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CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand
Kim Walesh

SUBJECT: SEE BELOW

DATE: April 19, 2019

Approved D.DSyl Date 4/19/19

SUPPLEMENTAL

SUBJECT: ELLIS ACT ORDINANCE RE-CONTROL PROVISIONS

REASON FOR SUPPLEMENTAL

The purpose of this supplemental is to inform the City Council about the results of the interviews with developers and lenders regarding the impact of the Ellis Act Ordinance re-control provisions; provide an analysis of the threshold density increase resulting in a net positive for affordable housing; and provide updated research from other communities regarding the re-control provisions in Ellis in order to assess the extent they make new residential projects more difficult to build, as requested from the February 5, 2019 City Council meeting.

ANALYSIS

On February 5, 2019, the City Council directed staff to return with additional research regarding the impact of the Ellis Act Ordinance re-control provisions on new development. The areas of research included are:

- Information from interviews with developers and lenders regarding the impact of Ellis Act Ordinance re-control provisions on new development;
- An analysis determining the threshold of new apartments that result in net positive affordable housing following demolition of existing rent stabilized apartments;
- Additional research on other cities' experience with the Ellis Act Ordinance re-control provisions;
- Results of tenant interviews and potential displacement; and
- An analysis on the current housing market and potential impact on displacement in San José.

I. RESULTS OF THE INTERVIEWS WITH DEVELOPERS AND LENDERS

Interviews were conducted with developers and lenders to better understand if the current Ellis Act provisions are preventing market rate housing from being constructed in San José. Because of the limited time, staff from the Housing Department and the Office of Economic Development interviewed developers who submitted preliminary planning applications on sites with rent stabilized apartments located on the proposed development site. A total of 12 proposed developments were identified as affected by the Ellis Act re-control provisions. Developers moving forward with projects not subject to re-control provisions, such as an affordable housing development and a development built on a property with a demolished building built after 1979, were not included in the interviews. Of the twelve proposed projects, ten developers represented the developments (two developers had more than one project). Three of the ten developers did not respond to our request. Seven interviews were conducted with developers and consultants who are working on residential projects affected by the Ellis Ordinance re-control provision. The interviews covered a range of topics, including:

1) a review of the proposed development;
2) reasons developers gave as to why a development was or was not moving forward;
3) developer's statements regarding the potential impact of the Ellis Act re-control provisions on proposed developments;
4) developer familiarity with the Ellis Act re-control provisions, including the Affordable Housing Waiver, and
5) the impact of potential affordability requirements on proposed developments.

Attachment A provides a summary of the comments made by developers and lenders.

Developer Feedback

Developers reported that there were multiple factors that have influenced them to reconsider or not move forward with their development proposals both in and outside of San José. Of the seven developers contacted, three indicated that they would not move forward with their proposed developments for reasons unrelated to the Ellis re-control provisions. Developers cited a range of issues that make moving forward with their projects challenging including dealing with historic buildings, high land costs, the time it takes to get through the development process, softening rents and City fees including housing and parks. None of the three developers stated they were not proceeding with their development due to the re-control provision.

The remaining developers expressed some concerns regarding the Ellis Act Ordinance re-control provision. Some developers indicated that their business model is to offer rent concessions in the first year in order to have a successful lease-up period and then increase rents in year two by as much as 10-20%. Therefore, they believed that restricting annual rent increases to 5% for potentially half of the apartments, as required under the current Ellis Act Ordinance, will make their project not viable.

Developers also expressed concern that they would be unable to benefit when future market rent increases could exceed 5%, but they will be exposed to the risks when rents are flat or may need to be decreased.

While developers expressed concerns about the Ellis re-control provisions, no one has been rejected for financing because of the Ellis re-control provision.

When talking with developers, it became clear some developers are making long-term investments while others intend to sell their buildings one or two years after lease-up. The short-term investors are highly concerned with capturing the maximum rent potential from the building within the first two years to maximize the value of the building. The value of the building is a function of the rents--therefore the higher the rents, the higher the value of the building when it is sold to a long-term investor. According to developers interviewed, the 5% limitation on half of the new units from the Ellis Act provisions may reduce the anticipated profit for short-term investors.

Lender Feedback

The Housing Department had limited success in interviewing lenders and investors given the time constraint, the lack of referrals from developers, and lenders' restrictive policies on disclosing lending practices. Staff interviewed three lenders and investors who work in the San José market. None of the lenders understood San José's specific requirements before talking to staff.

