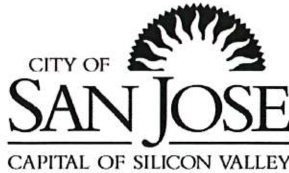

Memorandum

TO:	CITY COUNCIL	**FROM:**	Mayor Sam Liccardo
SUBJECT:	SEE BELOW	**DATE:**	September 24, 2019

APPROVED: [signature] 9-24-2019

SUBJECT: DOWNTOWN RESIDENTIAL HIGH-RISE FEE REDUCTION AND AHIF DOWNTOWN HIGH-RISE EXEMPTION PROGRAMS

RECOMMENDATION

Approve Staff's recommendation.

BACKGROUND

Despite the greatest building boom—and the worst housing crisis— in Silicon Valley's history, our Downtown has not seen a high-rise residential tower project break ground in nearly two years.

Staff has worked diligently to gather data to help the Council better understand the market forces at work in the residential market, and has sought to present as objective a picture as possible. Initially, staff began this work with Keyster Marston—a real estate consultancy firm that has frequently advised the Council and Staff on development issues—which presented findings to Council in March of 2018 that high-rise residential development was infeasible. When the South Bay Labor Council and Working Partnerships objected to the continued use of Keyser Marston in 2019, Staff scuttled that work to choose an expert identified by Ben Field, the CEO of the SBLC, and started over. That expert, Strategic Economics, is telling us exactly what Keyser Marston told us, and more importantly, what the market has been telling us: exceedingly high construction costs will prevent any residential builder from getting the financing to build a high-rise in Downtown for several years—despite a housing crisis that screams for more housing.

The High Rise Residential Fee Exemption— From 2006 to Today

Since the first high-rise residential fee reduction was proposed by then-Downtown councilmember Cindy Chavez some 13 years ago, the City has recognized that we won't get high-rise apartments built if we don't reduce the city's fees on this uniquely difficult construction type. In those days, the Council also voted to inject public Redevelopment Agency dollars into high-rise projects, a practice that we have—with better sense—abandoned in the last decade. The result through the first phase of high rise development was indicative of the perils faced by builders today: four towers got built, and two of them ended up in receivership—through bankruptcy.

Ever since, we have persisted to maintain a reduction in fees—and in the absence of a Redevelopment Agency, without any City subsidy—to enable high-rise housing to get built Downtown. Most recently, the Council extended fee reductions by approving the attached memorandum by myself and Councilmember Raul Peralez in 2016 (See Exhibit A). Since that time, construction costs have risen rapidly, according to a well-publicized report by Turner & Townsend, making Silicon Valley the most expensive place to build an apartment building in the nation, and by some measures, in the world.[1] Meanwhile, rents have flattened citywide, and particularly Downtown, where annual rent increases averaged 1.9%, 3.3%, 2.1% between 2016 and 2018, before resuming an upward trend this year.[2] In March of 2018, consultant Keyster Marston presented a report to Council demonstrating that under then-current market conditions, high-rise residential development was infeasible.

The fee exemption and reduction will soon expire. Given the acceleration of construction costs and the worsening gap in housing supply, the reasons articulated in that 2016 memorandum appear even more compelling today. The downtowns of other cities experiencing rising rents—such as Seattle, Dallas, Atlanta, and Austin—feature dozens of high-rise cranes in the air, and thousands of new downtown units. If Council doesn't extend the existing fee reductions, San Jose will continue to muddle through its housing crisis with a puzzling dearth of high-rise construction.

Only "Luxury" Housing?

The facts do not support the assertion, by some critics, that the fee reductions will only enable luxury housing development. The Graduate, one of the last two high-rise towers to break ground Downtown, features four beds to a single apartment (specifically, housing 1,039 rent-paying residents in only 260 units) and will target SJSU students with its marketing. Similarly, StarCity seeks to build an 800-unit high-rise concept that will be affordable-by-design for a workforce by relying upon a similar shared-space, small-unit, co-living concept. Nonetheless, StarCity remains unable to get financing today.

Why "Splitting the Baby" Does Not Help the Baby

Councilmember Peralez has urged that we should approve a fee reduction only as to some projects, while deferring action on two projects for further study. I decline to support that approach, for several reasons.

