COUNCIL AGENDA: 9/24/19
FILE: 19-821
ITEM: 4.3

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Kim Walesh
Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: September 11, 2019

Approved D DSyL   Date 9/13/19

SUBJECT: DOWNTOWN RESIDENTIAL HIGH-RISE INCENTIVE AND AHIF DOWNTOWN HIGH-RISE EXEMPTION PROGRAMS

RECOMMENDATION

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

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

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

OUTCOME

Approval of the recommendation will result in staff returning to Council with an ordinance and resolution to extend the completion deadlines of the current downtown high-rise incentive programs for construction related taxes and the Affordable Housing Impact Fee.

BACKGROUND

Increasing the number of residents in the Downtown has long been viewed as critical to support transit, retail, and the generation of more jobs in the City's core. To date, most high-rise residential development projects in the downtown have been approved utilizing some form of incentive. With this objective, the City Council approved incentives for high-rise residential development in 2007 (included only a parks-specific fee reduction) and again in 2012 (included both a parks fee and construction tax reduction). The Downtown High-Rise Incentive Program has successfully attracted 1,522 residential units which are complete. An additional 1,043 are under construction or soon to begin.

The incentive expired in 2016 at a time when financial and market conditions were tightening for new high-rise development. In this context, the City Council approved the extension of the Downtown High-Rise Residential Incentive Program on December 13, 2016 with the intent that the completion of additional high-rise projects will add housing units, attract additional employers, and increase transit use. The extension still applied to new residential structures 12 or more stories in height located in the Downtown Planned Growth Area but added the requirements that projects file a complete Planning application on or before December 31, 2017, obtain a Building Permit on or before July 31, 2018, and that 80% of the residential units have a final inspection scheduled on or before December 31, 2020.

The most recent Downtown High-Rise Residential Incentive Program suspended 50% of the City's two primary construction taxes (the Building and Structures tax SJMC 4.46 and the Commercial, Residential and Mobile Home Tax SJMC 4.47) on high-rise developments in the Downtown Area (Appendix A) and allowed for payment of the taxes to be delayed until the issuance of the Certificate of Occupancy. The tax reduction required that projects file a completed application for a development permit on or before December 31, 2017, and that a building permit had been issued on or before July 31, 2018.

The Incentive Program also reduced the park impact in-lieu fees charged for residential downtown high-rise developments to 50% of the applicable park impact in-lieu fees for multi-family 5+ units in the Downtown Area and allowed for payment of park impact in-lieu fees to be delayed until issuance of the Certificate of Occupancy.

On November 18, 2014, the City Council adopted the Affordable Housing Impact Fee Resolution establishing the AHIF program to address the increased need for affordable housing connected with the development of new market rate residential rental units. Under the AHIF program, new market-rate rental housing developments will be charged $17.00 per square foot of net rentable space (the "Fee") to address the impact of that type of development on the need for affordable housing. The resolution included a time-limited exemption for Downtown High-Rise rental projects. The Downtown High-Rise Exemption allows a development to be exempted from paying the Fee, if the following criteria are met:

- The rental development is located in the Downtown Core Area (as described in Resolution No. 73587 – adopted January 9, 2007);
- The rental development meets minimum height requirements where the highest occupied floor within the project must have a floor level elevation of at least 150 feet above the street level (as verified by plans submitted to the Building Division);
- The developer provides evidence that the development is not a for-sale development;
- The developer, prior to issuance of a Building Permit, records an Affordable Housing Impact Fee Agreement, specifying which fee shall apply in the event the developer fails to satisfy all waiver requirements; and

- The developer provides evidence that its final Certificates of Occupancy are ready to issue, except for the fee waiver, on or prior to June 30, 2021.

Currently nine projects have met the required milestones for current Downtown High-Rise Incentive (see Appendix A).

On December 19, 2017, the City Council adopted a new Downtown Core High-Rise Fee Category for Parks, Recreation, and Neighborhood Services, reflecting lower observed occupancy of existing high-rises in Downtown San Jose. Prior to this new category, high-rise developments paid the same rate as any project with 5 or more residential units. With this new permanent fee category in place, a reduction in Parks Fees is no longer included in the Downtown High-Rise Incentive.

On June 12, 2018, the City Council approved the Housing Crisis Workplan which included direction for staff to extend the 50% reduction on construction taxes to align it with the end date of the AHIF exemption.

On June 25, 2019, the City Council approved amendments to the municipal code to require workforce standards for private development projects receiving a subsidy and directed staff to move forward with a unique services agreement for a consultant to perform the required financial feasibility assessment of Downtown high-rise residential development, with the intent of staff returning to City Council with an extension and amendments to the Downtown Residential High-Rise Incentive.

ANALYSIS

Current Incentive

Construction Taxes: The City's construction taxes include the Building and Structure Construction Tax ("B&S") and the Commercial-Residential-Mobile Home-Park Building Tax ("CRMP"), both of which are based on the valuation of construction derived from the most current building valuation data table published by the International Code Council (ICC) or the developer's stated construction valuation, whichever is higher. The B&S tax rate on residential building construction valuation is 1.54%, and the CRMP tax rate on residential building construction valuation is 2.42%, for a combined tax of 3.96%. The value of these two combined taxes is estimated at $5,000 to $7,500 per unit. Proceeds are used to fund transportation-related projects and improvements, such as pavement maintenance, complete streets, pedestrian safety, and traffic calming projects.