Based on the three interviews, staff learned that a typical financing structure for a development's construction is up to 30-40% equity, both from the developers and from third-party equity investors, and 60-70% from commercial bank loans. Investors try to limit their risks and increase their financial returns. Commercial bank loans are secured by the value of the property and are typically senior over the equity debt. Therefore, they would be the first to be repaid in the event of liquidation. Equity debt is usually last in the capital stack and faces the highest risk. Lenders indicated that loans are generally underwritten assuming growth rates tracking the Consumer Price Index. As noted in the David Rosen's report, "typical underwriting standards use a 2% escalation on revenues and 3% on costs for the purpose of refinancing." The annual rent increase of 5% therefore should be adequate to meet their proforma projections.

Short-term equity providers and lenders generally participate in the development for only five years, so they are most concerned about risks regarding construction timeline, short-term market conditions such as market rents, and how quickly the apartments lease-up. These equity investment transactions are designed to maximize the rents in order to sell the building quickly at the highest sale price. Long-term lenders generally split 30-40% equity and 60-70% commercial bank loans and typically purchase the building at year five or six for a longer term investment. While some lenders expressed a negative perception of the Ellis re-control provision, it is unclear if they would actually refuse to loan on a development or offer less competitive rates because of the re-control provision.

The section below summarizes the staff insights gathered from talking with developers and lenders.

Lack of knowledge and understanding of San José's Ellis Act provisions

Both developers and lenders held misconceptions regarding the Ellis Act and the Apartment Rent Ordinance provisions. All of the lenders interviewed assumed that the allowable rent increases in San José were a factor of the Consumer Price Index, consistent with most rent stabilization programs throughout the State. More education is necessary to inform developers and lenders regarding local rent control and Ellis Act provisions. Rents set following demolition of rent stabilized apartments may initially be set at market rates and rents are limited to 5% annual rent increases thereafter. Rents are set again at market when a tenant voluntary leaves the apartment. Given the high turnover of Class A apartments (according to RealPage, the average annual turnover for Class A apartments is 44.6%), it is anticipated that ARO rents will be reset frequently. Additionally, developers and lenders must be educated regarding the option under the Ellis Act Ordinance to provide on-site affordable housing as an alternative to implementing re-control provisions.

Perceived economic impact resulting from the 5% annual rent increase limitation

<u>Limitations on rent increases during the lease-up period</u> – Developers expressed a concern that they would not be able to provide rent concessions during the initial lease up period. The Apartment Rent Ordinance states the annual rent increase of 5% is based on the rent paid in the prior year. The initial rent is defined as the actual rent paid by the tenant at commencement of the tenancy. As noted above, one developer stated they depress the initial rents in order to lease-up the building and a concern is that the 5% cap would not allow them to catch up after the first year. An alternative to the developer's practice of initially depressing the rents at lease-up (as is common in many business models) is to offer a rent reduction, such as one-month free rent, in the second month following payment of the first months' rent. Both the monthly discount method and this method can result in the same discount but the latter option resolves the developer's concerns about a 5% cap on a discounted rent. Therefore, the developer can rent the apartment at the rate they desire and generate interest with the free rent concession. Allowing increases greater than 5% after the end of the lease would be inconsistent with the policy goal of the Apartment Rent Ordinance which is to prohibit rent spikes.

<u>Limitations on rent increases following a recession and/or during a strong market</u> – Developers are concerned about the amount of time it takes to "catch up" on rents after a recession and/or the inability to increase rents rapidly when the market is hot. As stated in the David Rosen study, average rent increases in San José have rarely approached the 5% limitation. During the last recession, average rents declined by 8.7% and were followed by two years of growth at 4.4% and 3.3%. The 5% rent limitation will allow for the growth in rents following a recession. However, it should be noted, that while the average rent increases have not typically exceeded 5%, some developments may be able to achieve higher rent increases. To the extent, that residential development in San José is predominately being built in the higher end of the market, it may be the least resilient during a recession. The purpose of the 5% rent limitation is to provide stability

for renters during periods of spiking rents. Allowing increases in order to "catch up" with the market is inconsistent with the Rent Stabilization program and the policy goal of providing stability to renters.

<u>Loans to developments with rent stabilized apartments</u> – Developers were concerned that they would not be able to finance their developments with Ellis re-controls. Both debt and equity lenders underwrite loans using industry-standard growth rates of 2-3% on future rents. Interviews with both debt and equity lenders indicated that a 5% rent limitation is reasonable and would not impact their decision to move forward with an investment in new development. One lender stated that although the 5% rent limitation is reasonable, the concept of rent stabilization is not attractive. The ability to generate higher level of returns that exceed average growth rates is what attracts capital to markets like San José that are undergoing transformation. This perception of rent stabilization may or may not impact a lenders decision to invest in San José.

