CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Christopher Burton
Rosalynn Hughey
Nanci Klein

SUBJECT: **SEE BELOW**

DATE: October 19, 2023

Approved [signature] Date **10/20/2023**

SUBJECT: COST OF RESIDENTIAL DEVELOPMENT IN SAN JOSE STUDY SESSION

PURPOSE

The annual Cost of Residential Development Report (Report) and the Study Session are intended to provide City Council with insight into the economics of residential development, one of the primary challenges impeding the construction of new housing in San José. The Study Session will provide City Council with an update to the Report presented at the November 1, 2022 Study Session. The Report is comprised of two sets of analyses produced with the assistance of a consultant that evaluates the total cost of residential development in San José for market-rate and affordable housing.

OUTCOME

The Report provides an analysis of the impact of market and economic conditions on the cost to construct new market-rate and affordable housing in San José. City Council will hear a presentation from consultant Century | Urban on the findings of the updated Report, as well as insights from local industry experts in the fields of construction, real estate, financing, and affordable housing development.

BACKGROUND

In 2017, City Council directed staff to convene a City Council Study Session to discuss the aggregate impact of the fees and policies the City imposes on housing development and construction. The goal of the Study Session was to provide context and background for upcoming development-related items to be considered by City Council.

In 2018, City Council held two Study Sessions on April 26 and May 1 on the cost of residential development in San José that provided an overview of the local real estate market and residential development. Members of the Urban Land Institute provided a detailed summary of development financing and the impact of various City costs and policies on the viability of projects. Keyser Marston and Associates provided a detailed report, including a conceptual pro forma analysis for market-rate residential development based on the current market conditions in San José. The analysis in 2018 showed that new residential development was unlikely in many parts of San José based on economic conditions. The most likely area for new residential development was in West San José and development in Downtown and North San José had some potential.

In 2019, staff presented an update on the cost of residential development to City Council. This update found similar results as the 2018 study, suggesting that development remained feasible in West San José. Development in Downtown and North San José was again marginal and did not obtain a sufficient return to attract investment. Other areas of the City returned a negative value and were not possible. The 2019 update also included an additional analysis prepared by Keyser Marston and Associates on affordable housing.

In 2021, staff conducted a Request for Proposal and selected a new consultant to perform the work required to update the annual analysis. Century | Urban was selected as the consultant and the work to update the analysis with the consultant was initiated in early 2022. Century | Urban prepared a conceptual feasibility analysis for five residential rental and sale development prototypes most regularly seen in San José. The updated analysis revealed that none of the examined prototypes were feasible largely due to a 17% increase in Bay Area construction costs since the last analysis was completed, as well as a rise in interest rates and borrowing costs.

In 2023, the Report continues to show numerous challenges in developing both market-rate and affordable housing in the City. According to Century | Urban, average total development costs per unit, including the cost of materials and labor, increased 12% to 13% over the past 18 months and continue to be the most significant barrier to new housing construction. The recent experience in the City aligns with the Report findings in that 2023 new construction multifamily projects reported higher than anticipated funding gaps due to notable increases in their total development costs. Residential development in the City continues to face significant barriers related to increased costs of construction and financing.

ANALYSIS

The continued updates to the Report are an important tool for understanding the barriers to new housing construction. In particular, the updates provide a more detailed understanding of the factors both outside and within the City's control that impact the feasibility of residential development. These factors can contribute to the City's ability to deliver on its housing goals. As was the case in previous iterations, the analysis from the most recent Report continues to paint a bleak picture for future residential development in San José. Construction costs, despite a brief pause early in the pandemic, have continued to rise significantly and remain the biggest barrier to housing development in the City. This is a factor that the City has limited control over. On the other hand, City fees and the approval process for new developments are areas within the City's control to change.

New housing development for both market-rate and affordable housing is dependent upon private capital investment. From the start of the process, a developer will compile data based on estimated costs balanced against the estimated income that a new project will generate once completed. This model is referred to as a development "pro forma." It is created individually by a developer early in the development process and is refined as the project moves along in the process. The pro forma is an important part of the decision-making process as the model will show whether the proposed project is both financially feasible and a worthwhile investment for private capital. The data and assumptions included in a specific pro forma for market-rate development are typically treated as proprietary to that developer or investor and are not shared with the City or the public.

