

City of San José

Inclusionary Housing Analysis

ADMINISTRATIVE REVIEW DRAFT

Prepared for: City of San José

Submitted By: David Paul Rosen & Associates

Northern California

David Rosen, Principal
1330 Broadway, Suite 937
Oakland, CA 94612-2509
Phone: 510-451-2552
Fax: 510-451-2554
e-mail: David@DRAConsultants.com
www.draconsultants.com

Southern California

Nora Lake-Brown, Principal
3941 Hendrix St
Irvine, CA 92614-6637
Phone: 949-559-5650
Fax: 949-559-5706
e-mail: Nora@DRAConsultants.com
www.draconsultants.com

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Executive Summary

What is Inclusionary Housing?

Inclusionary housing programs require residential developers to provide a percentage of total units in projects over a specified size at below market rents or sales prices in conjunction with the market-rate units in the project. Over 170 jurisdictions in California have adopted inclusionary housing programs to increase the production of housing affordable to very low, low and/or moderate income households.

Inclusionary housing imposes a prospective cost on development that can be partially to completely offset with economic incentives and alternative compliance options. The City of San José Department of Housing commissioned David Paul Rosen & Associates (DRA) to conduct an analysis that measures the economic effect on developers of complying with alternative inclusionary requirements and the potential value of incentive “packages” that may be offered to offset the costs of the inclusionary requirements. This analysis will assist the City Council in making informed decisions regarding a potential inclusionary housing policy for San José.

Approach and Methodology

DRA analyzed the potential impact of alternative inclusionary housing requirements and incentives based on how housing currently gets built in San José. The current cost to build market-rate housing in San José was carefully developed and analyzed through collaboration with the Department of Housing, a series of interviews with developers familiar with residential development in the City, a review of pro formas and budgets of current Department of Housing and Redevelopment Agency projects, RS Means construction cost estimates and a series of public meetings with San José stakeholders. This process allowed the public to review the development cost assumptions and provide feedback, which was then incorporated into the analysis. This process produced the development prototypes, cost assumptions and incentives used in this study.

Five housing prototypes were developed to represent the type of housing currently being built and likely to be built in the near term in San José, in order to analyze the effect of inclusionary requirements on the City’s current development. Four of these prototypes represent ownership housing projects and one represents a rental project. The prototypes’ product type, density (expressed as dwelling units per acre or du/a) and unit count are:

- Owner Prototype 1 – High Rise Condos over subterranean parking, 100 du/a, 200 units total
- Owner Prototype 2 – Stacked Flat Condos over podium parking, 55 du/a, 157 units total

- Owner Prototype 3 – Townhomes with garage parking, 17 du/a, 75 units total
- Owner Prototype 4 – Single Family Detached Homes with garage parking, 9 du/a, 45 units total
- Renter Prototype 1 – Stacked Flat Apartments over podium parking, 55 du/a, 157 units total

In collaboration with City staff, DRA developed alternative set-aside scenarios representing a range of potential inclusionary requirements. The different scenarios vary in total percentage of inclusionary units required and the required affordability of those units. The set-aside scenarios for the renter and owner prototypes are presented in **Table E-1**.

Defining “Affordable” Housing

This study uses income limits and affordability standards, as defined by the United States Department of Housing and Urban Development (HUD) and the California Department of Housing and Community

Development. HUD income limits and affordable housing costs are expressed as a percentage of area median income (AMI). Santa Clara County’s area median income for 2007, as defined by HUD, is \$105,500 for a family of four.

For renters, affordable housing cost, including rent plus utilities, is defined as 30 percent of household income, adjusted for household size. Household income

is expressed as a percentage of AMI. For owners, affordable housing cost, including principal and interest, loan insurance (PMI), property taxes, fire and casualty insurance,

Table E-1 Inclusionary Scenario Alternatives San José Inclusionary Housing Analysis			
Affordability Set-Aside Scenario	Affordable Units as a % of Total Units	Income Limit (% Area Median Income)	Affordable Housing Cost (% Gross Income)
RENTAL PROTOTYPE:			
Scenario 1	8% 12%	50% AMI 80% AMI	30% of 50% AMI 30% of 60% AMI
Scenario 2	5% 10%	50% AMI 80% AMI	30% of 50% AMI 30% of 60% AMI
Scenario 3	5% 5%	35% AMI 50% AMI	30% of 35% AMI 30% of 50% AMI
OWNER PROTOTYPES:			
Scenario 1	20%	120% AMI	35% of 110% AMI
Scenario 2	5% 10%	90% AMI 120% AMI	30% of 90% AMI 35% of 110% AMI
Scenario 3	5% 5%	80% AMI 90% AMI	30% of 70% AMI 30% of 90% AMI

utilities and homeowner association fees, is defined as 30 and 35 percent of household income, adjusted for household size, for low and moderate income households, respectively. Household size adjustments are made using the occupancy standard of one person per bedroom plus one, per the California Health and Safety Code.

Measuring the Effect of Inclusionary Requirements

This study takes care to measure the economic effect of potential inclusionary requirements on residential development by first calculating the affordability cost of the various set-aside scenarios studied. The affordability cost is calculated as the total development cost of the affordable units less the income generated from selling or renting those units at the appropriate affordable sale price or rent. The cost savings represented by the various incentive packages studied are then analyzed against the affordability costs.

