



DAVID PAUL ROSEN & ASSOCIATES
DEVELOPMENT, FINANCE AND POLICY ADVISORS

3941 Hendrix Street
Irvine, California 92614-6637
tel: 949.559.5650
fax: 949.559.5706
nora@draconsultants.com
www.draconsultants.com

January 17, 2019

To: Kristen Clements, Jacky Morales Ferrand
From: Nora Lake-Brown, David Rosen
Subject: Moderate Income Housing Fund for San Jose, Revised Findings

The Housing Department of the City of San Jose (Department) requested DRA to conduct a market feasibility analysis of a multifamily rental housing moderate income fund (Fund), and its ability to provide an increment of moderate income affordability, as proposed in the Mayor's recommendations for the June, 2018 Housing Investment Plan for the City. DRA prepared a memo summarizing the findings of this analysis dated June 29, 2018. DRA concluded that such a Fund is viable for San Jose and has the ability to provide between 10% and 20% of units affordable to renter households at 80% or 90% of Area Median Income (AMI), respectively, for most project prototypes analyzed, given the availability of patient capital with moderate returns.

In September and December 2018 Housing Department management requested that DRA conduct sensitivity analysis of its June 29 report. This memorandum updates the findings of DRA's analysis, under the direction of Development management, to: 1) add two additional prototypes for Downtown and North San Jose, and 2) refine the tax analysis for returns to prospective Fund investors. DRA also refined the subordinate debt/equity analysis to incorporate accrued (rather than capitalized) interest on the subordinate debt/equity during construction and operation, based on the findings of DRA's developer interviews. Finally, for units affordable to households at 80% AMI, DRA showed returns with and without the property tax exemption for qualifying units.

DRA focused on the potential difference in development feasibility and project internal rate of return (IRR) to developers under a program that would reduce the cost of capital to finance new rental residential development in exchange for affordability restrictions targeted to moderate income renters.



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To complete this analysis DRA:

1. Conducted interviews with representatives of private debt and mezzanine debt/equity sources, using the interviewee list and interview questions outlined in DRA's memo dated February 9, 2018, plus additional sources recommended by DRA's literature review and the initial interviewees;
2. Prepared a financial analysis of seven prototypical rental developments, selected in consultation with Housing Department and Planning Department staff, using first mortgage financing terms and underwriting standards consistent with Fannie Mae and Freddie Mac multifamily loan programs and conventional mezzanine debt/equity cost of capital assumptions; and
3. Modeled the value to developers from the estimated lower cost of mezzanine debt/equity capital associated with a moderate income housing debt/equity fund and quantified the economic value of the lower cost of capital in terms of the number of affordable units at 80% or 90% of AMI that could be supported, as summarized in DRA's memo dated June 29, 2018.

This analysis will assist the Department in assessing whether and how moderate income rental housing production may be boosted with mezzanine financing from a fund offering a moderate rate of return.

SUMMARY OF FINDINGS

1. Multifamily Debt/Equity Fund Returns

In our lender and investor interviews and literature analysis, DRA focused on the following key questions regarding alternative debt and credit enhancement programs:

1. What is the cost of mezzanine debt/equity capital provided by existing multifamily debt/equity funds targeted at "moderate income" or "workforce" income levels, and how does it compare to market-rate multi-family housing financing? How are alternative costs structured in different funds: e.g., subordinate debt, subsidized debt, equity, REIT and structured finance. For



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- purposes of this memo, we refer to these alternative approaches collectively as moderate income debt funds.
2. Can the reduced cost of capital provided by a moderate income debt fund be used to provide affordability restrictions targeted at moderate income households for a percentage of units, while remaining attractive for developers?

DRA completed the following lender and investor interviews for this assignment:

- Andrew Ditton at Citibank;
- Stephanie McFadden at CBRE (formerly at Union Bank);
- Kenji Tamaoki at Prudential;
- Bob Simpson and Angela Kelcher at Fannie Mae;
- John Varones, Systema Capital;
- Ron Moelis, L+M Development Partners;
- The Jonathan Rose Companies;
- Chris Tawa, former director of Multifamily Mission Lending by the GSEs at the Federal Housing Finance Agency; and
- David Saltzman, California Community Reinvestment Corporation.