Cost of Residential Development Report: Market-Rate Housing

The Report is intended to provide insight into the current economic conditions impacting residential development. Each individual project or deal is unique, complex and often spans many years. To provide a measure of the feasibility of residential development at any given time, the Report uses conceptual prototypes. These prototypes do not represent specific projects but rather reflect the typical characteristics of development that have occurred in the City in recent years and that are considered in each of the sub-areas by the *Envision San José 2040 General Plan* (General Plan). The prototypes used in this update are unchanged from the previous Reports. In general, they remain reflective of the types of development the City has seen for new multifamily housing. In addition, keeping the prototypes consistent allows for an easier comparison of the results of this study to those of the previous studies.

The Report looks at market-rate for-sale and rental multifamily housing development in three different prototypes: a five-story low-rise building, a seven-story mid-rise building, and a 22-story high-rise building. It is important to distinguish these types of development as each requires a different type of construction, which means different materials are used in the construction of the buildings. These material types affect the cost of construction. In general, the types of construction become more expensive the higher the building height. These prototypes are analyzed in several different submarket areas.

The majority of new residential development considered in the General Plan is planned for densities higher than are currently found throughout the City. While much of the housing throughout San José is at lower densities (primarily single-family homes), the long-term strategy outlined in the General Plan is to provide opportunities for high-density housing to maximize the number of new units constructed and to meet the City's housing goals. The Report is intended to highlight current market conditions that present challenges to delivering the housing envisioned in the General Plan and, therefore, uses high-density housing prototypes as a basis for the analysis.

Through these conceptual prototypes, the consultant, Century | Urban, created a development pro forma that analyzes each prototype's feasibility based on the current market conditions. The prototypes and the associated assumptions are detailed in the Report and included in **Attachment A**.

Defining Residual Land Value

The Report uses standard assumptions and developer insights to create the underlying feasibility model. In this analysis, the measure of feasibility is Residual Land Value, which is the amount of value remaining to purchase land once projected revenues and all other costs associated with planning, constructing, and leasing/selling the project have been accounted for. These costs also include an expected return on investment for the developer and other investors consistent with industry standards that are used by both the development and investment communities to make decisions on where to focus projects and investments. When comparing relative development activity between San José and other cities around the state or even nationally, the level of feasibility or return is ultimately the measure by which decisions on which projects to pursue and move forward are made. A positive residual value indicates the development could pay up to a specific price for land and still be considered feasible. A residual value that is zero or negative indicates a development that is infeasible as there is no remaining value to purchase land.

The results in the Report are based on conceptual prototypes and not on specific projects. The Report provides a macro view of development feasibility in the City. This does not necessarily mean that individual projects will not start. Specific projects may have unique circumstances that enable them to move forward in the current conditions.

Market-Rate Housing Development Remains Infeasible in Any Area

The results from the Report are included in **Table A and Table B** below. To summarize, all prototypes show significant negative residual land values. This means that even before accounting for the purchase of land, the cost to construct the building is infeasible. The residual values shown are on a per unit basis. The locations are based on the Development Fee Framework/Inclusionary Housing Ordinance submarket areas. Downtown is a subsection of the Central area, and the south and east are composed of multiple areas in the southeast part of the City. Not all prototypes were tested in all locations, and cells on the table with *NA* (not applicable) indicate locations that were not tested.

Table A: Residual Land Values for Market-Rate Rental Housing by Size and Location (per unit)

Rental Prototypes /Location	**Low-Rise (5 stories)**		**Mid-Rise (7 stories)**		**High-Rise (22 stories)**	
Year	***2022***	**2023**	***2022***	**2023**	***2022***	**2023**
Central	*($257,000)*	($343,000)	*($338,000)*	($435,000)	*($498,000)*	($614,000)
West	*NA*	*NA*	*($216,000)*	($363,000)	*($376,000)*	($542,000)
Downtown	*NA*	*NA*	*NA*	*NA*	*($432,000)*	($568,000)
North	*NA*	*NA*	*($317,000)*	($429,000)	*($476,000)*	($607,000)
South and East	*($261,000)*	($323,000)	*NA*	*NA*	*NA*	*NA*