A land residual analysis is also employed in this study to examine the effects of the potential inclusionary requirements on residential development. Land residual analysis is commonly used by real estate developers, lenders and investors to evaluate development financial feasibility and select among alternative uses for a piece of property. The land residual methodology calculates the value of a development based on its income potential and subtracts the costs of development and developer profit to yield the underlying value of the land. An alternative land use that generates a negative land value is not financially feasible. Similarly, an alternative use which generates a land value lower than the land seller is willing to accept is infeasible. Recent land sales (“market comparables”) provide an indication of the range of land prices sellers may accept. As is evident in the market comparables of land sales in San José over the past four years, the range of land prices that sellers accept is wide, with prices fluctuating year to year.

Land residual analysis is the most realistic way to view the potential effect of inclusionary requirements on residential development in the City of San José. Developers and landlords already charge the maximum rents and sales prices the market will bear. Therefore, any increase in development costs resulting from government regulation, or other factors, will ultimately impact the price of land and/or profits to developers and owners, and cannot be passed on to the consumer. A reduction in developer profit margins does not necessarily render a project infeasible. Developers typically have a “threshold” profit and overhead requirements. These requirements are built into the development costs in this analysis.

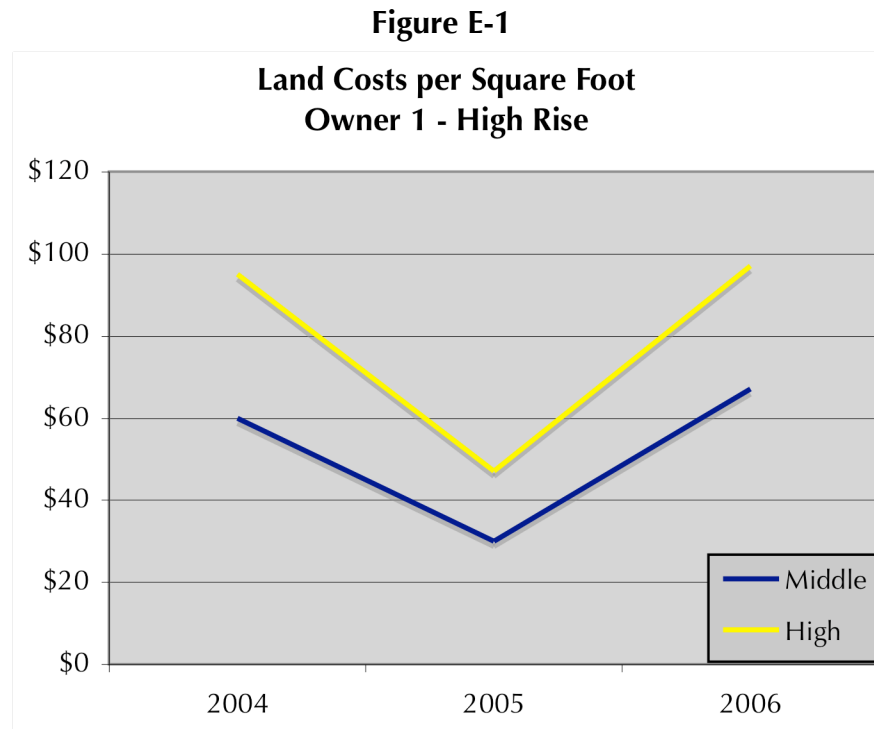
In some market climates, developers are willing to build, and lenders and investors are willing to finance, a development based on a “future value.” One example of such “speculative” development is constructing apartments that may later be sold as condominiums, or where market rents are expected to rise significantly in the future.

Residential land sales prices vary widely in different locations in San José. The land prices are tied to the market rents and/or sales prices in different market areas of the City. DRA

analyzed actual land sales prices reported in the San José Residential Land Value Survey updates from 2003, 2004, 2005 and 2006, as well as land sales reported in a recent land appraisal commissioned by the City's Housing Department.

“Low,” “Middle,” and “High” Rent/Sales Price and Land Value Scenarios

The market land sales comparables were divided into categories by the sites' intended product types, represented by the sites' intended residential densities. These sales were then divided into thirds based on price per square foot of site area to represent “low,” “middle,” and “high” land price ranges in the City. For the rental land residual analysis, DRA used low, middle and high average rent data from a survey of



current rents in market rate developments around the City to calculate rents for the low, middle and high rent/land values scenarios. Similarly, for the owner land residual analysis, DRA used low, middle and high average sales prices of attached (including stacked flat and townhome units) and detached units sold in 2006 (Source: First American Title Company) and low, middle and high average current asking prices for high rise units. These were used to calculate land residual values for the low, middle and high sales price scenarios.

The low, middle and high average land prices per square foot in San José over the four-year period examined in this study show wide fluctuation. The widest range in land price over the four years was seen in middle-cost land intended for high rise development, where the difference between the lowest average price and the highest average price in this period represents a 123 percent change, as shown in **Figure E-1**. The narrowest range

of land price was seen in low-cost land intended for stacked flat owner or renter units, with a range of only 13 percent, illustrated in **Figure E-2**.

On average, the trading range of land in San José between 2003 and 2006 was 63 percent, meaning that the average highest land price in this period was 63 percent higher than the average lowest land price. By contrast, inflation over this same time period was 13 percent. **Figure E-3** illustrates the trading range of land intended for townhomes, which ranged an average of 56 percent in the years studied. **Figure E-4** illustrates the trading range of land intended for single family homes, which experienced a 58 percent range in the years studied.

