CITY OF PALO ALTO

COUNCIL MEETING
09/21/2020
☑ Received Before Meeting
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BELOW MARKET RATE HOUSING PROGRAM ANALYSIS

September 21, 2020

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Background

- Opportunities for Affordable Housing Production
- City’s Inclusionary Requirement
- Palmer Fix (2009/2018)
- Council Direction to Update Inclusionary Requirements
- Economic Analysis (HIP / COVID)
- PTC / Staff Recommendation
- Next Steps
  - Continue to explore 20% inclusionary
  - RHNA / SB 35

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BMR HOUSING PROGRAM ANALYSIS

Strategic Economics

STRATEGIC ECONOMICS

September 21, 2020

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Economic Feasibility Study - *Key Questions*

- If the City increased the inclusionary BMR requirement to 20 percent on ownership housing, how would it impact the likelihood of development?

- If the City required 15 percent inclusionary BMR units for rental developments (instead of the impact fees), how would it impact the likelihood of development?

- How can land use/zoning strategies help to increase the share of inclusionary BMR units on-site?
  - e.g. increasing allowable densities/FAR, reducing retail requirements, and reducing parking requirements.

Approach and Methodology

- **Pro forma analysis** is commonly used by cities to assess the impact of public policy changes, like BMR requirements, on development in the short term.

- Analyzes costs of development in comparison to projected revenues to see if the development generates returns that are expected in the industry.

- Data sources included commercial real estate data from Costar and Redfin, interviews with local developers and brokers, and review of pro formas from other projects and clients in nearby cities.

- Tests “prototypes” that represent typical development projects, but individual projects may have different results under certain circumstances.

Feasibility Analysis Steps – Step 1

Generate Assumptions About:

- Development Prototypes
- Development Costs (land + hard construction + soft costs + financing)
- Project Values/ Revenues

Feasibility Analysis Steps

Ownership

Value
÷
Development Costs
=
Developer Return

Return on Cost

Highly Likely – Return on Cost is 18% or higher
Somewhat Likely – Return on Cost is over 15%
Less Likely – Net revenues are positive, but ROC is below 15%
Unlikely – Net revenues are negative

Rental

Operating Income
÷
Development Costs
=
Developer Return

Yield on Cost

Highly Likely – Yield on Cost is 5.0% or higher
Somewhat Likely – Yield on Cost is over 4.75%
Less Likely – Net revenues are positive but YOC is below 4.75%
Unlikely – Net revenues are negative

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FEASIBILITY ANALYSIS RESULTS

Ownership Results - *Current Zoning Regulations*

Inclusionary Housing Scenarios	Townhouse SOFA-II, RT 35	Downtown Condo Flats CD-C (with HIP)	Condo Flats CS (with HIP)
15% Inclusionary	Less Likely	Somewhat Likely	Unlikely
20% Inclusionary	Less Likely	Less Likely	Unlikely
25% Inclusionary	Less Likely	Less Likely	Unlikely
In-Lieu Fees	Less Likely	Highly Likely	Less Likely

Source: Strategic Economics, 2020.

- **New ownership development projects are not likely to support a 20% inclusionary BMR requirement under the City's current zoning regulations.**

Ownership Results – *Lower Parking & Retail*

Inclusionary Housing Scenarios	Townhouse SOFA-II, RT 35	Downtown Condo Flats CD-C (with HIP)	Condo Flats CS (with HIP)
15% Inclusionary	Highly Likely	Highly Likely	Highly Likely
20% Inclusionary	Highly Likely	Highly Likely	Somewhat Likely
25% Inclusionary	Less Likely	Highly Likely	Less Likely
In-Lieu Fees	Highly Likely	Highly Likely	Highly Likely

Source: Strategic Economics, 2020.

- **Reductions in the City's requirements for parking and ground-floor retail would make it more likely that development could support a higher inclusionary requirement of 20%.**

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Rental Results - *Current Zoning Regulations*

Inclusionary Housing Scenarios	Downtown Apartments CD-C (with HIP)	Apartments CS (with HIP)
15% Inclusionary	Somewhat Likely	Less Likely
20% Inclusionary	Somewhat Likely	Less Likely
25% Inclusionary	Less Likely	Less Likely
In-Lieu Fees	Highly Likely	Less Likely

Source: Strategic Economics, 2020.