Affordable Housing Impact Fee and Inclusionary In-Lieu Fee: In addition to the AHIF which applies to rental units, the City has also enacted an Inclusionary Housing Ordinance (IHO) which includes an In-Lieu Fee compliance option ("Inclusionary In-Lieu Fee") that a developer may pay if they choose not to include affordable units in their residential project. Initially the IHO only applied to for-sale projects, and then effective January 1, 2018, the IHO was applied to rentals. In order to transition rental downtown high-rise developments between the AHIF and IHO, nine qualified rental developments choose to remain under the AHIF and then City Council adopted a resolution on June 26, 2018 authorizing a reduction in the Inclusionary In-Lieu Fee to $0 (per In-Lieu unit) for High-Rise rental developments if they obtain issuance of all Certificates of Occupancy on or prior to June 30, 2021. These downtown high-rise rental projects may elect to build affordable units on-site or they may elect to qualify for this reduction in the Inclusionary In-Lieu Fee to satisfy the project's Inclusionary obligation. Currently, any new projects, whether rental or for-sale, being proposed in the Downtown are subject to the IHO. This memo does not address modifications to the IHO or extending the reduction in the Inclusionary In-Lieu Fee deadline. Housing staff will be returning on November 5, 2019 to discuss this further.

Feasibility Study

The adopted Workforce Standards Ordinance includes provisions that require private construction projects receiving a City subsidy to pay all workers employed on the construction the prevailing wage rate, as well as provisions for requiring apprenticeships, local hire, and use of unrepresented workers. The ordinance contains some exceptions to the definition of subsidy, including when the fee or tax reduction is applied uniformly across all private construction projects within a specific subcategory of use (such as 'high-rise residential'), and Council determines, based on the following criteria, that construction of the projects is not financially feasible absent the reduction:

1. Council's determination, supported by findings, must occur following a public hearing,
2. Council's findings must be supported by evidence presented at the public hearing, including a financial feasibility study analyzing whether construction of the projects within the specified subcategory of use is reasonably unlikely absent the fee or tax reduction,
3. The financial feasibility study must be performed by a consultant qualified to provide real-estate analytic services and procured through the City's usual procurement process, and
4. The Council must use reasonable efforts to conduct the hearing within 90 calendar days following completion of the financial feasibility study.

At the June 25 meeting Council provided direction to select an appropriate consultant from the list of consultants submitted by Ben Field on June 20, 2019, consisting of Economic and Planning Systems, Strategic Economics, AECOM, Grounded Solutions, and Economic Roundtable, in accordance with the negotiated settlement approved by City Council on April 3, 2018. Staff selected Strategic Economics to complete the required analysis.

Strategic Economics developed a static pro forma model to complete the required analysis (attached) and assess the financial feasibility of a typical high-rise development in the downtown. This conceptual pro forma was then modified to test scenarios for financial incentives, the impact of workforce standards, and the sensitivity of the results to various inputs to the model.

In addition to the requirements detailed above, the consultant study must address specified details of sub-class feasibility per Title 14 of the Municipal Code.

	Requirement	**Consultant Analysis**
a.	Whether construction of the Private Construction Projects in the specified Subcategory of Use is Financially Infeasible;	*Given currently high construction costs, a typical high-rise development in downtown San José is not financially feasible.*
b.	The reason(s) for any conclusion that construction of the Private Construction Projects in the specified Subcategory of Use is Financially Infeasible;	*The yield-on-cost for Scenario 1 is 4.13%, short of the target return of 5.25%. Development costs for high-rise apartments are estimated to average $651,000 per unit, with the escalating cost of construction (direct costs) and high land costs major factors impacting feasibility.* *With the current high level of development costs, average rents would need to increase by 20 percent (to $4.80 per net square foot or $3,840 per unit monthly) for the development to be feasible given current costs.*
c.	The anticipated duration of any condition(s) making construction of the Private Construction Projects in the specified Subcategory of Use Financially Infeasible;	*It may require a few years of favorable trends (e.g., a continued strong rental market combined with flat development costs) to reach the market conditions needed for feasibility. Apartment rent growth has averaged 4.6 percent annual growth over the past 10 years, but growth rates vary significantly depending on the specific year.*
d.	The estimated size of the financial gap between the Private Construction Projects in the specified Subcategory of Use being Financially Infeasible and financially feasible;	*A 21 percent reduction in total development costs (or $138,000 reduction per unit) would be required for a development of this type to be feasible.*

e.		Options for making construction of the Private Construction Projects in the specified Subcategory of Use financially feasible, including the following:	
	i.	Providing the proposed fee or tax reduction without requiring the payment of prevailing wages;	*Extending the incentives improves the financial picture slightly but is not sufficient for the development to reach feasibility.*
	ii.	Providing the proposed fee or tax reduction along with requiring the payment of prevailing wages; and	*Including workforce standards increases development costs by 4%.*
	iii.	Any additional options, other than the proposed fee or tax reduction, that would make construction of the Private Construction Projects within the specified Subcategory of Use financially feasible, provided that any such options must comply with all applicable laws and regulations, including the City's current general plan.	*Other policy solutions that could improve feasibility include relaxing building codes and participating in workforce training efforts.* These options would not make construction of the Private Construction Projects within the specified Subcategory of Use financially feasible. The three variables that were directly explored in the report were: • No incentive and no workforce standards • Incentives only • Incentives and workforce standards implemented

The analysis demonstrates the difficult development conditions that persist in Downtown. Construction costs are high region wide and continue to rise while rents in San Jose are lower than surrounding cities and therefore offer less attractive returns on investment. The analysis concludes that a fee/tax reduction and deferral will not be sufficient to ensure that projects are financially feasible alone in current market conditions. As noted in the analysis,

> *"Although the analysis found the prototype to be infeasible, some projects may have unique circumstances that influence development feasibility. This includes projects where the land was acquired at a reduced price. Specific financing arrangements, such as those utilizing the EB-5 and Opportunity Zones programs, may also help to improve project feasibility."*

Other means of achieving project feasibility may include reduced return to land owners, value engineering, and or cost controls.