Table B: Residual Land Values for Market-Rate For-Sale Housing by Size and Location (per unit)

For Sale Prototypes/ Location	Low-Rise (5 stories)		High-Rise (22 stories)	
Year	***2022***	**2023**	***2022***	**2023**
Central and West	*($307,000)*	($394,000)	*NA*	NA
Downtown	*NA*	NA	*($518,000)*	($611,000)
North	*($369,000)*	($419,000)	*NA*	*NA*
South and East	*($394,000)*	($342,000)	*NA*	*NA*

**The sales comparable data for the south and east submarkets showed a marked improvement in the sales price per square foot as compared to the sales comparable data for the 2022 study.*

Estimated Land Costs

Century | Urban also provided a land cost estimate based on location to provide context to the residual land values. Land prices estimated by the consultant (**Table C**) range from $25,000 to $85,000 per unit, depending on the geographic area. Due to limited land sale transactions for multifamily residential developments since the 2022 analysis, land values are estimated to be the same as the prior year's analysis.

Table C: Land Cost Estimates by Geographic Area

Land Prices Per Unit	South and East	Central	West	North	Downtown
Low	$40,000	$40,000	$65,000	$25,000	$25,000
High	$65,000	$65,000	$75,000	$85,000	$85,000

Construction Costs Remain a Barrier to New Development

The consultant also conducted a sensitivity analysis as part of the Report (**Exhibit C** in **Attachment A** to this memorandum) that looked at the impacts of various changes to multiple feasibility factors. For example, the sensitivity analysis included a 5% increase or decrease in rental rates, or a 5% increase or decrease in construction costs, etc. In all scenarios analyzed, the residual values did not shift to positive values that indicate feasibility. In all cases, the per unit residual values remained at significant negative levels. The largest improvement in feasibility was with a 5% reduction in construction costs. This analysis further shows the significant challenges faced in the current economic conditions for new market-rate construction and reinforces the major hurdle of construction costs.

In addition, two versions of Type I (high-rise) rental and sale prototypes are included –one version, which reflects standard City requirements for payment of an inclusionary in-lieu fee and construction taxes, and a "waiver" version, which reflects a waiver of payment of the inclusionary in-lieu fee and 50% reduction of select construction taxes.

Challenges to Provide Much-Needed Housing

The findings of this updated Report continue to point to an extremely unfavorable development climate throughout San José and, to some extent, the wider Bay Area. Development feasibility has decreased significantly for almost all of the proformas analyzed in the report and throughout all sub-areas.

Commercial real estate requires a balance between the costs associated with entitling, financing, and constructing a project and the total supportable cost realized in revenues from the lease or sale of units upon completion. A considerable number of variables go into each side of this equation but ultimately, if the balance is tipped towards infeasibility the project will be unable to obtain the financial resources necessary to proceed with the project. Several factors continue to impact this balance for residential development throughout San José but the primary amongst them continues to be construction costs, including the cost of materials and labor, which have continued to increase significantly since the start of the pandemic. The Report cites the Engineering News Record and TBD Consultants, both of which publish indices that track construction costs quarterly in the Bay Area. Both indices reflect major increases in cost since 2014 (over 200%) and even more significant increases since the first quarter of 2020 (up to 27%). While San José has experienced some rental rate and sale price growth over the same periods, construction cost growth has significantly outpaced both.

In addition to these "hard cost" increases, financial conditions for borrowing as well as services and City fees (soft costs) have significantly impacted development proformas. Increases in interest rates and borrowing costs driven in part by inflation and corresponding policy reactions have caused a decrease in market transaction volume and the availability of capital for construction projects. In addition to the cost of financing projects, the risk profile for new development has changed significantly. In addition to representing the required return developers expect from a potential project, the Return on Cost metric is often also used in assessing the viability of new projects by financial institutions considering construction loans. The Report assumed a Return on Cost of 5.75%, which already reflects an increase over the assumed Return on Cost in the 2022 Report, but subsequent discussions with members of the development community suggested that financial partners and lenders are targeting an even higher Return on Cost of 6.5%. The volatility of the current market and increased uncertainty of the economic outlook moving forward also create additional challenges.