<u>Limitations on rent increases could reduce the value of new buildings</u> – Developers were concerned that Ellis re-control provisions would not allow them to maximize their profit. Short-term investors and developers are typically anticipating a sale or refinancing of a new building in the first or second year following lease-up. Developers want to maximize the rents received prior to the sale as higher rents justify a higher sales price. The 5% rent limitation may reduce the potential for sharp rent increases leading up to a sale or refinancing event, however this will only impact the amount of profit made on the sale, not on the ability to pay the debt incurred to complete the development. This limitation on profit may or may not impact a lenders decision to invest in San José.

Potential policy changes to address specific concerns

<u>High rise development faces unique challenges</u> – Additional research is needed to understand the complexities and costs of high-rise development in San José to determine how Ellis Act provisions may impact this type of development. High-rise development is more expensive, and in Downtown San José the ability to earn returns on the investment is limited by the airport height limitations and high groundwater levels. A potential solution may be that high-rise developments have an option to replace the number of units demolished on a one-for-one basis with income-restricted affordable units or a lower than 50% re-control rate

<u>The exemption from re-control only applies under the Inclusionary Housing Ordinance</u> – The Affordable Housing Impact Fee program does not provide an option to build the affordable housing units on-site. Nine out of the 12 developments with existing Ellis re-control provisions are under the Affordable Housing Impact Fee program. Some of the developers have expressed an interest in wanting the option to provide affordable units on site. A change to the Ellis Act Ordinance and the Affordable Housing Impact Fee could be made to allow for an exemption of the current 50% re-control provision if a certain number of income restricted apartments are built on-site.

Summary

Overall, developers and lenders expressed concerns about the Ellis Act re-control provision but initially did not fully understand how it is implemented in San José. One of the primary concerns expressed is the inability to rapidly increase rents. Developers were optimistic that their developments would perform better than historical rent increases given the significant projected changes in the downtown and surrounding neighborhoods. They also expressed concern that given the current market cycle and investor choice, any perceived limitation on rents may negatively impact their developments.

II. THRESHOLD REPLACEMENT ANALYSIS

Staff was directed to consider other formulations that maintain a minimum one-to-one replacement of rent stabilized apartments with either rent stabilized or affordable apartments that would encourage construction of new housing. Staff calculated the increase in density needed in market rate development that would result in a replacement of the lost units with income-restricted affordable apartments.

7:1 is the break-even point for onsite affordable housing

Staff has determined that significant increases in density would result in the replacement of the rent stabilized apartments that are demolished with the application of the Inclusionary Housing requirement. The community benefit of high-density housing coupled with the Inclusionary Housing Ordinance requirement results in an overall positive outcome when the units are provided on-site. The calculation shows that when the number of total apartments demolished is replaced by seven times the number of original apartments, the loss of the rent stabilized apartments can be replaced with new income-restricted housing built on-site. An increase of density of eight times or more will result in a new positive number of affordable housing units.

Should the developer choose an option other than the onsite dispersed delivery of affordable unites, the density required to replace the rent-controlled unites with affordable units is 5:1., If the in-lieu fee option is selected, there will be a delay in the creation of new affordable housing units.

Table 1 below demonstrates how the original number of units demolished is replaced through the 15% on-site inclusionary build on-site requirement when seven times the original number of units are produced and five times when the 20% off-site requirement is applied.

Table 1 – Density Increase Necessary to Replace Demolished Units

Number of Units Demolished	Increase in Density	Number of New Units	15% of New Units	20% of New Units (off-site or in-lieu)
5	x2	10	2	2
5	x3	15	2	3
5	x4	20	3	4
5	**x5**	25	4	5
5	x6	30	4	6
5	**x7**	35	5	7
5	x8	40	6	8

Impact of increased density

Staff examined the impact of re-control when new development is proposed at a density level significantly higher than the existing building. When projects increase the density significantly, there are greater numbers of units subject to re-control which may act as an disincentive developers to increase the density of the development. One potential modification to re-control is to decrease the replacement requirement if certain levels of density are achieved as a way to avoid dis-incentivizing density.

Table 2 illustrates how density impacts the number of re-control under the current Ellis Act provisions.

