



COUNCIL AGENDA: 11/5/19

FILE: 19-995

ITEM: 4.6

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Kim Walesh
Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: October 23, 2019

Approved

Date

10/25/19

**SUBJECT: DOWNTOWN RESIDENTIAL HIGH-RISE INCLUSIONARY HOUSING
ORDINANCE FEE**

RECOMMENDATION

Accept the report on the Downtown High-Rise Feasibility Assessment and direct the Administration to return to Council with the appropriate resolutions to establish an in-lieu fee for Downtown High-Rise (Rental and For-Sale) under the Inclusionary Housing Ordinance in the amount of \$0, with annual increases to that in lieu fee, returning the Downtown High-Rise In lieu fee to the full amount by June 30, 2025; to make all of the required findings, and to amend the schedule of fees and charges accordingly.

OUTCOME

The outcome of this action will set the fee amount for downtown high-rise developments under the Inclusionary Housing Ordinance. This action will reduce the fee to \$0 for downtown high-rise developments and gradually increase the fee to the full fee amount over a five-year period, encouraging the development of high-rise residential housing in the downtown.

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, all high-rise residential developments in the downtown have been approved using some form of incentive. The City Council first 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 resulted in 1,522 residential units. 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 and allowed for payment of the taxes to be delayed until the issuance of the Certificate of Occupancy. 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 multifamily 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. In 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 José. Prior to this new category, high-rise developments paid the same rate as any project with five 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 26, 2018, the City Council adopted a resolution to authorize a reduction in the Inclusionary Housing Ordinance In-Lieu Fee to \$0 (per In-Lieu unit) for High-Rise rental developments in the Downtown with ten (10) or more floors or stories in height, not including any nonresidential uses where the highest occupied floor has a floor level elevation that is at least 150 feet above street level. In order to qualify for this reduction in the in-lieu fee, projects must obtain issuance of all Certificates of Occupancy on or prior to June 30, 2021. At this time, only one downtown high-rise has applied to be considered for this reduction in the IHO In-Lieu Fee.

More recently on September 24, 2019, the City Council considered amendments to the construction taxes using the analysis required under the new Workforce Standards Ordinance. The Council accepted the report on Downtown High-Rise Feasibility Assessment and directed staff to return with a resolution extending the certificate of occupancy deadline for the Affordable Housing Impact Fee exemption to December 31, 2023, and an ordinance update 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. This AHIF resolution and ordinance amendments to address the construction taxes will be heard separate from this item. This memorandum addresses projects not covered by the AHIF and which would therefore be subject to the IHO In-Lieu Fee, and recommends that its reduction is not a subsidy consistent with the adopted Workforce Standards Ordinance (SJMC 14.10).

ANALYSIS

The City Council is considering several changes to the Inclusionary Housing Ordinance. Introducing a new structure for the in-lieu fee is a part of the proposed ordinance changes. Staff has evaluated the pricing options for downtown high-rises under the Inclusionary Housing Ordinance. Due to the consideration of feasibility and the desire to encourage the development of high-rise housing in the downtown, the following is a scaled phasing over the coming five years for the in-lieu fee for downtown high-rise development:

Proposed Time Period	In-Lieu Fee for Downtown High-Rises (Rental and For-Sale)
Building permit by June 30, 2021	\$0/SF
Building Permit by June 30, 2022	\$0/SF
Building Permit by June 30, 2023	\$0/SF
Building Permit by June 30, 2024	\$13/SF
Building Permit by June 30, 2025	\$23/SF
Building Permit after June 30, 2025	Rental: \$43/SF; For-Sale: \$25/SF

Prior to issuance of a building permit, the Housing Department will coordinate with the developer to record an Affordable Housing Agreement, specifying which fee shall apply. IHO In-Lieu Fees are paid prior to release of Certificates of Occupancy.

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, the City 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 (**Attachment A**) 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. This analysis was previously reviewed by the City Council on September 24, 2019. No updates or changes have been made.

In addition to the requirements detailed above, the consultant study addressed 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;	<i>Under current conditions, a typical high-rise development in downtown San José is not financially feasible.</i>
b.	The reason(s) for any conclusion that construction of the Private Construction Projects in the specified Subcategory of Use is Financially Infeasible;	<p><i>The yield-on-cost for Scenario 1 is 4.13%, short of the target return of 5.25%. This is mainly due to the escalating cost of construction in the current market environment, currently estimated at \$651,000 per unit for a development of this type.</i></p> <p><i>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.</i></p>
c.	The anticipated duration of any condition(s) making construction of the Private Construction Projects in the	<i>As rental rates over the last ten years have averaged 4.6 percent annual growth (see Figure 5), it may require a few years of favorable conditions (strong rental</i>