Beyond the soft costs associated with entitlement and construction, multiple developers raised concerns about ongoing operating costs such as increasing insurance rates that have had a significant impact on baseline assumptions. Diminished net operating income would further impact supportable development costs, which in turn further diminishes feasibility.

City Fees and Taxes

There are a variety of City fees associated with processing development applications. Due to the "cost recovery model' of development services operations, applicants pay fees to several departments, including Fire, Planning, Building, and Code Enforcement, and Public Works. These fees pay directly for staff and the cost to the City to process and review the project. These fees represent less than 1% of the total cost per unit. There are also fees associated with public improvements such as sanitary sewer connection fees or street frontage improvements, among others. The largest component of City costs comes from inclusionary (affordable) housing in-lieu fees, parkland impact in-lieu fees, and construction taxes. Construction taxes, in general, fund transportation infrastructure, among other things, and are assessed based on the valuation of the new building. Parkland obligations for residential development can be satisfied through the dedication of improved or unimproved land, payment of an in-lieu fee, or a combination of both. The Report assumes a 25% reduction in parks fees for on-site recreational amenities. The fees and taxes included in the Report include a reduction based on average levels of credit for market-rate housing projects. Most qualifying affordable housing projects receive between 50% and 75% in park fee payment reductions. The City's inclusionary housing requirements can be fulfilled in a variety of ways including building new affordable housing units or through payment of an in-lieu fee.

Based on the data in the Report, these costs represent 5% to 10% of the total costs to build a unit (**Table D**). These numbers are marginal compared to the overall cost of the unit; however, they still add costs and contribute to the level of infeasibility. Reduction of these taxes and fees to zero would improve feasibility slightly, but would not fundamentally change the outcome of the analysis; more importantly, such elimination would also significantly reduce City resources necessary to support transportation infrastructure renovate and create new park infrastructure and support affordable housing and related grant-matching requirements that support all these programs.

It is important for staff and City Council to continue to understand the cost implications of all policy decisions in the near term that could add additional costs to new housing development or decrease potential future revenues that would otherwise support day-to-day City infrastructure. Any added costs would further contribute to the infeasibility of new market-rate construction.

Table D: City Taxes and Fees on a per Unit Basis

City Impact Fees and Taxes (rental)	Range per Unit	
Year	2022	2023
Planning/Building fees	$2,800 to $7,000	$3,100 to $7,700
Construction taxes	$6,400 to $6,800	$7,900 to $9,900
Parkland in-lieu fees	$9,800 to $20,800	$9,800 to $20,800
Inclusionary housing in-lieu fees	$21,000 to $49,600	$24,500 to $57,700
Total City Impact Fees and Taxes	**$40,000 to $84,200**	**$45,300 to $96,100**

Cost of Residential Development Report: Affordable Housing

Century | Urban also prepared a Report for the City regarding the recent impact of market conditions on the cost and feasibility of constructing affordable housing included in **Attachment B** – *Affordable Housing Development Cost Study*. The purpose of this study was to understand the changes in the cost of developing affordable housing within the City, the funding sources used to pay for such costs, and the unique attributes of affordable housing that contribute to its higher construction costs.

The study compared the cost of developing affordable housing in San José to similar costs in other large California cities. This study evaluated the period from March 2022 to February 2023 for eight projects in San José and 21 projects in other cities that received tax credit allocations during this period. These projects ranged in height from five to seven stories and proposed a large family, "Non-Targeted" or "Special Needs" housing type. Non-Targeted projects are projects with a geographic set aside rather than a target population set aside. Special Needs developments target individuals and families who are homeless or at risk of homelessness and need permanent affordable housing and supportive services. These types of developments provide supportive services to assist an individual or family retain their housing, improve their health status, maximize their ability to live, and, when possible, work in the community.