Table 2 – Examples of Re-control Provisions on Proposed Developments

Number of Units Demolished	Number of New Units in the Proposed Development	Re-control (Greater of 1:1 or 50% of new)	20% Affordable
5	249	125	50
16	22	16	4
20	85	43	17
30	218	109	44
124	710	355	142

Comparison of average rents of Class A market rents, rent stabilized apartment rents and affordable rents at levels required by the Inclusionary Housing Ordinance

Staff analyzed the average rents of Class A, B, and C market rate apartment rents, as well as rent stabilized and restricted affordable apartment rents to provide a comparison of the potential income levels of tenants in each apartment type. Assumed income levels were calculated for each market rate example by applying minimum income standards that market rate property managers use to qualify households to rent their apartments. Typically, the owner requires that the gross monthly income of the household must be at least 2.5 to 3 times the monthly rent. The income calculations for the restricted affordable apartments are based on the provisions of the Inclusionary Housing Ordinance, which assumes that the household cannot pay more than 30% of their income for the apartment. The one-bedroom assumes a two-person household and the two-bedroom assumes a three-person household. It should be noted, for market-rate apartments, the incomes listed are minimums needed to qualify. For the affordable apartments, incomes listed are maximum incomes allowed for qualifying households.

Table 3 – Average Effective Rents in San José and Incomes

	1 Bedroom Rents	1 Bedroom Income at 2.5 Factor	2 Bedroom Rents	2 Bedroom Income at 3.0 Factor
Class A	$2,752	$82,560	$3,292	$118,512
Class B	$2,383	$71,490	$2,846	$102,456
Class C	$1,794	$53,820	$2,279	$82,044
Rent Stabilized Apartments	**$1,644**	**$49,320**	**$1,957**	**$70,452**
Affordable Rent: 80% of the AMI	$1,890	$75,600	$2,126	$85,050
Affordable Rent: 60% of the AMI	$1,596	$63,840	$1,796	$71,820
Affordable Rent: 50% of the AMI	$1,330	$53,200	$1,496	$59,850

Sources: CoStar, February 27, 2019 and City of San José Housing Department and Rent Registry April 2, 2019
Costar Definitions for Building Class:
***Class A**: In general, a class A building is an extremely desirable investment-grade property with the highest quality construction. It may have been built within the last 5-10 years, but if it is older, it has been renovated to maintain its status and provide it many amenities.*
***Class B**: In general, a class B building offers more utilitarian space without special attractions. It will typically not have the abundant amenities and location that a class A building will have.*
***Class C**: In general, a class C building is a no-frills, older building that offers basic space. The property has below-average maintenance and management, a mixed or low tenant prestige, and inferior elevators and mechanical/electrical systems.*

The rental data from the Rent Stabilization Program Rent Registry, which currently represents 73% of total rent stabilized apartments, indicate that the average rent for a one-bedroom apartment is $1,644, and a two-bedroom apartments is $1,957. For a two-bedroom rent stabilized apartment, a family needs to earn a minimum of $70,452 to afford rent (assuming an owner requires a tenant earn income that is three times the amount of rent). These assumed income levels are comparable to households qualifying for restricted affordable apartment rents at 60% of area median income.

III. ADDITIONAL RESEARCH ON OTHER CITIES' EXPERIENCE WITH THE ELLIS ACT ORDINANCE RE-CONTROL PROVISIONS.

Staff also researched the different re-control provisions in other cities. Depending on the rental market, the Ellis Act Ordinance has had various impacts on the development of new housing in the jurisdictions.

The majority of cities' Ellis Act Ordinances require 100% re-control

There are six cities that have enacted local Ellis Act Ordinances. The ordinances of San Francisco, Berkeley, West Hollywood, and Santa Monica have provisions requiring that all new rental housing development, following an Ellis Act withdrawal, are subject to the rent control provisions of that jurisdiction. Los Angeles also requires 100% re-control but provides an exemption from rent control provisions to developers who replace the new units with 20% restricted affordable units. This provision is similar to the exemption in the San José Ordinance except the required target incomes are different. In Los Angeles, the target income is set at 80% of the AMI. In San José, the income targets are set at 50%, 80% and 100% of the AMI. **Table 4** summarizes these provisions. Mountain View provides a right to return to tenants impacted by an Ellis Act withdrawal, but re-control provisions are not currently in place. Mountain View is exploring whether to add a re-control provision.