Staff Recommendation

While City fees and taxes reductions are not the sole reason for development infeasibility in the Downtown area, they contribute to the total cost stack that developers must equate to the financial returns and opportunities that each individual project represents. There remains a significant public benefit to increasing the availability of housing and achieving a critical mass of residents in the Downtown. In addition to contributing to the vibrancy and economic success of the area, new high-rise development will deliver much needed residential capacity consistent with the goals and objectives of the City's Housing Crisis Workplan. Staff is therefore recommending bringing back the appropriate ordinance and resolution to enact the following:

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

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

Affected Projects

Nine high-rise development projects qualified for the Downtown High-Rise Exemption under the AHIF. The IHO, rather than the AHIF applies to projects submitted after that date. These nine developments are projected to result in 3,240 market-rate units.

Two of the projects, The Grad San Jose (formerly 'The Graduate') and Miro Towers, have recorded Affordable Housing Agreements in accordance with the AHIF, have received full Building Permits, and are under construction. The Grad San Jose is projected to complete construction by mid-2020 and thus meet the final incentive milestone requirement of final inspection of residential units by December 2020. Due to unforeseeable site issues which complicated and delayed construction, Miro Towers is projected to complete construction within the first two quarters of 2021, and while they could meet the current June 30, 2021 AHIF completion deadline, they will not meet the current construction tax incentive deadline.

The remaining seven projects are in the process of completing their entitlements and recording their agreements that will be required prior to releasing their Building Permits. Post and San Pedro is the only project that has received their foundation-only permit, and will need to record an Affordable Housing Agreement prior to the full release of their Building Permits and commencing construction. Based on the amount of time anticipated to construct a high-rise residential building (approximately 30-36 months), these projects are not anticipated to meet the current incentive or AHIF exemption completion deadlines.

Please see Attachment A for a list of eligible AHIF Downtown High-Rise Exemption projects.

Proposed Incentive Timeline

The current construction timeline for high-rise development in the Downtown is approximately 30 months. Working back from the proposed incentive completion date of December 31, 2023, would mean that projects will need to have started construction by at least June of 2021. Projects still working through the entitlement process may still have a significant amount of time to complete this process, develop construction level documents, and submit and receive a building permit. The proposed timeline will provide certainty and consistency regarding these fees to the project.

New rental projects being proposed in the Downtown can no longer qualify for the AHIF Downtown High Rise Exemption and as such would be subject to the IHO requirement. Staff will be returning on November 5, 2019 to discuss the IHO as it relates to future high-rise developments in the Downtown. Should Council take actions to modify the IHO in-lieu fee, then projects would still qualify for the construction tax portion of the incentive.

EVALUATION AND FOLLOW-UP

If Council accepts staff's recommendation, staff will return to City Council with the necessary resolution and ordinances to implement the incentives. Staff will also return to Council on November 5, 2019 with updates to the Citywide Cost of Development study and consideration of the Inclusionary Housing Ordinance.

Following approval of this program and the enacting ordinance, staff will develop Completion Agreements with high-rise project developers intending to benefit from the incentive program. Pursuant to California Government Code Section 53083, the City must conduct a public hearing upon providing a subsidy to these developments and as such staff will bring back each of the proposed agreements for Council consideration in a timely fashion.

Consistent with the requirements of the Mitigation Fee Act, the City will provide an annual report on actual AHIF revenues, future revenue projections, and expenditures of those revenues once revenues have been received, anticipated to be presented to City Council in October 2019. This report will not include any revenues that would otherwise have been generated by Downtown High-Rise rentals projects that have been exempted from the AHIF and these revenues were not included in the current Affordable Housing Investment Plan.

COST IMPLICATION SUMMARY

Due to the incentive being based on time rather than a specific development limit, the potential fiscal impacts of the program will not be fully understood until development applications are received. The attached financial feasibility analysis assumed that loss of revenue attributable to the proposed incentive would be approximately $3,250 from the combination of the Building and

Structures Construction Tax (SJMC 4.46), and the Commercial-Residential-Mobilehome Park Building Tax (SJMC 4.47), and approximately $14,608 from the AHIF, per residential unit.

The Building and Structures Construction Tax (SJMC 4.46), and the Commercial-Residential-Mobilehome Park Building Tax (SJMC 4.47), also known as the Construction Excise Tax, fund a significant portion of the Traffic Capital Improvement Program. Revenues from these taxes are dependent on the level and nature of construction activity moving through the building permit process.

The AHIF is currently $18.26 per square foot (FY19-20). The AHIF increased by 2.4% each fiscal year. If this extension to the deadline is granted, the AHIF would need to be amended annually until fiscal year 2022-2023 in the Schedule of Fees and Charges. There are no revenue or expense impacts in Fiscal Year 2019-2020. Although this change would result in less impact fees collected on the Downtown High-Rise rental developments that don't reach the original deadline, these fees are already considered foregone and are not included in budget projections or in the Five-Year Affordable Housing Investment Plan. If these projects identified in Attachment A qualify for the AHIF Downtown High-Rise exemption and meet the requirements, the project is exempted from paying the fee.

Pursuant to California Government Code Section 53083, the City must disclose information related to any economic development subsidy over $100,000 through a public hearing. These disclosures are required to include information on the estimated total amount of expenditure of public funds or revenue lost, and projected tax revenue. Staff will bring back these disclosures for individual projects in conjunction with the required project completion agreement.