First, more delay and more study doesn't help anyone. Our current development cycle appears very long in the tooth. If the past two recessions offer any guidance, the first recessionary winds we feel will stall any high-rise housing construction for another half-decade. We have seen reports from two expert consultants, nearly two years without a groundbreaking of a single high-rise tower, and unanimous calls from builders for action. We don't need further delay, or we will surely miss whatever is left of this cycle.

Second, Councilmember Peralez's do-it-yourself approach to real estate finance suffers from fundamental flaws. As the consultant will inform the Council, feeding a couple of basic

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[1] Lois Hansen, "New Bay Area Crown: Most Expensive Place in the World to Build," The Mercury News, April 25, 2019 (https://www.mercurynews.com/2019/04/25/new-bay-area-crown-most-expensive-place-to-build-in-the-world/)

[2] Strategic Economics, September 12,2019 Draft Report, "Financial Feasibility of Downtown High-rise Projects," p. 11, citing Costar.

variables (ie., the number of units, parking spaces, and square footage) from a single project into a financial formula that reflects an average or prototype high-rise project will produce very misleading results about the viability of that isolated project. For example, while the Aviato—what would be the largest high-rise co-living project in North America—might seem to pencil under a cookie-cutter set of assumptions, lenders and equity investors view it as a completely unproven product in the market. To take on such considerable risk, financial markets will demand a higher rate of return from the builder than a standard 5.25% cap rate, or else they won't finance the project. Moreover, the Aviato's approach of building very small units, common kitchens, and common living areas make the units affordable for workforce renters precisely because it will secure lower-than-market rents than a typical single-bedroom apartment. In short, neither standard revenue nor cap rates projections apply to this project, and it's a distortion of the consultant's approach to insist otherwise. For proof, one need only note finds the fact that the Council approved the reduction of fees for the Aviato in June 2018, and the developers have been unsuccessful at securing any financing to built it since that time. So too, taking a low-parking-ratio project out of context, and applying standard assumptions, will ignore that it will also earn a lower rent if tenants have no where to park, and lenders will demand a higher cap rate — indeed, lenders won't finance any project they consider "underparked." While any of us may insist that any of these project "should" pencil out, the evidence demonstrates that lenders and equity investors uniformly disagree—and their opinions matter more than ours if a project is to receive financing.

Third, Councilmember Peralez's piecemeal approach would violate the letter and spirit of the agreement we struck with the unions in 2018, along with the Workforce Standards Ordinance. The agreement specifically exempts from the definition of subsidy only those "fee or tax reductions applied uniformly across an entire subcategory of project, where Council makes findings of fact that…financing or construction of that subcategory of development is 'infeasible' without a fee or tax reduction, and reducing said fees is in the public interest." (Exhibit A to Liccardo April 4, 2018 Memorandum to Rules Committee). If a fee reduction to any project amounts to a "subsidy," then private workforce standards (such as prevailing wage, local hire, apprenticeship requirements, and the like) must apply *to every project in that subcategory*, thereby raising construction costs in excess of any savings the builder hoped to achieve from a fee reduction.

Rather than accepting the "residential high-rise" scope of the subcategory established in the original March 2018 agreement with the unions, Councilmember Peralez creatively invents three new subcategories that he might brand "buildings with sub-0.8 spaces/unit parking ratios," "co-living," and "high rises that are neither sub-parked nor co-living." His recalculation within each of these three "subcategories" yields the conclusion that the first two subcategories are somehow feasible. The error of his logic lies in the fact that one can always parse a subcategory into smaller subcategories to get to a desired result, so long as one can identify any differentiating characteristic. In this case, Councilmember Peralez chose to shoe-horn the characteristic of having a low parking ratio into its own subcategory, by characterizing low parking ratio buildings as a unique "building typology" of some kind, to satisfy the language of San Jose Muncipal Code Section 1410.100. Of course, there is no such "building typology," under any common understanding of the term.

As for the "co-living" subcategory, it suffers from the similar defect as the "low parking ratio" subcategory: it has only one proposed project. Of course, performing an analysis across an entire subcategory of projects ensures equitable treatment, and avoids playing favorites among

builders. Creatively carving out subcategories with no more than one representative member subjects the process to manipulation—though not Councilmember Peralez's intention— that can reward friends and punish enemies. Moreover, Councilmember Peralez's suggestion that we should subject co-living to further study is a curious one: there are no high-rise co-living projects in this city—or any other in North America—to study. In other words, the consultant would be relegated to simply taking notes from the only developer willing to build one—hardly an objective approach likely to yield reliable information. In short, there are good reasons to define the relevant subcategory as "high-rise residential," reasons that the City and unions embraced when they struck the agreement in March of 2018 that explicitly listed "high-rise residential" as a subcategory.