In addition, DRA reviewed available terms, underwriting and pricing on funds offered by Urban Strategy America Fund, New York City Housing Development Corporation, MassHousing, SF Bay Area Transit Oriented Affordable Housing Fund, Denver Regional TOD Housing Fund, New Generation Fund (Los Angeles), Avanath Capital Management, Enterprise Multifamily Opportunity Fund, PNC Bank Affordable Housing Preservation Fund, Turner Multifamily Impact Fund, Housing Partner Equity Trust and the Community Development Trust. DRA also reviewed the pricing and underwriting of the Catalyst Housing Acquisition Fund model presented to San Jose in January of this year.

Based on the interviews and literature review, the cost of capital provided by moderate income debt/equity funds ranges from 8% to 12%, compared to an estimated 12% or higher for conventional debt/equity financing.



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2. First Mortgage Financing

In terms of first mortgage financing, the key underwriting factors affecting first mortgage sizing include the DSCR, mortgage interest rate, loan to value ratio, amortization period, term, escalation rates for income and expenses and cap rates used to determine projected value upon exit. Fannie Mae and Freddie Mac (collectively, "GSEs") dominate originations for multifamily debt, and their pricing and underwriting criteria of necessity provide the benchmark for any discussion of multifamily debt (and equity) fund advantages aimed at moderate income rental housing development (and acquisition). Current term sheets for Freddie Mac and Fannie Mae fixed-rate multifamily loans are attached to this memo.

GSE underwriting standards include 2% escalation on revenues and 3% on expenses for the purpose of the refinancing exit test. Standard fixed-rate mortgage products for conventional multifamily properties from both Fannie Mae and Freddie Mac require a loan-to-value (LTV) ratio of no more than 80% and a minimum debt service coverage ratio (DSCR) of 1.25. (It is worth noting that in our interviews with moderate income debt fund partners of GSEs, higher LTV may be achievable)

Based on our cash flow analysis, however, first mortgage financing on new multifamily construction in San Jose is currently constrained by DSCR, rather than LTV requirements. First mortgages sized at a 1.25 DSCR resulted in loan-to-value ratios of only 49% to 52%¹ at the estimated time of conversion to permanent financing. All of the prototypes except Prototype 1 (Downtown Tower) and Prototype 1A (Downtown Podium) were able to satisfy the refinance test on these mortgages in year 15 at the 2% and 3% escalation factors.

DRA also confirmed through its interviews that mezzanine lenders and investors typically use similar escalators and refinancing tests as conventional lenders in assessing the viability of mezzanine debt and equity investments. Some interviewees among moderate income debt fund providers suggested they will accept more aggressive, that is, narrower, spreads between income and expense escalator in the San Jose market, based on third quarter 2018 market dynamics.

¹ With values calculated as capitalized stabilized net operating income.



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3. Feasibility of Multifamily Housing Development Prototypes in San Jose

The financial feasibility analysis demonstrates that segments of the multifamily housing market face challenges due to high development costs relative to current market rents, as summarized in **Table 1**. The capitalized value of estimated stabilized net operating income (in 2018 dollars) exceeds the estimated total development cost for all but the Downtown high-rise. The pre-tax internal rate of return on developer equity is less than the estimated 12 to 15% cost of capital under conventional financing for both Downtown prototypes and the large (600-unit) North San Jose prototypes (Prototypes 1, 1A, and 3, respectively). DRA also prepared projections of project after-tax IRRs, which in some cases showed improvement over the pre-tax returns.

Table 2 summarizes key characteristics of the development prototypes, which are described in more detail in Appendix A. Note that the prototypes do not specify parking. If the parking ratios exceed 1 space per unit, there may be material savings for reduced parking, which could be determined through sensitivity analysis of the prototypes.

Specific developments will perform better or worse than the prototypical projects modelled in this analysis. Projects with low land costs, for example, resulting from long-term ownership, and projects that are part of a longer-term investment strategy, in particular will perform better. Such projects, especially in North San Jose and Downtown, would particularly benefit from a moderate income debt fund modelled in this analysis.

In addition, market economics change constantly over time. Increases in rents relative to development (and finance) costs could tip more project IRR's into the feasible range. Of course, the reverse is also true: decreases in rents relative to development and finance costs will worsen feasibility.



