THE FEASIBILITY OF AFFORDABLE - FAMILY HOUSING DEVELOPMENT IN CALIFORNIA: THE FOR-PROFIT DEVELOPER'S PERSPECTIVE

by

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SUBMITTED TO THE DEPARTMENT OF ARCHITECTURE
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS OF THE DEGREE
MASTER OF SCIENCE IN REAL ESTATE DEVELOPMENT AT THE
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September, 1992

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ABSTRACT

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The primary purpose of this research was to determine the prospect for the involvement of the for-profit developer in affordable- family housing in California. The research was conducted in interviews with individuals from several for-profit development firms as well as Bridge Housing Corporation, a non-community based non-profit firm, lenders, and specialists from various local and state governmental agencies.

The central theme of the research was; to define the role of the for-profit developer in the affordable- family housing industry. The thesis is organized around that theme: Chapter I is written from the perspective of the developer and is dedicated to discussing the institutional framework within which the developer must operate; State policy and legislation, the lending environment, and the relative details of pertinent subsidy programs. Chapters II-IV are project case studies written from the perspective of the developer. All three studies involve for-profit/non-profit joint venture partnerships in the development of mixed-income affordable housing projects. Finally, Chapter V concludes the writing in a synthesis of the case studies and the primary research.

The findings of the research concluded that affordable housing development in California does represent an opportunity for the for-profit developer. However, succeeding in this arena involves in depth knowledge of an institutional framework quite different from that within which traditional market-rate development is practiced. The research concludes that local political support is the element most critical in working a project through this institutional maze. To acquire this support, it is crucial to select sites offering large-scale, mixed-income potential within a community which has adopted and carries out pro-active affordable housing policy. Further, within the current political environment, to gain local public appeal and access to essential subsidies, it is vital that the for-profit developer enter joint-venture arrangements with a public or private non-profit entity.

Thesis Supervisor: Langley Keyes, Professor of City Planning
Department of Urban Planning

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INTRODUCTION

Thesis Intent

The purpose of this research was to determine the prospect for the involvement of the for-profit developer in affordable- family housing in California, where insatiable demand for quality affordable housing has translated into a supply deficit beyond the production capacity of the current public and non-profit effort. At the same time, California's for-profit development industry is operating far below capacity as a result of the enduring national recession, local over-supply of most commercial product types, and the continuation of a national real estate credit crunch. This paper examines the role of the for-profit developer under these current conditions, subsequent to the HUD scandals of the 1980's which, in combination with difficult fiscal times, have resulted in significant cutbacks in the once noteworthy pool of federal subsidies:

Description of Research

A majority of the research was conducted in interviews with individuals connected to the affordable housing industry through both private and public channels. These interviews included several for-profit development firms of varying sizes, geographic concentrations, and historical focus, as well as Bridge Housing Corporation, a non-community based non-profit housing development firm. Discussions were held with housing specialists from various local governmental agencies as well as from the State government. Finally, interviews were held with lenders actively involved in affordable housing.

Thesis Organization

Though housing policy has significant influence on determining the feasibility of the for-profit firm's involvement in affordable housing development, the research is presented from the perspective of the developer, primarily in terms of its strategic options, rather than as a review and assessment of national policy. Chapter I briefly describes the magnitude of the need for affordable housing product in California and its resulting consequences on the State's livelihood. Most of this chapter is dedicated to discussing the complex institutional framework within which the developer must operate to successfully build affordable housing. Chapters II, III, and IV are written around the central theme of the research; the role of the for-profit developer in affordable housing. Here, three case studies are presented which involve mixed-income affordable housing projects currently in planning or under construction. The first study involves a suburban rental project in Orange County, sponsored by a joint-venture of private for-profit and non-profit firms. The second study involves a similar joint-venture in the development of a mixed-income single-family home and multi-family rental development on the fringe of San Jose. The third study involves the replacement of an urban public housing project by a for-profit firm under a development agreement with the City of Los Angeles. Chapter V, the conclusion presents a synthesis of the case studies and the primary research in the form of a strategy outline. Here, the role of, as well as the prospect for, the California for-profit-developer in the affordable housing sector is clearly defined.