It is important to view the effects of potential inclusionary requirements on the value of land in San José within the context of the wide trading range of land. A government action or regulation that affects the residual value of land without causing the land value to fall below its normal trading range

Figure E-2
Land Costs per Square Foot
Owner 2 - Stacked Flat

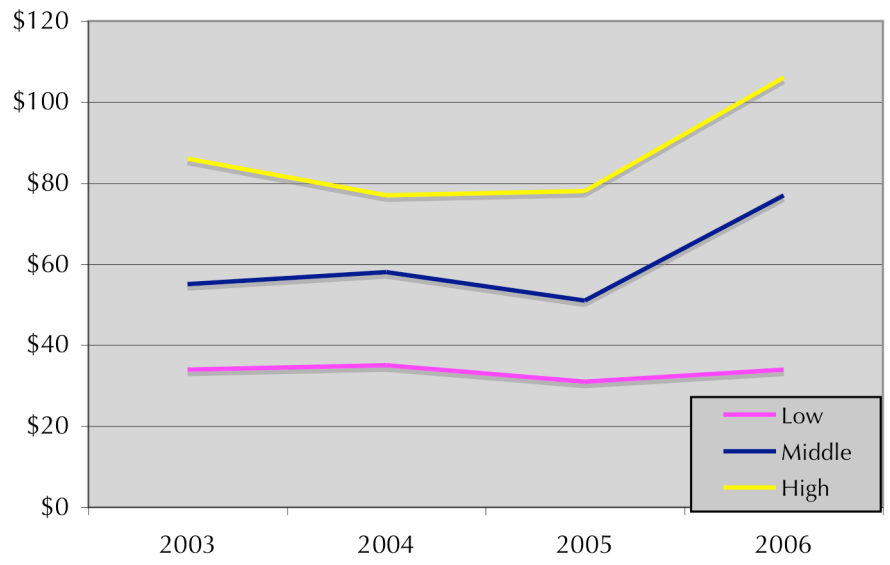
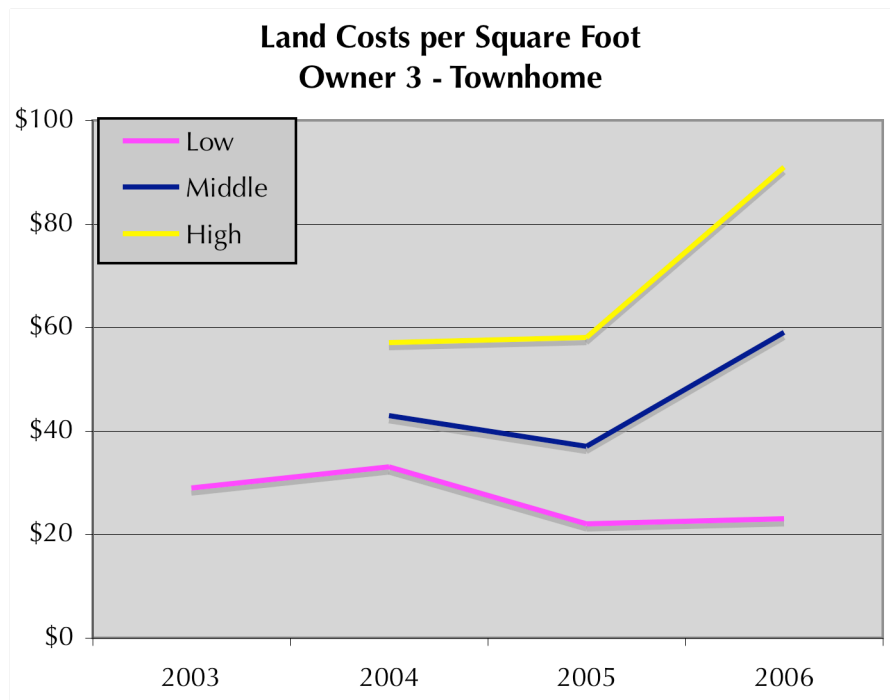


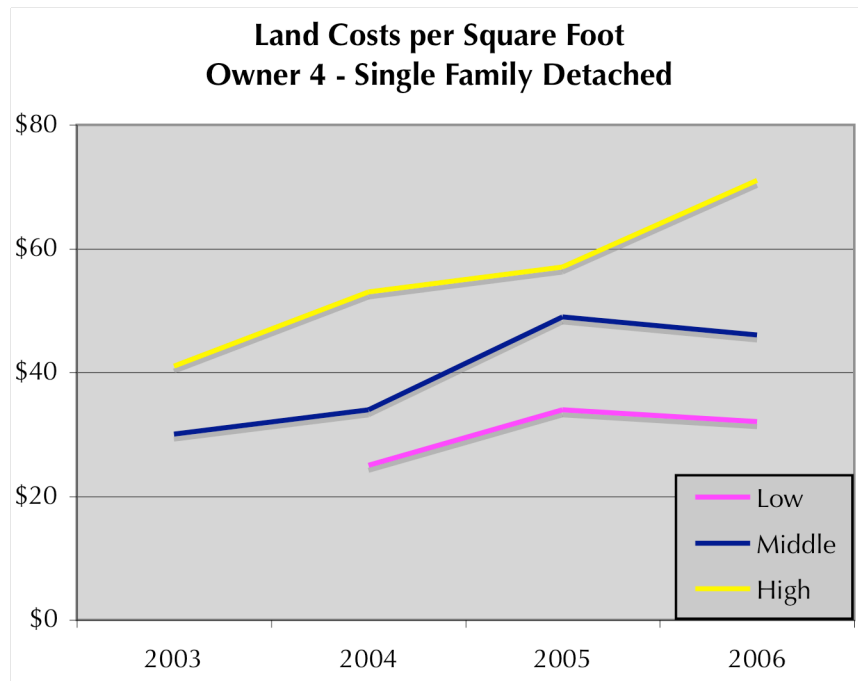
Figure E-3

Land Costs per Square Foot
Owner 3 - Townhome



is feasible. One that affects land value to such an extent that it falls below the normal trading range can have detrimental effects on future development. This study, then, presents the residual land value of the five development prototypes studied under the three inclusionary scenarios explained above. When one of these scenarios causes the residual land value to fall outside of that prototypes' trading

Figure E-4



range of land price, DRA examined the economic effects of different “packages” of potential offsets and incentives offered to the developer. The packages represent a range of tools the City of San José can use to offset the effects of inclusionary requirements on developments when those effects may be detrimental to the feasibility of a development. The offset packages studied are:

- Package 1: Density bonus;
- Package 2: On-site, alternative product type;
- Package 3: Off-site compliance, same product type;
- Package 4: Density bonus and affordable unit design modification;
- Package 5: Acquisition / Rehabilitation;
- Package 6: Off-site compliance, alternative product type and affordable unit design modification.

