KEYSER MARSTON ASSOCIATES.
ADVISORS IN PUBLIC/PRIVATE REAL ESTATE DEVELOPMENT

MEMORANDUM

ADVISORS IN:
Real Estate
Affordable Housing
Economic Development

BERKELEY
A. Jerry Keyser
Timothy C. Kelly
Debbie M. Kern
David Doezema
Kevin Feeney

LOS ANGELES
Kathleen H. Head
James A. Rabe
Gregory D. Soo-Hoo
Kevin E. Engstrom
Julie L. Romey
Tim R. Bretz

SAN DIEGO
Paul C. Marra

To: Patrick Ure, Bureau Manager
City of Long Beach

From: Kathleen Head

Date: January 15, 2020

Subject: Inclusionary Housing: Financial Evaluation – Peer Review Response

At your request, Keyser Marston Associates, Inc. (KMA) reviewed the *Peer Review of Inclusionary Housing Policy – Economic Analysis of Keyser Marston Associates* prepared by Beacon Economics, LLC and dated November 22, 2019 (Beacon Analysis). The Beacon Analysis pertains to the Inclusionary Housing: Financial Evaluation (KMA Financial Evaluation) that was prepared Keyser Marston Associates, Inc. (KMA), and is dated July 21, 2019.

The key issues of concern that are identified in the Beacon Analysis can be summarized as follows:

1. The prototype projects used in the KMA Financial Evaluation do not reflect the characteristics of residential development that has recently been developed, or is anticipated to be developed, in downtown and midtown Long Beach.

2. The KMA pro forma analyses understate the development costs and overstate the achievable market rate rents and sales prices for new residential development.

3. The land cost reduction methodology that KMA applied to identify the supportable Inclusionary Housing requirements does not reflect Long Beach specific economic and housing market conditions.

The Beacon Analysis identifies numerous additional specific concerns. However, the preceding summary provides the general concepts that led Beacon to conclude that the Inclusionary Housing production requirements recommended by KMA cannot be supported.

PROTOTYPE PROJECTS

The first step that KMA undertook in preparing the KMA Financial Evaluation was to review the characteristics of residential projects in Long Beach that have recently been developed and that are in the pipeline. Based on that review, KMA created a rental prototype and an ownership prototype.

Rental Prototype

KMA created a rental prototype that is largely based on the Broadway & Magnolia Apartments project. Some key characteristics of the Magnolia & Broadway Apartments project are:

1. The development site is comprised of 32,870 square feet of land area after required dedications.
2. The project includes 142 units.
3. The leasable residential area represents approximately 86% of the residential gross building area.
4. The 179 parking spaces are provided on one subterranean level, one at-grade level, and one above ground level.

The following characteristics were included in the KMA rental prototype project:

1. The development site area was set at 32,870 square feet.
2. KMA analyzed the following development scopes:
    a. A base case project that includes 94 units. This represents the development standards that were imposed by the City of Long Beach (City) prior to the adoption of the 2017 updates to the Downtown Community Plan.

b. An increased density project that includes 140 units. This represents the development standards imposed by the 2017 updates to the Downtown Community Plan. The incentives included in these updates assist in mitigating the impacts associated with the imposition of Inclusionary Housing requirements.

3. KMA set the leasable area at 80% of the gross building area. This is a more conservative assumption than the ratio of leasable to gross building area embodied by the actual project that served as the basis for the prototype.

4. The parking included in the two development scopes include 182 spaces and 175 spaces, respectively based on the relevant Downtown Community Plan requirements. KMA applied a conservative approach in the prototype project by placing the parking in two subterranean levels.

Ownership Prototype

Recent residential development in downtown Long Beach has been focused on rental projects. However, it should be noted that several projects have obtained subdivision maps that will allow the units to be sold as condominiums at some point in the future. For analysis purposes, KMA chose to create a condominium prototype based on the LB at 14th Street, which is a dedicated condominium project. The characteristics of the LB at 14th Street project can be described as follows:

1. The development site consists of 49,484 square feet of land area.

2. The project includes 65 units.

3. The 90 parking spaces are provided in garages, covered carports, and open stalls.

The KMA prototype embodies the following characteristics:

1. The development site consists of 43,560 square feet of land area.

2. The prototype is set at a density that is approximately 22% higher than the LB at 14th Street development scope. This was done to reflect the higher density of mapped rental projects that are being developed.

3. The saleable area is set at 80% of the gross building area.

4. The 142 parking spaces are provided in an above ground podium. This is a more conservative assumption than the LB at 14th Street parking configuration.