The study showed that the average cost per unit for all San José projects was 23% higher than the average cost per unit for other City projects, and notably, the average cost per unit for Special Needs projects in San José were 43% higher than the average cost per unit for Special Needs projects in other cities. Acquisition costs per unit were 33% higher for all San José projects than in other cities. **Table E** provides the total development cost, average per unit.

Table E: Total Development Costs, Average per Unit

	San Jose Projects	Other City Projects	San Jose Cost Difference
All Projects	$811,700	$658,800	23%
Large Family	$875,700	$727,000	20%
Special Needs	$925,600	$683,600	35%
Non-Targeted	$588,600	$553,700	6%

* This refers to the 21 projects in other cities studied in the report.

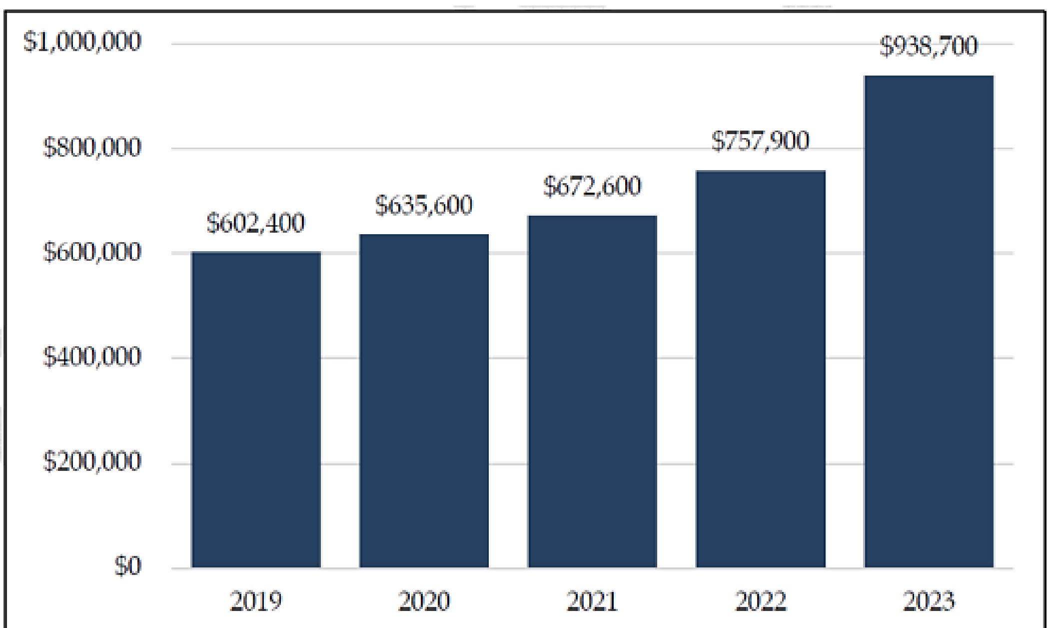
The findings summarized below outline the challenges and major cost factors that impact affordable housing developments in light of recent economic and market fluctuations, and demonstrate why the cost of affordable housing is more expensive in San José than in other cities.

General Trends

Escalation of Construction Cost

Similar to the findings from the market-rate study, construction costs have been a significant challenge for affordable housing development. Annual construction cost escalation averaged between approximately 8% from 2010 to 2020. While the increase was only 1% during the pandemic, 2021 showed a significant increase of 15% followed by an 8% increase in 2022 with major contributors being material and labor costs. This double-digit increase over an 18-month period led to per-unit costs for both large families and special needs units averaging around $900,000 per unit, which were 20%-35% higher than other cities. **Chart 1** provides the total development costs per unit by year.