PUBLIC OUTREACH

The attached feasibility study by Strategic Economics was developed with stakeholder outreach which included outreach meetings on May 29, 2019, August 5, 2019, and August 13, 2019, as well as additional individual interviews. Staff has been coordinated closely with representatives from Working Partnerships USA to ensure the proposed scope of the study met the intent of Workforce Standards ordinance.

This report will be made available to the public on September 13, 2019 through the Housing Website, and on the City of San José website and in hard copy in the City Clerk's office, prior to the City Council meeting scheduled for September 24, 2019.

COORDINATION

This report has been coordinated with memorandum was coordinated with the City Attorney's Office and the City Manager's Budget Office.

COMMISSION RECOMMENDATION/INPUT

No commission recommendation or input is associated with this action.

CEQA

Not a Project, PP17-009, Staff Reports, Assessments, Annual Reports, and Informational Memos that involve no approvals of any City action.

/s/
KIM WALESH
Deputy City Manager
Director of Economic Development

/s/
JACKY MORALES-FERRAND
Director,
Housing Department

For questions, please contact Chris Burton at (408) 535-8114, or Rachel VanderVeen at (408) 535-8231.

Attachment A – AHIF Projects Eligible for Downtown High-Rise Exemption
Attachment B – Financial Feasibility of Downtown High-rise Projects and Potential Impact of Incentives and Workforce Standards, Strategic Economics, September 12, 2019

Attachment A

	Project Name	Council District	Project Address	Developer	Building Permits Issuance Date	Number of Units	Square Footage	If Paying AHIF FY 22-23 ($19.61)	Status
	Eligible AHIF Downtown High-Rises								
1	**The Graduate Amcal**	3	80 E San Carlos	AMCAL Housing	12/19/17	260	261,436	$ 5,126,760	Under Construction
2	**Miro SJSC Towers**	3	193 E Santa Clara	Bay View Development	12/22/17	630	587,728	$ 11,525,346	Under Construction
3	**Aviato**	3	199 Bassett Ave	KT Urban/StarCity	N/A	302	285,612	$ 5,600,851	Entitled
4	**Greyhound**	3	70 S. Almaden	Z & L Properties	N/A	708	705,420	$ 13,833,286	Entitled
5	**Gateway Tower**	3	455 S First St	The Core Companies	N/A	300	235,305	$ 4,614,331	Entitled
6	**4th Street Metro Station**	3	439 S 4th St	Caruso Designs	N/A	218	197,669	$ 3,876,289	Not Entitled
7	**The Carlyle**	3	65 Note Dame	Insight Realty	N/A	220	191,915	$ 3,763,453	Not Entitled
8	**Post & San Pedro**	3	171 Post St	Simeon Properties	N/A	228	179,067	$ 3,511,504	Added Units
9	**27 West**	3	27 S 1st St	Alterra Worldwide	N/A	374	273,056	$ 5,354,628	Entitled
					TOTAL	**3,240**	**2,917,208**	**$ 57,206,449**	

MEMORANDUM

To: Chris Burton, City of San José

From: Strategic Economics

Date: September 12, 2019

Subject: DRAFT Financial Feasibility of Downtown High-rise Projects and Potential Impact of Incentives and Workforce Standards

Background and Memo Purpose

On July 25th, the San José City Council approved the first part of an ordinance that outlines workforce standards for private development receiving a public subsidy. The ordinance provides for a fee or tax reduction applied uniformly to all private construction projects within a specific subcategory of use (such as high-rise residential) if it is determined that construction of the project is financially infeasible.

As the City considers the extension of public subsidies for high-rise development in Downtown San José, City staff requested Strategic Economics to perform an analysis of the financial feasibility of such developments. This memo summarizes the results of the analysis, as well as the financial impact of extending the two fee incentives currently in effect for this subcategory. The two incentives under consideration are:

1) **Construction tax reduction.** This applies to projects that receive a foundation permit by July 2018 and compete final inspection of 80% of the units by December 2018. The City is considering removing the deadline for securing a foundation permit and extending the Certificate of Occupancy deadline to June 30, 2023.
2) **Affordable Housing Impact Fee Exemption.** Projects may also be exempted from the Affordable Housing Impact Fee if the developer provides evidence that its final Certificates of Occupancy are ready to issue on or prior to June 30, 2021. The City is also considering extending this deadline to June 30, 2023.

The remainder of this memo contains the following:

- A description of the pro forma approach to modeling development feasibility and the policy scenarios tested;
- A description of the conceptual building prototype and key development assumptions used in the analysis;
- A discussion of the impact of workforce standards on development costs; and
- The results of the analysis on the conceptual pro forma.

Pro Forma Approach

Strategic Economics developed a static pro forma model (outlined below) to assess the financial feasibility of a typical high-rise development in the downtown. This conceptual pro forma was then modified to test scenarios for financial incentives, the impact of workforce standards, and the sensitivity of the results to various inputs to the model.

The steps in the pro forma method are:

- Develop a conceptual **building prototype**, specifying the size of the site, the number and average size of the residential units, overall building floor area, and parking.
- Estimate all **development costs** for the prototype, including land cost, direct construction costs ("hard" costs), indirect costs ("soft" costs such as development fees, permits and overhead), and financing costs.
- Estimate the **net operating income** to be generated by the project, based on assumptions about market-rate apartment rents in Downtown San José and other sources of revenue. The net operating income is defined as the gross revenue that could be generated by the project, less an allowance for vacancy and operating expenses.
- Calculate the developer return. For income-generating developments such as the rental apartment prototype in this study, a common metric for developer return is **yield-on-cost**. Yield-on-cost is defined as the net operating income (defined above) in the first stabilized year after lease-up, divided by the total development costs.
- **Test feasibility** by comparing the project return to a "target return," or industry standard return that a developer would expect to see for a project of this type.