Table 4 – Summary of Cities with Ellis Act Provisions

	San Francisco	Berkeley	West Hollywood	Santa Monica	Los Angeles	Mountain View
What is covered by Ellis?	3 units or more	All	2 units or more & single family homes when tenant occupied	4 units or more & single family homes	2 units or more	3 units or more
How many replacement units will be subject to re-control?	All	All	All	All	All	None
Are there exemptions to re-control?	N/A	N/A	N/A	N/A	Yes	N/A

Development activity in other cities

Many jurisdictions are not seeing demolition following Ellis Act removals – the request from a property owner to remove their apartments from the rental market. The six cities with Ellis Act Ordinance have experienced a range of outcomes with respect to actions taken following removal of apartments from the rental market. Cities such as Berkeley and San Francisco have adopted policies discouraging the demolition of current rent stabilized housing through strict review processes and permitting restrictions. Other cities such as Santa Monica and West Hollywood are experiencing limited new construction following Ellis Act removals due to developers choosing to build condominiums or waiting five years before bringing new rental housing onto the market (avoiding re-control requirements).While Mountain View is experiencing high levels of Ellis Act removals followed by demolition and new construction activity, the Mountain View Ellis Act does not currently include a re-control provision. Los Angeles also has a high level of Ellis Act removals followed by redevelopment activity. The Ellis Act in Los Angeles includes an exemption from re-control provisions when affordable housing units are provided on-site, so theirs is the best case example for the City of San José.

In the City of Los Angeles, the Ellis Act Ordinance was adopted in 2006 impacting approximately 630,000 apartments. An owner may apply for re-control exemption if: 1) replacement of the number of demolished rental units with a number of affordable housing units (80% AMI) at least equal to the number of withdrawn rental units subject to the Rent Stabilization Ordinance on a one-for-one basis, or 2) at least 20% of the total number of newly constructed rental units, whichever is greater. The affordable housing units must be located in the newly constructed developments. Since the adoption of the Ellis Act Ordinance in Los Angeles, the new projects were typically replacing the number of apartments demolished by 2.5 times that original number of units with 100% re-control. According to the data provided by Los Angeles, from July 2014 to March 2019, Los Angeles has received a total of 1,735 project applications and 6,773 units withdrawn, with the following breakdown:

Table 5 – Ellis Act Activity in City of Los Angeles from July 2014 to March 2019

Number of Ellis Projects	# of Units in Ellis Projects	% of Total Projects	Redeveloped As
748	2,967	43%	Rental Housing
300	1,260	17%	Undecided
214	504	12%	Single Family
104	180	6%	Commercial
65	299	4%	Condominiums
304	1,563	18%	Other conversions including: Co-op ownership, hotel, housing for vets, elder care facility
1,735	**6,773**		

Many of the new rental developments assembled land parcels after the Ellis Act requirements and the 100% re-control provision was applied on the entire new development. It is not clear from the information provided if the average densities in Los Angeles approach those desired in San José. While the majority of developments were redeveloped as rental housing, it is not clear how many developers choose other redevelopment options in order to avoid the Ellis re-control provisions. Regardless, Los Angeles staff do not believe that the Ellis Act has stopped the redevelopment of residential apartments in Los Angeles.

IV. RESULTS OF TENANT INTERVIEWS AND POTENTIAL DISPLACEMENT

Staff conducted site visits and door-to-door interviews with 57 tenants living in four properties where the owner indicated interest in withdrawing the apartments from the rental market. This represents 35% of the total units in the four properties. The purpose of the interviews was to determine if tenants could afford to live in the new development, to learn more about the current rents they are paying and their occupation. **Attachment B** provides a summary of the tenant interviews.

Tenants who would be displaced from their rent stabilized apartments reported they would not be able to afford Class A market rents if faced with their owner removing their apartment from the rental market. It is unknown whether tenants would qualify for an affordable housing apartment if the developer choose to provide the inclusionary option. It is possible tenants would be displaced by the redevelopment regardless of the option chosen by the developer.

Interviews revealed that the occupants of these rent stabilized buildings generally represented three profiles for the larger complexes: 1) recent immigrants; 2) working class families; 3) very-low income households who often doubled up to afford the apartments. Each building represents a different sub-population based on the location and condition of the building. More research is needed to better understand how redevelopment impacts displacement.

V. CONCLUSION

Re-Control provisions may limit returns to developers and owners in areas of increasing desirability, but limiting increases to 5% provides stability in the rental market.