More Options for Affordable Funding
In the months ahead, we look forward to exploring other avenues for expanding funding for affordable housing—all of which I have publicly supported—including a commercial linkage fee, a local citywide housing revenue measure, and a regional housing revenue measure contemplated by AB1487. No amount of squeezing of non-existent high-rise residential construction, however, will elicit any juice. By declining to reduce fees, we'll see no construction, and no affordable housing fees. By reducing fees, at least we'll see housing—and some of those apartments, moreover, will be affordable-by-design.

We should approve Staff's recommendation. High-rise housing construction has stalled. We face a straightforward choice: either reduce fees and get housing built, or we sit on our hands and hope for some miracle to address this housing crisis for us. We should choose the former.

EXHIBIT A

Memorandum

TO: RULES AND OPEN GOVERNMENT COMMITTEE

FROM: Mayor Sam Liccardo
Councilmember Raul Peralez

SUBJECT: **EXTENSION OF DOWNTOWN HIGH-RISE INCENTIVE PROGRAM**

DATE: November 22, 2016

Approved Date 11.22.16

RECOMMENDATION

Approve a request to agendize for City Council deliberation on December 13, 2016, to direct the City Manager to extend the Downtown High-Rise Incentive Program for new construction of residential buildings of at least 12-stories in height for the next 1,500-units (including existing allocations) in the Downtown Growth Area, as defined by the Planned Growth Area Diagram in the Envision 2040 San José General Plan (Attachment 1).

1. Similar to the pre-existing incentive structure, the renewed incentive program should consist of the following elements:
   a. Identification of a single point of contact in the Planning Department for high-rise projects;
   b. Expediting the site development permit process such that a decision will be reached at a Director's Hearing within 120-days upon filing of a completed application and with the applicant's full compliance of regulations relating to public outreach and architectural review;
   c. Deferral of fees and taxes to be paid at the time of issuance of a Certificate of Occupancy; and
   d. Reduction of the aggregate fee and tax burden at levels commensurate with the following:
      1. Reduce Park Fees by 50%;
      2. Reduce Construction-related Taxes by 50%; and
      3. Other fees or taxes that staff may publicly propose to Council, upon Council approval.

2. To qualify for any of these incentives, the high-rise residential development must:
   a. Break ground by July 2018, and be completed by December 2020
   b. Retain contractors licensed by the State of California and the City of San José;
   c. Employ only construction workers who possess licenses and certifications required by the State of California; and
   d. Post bids on websites such as The Bay Area Builders Exchange for sub-contractors to readily access work to bid on for local workers in the 9 Bay Area Counties, including Santa Cruz, Monterey, and San Benito Counties;

3. In addition, the developer who opts in to the Downtown High-Rise Residential Incentive Program shall make good-faith efforts to:
    a. Comply with the State of California's apprenticeship program requirement that at least 16.7% of the hours worked by their respective construction workforces on the project must be worked by registered apprentices from approved apprenticeship training programs; and
    b. Ensure that 25% of those registered apprentices are identified as having an employment barrier such as homeless, veterans, or at-risk youth.

BACKGROUND

Through a period in which development in Silicon Valley has soared to record levels, we haven't seen a high-rise tower break ground in Downtown since February of 2015, our second month in office. We have heard roundly from the development industry that while many projects have obtained permits, or sit on the verge of doing so, the financing required to begin construction remains beyond their reach. (See Attachment 2 for a list of pending downtown high-rise residential projects.)

Why has project financing become so precarious? The outlook for new housing development has darkened as construction costs have increased by 60% over the past 36-months, with direct per-unit construction costs—not counting such "soft" costs as entitlements, marketing, or sales--estimated at approximately $450,000 and $550,000 for apartments and condominiums, respectively. City fees have also grown substantially, particularly in two areas: park dedication ordinance (PDO) fees, and affordable housing inclusionary/impact fees, making new projects more difficult to finance for a developer purchasing the land under a different set of fee assumptions. Flattening rents, moreover – one recent source estimated at an 8% decrease year-over-year—may come as a relief to many of our struggling residents, but rent stagnation undermines investment demand amid rising construction costs.

