis.

- Ordinance states "Consultant must address… Any additional options, other than the proposed fee or tax reduction, that would make construction of the Private Construction Projects within the specified Subcategory of Use financially feasible"
- Stakeholders, staff and the consultant were asked to provide additional options, but none that would substantially effect the financial model were presented by any of said parties.
- Opportunity zones may have the potential to change return expectations for an individual investor, however there are no precedents to date. Developers interviewed for the study stated that the opportunity zone has helped to attract additional investor interest, but has not reduced return expectations.
- Value engineering and cost controls are broad categories that have insufficient detail to reflect changes in the pro forma.
- Developer return is addressed in the establishment of a yield on cost threshold.
- Analysis does acknowledge that use of more skilled and experienced union labor could help to reduce project delays, which can reduce carrying costs and developer risk, however consultant was not able to enumerate this so as to include an estimate of the impact of workforce standards.

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Recommendation

Accept the report on the Downtown High-Rise Feasibility Assessment and direct staff to return to Council with the appropriate ordinance and resolution to enact the following:

1. Extending the certificate of occupancy deadline for the Affordable Housing Impact Fee exemption to December 31, 2023.

2. Amending Title 4.46 and 4.47 to align the construction tax reduction with the certificate of occupancy deadline for the Affordable Housing Impact Fee exemption, and removing the planning and building permit requirements.

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Downtown High-Rise Fee Exemption and Tax Reduction

September 24, 2019

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