Housing demand and supply determines the ability of developers to set rents at a level that can generate a return on their investment. High cost environments like San José diminish a developer's ability to generate these returns through conventional replacement and redevelopment of residential buildings. To maximize the opportunity for return, developers often look to get ahead of market trends and invest in areas that may be subject to increased demand and desirability in the future. Changes within a local submaket, such as proximity to major transit investments or access to major employers may increase demand in a particular area and might result in rents spikes that exceed a typical annual increase. The Ellis Act re-control provisions provide protections for residents living in these areas by ensuring a maximum limit of 5% on annual rent increases.

While the Ellis Act re-control provisions provide stability for tenants during strong rental markets, in cases where developers are speculating on the future desirability of growth areas, it may affect the financial feasibility of market rate rental development, especially for shorter-term developers and investors.

In the 2016 audit of the Apartment Rent Ordinance, the City Auditor reported that their modeling showed "that the 5 percent limit on annual rent increases… would protect tenants only in the most dramatic market spikes." And that "controlling these rent spikes may provide critical relief." The 5% annual increase allowed under San José's Apartment Rent Ordinance has had a modest impact on limiting the actual rents in San José since it has been passed because the average market rent increases have been less than 5% each year. Changes that would allow owners to receive increases higher than 5% undermine the basic provisions of providing tenant stability in the rental market.

Deed-restricted affordable housing provides access to low-income households

Alternatively, building on-site affordable units is currently an option for developers to avoid the re-control requirements. Developers and lenders are familiar with deed-restricted affordable housing and are willing to explore options to provide affordable units on-site rather than rent stabilized apartments. Finally, some advocates support the exemption to re-control option that allows a developer to provide on-site income restricted housing.

There are many benefits of providing affordable units on-site as an alternative to rent stabilized apartments. More cities in California and across the country have inclusionary requirements as compared to rent stabilization programs, resulting in a higher level of knowledge and understanding of affordable housing. Both developer and lenders perceive that affordable housing requirements are more predictable than rent stabilization requirements. The units will remain affordable over time because vacancy decontrol is not allowed. There is a possibility that the displaced tenant may be able to return to the development depending on the target AMI and income of the displaced resident. More importantly, providing an affordable unit on-site as an alternative to re-control will result in the replacement of an apartment with an affordable rent with an affordable unit, maintaining the overall number of affordable units citywide. Tenants and the neighborhood may benefit from a new, improved building.

City is unable to meet the need for affordable housing

San José is lagging behind in meeting the need for affordable housing. The Housing Element establishes a strategy to meet a jurisdiction's future housing needs defined by its Regional Housing Need Assessment. Just as there is segmentation in the labor market with different incomes for workers, there is segmentation in the housing market to serve households of different incomes. A large portion of San José's current RHNA goal (42%) requires homes that are affordable for Extremely Low-Income (30% AMI), Very Low-Income (60% AMI), and Low-Income (80% AMI) households as defined by the California Department of Housing and Community Development.

The City has only met 13% of its affordable housing goal. The market is not producing new housing affordable for residents below 110% AMI. San José is 18,038 units short from meeting its affordable housing RHNA goal for the year 2022. In response to the need for affordable housing in San José, the City Council set a goal of building 10,000 affordable units between 2017 and 2022. Staff estimates that with current resources for affordable housing, San José may be able to achieve a total of 5,667 new affordable apartments to be produced. This shortage of affordable housing is understated as RHNA only tracks future not current demand. Demolishing rent stabilized apartments and replacing them with Class A apartments reduces the housing opportunities and choices for Low and Very Low- income renters in San José and will exasperate the current need for low-income housing.

Production of new market-rate apartments does not provide housing choices for low and very low income households in the near term

A commonly held view is that increasing housing supply at any price point is an anti-displacement strategy because increased supply will free up more affordable housing choices. The concept of "filtering" describes the effect when older market-rate housing becomes more affordable as they age and then new apartments are added to the market. The theory proposes that when a resident chooses a higher-priced new apartment, they leave behind a vacancy that can then be filled by someone else moving up the housing ladder into that apartment. This "filtering" argument supports the idea that any new production is good for the overall market, and increases housing affordability generally. In a recent U.C. Berkeley study "Housing Production, Filtering and Displacement: Untangling the Relationships," researchers found that the "filtering process can take generations, meaning that apartments may not filter at a rate that meets needs at the market's peak, and the property may deteriorate too much to be habitable." They found that filtering takes a far longer time to lower prices in high-demand housing regions such as ours, and only for a tiny portion of apartments each year. The authors indicate that assuming new housing is built for median-income families in the Bay Area, "it would take approximately 15 years before those units filtered down to people at 80% of the median income and closer to 50 years for households earning 50% of the median income."