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Table 1 Summary of Findings Multifamily Housing Feasibility Assessment 2018					
Prototype	Building Type	Capitalized Value Per Unit	Total Development Cost Per Unit	Estimated Profit Per Unit (% of TDC)	15-Year Pre-Tax Internal Rate of Return (IRR)¹
1 Downtown Tower	Type I	\$668,000	\$684,000	(\$16,000) (-2%)	N/A
1A Downtown Podium	Type III	\$629,000	\$615,000	\$14,000 (2%)	-19%
2 West San Jose	Type III	\$673,000	\$502,000	\$171,000 (34%)	19%
3 North San Jose	Type III	\$604,000	\$566,000	\$38,000 (7%)	9%
3A No. San Jose Phased	Type III	\$604,000	\$556,800	\$47,000 (8%)	12%
4 South & East San Jose	Type V	\$576,000	\$477,000	\$99,000 (21%)	15%
5 Central San Jose	Type III	\$614,000	\$496,000	\$118,000 (24)	18%

Source: City of San Jose; DRA.

¹ Represents pre-tax IRR on developer equity (estimated at a minimum of 10% of TDC), assuming sale of the project in year 15. "N/A" indicates the IRR cannot be calculated because of the negative cash flow stream.



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	Downtown Tower	Downtown Podium	West San Jose	North San Jose 600 Units	North San Jose 300 Units	South and East San Jose	Central San Jose
Construction Type	Type I High-Rise	Type III Over Podium	Type III Over Podium	Type III Over Podium	Type III Over Podium	Type V Over Podium	Type III Over Podium
Stories	20 Stories	7 Stories	7 Stories	7 Stories	7 Stories	5 Stories	7 Stories
Density	320 dus/acre	90 dus/acre	90 dus/acre	90 dus/acre	90 dus/acre	65 dus/acre	90 dus/acre
Total Units	300	200	200	600	300	300	200
Studios	0	0	0	60	135	30	30
One BR	180	120	140	270	105	150	90
Two BR	120	80	60	210	30	90	80
Three BR	0	0	0	60	0	30	0
Ave. Unit Size	908 SF	908 SF	855 SF	941 SF	941 SF	890 SF	840 SF

Source: City of San Jose; DRA.

Escalation rates of 2% on revenues and 3% on operating costs were used for the refinance tests on the first mortgage financing as described above. For the purpose of calculating project IRRs, DRA used escalation rates of 2.25% on market rents and 2.50% on operating costs, based on mezzanine lender standards. Historically in San Jose from 2009 to 2017, monthly apartment rents per unit increased at an average annual rate of 3.5% while per square foot rents increased at an average of 3.3% annually (see Table 6 at the end of this memo).

The IRR was calculated assuming developer equity equal to 10% of development costs. The amount of the mezzanine debt/equity investment equals the difference between total development costs and the amount of the supportable first mortgage plus developer equity. Interest on the mezzanine debt/equity investment is accrued during the construction period and in any year that cash flow is insufficient to pay



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the annual return of 12% on the 100% market-rate prototypes. Annual net cash flow to the developer equals net operating income less the annual return on the mezzanine debt/equity.

For some projects, the reduced cost of capital from a moderate income debt fund may make the development feasible, but would not provide any increased affordability. For others, a portion of the value of the reduced cost of capital could be captured in terms of moderate income housing restrictions.

4. Potential Affordable Housing Production from Moderate Income Rental Housing Fund

Each prototype is analyzed under the following three affordability scenarios, to determine whether a moderate income housing fund providing lower cost capital may be successful in producing affordable units:

Scenario 1: 100% market-rate projects

Scenario 2: 10% of project units affordable at 80% of AMI

Scenario 3: 20% of project units affordable at 90% of AMI

Results of the analysis are summarized in **Table 3**. Measures include the 15-year pre- and post-tax project IRRs.

For the purposes of calculating affordable rents by unit bedroom count, DRA used the 2018 AMI of \$125,200 for the San Jose-Sunnyvale-Santa Clara HUD Metro FMR Area (HMFA), assuming 30% of gross income for rent plus utilities,¹ and Health and Safety Code standards of one person per bedroom plus one. We suggest a discussion with Department staff and City officials about using a 35 percent standard for moderate income households, that is, those earning more than 80 percent Area Median Income (AMI). This will improve the development feasibility of pairing affordable rent restrictions with the moderate income debt. Given high median income in San Jose, such a standard for moderate income households may be reasonable.