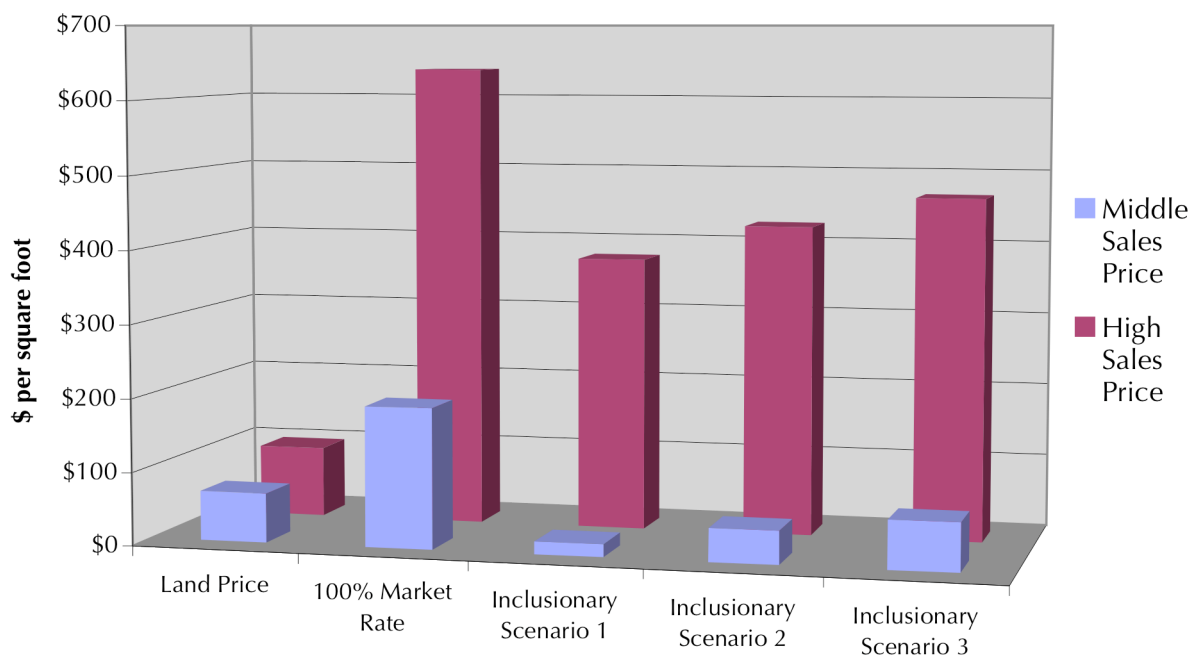
Development in San José is not currently subject to maximum density requirements, thus developers currently build to the optimum density given the limitations of their product type and the housing market. A density bonus policy in this development environment is therefore irrelevant. However, DRA examined the effects of a density bonus, assuming the

bonus provides an increase in the prototypes' original densities as an incentive for including affordable units in the development.

Findings – Owner Prototypes

Figure E-5 illustrates the land residual values for Owner Prototype 1 under all three inclusionary scenarios and assuming middle and high market sales prices. **Figure E-6** illustrates the land residual analysis findings for Owner Prototype 2 under all inclusionary scenarios. **Figures E-7** and **E-8** similarly present the findings for Owner Prototypes 3 and 4, respectively.

Figure E-5
Residual Land Value
Owner 1 - High Rise Condos



Inclusionary Scenario 1: 20% of units affordable at 110% AMI.

Inclusionary Scenario 2: 5% of units affordable at 90% AMI and 10% at 110% AMI.

Inclusionary Scenario 3: 5% of units affordable at 70% AMI and 5% at 90% AMI.