	specified Subcategory of Use Financially Infeasible;	<i>market combined with flat development costs) to reach feasibility.</i>
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;	<i>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.</i>
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;	<i>Extending the incentives improves the financial picture slightly but is not sufficient for the development to reach feasibility.</i>
ii.	Providing the proposed fee or tax reduction along with requiring the payment of prevailing wages; and	<i>Including workforce standards increases development costs by 4%.</i>
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.	<p>No additional options have been identified through the process of developing the analysis.</p> <p>The three variables that were explored were:</p> <ul style="list-style-type: none"> • 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 José are lower than surrounding cities and therefore do not meet the minimum threshold for return on cost. 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 average site does not pencil, some projects may move forward under a particular set of conditions, such as having a lower land basis or higher than normal

expected revenues. Specialized financing sources, such as the EB-5 program¹, can also be a factor in helping projects to proceed."

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. Based on Council direction of September 24, 2109, staff is recommending bringing back the appropriate ordinance and resolution to enact the following:

1. Set the in-lieu fee for downtown high-rise development at \$0.
2. Graduate the fee over time, returning the Downtown High-Rise fee to the full amount by June 30, 2025.

EVALUATION AND FOLLOW-UP

Staff will return with the necessary resolution to implement the incentives. 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.

During the Council hearing on September 24, 2109, staff committed to return with further information regarding the impact of the Workforce Standards on the cost of development. Staff is working on a supplemental memorandum that will detail initial work that is being completed, a plan for further coordination, and a potential timeline for returning to Council.

¹ Congress created the EB-5 Program in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors.

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 Inclusionary Housing Ordinance in-lieu fee is currently \$125,000 per unit (FY19-20). One project, Garden Gate Tower, is requesting to be considered a Downtown High-Rise under the IHO. The project applicant is requesting the approval of two site use options and has selected the in-lieu fee to satisfy their IHO obligation:

Option 1) 290 Residential Units = resulting in \$7.2 M in in-lieu fees

Option 2) 793 Co-Living bedrooms = resulting in \$19.8 M in in-lieu fees

Staff is recommending changes to the in-lieu fee structure. Changes to the fee may impact the cost implications of this recommendation. The Garden Gate Tower project would pay the following in-lieu fees under the new in-lieu fee structure:

Option 1) 290 Residential Units (280K sq ft) = resulting in \$5.1M in in-lieu fees

Option 2) 793 Co-Living bedrooms (200K sq ft) = resulting in \$3.6 M in in-lieu fees

Although this change would result in less impact fees collected on the downtown high-rise developments that move forward, these estimated fees from the recently submitted Garden Gate Tower project were not included in the previous budget projections or in the Five-Year Affordable Housing Investment Plan.

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.

In addition, the Housing Department has hosted seven outreach meetings to members of the development community and other stakeholders to discuss the potential updates to the overall Inclusionary Housing program. Housing Department staff have met in-person with individual developers to discuss their projects, current requirements, and the potential updates to the IHO.

HONORABLE MAYOR AND CITY COUNCIL

October 23, 2019

Subject: Downtown Residential High-Rise Inclusionary Housing Ordinance Fee

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This report will be made available to the public on October 25, 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 November 5, 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

This item was not heard by the Housing and Community Development Commission, as setting fees for the Inclusionary Housing Ordinance program does not fall under the functions, powers and duties of the Commission delineated in Section 2.08.2840 of the San José Municipal Code.

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 – Financial Feasibility of Downtown High-rise Projects and Potential Impact of Incentives and Workforce Standards, Strategic Economics, September 10, 2019



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 complete 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.

Financial Feasibility of Downtown High-rise Projects

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		
<i>(Municipal fees are itemized separately, see Figure 3.)</i>		
Arch, Eng & Consulting	% of hard costs	6.0%
Taxes, Insurance, Legal & Accounting	% of hard costs	3.0%
<u>Other Soft Costs</u>	<u>% of hard costs</u>	<u>3.0%</u>
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.

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.

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 between \$6.00 to \$7.00 per square foot.