ALTERNATIVES FOR POTENTIAL POLICY MODIFICATIONS

Given the information collected through this process, staff developed policy alternatives for the City Council to consider regarding Ellis Act provisions. Three of these options all provide incentive to build affordable housing on-site. One is aimed at increasing housing production consistent with the density goals of the General Plan, while maintaining future protections on rent increases within development areas.

Table 6 illustrates how the potential alternatives may impact proposed developments.

Table 6: Impact of Policy Alternatives on Example Proposed Developments

		Current Requirements		Mod #1	Mod #2	Mod #3
Number of Units Demolished	Number of New Units in the Proposed Development	Re-control (Greater of 1:1 or 50% of new)	20% Affordable	Affordable Waiver (greater of one-to-one or 15% replacement)	Re-control for one-to-one plus 15% of additional apartments	High Rise Waiver (1x Affordable @ 80% AMI)
5	249	125	50	37	42	5
16	22	16	4	16	17	16
20	85	43	17	13	30	20
30	218	109	44	33	58	30
124	710	355	142	124	212	124

MODIFICATION #1 – Revise the On-Site Affordable Housing Waiver

The 50% re-control provision would remain in place, but the affordable housing waiver would be modified to reduce the replacement requirement from 20% to 15%. A developer could receive a waiver for the re-control provisions if:

1) 15% of the new units built on site are consistent with the Inclusionary Housing Ordinance standards (6% at 50% of the AMI and 9% at 80% of the AMI); or
2) Replace the number of demolished units on a one-for-one basis with affordable housing units restricted at 80% of the AMI, whichever is greater.

Pros: In order to replace the rent levels that were lost from removal of the rental market, a developer may replace the rent stabilized apartments with affordable apartments on-site. This allows the right to return provision to be effective creating affordable rents for the existing tenants. Without the affordable rents, the majority of displaced residents will not have the option to return to the new housing because they would not be able to afford the rents.

Cons: Reducing the requirement to 15% will not result in a net gain. Developers and property managers will have to manage affordability restrictions for the long term. It is not known how many of the former residents would qualify for income-restricted affordable housing.

MODIFICATION #2 – Adjust Re-Control Provision for Higher Density Projects

A change to the Ellis Act Re-control provisions would require requiring re-control provisions be required for the original number of apartments demolished (on a one-for-one basis) plus 15% of all new units beyond the number demolished be re-controlled.

Pros: Encourage the development of new high density development consistent with the vision of the General Plan; avoid dis-incentivizing density.

Cons: Loss of older, lower rent/income rent stabilized apartments. Rents of newer replacement housing will be reset at new construction market rents, and may turn-over at a higher rate.

MODIFICATION #3 – High-Rise Waiver

The 50% re-control provision would remain in place, but high-rise developments would receive a waiver of re-control provisions if they provided affordable housing units on site at the 80% AMI level on a one-for-one basis.

Pros**:** High rise developments face unique cost-related challenges and may be able to move forward by replacing the number of rental units demolished with affordable housing units on-site. This provision provides an incentive for developers to include income-restricted units on-site.

Cons**:** High-rise developments are the highest density developments in the City, based on the large number of units built, there is a higher potential for new affordable housing units. Reducing the requirement for this type of development has an opportunity cost to the community in providing more affordable housing units, if the high-rise housing ends up getting built.

MODIFICATION #4 – Affordable Housing Impact Fee Program Change

A change to the Affordable Housing Impact Fee Resolution could be made to allow for a credit to the developer obligated to pay the Affordable Housing Impact Fee to reduce the amount due if income restricted apartments are built on-site in an effort to utilize the On-site Affordable Housing Waiver.

Pros**:** Encourage the development of on-site affordable housing in a number of projects subject to both the Affordable Housing Impact Fee and the Ellis Act provisions.

Cons**:** The Affordable Housing Impact Fee program is sunsetting, therefore any changes to the policy will have a limited impact on future development. Requires changes to multiple Ordinances.