Chart 1: San José Projects Total Development Costs per Unit by Year



YOY % Change	NA	6%	6%	13%	24%

Increase in Cost of Financing

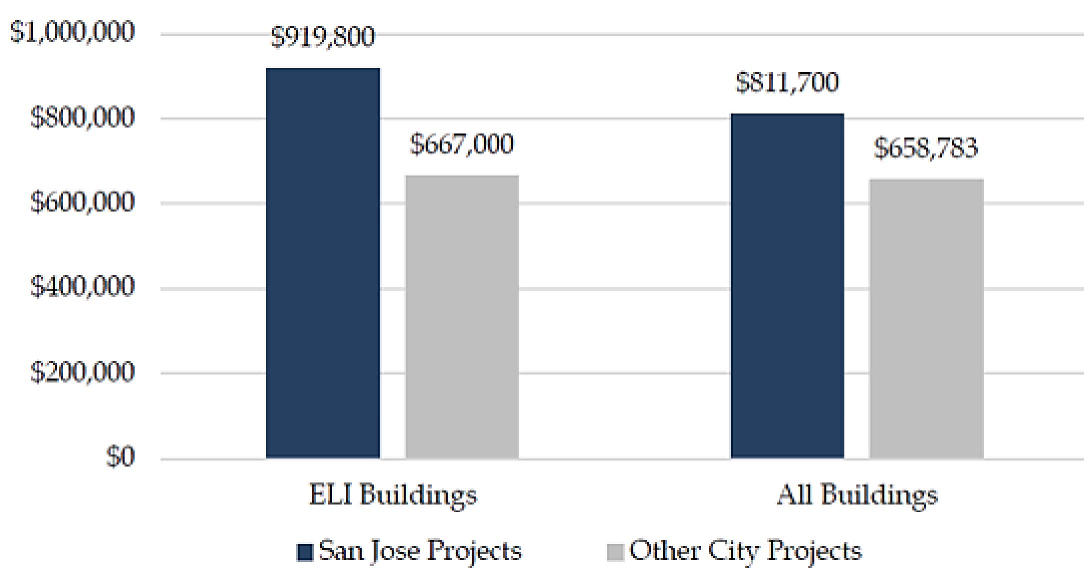
Financing for affordable housing developments is more complicated in that it requires multiple sources of funding, not just equity and debt. Projects have to apply to at least five to six sources of funding, which on average can take two to three years to acquire as some federal and state sources offer only a single application round a year. In addition, obtaining tax credit allocations is a highly competitive process and demand is often double what is available. Due to inflation, the recent increase in interest rates from around 4% to 8% has had a significant impact on the cost of obtaining financing to cover affordable housing development costs. The length of time it takes to acquire multiple funding sources exposes the borrower to interest rate fluctuations and other variable costs before the close of financing following a tax credit allocation. Multiple funding sources also bring additional compliance, regulatory, and legal costs. More than 60% of the construction financing is funded through a senior lender construction loan. Increases in interest rates drive up the cost of loans from banks. Affordable housing developments offer deeper affordability and generate lower rental income, making it difficult to meet the senior lender's debt service requirements. As a result, the developer obtains a smaller senior loan and, to cover the gap, seeks larger commitments from lenders willing to provide debt with lower interest rates, typically government lenders including the state, county, and the City.

The City of San José Versus Other Cities

<u>Deeper Affordability Levels</u>

San José developments provide deeper affordability, with approximately 75% of San José projects setting aside 50% or more units for extremely low-income households, in comparison to approximately 43% of other cities' projects. Development costs for extremely low-income buildings are higher, as shown in **Chart 2** below, due to the larger average unit size in these projects. Special Needs units in the City are 33% larger in square feet on average than in other cities. The larger average unit size accommodates the larger household size for extremely low-income units and Special Needs units.

Chart 2: Average Development Cost Extremely Low Income (ELI) Buildings Compared to All Buildings