POLICY SCENARIOS

After developing the general pro forma model, Strategic Economics modified certain assumptions to test the economic impacts of extending the fee incentives and requiring workforce standards. Three policy scenarios were tested in this study:

1. **No incentive, no workforce standards.** This scenario assumes full payment of the Affordable Housing Impact Fee and all construction taxes. As no incentive is offered in this scenario, the development is also assumed not to be required to comply with additional workforce standards in association with discounts and waivers of municipal fees.
2. **Incentives only.** This scenario assumes the development receives the incentives offered on the AHIF and construction taxes, but no additional workforce standards are applied.
3. **Incentives + Workforce Standards.** This scenario assumes the fee incentives are offered as a condition of the development project adhering to workforce standards.

The next section describes the building prototype and key assumptions for the conceptual pro forma model. The research and assumptions for modeling the workforce standards policy are described in the following section.

Building Prototype and Key Assumptions

This section describes assumptions about the conceptual building prototype, development costs (including the full municipal fee and incentive fee levels), sources of revenue, and developer return.

To develop the conceptual building prototype and market assumptions, Strategic Economics reviewed recent high-rise construction and development proposals in the Bay Area, collected market data for apartment rents and land costs in the Downtown, and interviewed a range of developers and general contractors experienced with high-rise development in San José. Strategic Economics also reviewed two feasibility analyses for San José high-rises conducted by Keyser Marston Associates in 2018 and 2019.[1]

CONCEPTUAL BUILDING PROTOTYPE

Strategic Economics analyzed a building prototype as shown in FIGURE 1. The site size, height, and building program for the prototype were based on recently built and proposed residential high-rises in San José. The prototype is assumed to be 250 feet in height, the maximum allowable height in the downtown. It is modeled as an apartment rental project with an assumed average unit size of 800 square feet. While this unit size is slightly smaller than what is typical for recently built projects, it is in line with many proposed developments in San José.

The conceptual prototype represents a typical, market-rate high-rise residential project in Downtown San José. Other development proposals are possible, such as condominium, mixed-used, or co-living developments. Co-living projects, which include larger unit sizes with many bedrooms, are of particular interest because one such development ("The Grad San Jose" student housing) is currently under construction. It is difficult to draw concrete conclusions about the feasibility of co-living developments given the untested nature of the market. It is also not known whether sufficient demand exists to support additional development of this type.

PARKING

The off-street parking ratio for the conceptual prototype is assumed to be 0.8 spaces per residential unit. The assumed ratio is somewhat lower than the amount of parking that has been supplied in past developments, with the expectation that future BART service will reduce the need for off-street parking in future developments. For high-rise developments in San José, most off-street parking is typically provided underground, with a smaller portion of the parking provided above ground in a podium or other structure. Mechanical parking stackers are sometimes used, which have a similar average construction cost per space, according to developers.

[1] "Downtown High-rise Residential Incentive Analysis," Keyser Marston Associates, September 27, 2018; "2019 Update to Downtown High-Rise Residential Incentive Analysis," Keyser Marston Associates, July 12, 2019.

FIGURE 1: CONCEPTUAL HIGH-RISE PROTOTYPE

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

* Building efficiency is the percentage of total rentable floor area (net square feet) divided by the gross building area.
Source: Strategic Economics, 2019

DEVELOPMENT COSTS

Development cost assumptions are summarized in FIGURE 2 and are described in more detail below.

LAND AND SITE COSTS

For the land cost assumption, Strategic Economics reviewed comparable land sales for residential development in Downtown San José. For downtown residential developments greater than 250 units, land costs ranged from $21,000 to $64,000 per unit. Based on this data and developer feedback, Strategic Economics assumed $60,000 per unit, which is equivalent to $505 per square foot of land for the prototype in this study. This assumption includes any costs associated with demolition and site preparation.

DIRECT COSTS

“Direct” or “hard” costs include all vertical costs of constructing the building, including the parking areas, and installing interior finishes. Based on developer feedback and a review of similar feasibility studies in the Bay Area, Strategic Economics assumed typical hard costs of $370 per square foot of gross residential building area. This average cost assumes Type I high-rise construction in the absence of the workforce standards considered in this study. With workforce standards, hard costs are assumed to rise by nine percent. The impact of workforce standards on construction costs and project timelines is discussed in more detail in the next section.

Direct costs for parking were estimated separately at $75,000 per space, assuming that most parking would be provided underground. (As mentioned above, mechanical stackers may be used under some circumstances, but this parking configuration typically comes at a similar per-space cost.)

Indirect Costs

Estimated indirect (or "soft") costs include project expenses such as permits, architectural fees, engineering fees, insurance, taxes, legal services, accounting fees, a contingency allowance, and developer overhead. (Financing and municipal fees were considered in separate line items and are described below.)

The indirect costs listed above were assumed to be 12 percent of direct costs, with an additional 5 percent contingency. These indirect costs were calculated for the development scenario with no incentives or workforce standards and held constant for the other scenarios.

Municipal Fees

Municipal fees (Figure 3) include the affordable housing impact fee, parks fee, development permitting fees, and development construction taxes. Fees per unit were estimated with and without the applicable incentives as outlined at the beginning of this memo.