Summary: Prototype Projects

The prototypes used in the KMA Financial Evaluation are based on actual residential projects that have recently received entitlements from the City. Therefore, KMA takes issue with the Beacon Analysis assertion that it is physically impossible to achieve the development scopes that were applied in the prototypes.

FINANCIAL ASSUMPTIONS

As part of the Beacon Analysis, Beacon independently prepared financial analyses that were based on completely different cost and revenue assumptions than were applied in the KMA Financial Evaluation. The comparisons are described in the following sections of this memorandum:

Rental Prototype

The 100% market rate rental scenario includes 94 units, which represents a density of 125 units per acre. A comparison between the development costs included in the KMA Financial Evaluation and the costs included in the Beacon Analysis is presented in the following table:

Development Cost Comparison – 100% Market Rate Rental Scenario

	KMA	Beacon
Land Cost	$6,738,000	$8,217,000
Total Direct Costs	25,483,000	39,217,000
Total Indirect Costs	6,748,000	9,315,000
Total Financing Costs	1,963,000	5,635,000
Total Development Costs	$40,932,000	$62,384,000
Per Unit	$435,400	$663,660
Percentage Increase		53%

The increased costs applied in the Beacon Analysis can be allocated as follows:

1. Approximately 28% of the difference is related to the increased gross building area that Beacon applied to the rental prototype scope of development; and

2. Approximately 72% of the difference is related to additional costs that were included in the Beacon Analysis.

The results of the stabilized net operating income analyses for the 100% market rate rental scenario are presented in the following table:

Stabilized Net Operating Income Comparison 100% Market Rate Rental Scenario		
	KMA	Beacon
Effective Gross Income	$3,092,000	$2,742,000
<u>Operating Expenses</u>		
General Operating Expenses	$423,000	$423,000
Property Taxes	443,000	442,000
Reserves Deposits	14,000	14,000
Total Operating Expenses	($880,000)	($879,000)
Stabilized Net Operating Income	$2,212,000	$1,863,000
Percentage Decrease		16%

As can be seen in the preceding table, there is effectively no difference in operating expense estimate applied in the KMA Financial Evaluation and the Beacon Analysis. The fundamental difference is found in the rent revenue estimates. The primary differences cited in the Beacon Analysis are:

1. KMA applied a 10% premium to the weighted average rents derived from the rent survey included in the KMA Financial Evaluation. Beacon opined that there is no support for the notion that newly constructed units will command higher rents than is achievable for existing projects.

2. The Beacon Analysis contends that the unit square footages used in the KMA Financial Evaluation do not match the average unit sizes presented in the rent survey. That is not an accurate statement. However, as Beacon pointed out, there is an outlier in the studio unit section of the survey that created a significant over statement of the achievable studio unit rents.

In response to the concerns identified in the Beacon Analysis, the City staff undertook a survey of four recently constructed rental projects in downtown Long Beach. The results of that survey are presented in the following table:

Downtown Rent Survey – New Construction Buildings: December 2019				
Name	# of Units	Unit Size (SF)	Total Rent	Rent Per SF
Studio Units				
Oceanaire	15	618	$2,307	$3.73
The Current	30	685	$2,480	$3.62
AMLI Park Broadway	29	736	$2,544	$3.46
The Pacific	60	537	$1,979	$3.69
Weighted Average		622	$2,250	$3.63
One-Bedroom Units				
Oceanaire	101	733	$2,675	$3.65
The Current	149	841	$2,705	$3.22
AMLI Park Broadway	143	778	$2,681	$3.45
The Pacific	53	740	$2,470	$3.34
Weighted Average		784	$2,663	$3.40
Two-Bedroom Units				
Oceanaire	93	1,154	$3,433	$2.97
The Current	44	1,182	$3,988	$3.37
AMLI Park Broadway	50	1,155	$3,716	$3.22
The Pacific	50	1,051	$3,184	$3.03
Weighted Average		1,138	$3,543	$3.11

The rents presented in the preceding table represent the effective rents after deductions for concessions offered by the projects. When these actual rents are used in the KMA pro forma analysis, with no premium added, the stabilized net operating income is 3.4% higher than the estimate included in the KMA Financial Evaluation. For reference purposes, the December 2019 survey generates rent revenue that is approximately 19% higher than the estimate applied in the Beacon Analysis.