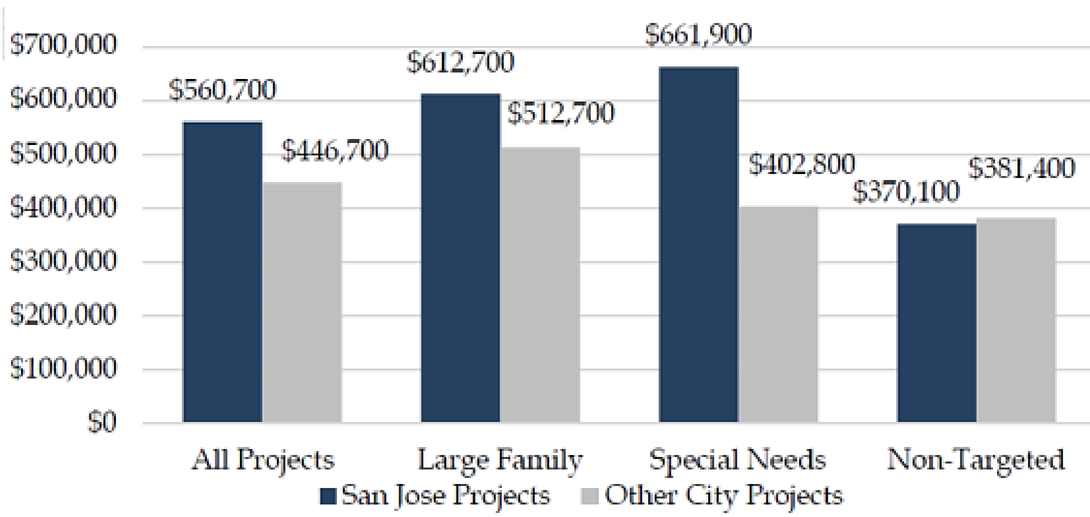
<u>Higher Direct Construction Costs</u>

Direct construction costs represent approximately 69% of total construction costs and have been increasing by 12% annually. The cost of labor and materials to construct buildings, site improvements and parking are higher in San José when compared to other cities. There is also a significant cost difference for Special Needs projects in San José compared to other cities. A shortage in the construction labor market and prevailing wage requirements applicable to San José projects result in higher direct construction costs for these projects. Many cities like San

José require that projects that receive City subsidies pay the prevailing wages set for by the state. However, not all cities have this requirement.

Table F: Total Direct/Hard Development Costs, Average/Unit

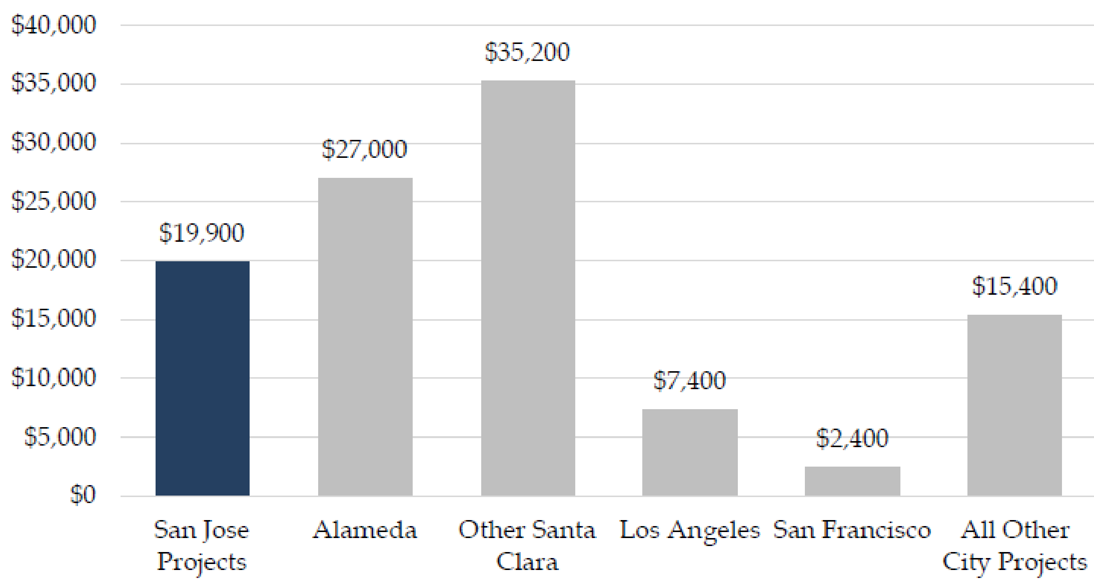
	San Jose Projects	Other City Projects	San Jose Cost Difference
All Projects	$560,700	$446,700	26%
Large Family	$612,700	$512,700	20%
Special Needs	$661,900	$402,800	64%
Non-Targeted	$370,100	$381,400	-3%



Higher Impact Fees

Cities impose impact fees and taxes, such as traffic impact, construction taxes, and parkland in-lieu fees, on new development to fund the infrastructure needed to support new housing. These charges can support important local services, such as schools, parks, and transportation. San José's impact taxes and fees averaged $20,000/unit versus $15,000/unit in other cities. As outlined in **Chart 3** below, projects in the City and County of San Francisco and the City of Los Angeles receive impact fee waivers that are proportionally higher than San José.