Financing

Financing costs assume a construction loan with the terms shown in Figure 2, including a 36-month construction period for high-rise development.

FIGURE 2: DEVELOPMENT COST ASSUMPTIONS AND DEVELOPER RETURN

Assumption	Unit of measure	Value
Land Costs		
Land Cost and Site Preparation	per square foot	$505
	per unit	$60,000
Direct Costs		
Building Area Construction [a]	per gross sf	$370
Parking	per space	$75,000
Premium for workforce standards	% of hard costs	9%
Indirect Costs		
(Municipal fees are itemized separately, see Figure 3.)		
Arch, Eng & Consulting	% of hard costs	6.0%
Taxes, Insurance, Legal & Accounting	% of hard costs	3.0%
Other Soft Costs	% of hard costs	3.0%
Total Soft Costs (Excluding Fees)	**% of hard costs**	**12.0%**
Contingency	% of hard costs	5.0%
Financing		
Amount Financed (Loan-to-cost)	% of hard + soft costs	65%
Average outstanding balance	% of amt financed	55%
Construction Loan Fee	% of amt financed	1.0%
Construction Interest (annual)	% of outstanding balance	5.5%
Term	months	36
Developer Return		
Minimum Yield-on-Cost	NOI / TDC [b]	5.25%

[a] Assumes no workforce standards.
[b] NOI = net operating income; TDC = total development costs
Source: Strategic Economics, 2019

FIGURE 3: MUNICIPAL FEE ASSUMPTIONS (PER UNIT)

Fee Category	Description	Before incentives	With Incentives
Affordable Housing Impact Fee	AHIF is $18.26 per net residential square foot.	$14,608	Waived
Parks Fee (net of credits)	Parks fee is $14,600 less an assumed credit of 30%.	$10,220	$10,220
Development Permits	Building Permit Fee and other development permits.	$6,500	$6,500
Construction Taxes	CRMP and B&S Construction taxes assumed to be $6500 per unit or $3250 with the incentive. Other construction taxes are assumed to be $200 per unit.	$6,700	$3,450
	Total	**$38,028**	**$20,170**

Source: Strategic Economics, 2019.

REVENUES

Strategic Economics reviewed current apartment rent data for recently constructed high-rise projects in Downtown San José and consulted with developers to estimate project revenues and ongoing expenses. Average monthly rents were assumed to be $4.00 per square foot, or $3,200 per unit (FIGURE 4). The rent per square foot, which is slightly higher than current rental properties at the top of the market, reflects the smaller unit sizes of new project proposals in downtown San Jose.

Other revenues, which include charges for laundry, storage services, pet fees, late fees and other services, were assumed to average $250 per unit per month.

FIGURE 4: REVENUE ASSUMPTIONS

Assumption	Unit of measure	High-rise Apartment
Average Monthly Rent		
Per net sq. ft.	per nsf	$4.00
Per unit	per unit	$3,200
Other Monthly Revenues	per unit	$250
Vacancy	% of GSI [a]	5%
Operating Expense	% of GSI [a]	30%
Cap Rate	NOI / Proj Value [b]	4.25%

[a] GSI = Gross Scheduled Income, or the income that would be generated with zero vacancy.
[b] NOI = Net Operating Income.
Source: Strategic Economics, 2019.

DEVELOPER RETURN

Based on feedback from developer interviews and recent feasibility studies of similar rental apartment projects, Strategic Economics set the target yield-on-cost assumption to 5.25 percent.

Impact of Workforce Standards Requirements

Strategic Economics reviewed academic papers and reports on construction wages and costs, and interviewed stakeholders, including contractors, developers, and labor representatives to estimate the cost implications associated with the proposed workforce standards. Based on direction from stakeholders and City staff, Strategic Economics concluded that a prevailing wage requirement would generally meet many of the workforce standards, such as apprenticeships and hiring of local/disadvantaged workers. Therefore, for the purposes of this analysis, Strategic Economics quantified the cost of the workforce standards by measuring the cost of implementing a prevailing wage requirement in which non-union construction workers would be paid at wages equivalent to union wages.

The cost of a prevailing wage requirement on high-rise construction depends on a variety of factors, including the volume of development/construction activity and the availability (or shortage) of skilled workers for projects. At the present time, the Bay Area is in the midst of a construction boom, driven by both public and private investments. Stakeholders agreed that the principal cause of high construction costs in the Bay Area is the shortage of skilled labor, particularly for the specialized trades. Under cooler market conditions, the overall cost of construction would likely be significantly lower for both union and non-union labor.

Existing studies of the cost impacts of prevailing wage requirements have focused on low and mid-rise housing construction. One 2018 study conducted a statistical analysis of the impact of prevailing wage requirements for nonprofit low income housing tax credit (LIHTC) projects, and found that the cost increase was between five and seven percent.[2] A much earlier study from 2005 estimated that the prevailing wage requirement increased costs by 9 to 37 percent.[3] However, because these studies were based on statewide analysis for wood-frame buildings, these findings cannot be easily applied to high-rise development projects, which require different construction materials, technologies, and skills.

According to interviews, the majority of construction labor on high-rise projects, including subcontractors, are typically union workers. The exception is Mechanical, Electrical, and Plumbing (MEP) trades, for which there are non-union sub-contractors that typically pay lower than union wages. According to general contractors, the MEP share of overall construction costs is typically between 30 and 40 percent. Union MEP subcontractors typically cost about 20 to 30 percent more than non-union contractors. Taking the mid-range of these assumptions, Strategic Economics estimated that the requirement for prevailing wages on high-rise development would increase total construction costs by nine percent.