Figure E-6

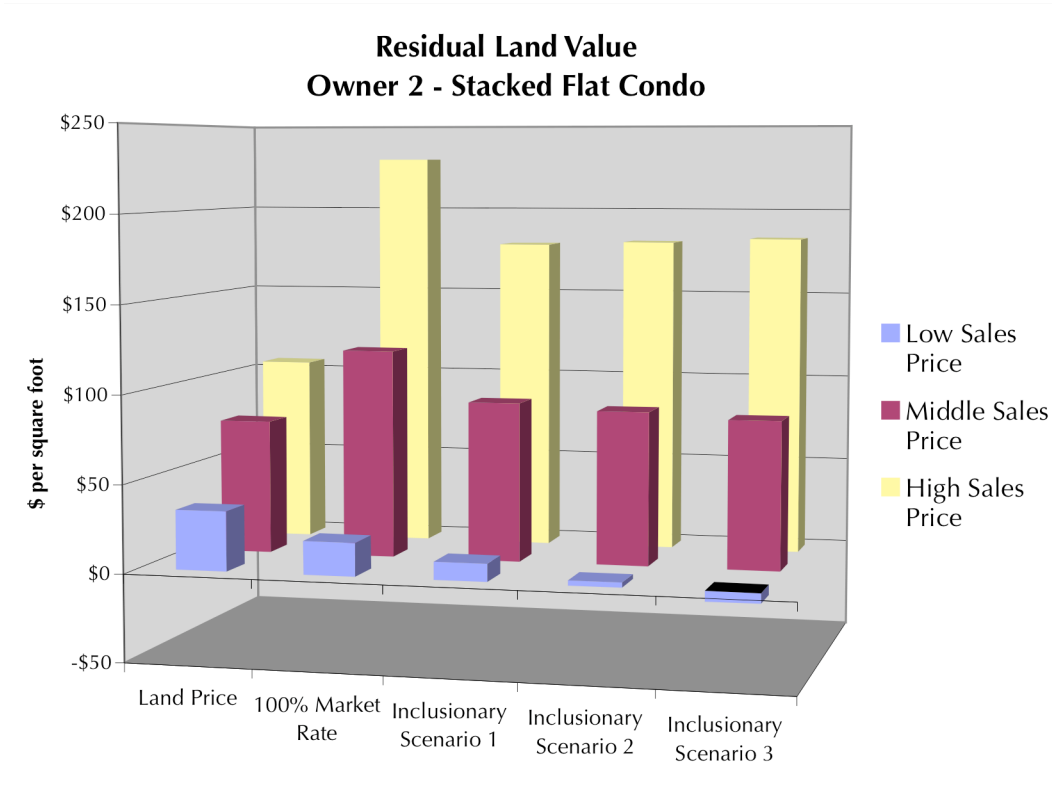
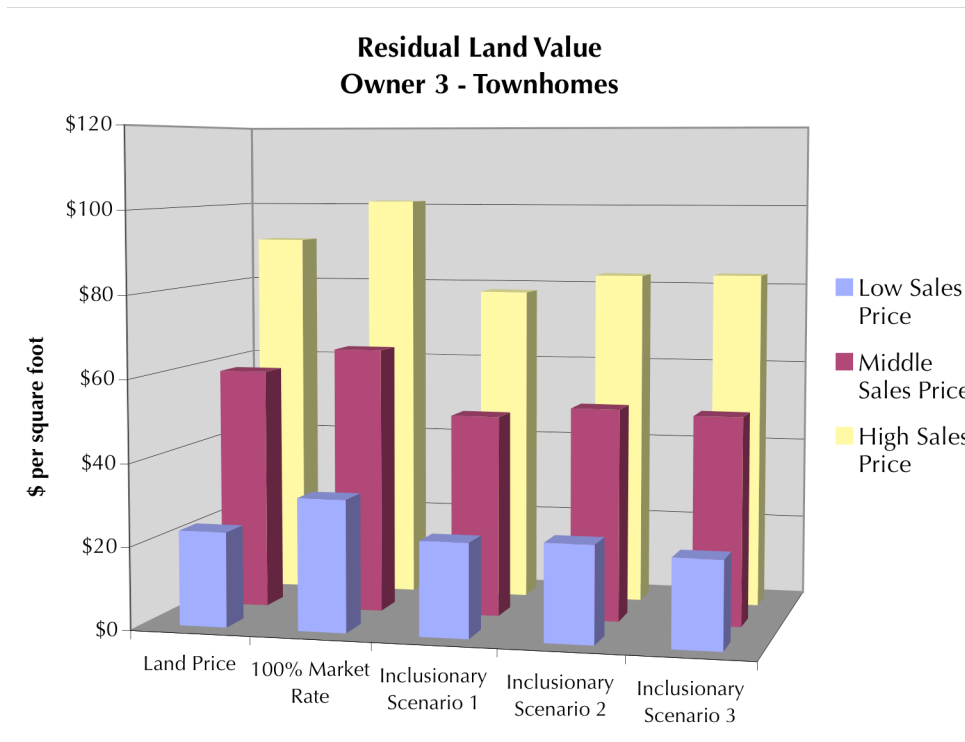