- **Downtown rental projects are somewhat likely to support a 15% or 20% inclusionary BMR requirement under the City's current zoning regulations.**
- **In the lower density CS zone, rental apartments have a lower likelihood of supporting BMR requirements.**

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Rental Results – *Lower Parking and Retail*

Inclusionary Housing Scenarios	Downtown Apartments CD-C (with HIP)	Apartments CS (with HIP)
15% Inclusionary	Highly Likely	Highly Likely
20% Inclusionary	Highly Likely	Somewhat Likely
25% Inclusionary	Somewhat Likely	Somewhat Likely
In-Lieu Fees	Highly Likely	Highly Likely

Source: Strategic Economics, 2020.

- **Reductions in the City's requirements for parking and ground-floor retail would make it more likely for a rental project to deliver 15% BMR units on-site.**

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Rental Results – *Lower Parking and Retail*

Inclusionary Housing Scenarios	Downtown Apartments CD-C (with HIP)	Apartments CS (with HIP)
15% Inclusionary	Highly Likely	Highly Likely
20% Inclusionary	Highly Likely	Somewhat Likely
25% Inclusionary	Somewhat Likely	Somewhat Likely
In-Lieu Fees	Highly Likely	Highly Likely

Source: Strategic Economics, 2020.

- **Reductions in the City's requirements for parking and ground-floor retail would make it more likely for a rental project to deliver 15% BMR units on-site.**

Effects of COVID-19

Results depend on assumptions about construction costs, land prices, and rents/sales prices. If any of these conditions change, the results would be different.

There is insufficient data to confidently predict the cost and revenue impacts at this time.

- Will housing prices and rents decrease and by how much?
- Will construction and land costs continue to rise?

Ownership Prototypes

	Prototype 1a Townhouse, Current Zoning	Prototype 1b Townhouse, Reduced Retail and Parking	Prototype 2a Downtown Condo Current Zoning	Prototype 2b Downtown Condo Reduced Retail and Parking	Prototype 4a Condo Flats, Current Zoning	Prototype 4b Condo Flats, Reduced and Parking
Overview						
Zoning Designation	SOFA-II, RT 35	SOFA-II, RT 35	CD-C (with HIP)	CD-C (with HIP)	CS (with HIP)	CS (with HIP)
Stories	3	3	3 to 4	3 to 4	3 to 4	3 to 4
Parcel Size (acres)	0.50	0.50	0.34	0.34	0.68	0.68
Total Floor Area Ratio (FAR)	1.14	1.07	3.00	2.85	1.49	1.23
Residential Program						
Total Units	16	16	26	26	20	20
Du/Acre	32	32	76	76	29	29
Average Unit Size	1,250	1,250	1,346	1,346	1,500	1,500
Retail (sf)	3,000	1,500	3,750	1,500	9,035	1,500
Total Required Parking Spaces	47	16	53	26	78	20
Parking Type Mix						
Surface Spaces	0%	0%	0%	0%	22%	0%
Underground Spaces	0%	0%	100%	100%	78%	0%
Podium Spaces	100%	100%	0%	0%	0%	100%

Rental Prototypes

	Prototype 3a	Prototype 3b	Prototype 5a	Prototype 5b
	Downtown Apartments, Current Zoning	Downtown Apartments, Reduced Retail and Parking	Apartments, Current Zoning	Apartments, Reduced Retail and Parking
Overview				
Zoning Designation	CD-C (with HIP)	CD-C (with HIP)	CS (with HIP)	CS (with HIP)
Stories	3 to 4	3 to 4	3 to 4	3 to 4
Parcel Size (acres)	0.34	0.34	0.68	0.68
Total Floor Area Ratio (FAR)	2.99	3.00	1.50	1.27
Residential Program				
Total Units	54	54	50	51
Dwelling Units Per Acre	157	157	73	74
Weighted Average Unit Size (sf)	647	647	606	609
Ground-Floor Retail (sf)	3,750	1,500	9,035	1,500
Total Required Parking Spaces	63	54	88	51
Parking Type Mix				
Surface Spaces	0%	0%	19%	33%
Underground Spaces	100%	100%	81%	0%
Podium Spaces	0%	0%	0%	67%

REFERENCE MATERIALS

Feasibility Analysis Steps

Step 1.
- Develop "prototypes" that represent projects that would be subject to the BMR policy