The following table summarizes the KMA Financial Evaluation and Beacon Analysis estimates of the stabilized return on total investment for the 100% market rate rental scenario:

Stabilized Return on Total Investment – 100% Market Rate Rental Scenario		
	KMA	Beacon
Stabilized Net Operating Income	$2,212,000	$1,863,000
Total Development Costs	$40,932,000	$62,384,000
Stabilized Return on Total Investment	5.4%	3.0%

The Beacon Analysis concluded that their assumed increases in costs and reductions in stabilized net operating income results in a stabilized return that is below the threshold under which market rate rental projects would be deemed feasible for development. While the math applied by Beacon is accurate, their conclusion that market rate apartment development is not feasible is contradicted by the number of rental projects that have recently been developed and those that have completed the entitlement process.

Ownership Prototype

The 100% market rate ownership scenario includes 71 units, which equates to a density of 71 units per acre. A comparison between the development costs included in the KMA Financial Evaluation and the costs included in the Beacon Analysis is presented in the following table:

Development Cost Comparison - 100% Market Rate Ownership Scenario		
	KMA	Beacon
Land Cost	$5,881,000	$10,890,000
Total Direct Costs	18,366,000	28,996,000
Total Indirect Costs	5,118,000	6,375,000
Total Financing Costs	1,832,000	3,429,000
Total Development Costs	$31,197,000	$49,690,000
Per Unit	$439,400	$699,900
Percentage Increase		59%

The increased costs applied in the Beacon Analysis can be allocated as follows:

1. Approximately 24% of the difference is related to the increase in gross building area that Beacon applied to the ownership prototype scope of development; and

2. Approximately 76% of the difference is related to additional costs that were included in the Beacon Analysis.

The results of the stabilized net operating income analyses for the 100% market rate ownership scenario are presented in the following table:

Projected Net Sales Revenue - 100% Market Rate Ownership Scenario		
	KMA	Beacon
Gross Sales Revenue	$35,979,000	$31,281,600
Total Cost of Sales	(1,979,000)	(1,720,500)
Net Sales Revenue	$34,000,000	$29,561,100
Average Gross Sale Price Per Unit	$506,700	$440,600
Percentage Decrease		13%

The KMA sales price estimates were based on the results of a resale survey of condominiums in the downtown and midtown areas. A significant percentage of these resales were for condominiums that were built in the 1970s and 1980s. To reflect the age of this inventory, KMA applied a 15% premium to the average sales prices for each unit type that was included in the survey. Beacon rejected the assumption that new condominium units will command a sales price premium over units that were constructed 40+ years ago.

The following table summarizes the KMA Financial Evaluation and Beacon Analysis estimates of the developer profit generated by the 100% market rate ownership scenario:

Stabilized Return on Total Investment – 100% Market Rate Ownership Scenario		
	KMA	Beacon
Net Sales Revenue	$34,000,000	$29,561,100
Total Development Costs	(31,197,000)	(49,690,000)
Developer Profit	$2,803,000	($20,129,000)
As a Percentage Development Costs	9.0%	(40.5%)

It is clear that if the Beacon Analysis assumptions are accurate, condominium development is not feasible in downtown and midtown Long Beach. In fact, if these assumptions are correct, it should be anticipated that no condominium development will occur any time within the foreseeable future.

It is true that recent development has focused on rental projects. However, as mentioned previously, a number of condominium projects have recently completed the entitlement process. Moreover, a significant percentage of the recently developed rental projects have obtained subdivision maps with the intention of selling the units as condominiums at some point in the future.

Affordable Sales Prices

There is an approximately 32% difference between the affordable sales price estimates included in the KMA Financial Evaluation and the Beacon Analysis. This difference is caused by the following factors:

Affordable Sales Price Calculation Assumptions		
	KMA	Beacon
Mortgage Interest Rate	5.31%	4.375%
Home Buyer Down Payment	5%	20%

The affordable sales price estimates are presented in the following table:

Affordable Sale Price Estimates – Moderate Income Households			
	Supportable Mortgage	Down Payment	Affordable Sales Price
Studio Units			
KMA	$197,500	$10,400	$207,900
Beacon	$219,914	$54,979	$274,893
One-Bedroom Units			
KMA	$219,700	$11,600	$231,300
Beacon	$244,583	$61,146	$305,729
Two-Bedroom Units			
KMA	$235,300	$12,400	$247,700
Beacon	$262,008	$65,502	$327,510
Percentage Increase			
Three-Bedroom Units			
KMA	$263,500	$13,900	$277,400
Beacon	$293,386	$73,347	$366,733
Four-Bedroom Units			
KMA	$284,600	$15,000	$299,600
Beacon	$316,920	$79,230	$396,150

An Inclusionary Housing program is intended to provide home ownership opportunities to households who otherwise would not have the wherewithal to purchase a home. Over the past 30+ years KMA has assisted cities and now former redevelopment agencies in structuring and implementing home buyer programs. We have also participated in the home buyer selection process for Inclusionary Housing program projects in several cities. The following issues consistently arise in the process:

1. The home buyer does not have the resources to make a down payment of the magnitude that market rate home buyers can provide. Home buyers with limited down payment funds are actually a target of home buyer programs, because those households need the assistance.