Figure E-7

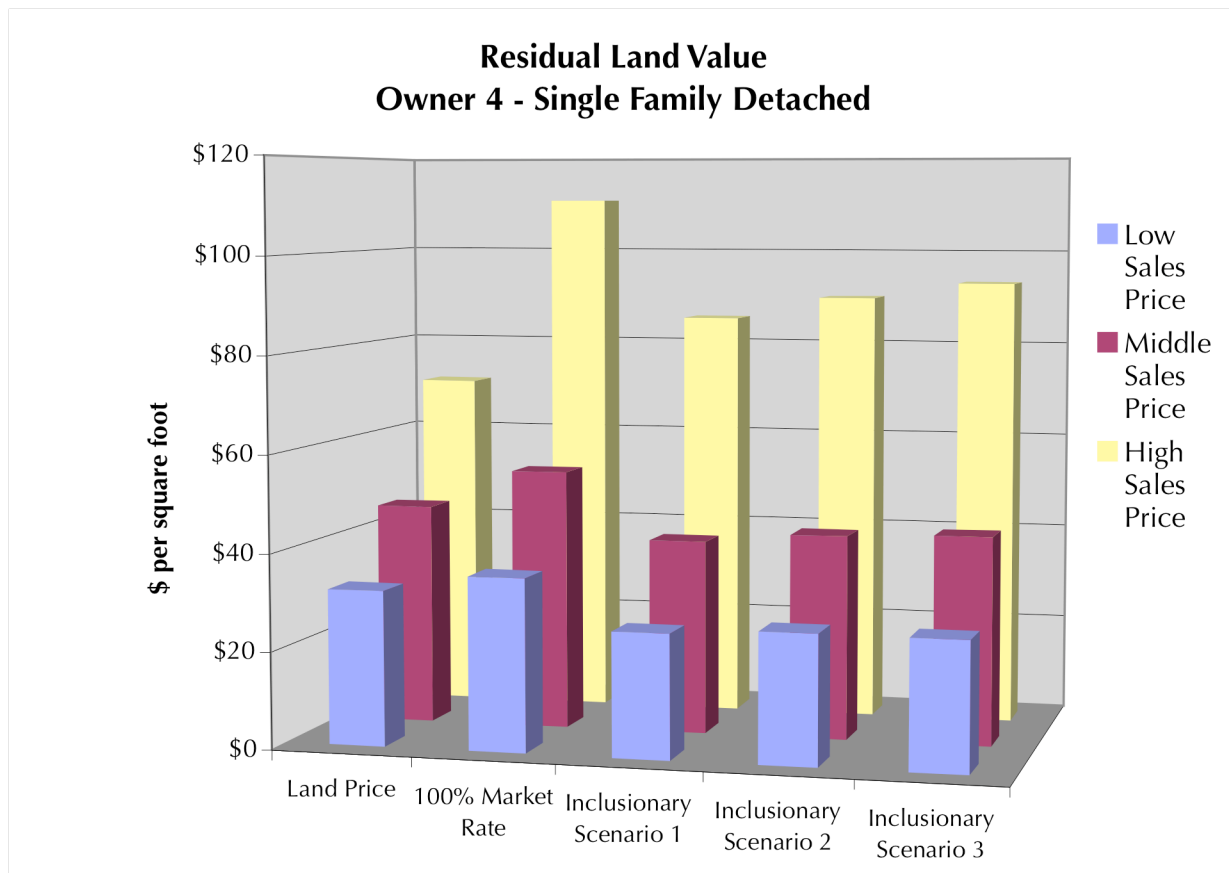


Inclusionary Scenario 1: 20% of units affordable at 110% AMI.

Inclusionary Scenario 2: 5% of units affordable at 90% AMI and 10% at 110% AMI.

Inclusionary Scenario 3: 5% of units affordable at 70% AMI and 5% at 90% AMI.

Figure E-8



Inclusionary Scenario 1: 20% of units affordable at 110% AMI.
 Inclusionary Scenario 2: 5% of units affordable at 90% AMI and 10% at 110% AMI.
 Inclusionary Scenario 3: 5% of units affordable at 70% AMI and 5% at 90% AMI.

Inclusionary Scenario 1

All owner prototypes remain feasible assuming high unit sales prices for the market rate units.

All owner prototypes, with the exception of Owner 1 – High Rise Condos, remain feasible assuming middle market sales prices. Owner 1 is rendered feasible with alternative compliance package 4, where inclusionary requirements are met through acquisition and rehabilitation of existing rental units. The residual land values of Owner 1, assuming middle market sales prices and inclusionary scenario 1 with offset packages, are illustrated in **Figure E-9**.

Under low market sales price assumptions, Owner 2 – Stacked Flat Condos, is not feasible as a 100 percent market rate project. No alternative compliance option renders this prototype feasible. This suggests that developers are not developing this product in low

sales price market areas within the City. Owner 3 and 4 – Townhomes and Single Family Detached Homes, are feasible assuming low market sales prices. The residual land values with no offset packages for Owner 3 and 4 fall at the low end, but within, the trading range of land prices. The most valuable offset packages for these prototypes are: package 1, density bonus; package 5, density bonus and design modification and package 3, off-site construction of the same product type.

Inclusionary Scenario 2

All owner prototypes remain feasible assuming high unit sales prices for the market rate units.

All owner prototypes, with the exception of Owner 1 – High Rise Condos, remain feasible assuming middle market sales prices. Owner 1 is rendered feasible with alternative compliance package 4, where inclusionary requirements are met through acquisition and rehabilitation of existing rental units.

Under low market sales price assumptions, Owner 2 – Stacked Flat Condos, is not feasible as a 100 percent market rate project. No alternative compliance option renders this prototype feasible. This suggests that developers are not developing this product in low sales price market areas within the City. Owner 3 and 4 – Townhomes and Single Family Detached Homes, are feasible assuming low market sales prices. The residual land values with no offset packages for Owner 3 and 4 fall at the low end, but within, the trading range of land prices. All alternative compliance packages, with the exception of off-site construction of the same product type, increase residual land values for these prototypes.

Inclusionary Scenario 3

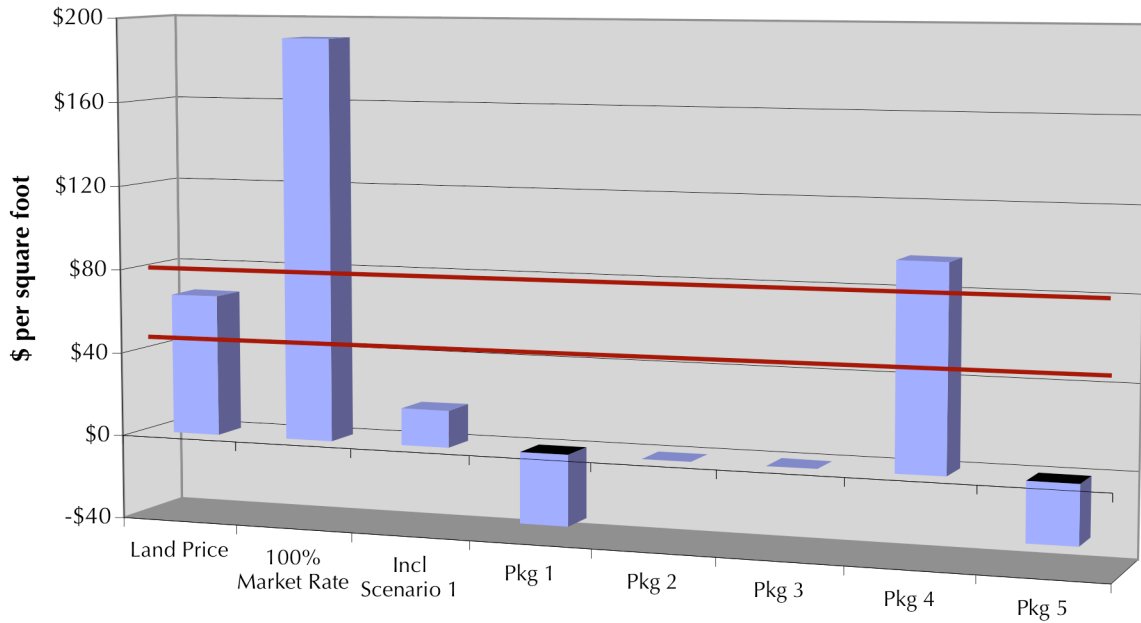
All owner prototypes remain feasible assuming high unit sales prices for the market rate units.