Why do these challenges uniquely afflict high-rise residential construction? Unlike mid-rise or single-family construction, high-rises entail substantially higher construction costs, with such additional requirements as steel construction, multiple elevator shafts, and firefighting life-safety equipment. Park dedication fees on Downtown high-rise development also far exceed those of any other part of the city. High-rise development also comes with substantially greater risk; developers cannot "phase" high-rise projects to sell units as they build; they must take the $150 million "leap" all at once. Moreover, although high-rise development in many (if not most) cities benefit from fee reductions or incentives of some sort, San José's Downtown possesses uniquely challenging topography—with a low airport flight path and a high water table—substantially reducing the margins of high-rise builders here. In short, the margins are lower, and the risks higher.

We must also recognize what this proposal is *not*: it is not a "giveaway" of public money. To the contrary, for those several projects which remain stalled for lack of financing, this can result in a net fiscal gain to the taxpayer, if future revenues are properly discounted over time. Why? A project that does not get built will not generate any fee revenue; regardless of the fee rate, one hundred percent of zero is zero. On the other hand, if successful in stimulating a couple of projects to break ground, this fee reduction incentive will still generate tens of millions of fees and construction taxes. That calculation doesn't count the long-term fiscal gains that accrue to the public whenever a developer converts a surface parking lot to a $150 million tower. Property tax revenue

alone will jump by almost $ 2 million *annually*, for a half century or more. While some of the projects might get built sometime in the future—perhaps during the next cycle, or a couple decades from now—the deferral of those economic and fiscal benefits comes at a measurable cost. In short, the real cost lies in doing nothing.

Why should the Council so uniquely concern itself with one type of construction, that is, with high-rise residential towers? For a host of reasons, San José's fiscal, environmental, and civic ambitions rest on high-rise development, particularly in its core:

- **Housing Affordability by Design**: By reducing unit sizes and enabling auto independence, transit-oriented high-rise development can reduce the cost of living in our expensive Valley by 30% or more.
- **Environmental Sustainability**: Very high residential densities near transit stations substantially reduce per-person GHG emissions from auto travel, boosting the share of commute trips by foot, bike, and transit. Also, high-rise buildings are more energy efficient, and water consumption drops by 50% without yards associated with single-family construction. High-rises provide the greenest path for the City's development.
- **Fiscal Sustainability**: Most housing in San José is built at a loss to taxpayers, who must foot the bill for delivering services that exceed the per-capital revenues from property taxes and other residential fees. By pushing densities above 100 DU/AC, high-rise housing maximizes property tax and other revenue, while constraining service delivery costs to concentrated areas that benefit from economies of scale.
- **Downtown Revitalization**: Nearly any retail consultant will reiterate that Downtown will not attract large-scale infusion of retail and restaurants without a much larger "critical mass" of residents, requiring the construction and tenancy of another 10-15 high rise towers.
- **Boosting Housing Supply**: High-rise construction in Downtown does not require rezonings, general plan amendments, environmental review, and generally does not meet with any significant neighborhood opposition. As a result, high-rise builders can get a building permit to build 250 or more units within a few months of application.

Only time will tell whether we have a sufficiently wide window for high-rise residential development, or whether this set of incentives will actually work to get any shovels into the ground.

One thing appears certain, however: doing nothing will assure the continuation of the status quo. Waiting for the "next cycle" to arrive for new high-rise development will only defer the public benefits—among them, millions in annual property taxes, and thousands of new homes—for many years, and subject Downtown's revitalization to the whims of another decade's shifting economic winds.

We can either wait for things to happen, or make things happen. We urge Council to join us in the latter endeavor.

ATTACHMENT 1

Envision 2040 San Jose General Plan
Downtown Growth Area

Map Prepared by the City of San Jose Planning Division, November 2016

ATTACHMENT 2

LIST OF HIGH-RISE RESIDENTIAL DEVELOPMENT PROJECTS

UNDER CONSTRUCTION

	Unit Count
Silvery Towers	643 Units

APPROVED

	Unit Count
Post and San Pedro	202 Units
Parkview Towers	220 Units

IN ENTITLEMENT PROCESS

	Unit Count	
North San Pedro Tower 3	313 Units	
Gateway Tower	292 Units	
Greyhound Towers	781 Units	
SJSC Towers	600 Units	
300 South 2nd Street	260 Units	
Alterra Towers	324 Units	
Museum Place	334 Units	Total: 2,904 Units