¹ Using current utility allowances from the Santa Clara County Housing Authority.



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Table 3 Projected Returns under Market-Rate¹ and Affordable² Scenarios Multifamily Housing Feasibility Assessment							
Financing/ Affordability Scenario (% Units @ % AMI)	Down- town Tower	Down- town Podium	West San Jose	North San Jose 600 Units	North San Jose 300 Units	South and East San Jose	Central San Jose
100% Market Rate with 12% Cost of Capital							
Project IRRs							
Pre-Tax	N/A	-19%	19%	9%	12%	15%	18%
Post-Tax	N/A	N/A	13%	3%	11%	15%	17%
Housing Fund with 8% Cost of Capital							
10% @ 80% AMI w/o PTE³							
Project IRRs							
Pre-Tax	N/A	3%	17%	9%	15%	14%	16%
Post-Tax	N/A	1%	9%	3%	15%	15%	15%
10% @ 80% AMI w PTE³							
Project IRRs							
Pre-Tax	N/A	6%	17%	10%	16%	15%	16%
Post-Tax	N/A	5%	10%	5%	16%	15%	16%
20% @ 90% AMI							
Project IRRs							
Pre-Tax	N/A	1%	16%	9%	19%	15%	15%
Post-Tax	N/A	-3%	7%	3%	18%	15%	15%

¹Assumes 12% cost of capital for 100% market rate scenarios.

²Assumes 8% cost of capital for fund financing, with an affordable housing set-aside.

³Units at 80% AMI or below are eligible for a welfare property tax exemption (PTE), however a non-profit co-general partner is required to qualify.

"N/A" indicates the IRR cannot be calculated because of the negative cash flow stream.

Source: DRA



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For the scenarios assuming 10% affordable units at 80% of AMI, DRA calculated returns with and without a property tax exemption. Under California law, units at 80% of AMI or below are eligible for a welfare property tax exemption. However, to qualify for such an exemption, the property must have a nonprofit 501(c)(3) corporation with significant management responsibilities as part of the ownership structure. Market-rate rental housing developers may or may not be willing to grant such control to nonprofit partners in exchange for partial property tax exemptions.

Most of the prototypes generate a minimum IRRs in excess of 12% for both the market-rate scenario and both affordability levels. One main exception is the Downtown high-rise (Prototype 1) which, based on Keyser Marston's earlier prototype, reflects a 20-story story tower. Review of the pipeline projects in the Diridon Station Area and the entire Downtown indicates that many residential developments under construction and planned are 5- to 7-story buildings, like Prototypes 2, 3 and 5. Few high-rise multifamily rental towers are currently under construction. Given the high cost of constructing a Type 1 tower and the sensitivity of the analysis to cost, DRA tested a revised Downtown podium prototype (Prototype 1A) using a 7-story Type III building.

While the Downtown podium prototype shows improved financial performance compared to the high-rise tower, it still performs more poorly than the other podium prototypes in West, North and Central San Jose. The reasons for this include:

- Estimated land costs of \$294 per square foot in the Downtown that are almost triple the other areas (\$119 in West San Jose, \$99 in North San Jose, and \$110 in Central San Jose). The land cost estimate for the Downtown is based on comparable sales between 2015 and 2017. While the weighted average price for these comparables was approximately \$294, two of the 2017 comps showed sales prices of \$140 and \$153 per square foot, respectively.
- The estimated average rent per square foot based on CoStar data for newer buildings is lower in the Downtown than in West San Jose (\$3.56 and \$3.93 per square foot, respectively).

The performance of the Downtown podium prototype is sensitive to assumptions on rents and land prices. Either reducing the land cost to \$150 per square foot OR



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increasing the rent to the West San Jose average of \$3.93 produce an IRR of 14% to 15% for the Downtown prototype.

The North San Jose prototype drops below a 12% IRR under market-rate and both affordability options. DRA hypothesized that the large size of this prototype, 600 units and at least twice the size of the other prototypes, may be a drag on financial feasibility given the lengthy lease-up and conversion period. DRA tested a second prototype for North San Jose representing the first phase of such a development comprised of 300 units. This smaller prototypes shows improved financial performance with IRRs in excess of 12% for the market-rate and affordable scenarios.