2. The home buyer exhibits a higher back-end ratio than the typical ratios applied in conventional lenders' underwriting standards.

3. In order to attract home buyers who are willing to accept either a resale restriction, or equity appreciation sharing arrangement, the home price must represent a significant discount from the unrestricted market rate price. In fact, the affordable sales price is typically sufficiently lower than the unrestricted market rate price to relieve the home buyer of the obligation to obtain private mortgage insurance (PMI).

There is a disconnect between Beacon's assertion that the mortgage interests rates in the KMA analysis are too high, and the countervailing assertion that KMA did not take PMI requirements into account. That notwithstanding, the primary reason that KMA applies a 100 basis points premium over current mortgage interest rates is to reflect the fact that the economy has been experiencing generationally low interest rates.

Affordable ownership homes are subject to long-term resale restrictions. Therefore, it is important not to set the initial sales prices that will decline over time as interest rates increase. Moreover, given that the Inclusionary Housing program will be in place over time, it is appropriate to apply conservative underwriting assumptions.

Summary: Financial Assumptions

If the financial assumptions applied in the Beacon Analysis are accurate, it is not financially feasible to develop market rate rental or ownership housing development. Beacon effectively reaches these conclusions by including the following statements:

1. For rental projects: “A 3% ROI is likely lower than the cap rate of the submarket. Therefore, under current circumstances, such project might not materialize.”[1]

2. For ownership projects: “Using revised, current estimates, the prototype is extremely far from being feasible.”[2]

These conclusions are difficult to support given the magnitude of recent residential development activity and entitled residential development that is in the pipeline.

It is important to understand that prototype developments are somewhat generic by nature. They are meant to reflect average or typical projects rather than any specific project. It should be expected that specific projects will vary to some degree from the prototype.

METHODOLOGY USED TO SET THE RECOMMENDED REQUIREMENTS

The Beacon Analysis acknowledges that, absent the provision of incentives that mitigate the financial impact created by the imposition of affordable housing requirements, a cost component such the supportable land price will decrease. After preparing 25 Inclusionary Housing analyses over the past 15 years, the KMA Los Angeles office has found that the following sequence of events typically occur when an Inclusionary Housing ordinance is adopted:

1. Immediately following the approval of an Inclusionary Housing program, the financial impacts created by the imposition of affordable housing requirements are largely borne by developers that had purchased property prior to the imposition of the requirements.

[1] Page 78 of the Beacon Analysis.
[2] Page 82 of the Beacon Analysis.

2. After an Inclusionary Housing program is adopted, developers that have not purchased land will attempt to bargain for a lower land price that reflects the impacts created by the Inclusionary Housing requirements.

3. During the initial implementation period for an Inclusionary Housing program, some property owners are reluctant to accept the fact that their land value has decreased, and they defer selling their property until market demand causes prices to increase.

4. As is the case with all development requirements, over time land prices will adjust to reflect the value supported by the market given the restrictions imposed on the property.

Beacon appears to accept the premise that a land cost reduction methodology is potentially an acceptable evaluation tool. However, the Beacon Analysis also stated that by applying a blanket 30% land cost reduction in establishing the recommended Inclusionary Housing requirements, KMA did not take into account the "local economic and housing market conditions as well as local and state regulatory and political framework".[3]

It is KMA's opinion that this statement represents a misunderstanding of the underlying factors that guided the creation of the KMA evaluation methodology. To that end, the following describes the process by which KMA developed our evaluation methodology over time:

1. In the early days of Inclusionary Housing program adoptions, jurisdictions generally identified a desired mix of requirements and created Inclusionary Housing programs without undertaking financial feasibility analyses.

2. In the late 1990's, firms like KMA started preparing financial studies in support of proposed Inclusionary Housing ordinances:

    a. The jurisdictions still mainly identified the requirements they wished to adopt, and then used the financial analysis to illustrate the impacts that would potentially be generated.