/s/
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Director, Housing Department

/s/
KIM WALESH
Deputy City Manager

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ATTACHMENTS

- **Attachment A –** Summary of Lender and Developer Feedback
- **Attachment B –** Summary of Tenant Feedback

ATTACHMENT A

SUMMARY OF DEVELOPER AND LENDER FEEDBACK

Summary of Interviews with Developers

Developer Interviews

Factors to Consider when Determining if the Development will Move Forward

- Financial feasibility – price difference between the current sale price and the redevelopment resale value.
- Historic structures on adjacent parcels are presenting a challenge.
- Challenges negotiating land price.
- Park fees are challenging for the development.
- Housing type is challenging; wanting to explore options such as co-living to make the development move forward.
- The developer's lender needs to see $4,000 monthly rent for the new apartments to make the investment.
- Developer is looking for a 10% return; narrow margin considering all of the variables that may shift during the development process.
- Ellis requirements represent another item in a long list of requirements by the City that make developing residential difficult.
- Developing in an opportunity zone – rushed timeline means the Developer needs the development process to move forward quickly to maintain investment.
- Developers are making investments in areas where they think the market will develop and improve over time – speculating on the opportunity to make a larger return in areas as they become more desirable. Ellis potentially limits the opportunity (and therefore the attractiveness) of these areas.
- Land costs already reflect future investment in San José including Bay Area Rapid Transit (BART) and Diridon expansions. Returns must be made on the development to recapture the initial funding of the land purchase.
- High rise housing developments face unique challenges due to the cost of development and difficulty building to the heights necessary to cover the costs.
- While the cost of steel, glass and labor are always a concern, the cost of land in San José is the greatest concern.
- Softening rents are making new developments difficult to move forward.

Familiarity with Affordable Housing Programs

- No direct experience with affordable housing.
- Familiar – interested in producing the 20% affordable option rather than having 50% of the new apartments subject to the Rent Stabilization program.
- Very interested in affordable housing – if the requirement to replace the demolished apartments on a one-for-one basis with affordable apartments restricted at 80% to 100% Area Median Income (AMI), the development could move forward. This option would be preferred over the 50% re-control provision.

Summary of Interviews with Lenders

Lender Interviews

Current Market

- Developments are moving forward with approximately 30% from equity investors and 70% from typical bank loans. Equity investors are assuming greater risk on the development.
- Equity investors are concerned about the first five years of a development – construction and lease up are the most critical points in the process.
- Long-term investors purchase the property once construction is complete and the building is stabilized – meaning it is leased up for one to two years.

Impact of Ellis Act on Development

- In general, equity investors and bank underwriters are projecting conservative growth rates on rents generally tracking the Consumer Price Index (CPI). The 5% annual increases under the re-control provisions are generous and reasonable.
- Debt providers will be comfortable with a 5% growth rate; equity investors may feel a little tighter with the 5% limitation; overall, both types of lenders will find a 5% rent increase reasonable.
- Approximately 70% of the developers partnered with use rent discounting as a business model to ensure an expedited lease up period. If the re-control provisions would not allow the rents to "catch up" to market in the first two years, this may be a challenge.

Familiarity with affordable housing programs

- Familiar – affordable rents work at the 80% to 100% AMI levels when included in a market-rate development.
- Familiar – for sale is challenging to make work due to the high sale prices; rental at lower income levels is also challenging. Generally, affordable housing works best when concentrated in a separate building.
- Deed restrictions are predictable and the programs are clearly defined.

ATTACHMENT B

SUMMARY OF TENANT FEEDBACK

Summary of Interviews with Tenants

Tenant Interviews

Current Rent Levels

- $1,900
- $1,992
- $2,042
- $2,100
- $2,300

Aspects of living in this Neighborhood or Complex

- Access to transportation, such as light rail, is critical to some residents.
- Lack of maintenance or dilapidated buildings, but rents are still high.
- Immigrants of India - work for tech companies but are contracted out and do not make a six figure salary, or they make a six figure salary, but support their families back home. Cost of day care and school is also expensive and eats away at what appears to be a larger salary.
- Transportation and amenities attract lower income families to certain neighborhoods, and also attract tech workers traveling to neighboring cities.
- Majority are seniors with fixed incomes, that live pay-check to pay-check. Can't imagine moving to another apartment because of market-rate rents. Residents would most likely have to leave the State or would be forced to move in with family members.
- Long-term tenants who have established a community and raised their families feel uncertain and uneasy about pressures of displacement. Questions such as, "Where will I move to?"; "What will happen to my neighbors?"; and "How will I afford market-rate rents?"

Occupation and Work Location

- Hospital – City of Santa Clara
- Software engineer – City of Palo Alto
- Teacher – City of San José
- Real estate – City of San José
- Driver – City of San José
- Engineer – City of San José
- Consultant – City of San José
- Custodian and truck driver – City of San José
- Construction – City of San José
- Retired and on fixed-income
- Domestic worker- City of San Jose