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[2] Littlehale, S. (2017). Revisiting the Costs of Developing New Subsidized Housing: The Relative Import of Construction Wage Standards and Nonprofit Development. Berkeley Planning Journal, 29(1), 101-128. https://escholarship.org/uc/item/9js5d61m

[3] Dunn, S. Quigley, J., Rosenthal, L. (2005). The Effects of Prevailing Wage Requirements on the Cost of Low-Income Housing. Industrial and Labor Relations Review, 59(1), 141-157.

It is important to note that this cost differential is not just the difference in wages, but also includes additional contractor fees and “mark-ups” that subcontractor firms charge general contractors when submitting their bids. Strategic Economics was not able to obtain a detailed breakdown of payroll and other costs.

While stakeholders agreed that a prevailing wage requirement would usually increase overall construction costs, labor representatives and contractors also noted that using less experienced, non-union workers increases the likelihood of project delays, which can lead to increased carrying costs and financing costs for developers. Delayed projects also result in delayed returns and potentially additional risk exposure for the developer and investors.

Conceptual Pro Forma Analysis Results

The results of the analysis are summarized in FIGURE 6 and FIGURE 7. FIGURE 6 is a pro forma statement showing the total costs, revenues, and developer return for each scenario. FIGURE 7 shows the same information on per-unit basis.

- **Given currently high construction costs, a typical high-rise development in downtown San José is not financially feasible.** The yield-on-cost for Scenario 1 is 4.13%, short of the target return of 5.25%. Development costs for high-rise apartments are estimated to average $651,000 per unit, with the escalating cost of construction (direct costs) and high land costs major factors impacting feasibility.[4]
- **A 21 percent reduction in total development costs (or $138,000 reduction per unit) would be required for a development of this type to be feasible.** Assuming a net annual operating income of $27,000 per unit under current market conditions, development costs would need to be at most $513,000 per unit to reach a 5.25 percent yield-on-cost target.
- **Extending the incentives improves the financial picture slightly but is not sufficient to make the prototype development feasible.** Incentives reduce total development costs by 3 percent ($19,000 per unit), well short of the 21 percent cost reduction needed.
- **With current development costs, average rents would need to increase by 20 percent (to $4.80 per net square foot or $3,840 per unit monthly) for high rise apartments to be feasible.**[5] Assuming development costs of $651,000 per unit, annual net operating income would need to be $34,000 per unit to reach the target developer return.

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[4] Total development costs are estimated to be $635 per square foot of building area, or eight percent higher than the similar prototype analyzed by Keyser Marston Associates in 2018-2019.

[5] For comparison, average monthly rents for newly built high-rises in San Francisco range generally range between $6.00 to $7.00 per square foot.

(footnote continued)

- **It may require a few years of favorable trends (e.g., a continued strong rental market combined with flat development costs) to reach the market conditions needed for feasibility.** Apartment rent growth has averaged 4.6 percent annual growth over the past 10 years, but growth rates vary significantly depending on the specific year (see FIGURE 5)[6]. The planned BART extension and plans for Google Village can also be expected to help support improvement in the market over time. In addition, the BART extension to San Jose is scheduled to be completed by 2026. The anticipation of BART service is expected to reduce the need for on-site parking in future development projects, resulting in reduced development costs.
- **Development feasibility may be improved in specific circumstances with lower land costs or financing sources with different project return requirements.** Note that the feasibility assessment is for a typical high-rise apartment project. Although the analysis found the prototype to be infeasible, some projects may have unique circumstances that influence development feasibility. This includes projects where the land was acquired at a reduced price. Specific financing arrangements, such as those utilizing the EB-5 and Opportunity Zones programs, may also help to improve project feasibility.[7]
- **Other policy solutions that could improve feasibility include relaxing building codes and participating in workforce training efforts.** Developers and contractors interviewed for this study pointed to upcoming building code requirements coming into effect that could significantly add to costs. Others suggested the City participate in workforce training efforts to help alleviate the current labor shortage.
- **The required workforce standards, in combination with extending the incentives, results in a net increase in development costs of four percent.** Assuming both financial incentives and labor requirements are in effect, total development costs are $24,000 higher per unit than in Scenario 1. The higher cost of adhering to workforce standards should be weighed against using lower cost / open shop labor, which contractors and union representatives have stated run a higher risk of project delays. The carrying costs of project delays, including higher financing, taxes, and other soft costs, could be as high as $800,000 (0.2 percent of development costs) per month. Each month of delay would also delay approximately $1.2 million of net operating income at project stabilization.
- **Treating downtown high-rises as subject to the Inclusionary Housing Ordinance (IHO), instead of the Affordable Housing Impact Fee, could increase development costs by an additional two percent.** Assuming the developer chooses the in-lieu fee option in the IHO, in-lieu fees would equate to $25,000 per unit, or $10,392 higher than the AHIF.