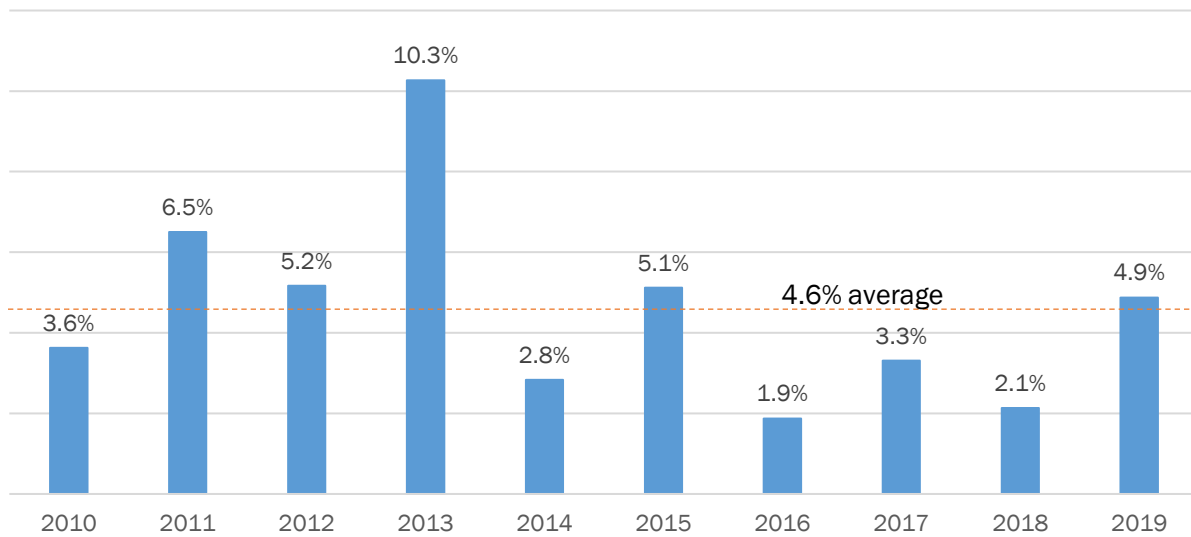
(footnote continued)

- **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.

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			
<i>(millions of \$)</i>			
Annual Gross Scheduled Income	\$22.8	\$22.8	\$22.8
Less Vacancy	-\$1.1	-\$1.1	-\$1.1
<u>Less Expenses</u>	<u>-\$6.8</u>	<u>-\$6.8</u>	<u>-\$6.8</u>
Net Operating Income	\$14.8	\$14.8	\$14.8
Capitalized Value	\$348.2	\$348.2	\$348.2
Development Costs			
<i>(millions of \$)</i>			
Land and Site Costs	\$33.0	\$33.0	\$33.0
<i>Memo: Land Costs in \$ per sf land</i>	<i>\$505</i>	<i>\$505</i>	<i>\$505</i>
Direct Costs			
Building Area	\$208.7	\$208.7	\$229.9
<u>Parking</u>	<u>\$33.0</u>	<u>\$33.0</u>	<u>\$33.0</u>
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
<u>Financing</u>	<u>\$21.3</u>	<u>\$20.6</u>	<u>\$22.0</u>
Subtotal Indirect Costs	\$71.2	\$60.7	\$62.1
<u>Contingency</u>	<u>\$12.1</u>	<u>\$12.1</u>	<u>\$13.1</u>
Total Development Costs	\$358.0	\$347.5	\$371.1
<i>% Change from Scenario (1)</i>		-3%	+4%
Feasibility			
<i>(millions of \$)</i>			
Net Operating Income	\$14.8	\$14.8	\$14.8
<u>Total Development Costs</u>	<u>\$358.0</u>	<u>\$347.5</u>	<u>\$371.1</u>
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			
<i>(rounded to thousands of \$)</i>			
Annual Gross Scheduled Income	\$41,000	\$41,000	\$41,000
Less Vacancy	-\$2,000	-\$2,000	-\$2,000
<u>Less Expenses</u>	<u>-\$12,000</u>	<u>-\$12,000</u>	<u>-\$12,000</u>
Net Operating Income	\$27,000	\$27,000	\$27,000
Capitalized Value	\$633,000	\$633,000	\$633,000
Development Costs			
<i>(rounded to thousands of \$)</i>			
Land and Site Costs	\$60,000	\$60,000	\$60,000
<i>Memo: Land Costs in \$ per sf land</i>			
Direct Costs			
Building Area	\$379,000	\$379,000	\$418,000
<u>Parking</u>	<u>\$60,000</u>	<u>\$60,000</u>	<u>\$60,000</u>
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
<u>Financing</u>	<u>\$39,000</u>	<u>\$37,000</u>	<u>\$40,000</u>
Subtotal Indirect Costs	\$129,000	\$110,000	\$113,000
<u>Contingency</u>	<u>\$22,000</u>	<u>\$22,000</u>	<u>\$24,000</u>
Total Development Costs	\$651,000	\$632,000	\$675,000
<i>Change from Scenario (1)</i>		-\$19,000	+\$24,000
Feasibility			
<i>(rounded to thousands of \$)</i>			
Net Operating Income	\$27,000	\$27,000	\$27,000
<u>Total Development Costs</u>	<u>\$651,000</u>	<u>\$632,000</u>	<u>\$675,000</u>
Project Yield-on-cost (5.25% for feasibility)	4.15%	4.27%	4.00%

Source: Strategic Economics, 2019.