The results of the cash flow analysis suggest that the reduced cost of capital from a moderate income housing could produce a significant percentage of units affordable to moderate income tenants.

CASH FLOW ANALYSIS

DRA prepared cash flow analyses estimating the internal rate of return (IRR) generated by prototypical newly constructed multifamily apartment projects. The cash flow analysis estimates available net cash flow after first mortgage debt service for the seven housing prototypes and calculates the IRR on mezzanine debt/equity used to finance the portion of total development costs not covered by the first mortgage.

DRA analyzed project cash flows for the prototypes assuming conventional subordinate debt/equity financing of 100% market-rate housing at a market-rate cost of capital (12%), compared to to cash flows assuming moderate income housing fund financing at a lower cost of capital (8%) incorporating alternative affordable housing requirements.

DRA's analysis uses:

- Prototypical housing projects for high density apartment development with a focus on selected Urban Villages, the Downtown and North San Jose. The analysis uses seven prototypes defined in terms of product type, construction type, building stories, average unit size and density representing high density



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apartment development in Downtown, West San Jose, North San Jose, South and East San Jose, and Central San Jose. The original prototypes for these five geographic areas are consistent with the five prototypes used in the Keyser Marston Associates “Conceptual Pro Forma Analysis” dated April 12, 2018. DRA used CoStar data by geographic subarea to refine the prototypical housing developments in terms of total units, unit bedroom count distribution, and unit square footages.¹ DRA added two additional prototypes: a lower density Downtown prototype with podium rather than steel construction, and a smaller prototype (300 units rather than 600 units) in North San Jose.

- Loan terms (LTV, DSCR), and current interest rates² for multifamily fixed rate mortgages used by Fannie Mae and Freddie Mac (estimated at 5.15% for 30-year term and amortization). Interest rates have risen since DRA’s June 29, 2018 analysis, which assumed a permanent loan interest rate of 4.5% based on current Fannie Mae and Freddie Mac interest rates at that time.
- Data from CoStar on rents by unit bedroom count and subarea within the City of San Jose for four and five star (CoStar equivalent of Class A) apartment properties constructed since 2015, representing rents for newly constructed properties.
- Operating cost data for conventional apartment properties in San Jose from the Institute of Real Estate Management, by housing product type.
- Development impact fee estimates which include the City’s affordable housing fee; therefore, the prototypical projects do not contain on-site inclusionary units.

DRA’s post-tax IRR on the prototypical projects is calculated incorporating the following assumptions:

- Modified Accelerated Cost Recovery System (MACRS) 27.5-year straight line depreciation for residential buildings.
- Corporate tax rate of 21% applied to annual partnership income/loss.

¹ As discussed later in this memo, DRA added two additional prototypes representing modifications to the Downtown and North San Jose prototypes.

²As of January 10, 2019, interest rates for 65% LTV Fannie Mae fixed-rate loans range from 4.91% for 5-year terms to 5.16% for 30-year terms and for 80% LTV Freddie Mac loans range from 4.29% for 5-year terms to 4.69% for 10-year terms.



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- Sale of the building in year 15 at its capitalized value using the exit cap rate, less 3% sales costs.
- Adjusted cost basis in year 15 deducting cumulative depreciation taken.
- Depreciation recapture tax at 25%, as applicable.
- 15% tax rate on capital gains.

Table 4 summarizes the financing assumptions used in the analysis. **Table 5** summarizes rent and operating costs assumptions.

Table 4 Cash Flow and Financing Assumptions San Jose Moderate Income Housing Analysis	
Escalation Rates: Underwriting and Refinance Analysis	
Unregulated Rents	2.25%
Restricted Rents	2.00%
Laundry/Misc. Income/Parking Income	2.50%
Operating Costs	2.50%
Cap Rates	
Entry Cap Rate (by prototype)	4.00% to 4.25%
Exit Cap Rate	5.50% to 5.75%
Financing Assumptions	
First Mortgage Interest Rate	5.15%
Amortization Period	30 years
Maximum Debt Service Coverage Ratio (DSCR)	1.25
Maximum Loan to Value (LTV) Ratio	80%
Refinance Assumptions	
Interest Rate	6.5%
Amortization Period	30 years
Maximum DSCR	1.25
Maximum LTV	80%

Sources: Lender and investor interviews; GSE term sheets; DRA.