Chart 3: Impact Fees/Unit



A current work item in the Housing Crisis Work Plan is to assess reducing the construction taxes charged to affordable housing developments. Staff initiated internal discussions around this item, but due to staffing changes in the Housing Catalyst role, this work has been put on hold. As part of this work effort, staff will seek to understand how San José construction taxes compare to other jurisdictions.

<u>Higher Financing Costs</u>

Affordable housing projects are financed through multiple financing sources. Financing costs represent approximately 9% of San José projects and other City project's total development costs. It should be noted that financing costs have doubled in the past 12 months.

San José projects averaged approximately six funding sources per project. Each additional funding source potentially adds costs due to extended timelines and/or operational requirements. This layering of capital is causing long delays, which can add significantly to hard costs in a rapidly rising construction cost environment.

As projects become more complex, affordable housing developments also experience higher soft costs such as increased legal and consultant fees as well as syndication costs associated with financial consultants needed to manage multiple funding streams and partners. In addition, public funding in California can be highly fragmented creating a need to coordinate between state, county, and local funding sources. **Table G** provides the average financing cost per unit.

Table G: Average Financing Cost per Unit

Application Year	San Jose Projects	Other City Projects
2019	$30,700	$39,500
2020	$40,900	$34,800
2021	$43,600	$37,600
2022	$69,000	$53,000
2023	$103,800	$65,400

Lower Federal Equity Pricing

Affordable housing projects raise capital to fund development costs through investor equity, referred to as tax credit equity. An investor receives credits over a 10-year tax credit period. As the amount of tax credits available for allocation is fixed each year, the pricing of tax credits directly affects the number of units that can be financed through public funding sources. A lower tax credit price requires more state and local subsidies to fill financing gaps.

Some City of San José projects received equity pricing as low as 0.90 cents to the dollar in 2022-2023. Equity investments are a significant source of funding at the conversion phase when the construction is complete, and equity capital is injected into the project to take out the senior lender construction loan balance. When equity pricing and investment equity are lower, the development must procure additional subsidies to bridge the funding gap.

CONCLUSION

The updated Report shows that the current economic conditions remain a significant barrier to the construction of new market-rate and affordable housing. Similar to last year's Report, none of the prototypes assessed were shown to be feasible under current market conditions, and in fact, conditions have worsened. This is apparent in the current decline in permitting and construction activity throughout the City.

The affordable housing cost study identifies additional significant barriers to financing and building affordable housing developments. Total development costs for affordable housing continue to have material consequences for the supply of new affordable housing at a time when San José lacks enough affordable housing to meet residents' needs, with a severe shortage of adequate, affordable housing for extremely-low-, very-low-, low-, and moderate-income households.

EVALUATION AND FOLLOW-UP

Staff plans to update the report annually as part of its ongoing work on housing policy. The next update is anticipated in the fall of 2024. Staff will also continue to bring forward further analysis and recommendations regarding the impacts on development costs through the Housing Catalyst Work Plan and continued work on the Development Fee Framework.

PUBLIC OUTREACH

Meetings with development community members were held on September 28 and October 12, 2023. A draft version of the Report was shared with participants at these meetings. A meeting with affordable housing developers was held on October 4, 2023, to review the findings of the Cost of Affordable report and seek input. This memorandum will be posted on the City's Council Agenda website for the October 26, 2023, City Council Study Session.

/s/	/s/	/s/
CHRISTOPHER BURTON Director, Department of Planning Building and Code Enforcement	ROSALYNN HUGHEY Deputy City Manager and Acting Housing Director	NANCI KLEIN Director of Economic Development and Cultural Affairs

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ATTACHMENTS:

Attachment A – Cost of Development by Century | Urban
Attachment B – Affordable Housing Development Cost Study by Century | Urban