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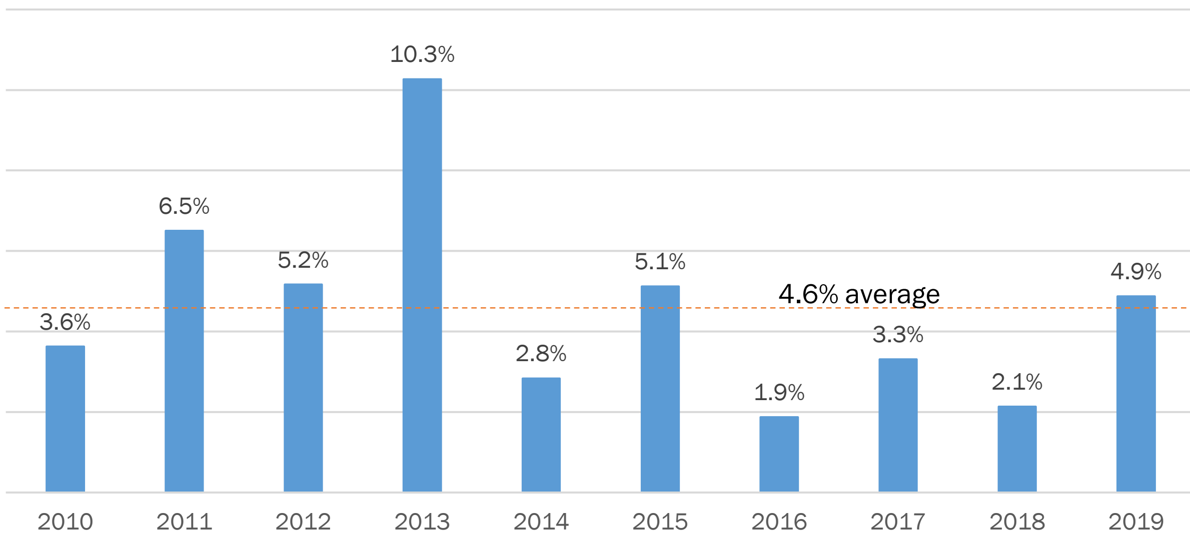
[6] The growth rate in rents shown in Figure 5 represents a sampling of all apartments in the Downtown, not just newly built product, where rental trends may vary somewhat from the average.

[7] Developers interviewed for this analysis reported that the Opportunity Zones program is helping to attract investor interest in San José, but said that this is not having an impact on the fundamental economics of development. It is possible, however, that some projects receiving Opportunity Zone investment may have reduced return expectations (given that investors are receiving other tax benefits).

FIGURE 5: AVERAGE APARTMENT RENT GROWTH OVER PRIOR YEAR, DOWNTOWN SAN JOSE, 2010-2019



Source: Costar, 2019; Strategic Economics, 2019.

FIGURE 6: DEVELOPMENT PRO FORMA BY SCENARIO

	(1) No Incentives, No Workforce Standards	(2) Incentives Only	(3) Incentives + Workforce Standards
Revenues			
(millions of $)			
Annual Gross Scheduled Income	$22.8	$22.8	$22.8
Less Vacancy	-$1.1	-$1.1	-$1.1
Less Expenses	-$6.8	-$6.8	-$6.8
Net Operating Income	$14.8	$14.8	$14.8
Capitalized Value	$348.2	$348.2	$348.2
Development Costs			
(millions of $)			
Land and Site Costs	**$33.0**	**$33.0**	**$33.0**
Memo: Land Costs in $ per sf land	*$505*	*$505*	*$505*
Direct Costs			
Building Area	$208.7	$208.7	*$229.9*
Parking	$33.0	$33.0	$33.0
Subtotal Direct Costs	**$241.7**	**$241.7**	**$262.9**
Indirect Costs			
Soft Costs	$29.0	$29.0	$29.0
Municipal Fees	$20.9	*$11.1*	*$11.1*
Financing	$21.3	*$20.6*	*$22.0*
Subtotal Indirect Costs	**$71.2**	**$60.7**	**$62.1**
Contingency	$12.1	$12.1	$13.1
Total Development Costs	**$358.0**	**$347.5**	**$371.1**
% Change from Scenario (1)		*-3%*	*+4%*
Feasibility			
(millions of $)			
Net Operating Income	$14.8	$14.8	$14.8
Total Development Costs	$358.0	$347.5	$371.1
Project Yield-on-cost (5.25% for feasibility)	**4.13%**	**4.26%**	**3.99%**

Source: Strategic Economics, 2019.

FIGURE 7: DEVELOPMENT PRO FORMA BY SCENARIO (ON A PER RESIDENTIAL UNIT BASIS)

	(1) No Incentives, No Workforce Standards	(2) Incentives Only	(3) Incentives + Workforce Standards
Revenues			
(rounded to thousands of $)			
Annual Gross Scheduled Income	$41,000	$41,000	$41,000
Less Vacancy	-$2,000	-$2,000	-$2,000
Less Expenses	-$12,000	-$12,000	-$12,000
Net Operating Income	$27,000	$27,000	$27,000
Capitalized Value	$633,000	$633,000	$633,000
Development Costs			
(rounded to thousands of $)			
Land and Site Costs	**$60,000**	**$60,000**	**$60,000**
Memo: Land Costs in $ per sf land			
Direct Costs			
Building Area	$379,000	$379,000	*$418,000*
Parking	$60,000	$60,000	$60,000
Subtotal Direct Costs	**$439,000**	**$439,000**	**$478,000**
Indirect Costs			
Soft Costs	$53,000	$53,000	$53,000
Municipal Fees	$38,000	*$20,000*	*$20,000*
Financing	$39,000	*$37,000*	*$40,000*
Subtotal Indirect Costs	**$129,000**	**$110,000**	**$113,000**
Contingency	$22,000	$22,000	$24,000
Total Development Costs	**$651,000**	**$632,000**	**$675,000**
Change from Scenario (1)		*-$19,000*	*+$24,000*
Feasibility			
(rounded to thousands of $)			
Net Operating Income	$27,000	$27,000	$27,000
Total Development Costs	$651,000	$632,000	$675,000
Project Yield-on-cost (5.25% for feasibility)	**4.15%**	**4.27%**	**4.00%**

Source: Strategic Economics, 2019.