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Table 5					
Monthly Rent and Annual Operating Cost Assumptions					
San Jose Moderate Income Housing Analysis					
	Downtown San Jose	West San Jose	North San Jose	South and East San Jose	Central San Jose
Average Rent/Unit ¹	\$3,200	\$3,400	\$3,100	\$2,800	\$3,100
Average Rent/SF ¹	\$3.56	\$3.93	\$3.33	\$3.09	\$3.69
Operating Costs/Unit ²	\$11,500	\$11,000	\$11,400	\$8,200	\$10,600

¹Rent assumptions based on project and average data by submarket area from CoStar for properties built 2015 through 2017.

²Based on total annual operating expenses per square foot, including property taxes, from Institute of Real Estate Management 2017 Income/Expense Analysis for San Jose.

Sources: CoStar; IREM; City of San Jose; DRA.

Table 6 and **Charts 1** and **2** show the annual percentage increase in the average effective monthly rent per unit and average effective monthly rent per square foot¹, along with the Consumer Price Index for all urban consumers for rent (CPI-U Rent), from 2006 through 2017. Since 2009, the lowest point in the market during this period, the average annual increase in monthly rents has been 3.5%, well below the 5% ARO cap. Additional data on the CPI-U Rent back to 1970 indicates the average annual increase over the past 46 years has averaged 4.9%. With these rent trends, it would be difficult to support underwriting projected rent increases over 5% per year.

¹For 4 and 5 star properties as rated by CoStar (5 stars is the highest rating).