All owner prototypes remain feasible assuming middle unit sales prices for the market rate units.

Under low market sales price assumptions, Owner 2 – Stacked Flat Condos, is not feasible as a 100 percent market rate project. No alternative compliance option renders this prototype feasible. This suggests that developers are not developing this product in low sales price market areas within the City. Owner 3 – Townhomes, is infeasible assuming low market sales prices and inclusionary scenario 3. All alternative packages, with the exception of package 4, off-site construction of the same product type, render the prototype feasible. Owner 4 – Single Family Detached Homes, is feasible assuming low market sales prices.

Figure E-9

**Residual Land Value
Owner 1 - High Rise Condos, Middle Sales Price
Inclusionary Scenario 1 with Offset Packages**



Inclusionary Scenario 1: 20% of units affordable at 110% AMI.

Pkg 1: 20% Density Bonus

Pkg 2: On-Site Alternative Product Type – N/A

Pkg 3: Off-Site Construction, Same Product Type – N/A

Pkg 4: Acquisition/Rehabilitation

Pkg 5: 20% Density Bonus and Design Modification

— Trading range of land, 2003 – 2006.

Findings – Renter Prototypes

The land residual analysis findings for the renter prototype, under all inclusionary scenarios and market rent assumptions, are presented in Figure E-10.

The renter prototype is infeasible as a 100 percent market rate development when assuming low and middle rents.

With high rents, the renter prototype is feasible as a market rate project, but infeasible under all three inclusionary scenarios.

The findings suggest that development of renter housing is speculative in San José at this time. Developers building rental housing are doing so on the assumption of luxury rents and/or that rents will increase in the future. This is consistent with the finding that there has been very little market-rate rental development in San José in the last several years.

Inclusionary Scenario 1

The renter prototype is infeasible assuming low and middle market rents and inclusionary scenario 1.

With high rent assumptions, the renter prototype is feasible with inclusionary scenario 1 and alternative compliance package 1, 50 percent density bonus or package 5, 50 percent density bonus and design modification.

Inclusionary Scenario 2

The renter prototype is infeasible assuming low, middle and high market rents and inclusionary scenario 2. No alternative compliance packages render the prototype feasible.