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[3] Page 60 of the Beacon Analysis.

b. KMA measured the impact in terms of the reductions to the supportable land cost.

c. The impact on supportable land cost was the analysis finding, not a variable that was used in establishing the affordable housing requirement.

3. None of the court cases that have dealt with Inclusionary Housing have defined specific parameters that would be deemed acceptable. Instead the courts have limited the guidance to following:

   a. The requirements cannot be "Confiscatory"; and

   b. The requirements cannot deprive a property owner of a fair and reasonable return on their investment.

4. In the early 2000's, KMA expanded the reduction in supportable land cost methodology to include an analysis of how long it would take for land values to recover during stable economic times:

   a. The establishment of an acceptable time period is a policy decision for each jurisdiction to make.

   b. A combination of factors led to the finding that a 30% land cost reduction could be recouped within a +/- three year period. This was deemed to be acceptable by the jurisdictions that KMA assisted with program adoption during that era.

5. Starting in 2005, the State Legislature began enhancing the benefits provided by the California Government Code Sections 65915-65918 (Section 65915) density bonus. Over time, amendments to the legislation have created benefits that are often sufficient to mitigate or eliminate the impacts created by well-structured Inclusionary Housing requirements.

The KMA evaluation methodology is specifically tailored to the characteristics of each jurisdiction in which we work. As discussed previously, the tasks that KMA undertakes in preparing Inclusionary Housing analyses can be described as follows:

1. KMA gathers information pertaining to residential projects in the community that have been recently developed and those that are in the pipeline.

2. KMA compiles market data related to the pertinent housing product types.

3. Based on the available information, KMA creates prototype developments and then prepares pro forma analyses to assist in identifying the Inclusionary Housing obligations that can be supported.

Summary: Methodology Used to Set the Recommended Requirements

The KMA Los Angeles office has prepared 25 Inclusionary Housing analyses over the past 15 years. In several cases KMA has continued to work with the jurisdiction to implement the adopted programs. In addition, as economic conditions have changed over time KMA has assisted clients in amending the ordinances that KMA assisted in creating initially.

A primary focus of KMA's Inclusionary Housing work is to assist in structuring programs that balance the interests of property owners and developers against the public benefit created by the production of affordable housing units. This aligns with the California Government Code Section 65583 (a) requirement that an Inclusionary Housing program should not create a constraint to development.

CONCLUSIONS

In a memorandum dated October 21, 2019, the California Department of Housing and Community Development (HCD) provided guidance for the implementation of Inclusionary Housing requirements on rental development under the auspices of AB 1505. In brief, the HCD memorandum explicitly states that a financial feasibility evaluation can only be required for Inclusionary Housing programs that require more than 15% of the units to be rented to households earning less than 80% of the area median income (AMI).

For reference purposes, the KMA Financial Evaluation concluded that the following affordable housing requirements can be supported in Submarket #1:

Financially Feasible Inclusionary Housing Percentages	
Alternative	Inclusionary Percentage
Single Income Category Inclusionary Alternatives	
Moderate Income Alternative	19%
Low Income Alternative	12%
Very Low Income Alternative	11%
Mixed Income Category Inclusionary Alternatives	
20% Very Low Income & 80% Low Income	12%
80% Very Low Income & 20% Low Income	11%
30% Low Income & 70% Moderate Income	14%
Ownership Housing Development	
Moderate Income Alternative	10%

The City's Draft Inclusionary Policy Outline recommends that the following Inclusionary Housing requirements be imposed in Submarket #1:

City Recommended Inclusionary Housing Requirements
Rental Option A: 8% Requirement - Alternatives 20% Very Low Income / 80% Low Income 100% Low Income
Rental Option B:10% Requirement – Alternatives 40% Very Low Income / 60% Moderate Income 50% Low Income / 50% Moderate Income
Rental Option C: 12% Requirement: 30% Low Income and 70% Moderate Income
Ownership Option: 10% Moderate Income Requirement

The City is currently proposing to phase in the Inclusionary Housing requirements under the following schedule:

City Recommended Inclusionary Housing Phase-In Period for the Requirements		
	Downtown	Midtown
Year 1	40%	40%
Year 2	50%	40%
Year 3	70%	50%
Year 4	100%	70%
Year 5+	100%	100%

As can be seen in the preceding tables, the City is proposing to impose less restrictive Inclusionary Housing standards than are supported by the KMA Financial Evaluation. In addition, the City is proposing to phase in the requirements over a multiyear schedule: The combination of these factors enhances the balance between the interests of property owners and developers against the public benefit created by the production of affordable housing units.