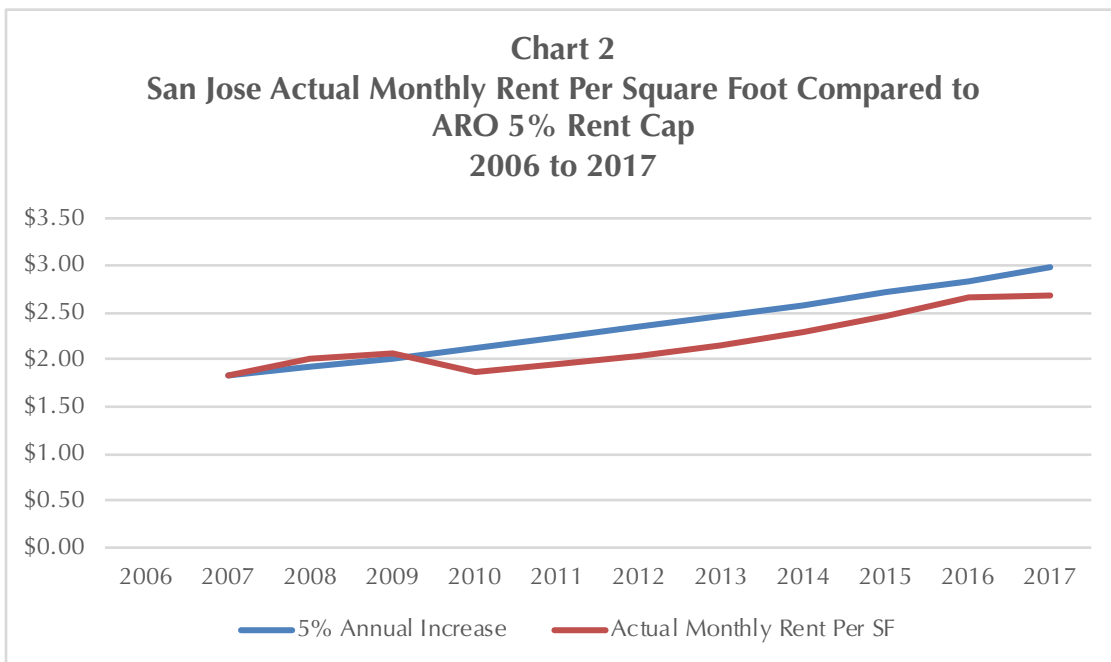
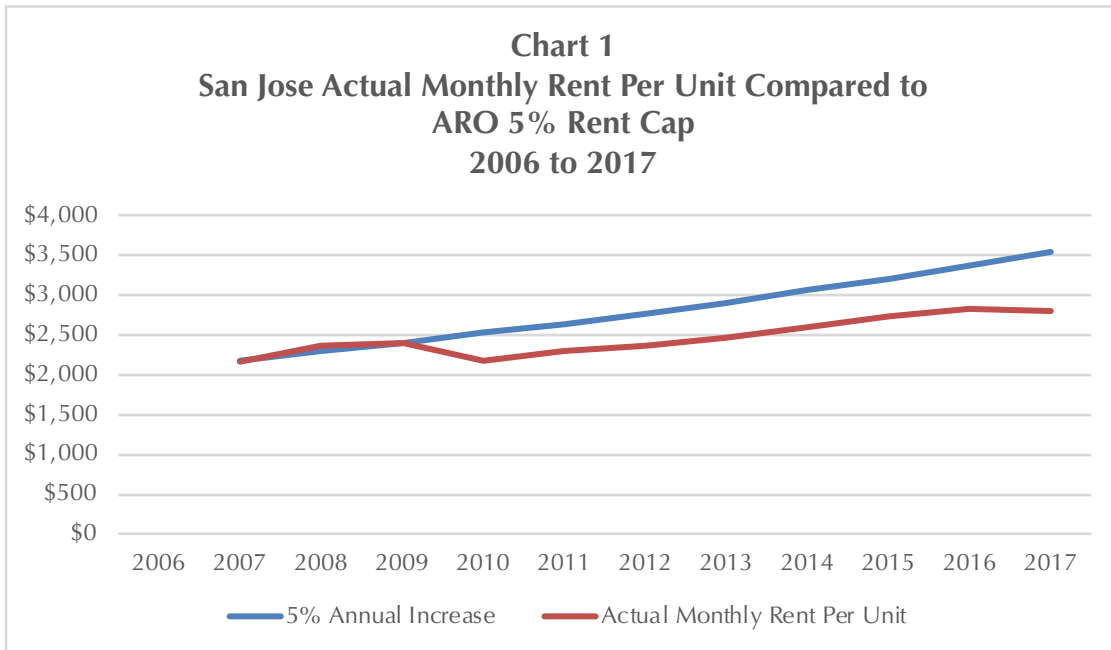
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Table 6					
Annual Percentage Increase in Apartment Rents¹ and the Consumer Price Index					
2006 to 2017					
	Effective Monthly Rent Per Unit¹		Effective Monthly Rent Per Square Foot¹		CPI-U Rent)
Year	\$	Annual Change	\$	Annual Change	
2006	\$2,172	--	\$1.83	--	--
2007	\$2,348	8.1%	\$2.00	9.3%	3.9%
2008	\$2,379	1.3%	\$2.06	3.0%	4.1%
2009	\$2,171	-8.7%	\$1.86	-9.7%	3.2%
2010	\$2,278	4.9%	\$1.95	4.8%	-0.1%
2011	\$2,353	3.3%	\$2.03	4.1%	2.3%
2012	\$2,449	4.1%	\$2.15	5.9%	4.1%
2013	\$2,599	6.1%	\$2.28	6.0%	4.5%
2014	\$2,721	4.7%	\$2.45	7.5%	5.5%
2015	\$2,823	3.7%	\$2.66	8.6%	6.1%
2016	\$2,782	-1.5%	\$2.68	0.8%	--
2017	\$2,869	3.1%	\$2.75	2.6%	--
2009 - 2017	--	3.5%	--	3.3%	3.7%

¹Includes 4- and 5-star properties as rated by CoStar (5 stars is the highest rating).
Source: CoStar; City of San Jose, DRA.



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Appendix A contains the detailed financial analysis, including a description of the rental prototypes, development costs, net operating income and cash flow projections for each prototype.

ATTACHMENTS:

1. Appendix A: Multifamily Residential Moderate Income Housing Fund Market Feasibility Analysis
2. Fannie Mae Fixed-Rate Mortgage Loans Multifamily Term Sheet
3. Freddie Mac Conventional Fixed-Rate Loan Term Sheet