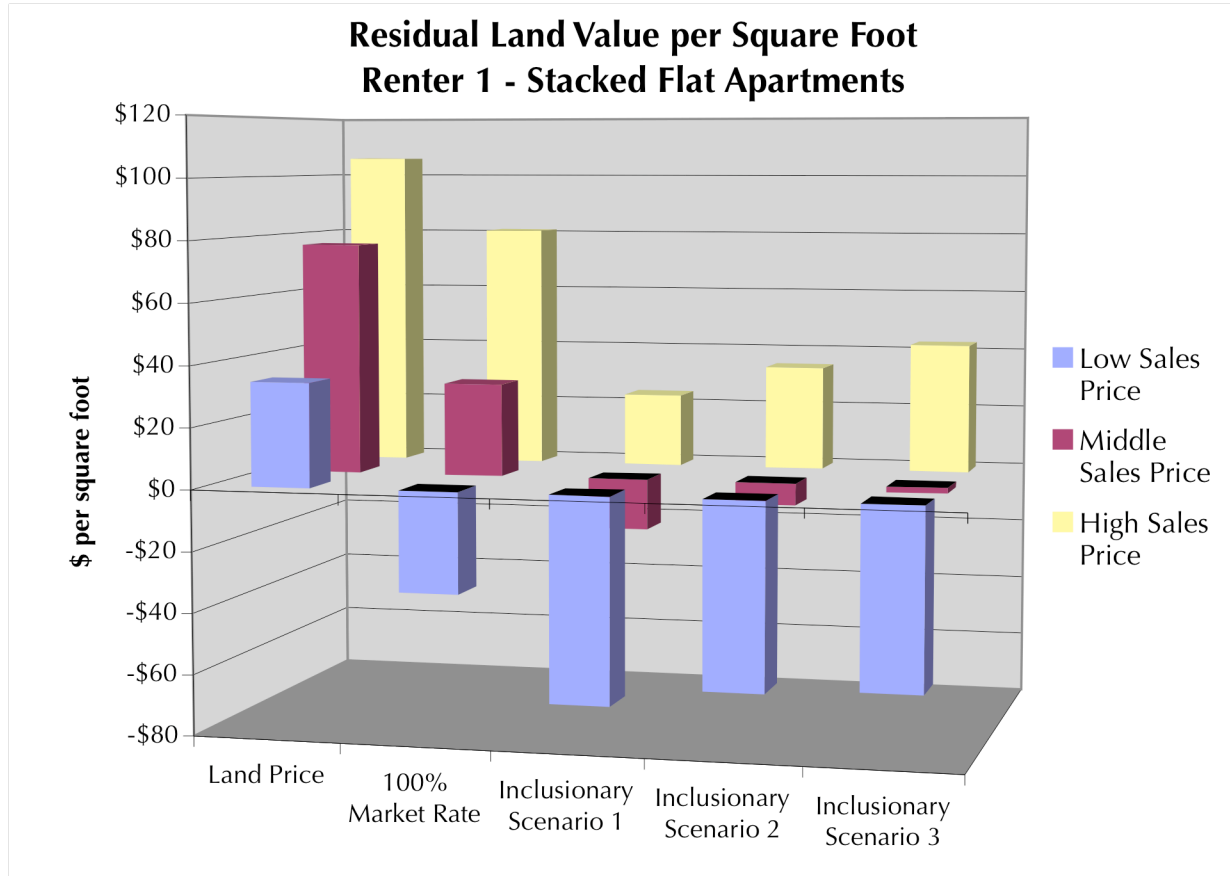
Inclusionary Scenario 3

The renter prototype is infeasible assuming low, middle and high market rents and inclusionary scenario 3.

With middle or high rent assumptions, the renter prototype is rendered feasible with inclusionary scenario 3 and alternative compliance package 1, 50 percent density bonus or package 5, 50 percent density bonus and design modification.

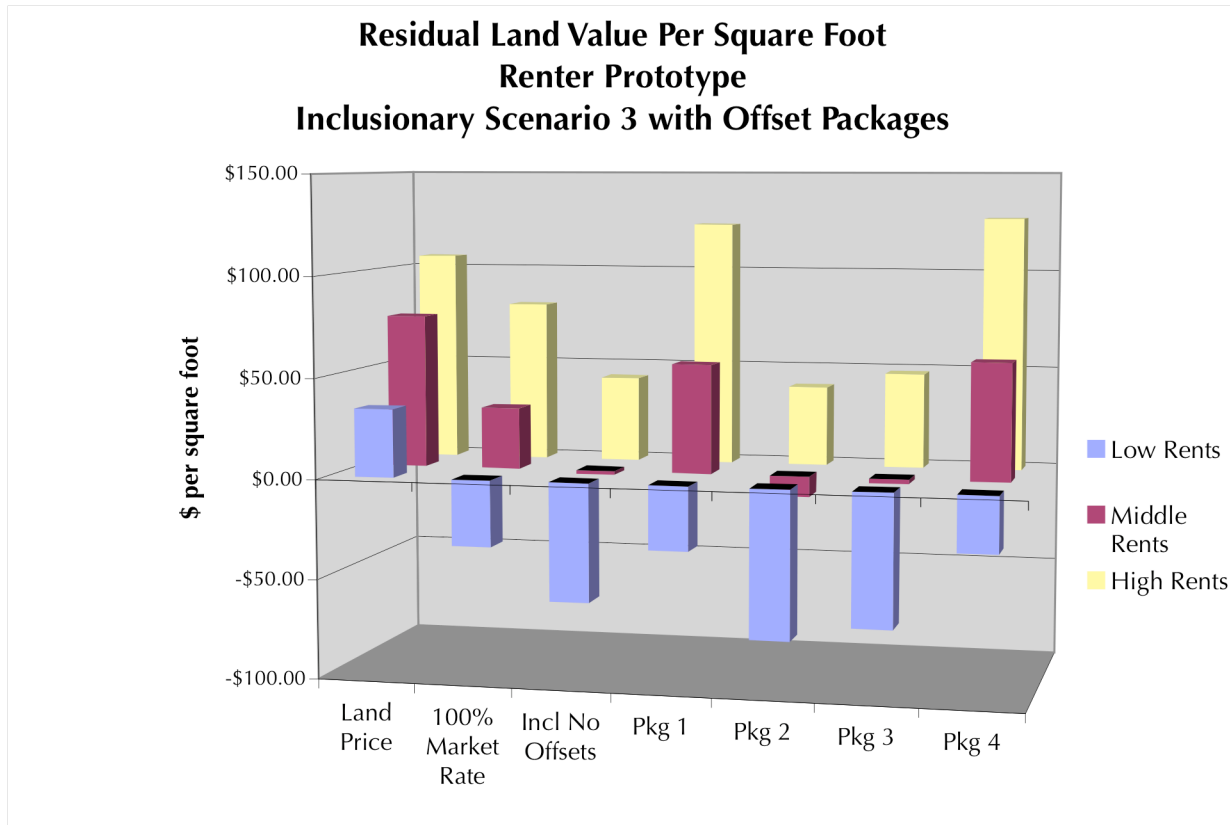
The land residual values for the renter prototype under inclusionary scenario 3 with offset packages are presented in **Figure E-11**.

Figure E-10



Inclusionary Scenario 1: 8% of units affordable at 50% AMI and 12% at 60% AMI.
 Inclusionary Scenario 2: 5% of units affordable at 50% AMI and 10% at 60% AMI.
 Inclusionary Scenario 3: 5% of units affordable at 35% AMI and 5% at 50% AMI.

Figure E-11



Inclusionary Scenario 3: 5% of units affordable at 35% AMI and 5% at 50% AMI.

Pkg 1: 50% Density Bonus

Pkg 2: Off-Site New Construction

Pkg 3: Acquisition/Rehabilitation

Pkg 4: 50% Density Bonus and Design Modification