Step 2.
- Develop assumptions about the % inclusionary requirement, income targets, and affordable sales prices and rents for BMR units (for residential prototypes only)

Step 3.
- Collect key inputs for the pro forma model - rents, sales prices, land costs, hard construction costs, soft costs based on variety of data sources

Step 4.
- Tally all development costs and subtract from project value to calculate net value
- Divide the net value or net operating income by total development costs to calculate return
- Compare the return to the minimum thresholds to determine if it is feasible

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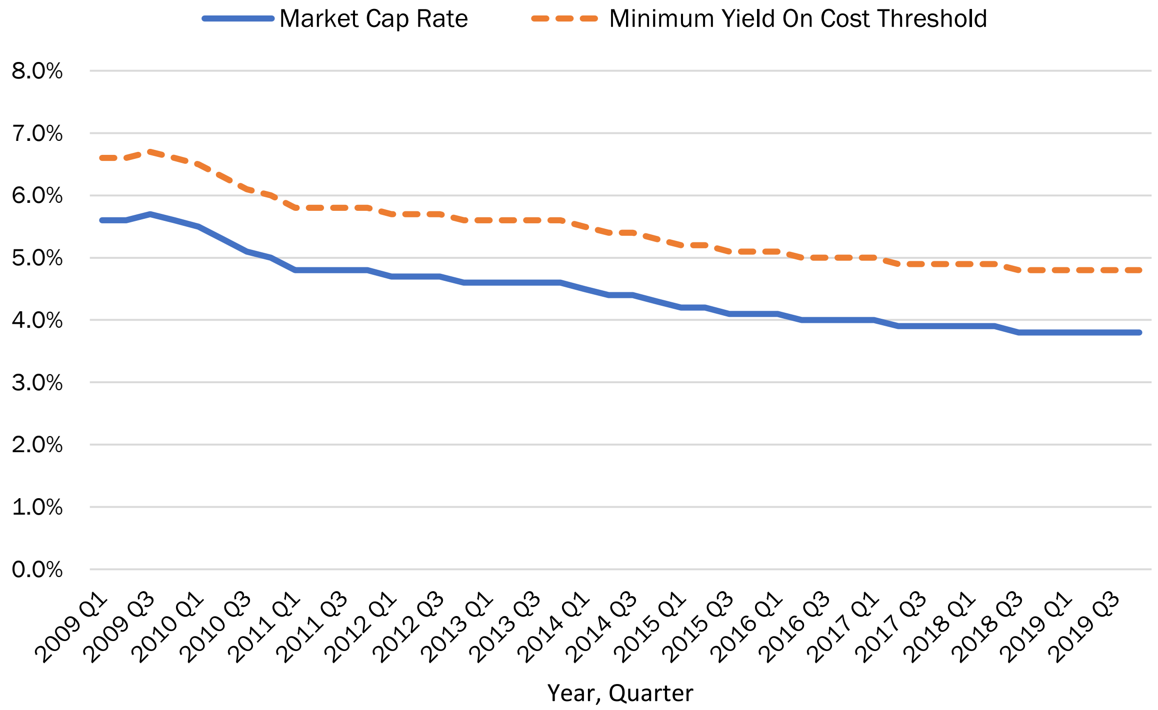
Rate of Return (Yield on Cost)

Santa Clara County Multi-Family Cap Rates, 2009-2019



Source: Costar, 2019; Strategic Economics, 2019.

- Rates of return are pegged to market cap rates
- Rising cap rates suggest a riskier investment climate; falling cap rates indicate a healthier environment
- Market cap rates for multifamily housing have been extremely low in the last 2 years
- Investors and developers have been willing to accept lower rates of return because perceived risk of investment is low

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Recommendation

Recommendation

Staff and the Planning and Transportation Commission (PTC) recommend that the City Council:

1. Discuss the draft economic analysis analyzing **potential increases to inclusionary housing requirements**;
2. **Maintain the inclusionary housing requirements** at 15% for ownership housing units and retain the housing impact fee for rental housing projects; and
3. **Direct staff and the PTC to explore possible zoning amendments or other factors that could support a future 20% inclusionary requirement** for ownership and rental housing while recognizing that such analysis will be constrained without funding for additional consultant resources.

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