CHAPTER ONE

WORKING THROUGH THE INSTITUTIONAL MAZE

The Need

California has among the most serious housing problems in the country. For more than a decade, a failure to produce an adequate supply of housing at affordable prices has left the State with homeownership costs almost twice the national average and rental costs among the highest in the nation. According to the State Department of Housing and Community Development (HCD), to accommodate the projected growth for the 1990's, California will need approximately 300,000 new housing units per year. Of this, 40% (120,000 units per year) should be affordable to low-income households (i.e. those earning less than 80% of the median income of the area in which they live). During the last decade, an annual average of 210,000 housing units were built statewide; and best estimates show that less than a quarter of those homes were affordable to lower income households.[1]

According to HCD, in addition to the current requirement for new housing, current residents also have pressing housing needs. In 1990, less than one in ten renters could afford to buy a new home, and over two million lower-income households were spending more than a third of their income on housing. In addition, 19.6% of the renters in California were living in overcrowded conditions, a measure of housing inadequacy which has doubled since 1980, after several decades of decline. Finally, 1.37 million houses or apartments (13% of all housing units) in California need rehabilitation or replacement.[2]

This affordability crisis no longer impacts just the very poor. It is now an acute problem for most of the workforce. The problem confronts teachers, police officers, firefighters, nurses, commercial and industrial workers, entry-level professionals. It is a problem of both the young and the old. Furthermore, it is even a problem of for the relatively affluent middle-aged homeowners, who often must confront both the housing needs of their grown children as they form new families, and of their elderly parents who are trapped on fixed incomes.[3]

Businesses, as well as consumers, suffer from the scarcity of reasonably priced homes. As households migrate away from California to regions with more affordable housing, the competition for qualified employees increases, as well as the pressure to raise salaries to accommodate housing costs, and to compensate for long, costly, and often fatiguing commutes. Employee turnover and dissatisfaction increase, and labor efficiency decreases. Gridlocked freeways in southern California and in the Bay Area are clogged with frustrated and angry long-distance commuters, who are wasting gasoline, polluting and degrading air quality, and demanding huge investments of investments of public and private funds in new highways, transit systems, and parking facilities. In a vicious cycle, many of these same people believe that only and end to job growth and a moratorium on new housing can solve the problem, resulting a more difficult setting in which to develop affordable housing.[4]

Carrots and Sticks

As evidenced above, the housing crisis in California is now a concern of all factions of the population. At the same time, the most severe real estate credit-crisis since the Great Depression is taking place. Moreover, federal support of affordable-housing is at its lowest level in decades-HUD's budget is 20% of what it was twelve years ago[5]. As a result of these phenomena, housing policy at the State level is receiving increasingly more attention. That policy is carried out through a complicated system involving the use of the state's zoning enabling powers, the administration of the remaining federal subsidy programs, and the implementation of state-level subsidy and incentive programs. This system in place and growing in complexity, in combination with what is currently a demanding lending environment, produces a complex maze through which a real estate developer must maneuver to successfully develop affordable housing. The following is a description of this "carrot and stick" framework from the perspective of the private real estate developer. First is a summary of pertinent State legislation. Second, a synopsis of the current real estate lending environment. Finally, an outline of relevant subsidies available at all levels of government.

I. State Housing Legislation

State Housing Element Law:

To ensure that all levels of government adequately respond to these serious needs, state law (adopted 1980) requires each city and county to adopt a "housing element" as part of its general plan. A general plan must contain at least seven elements relating to; land use, circulation, conservation, open space, noise, safety, and housing. Of the seven, only the housing element is subject to mandatory review by a state entity; HCD.[6]

Definition:

As required by the state, "the housing element shall consist of an identification and analysis of existing and projected housing needs and a statement of goals, policies, quantified objectives, and scheduled programs for the preservation, improvement and development of housing. The housing element shall identify adequate sites for housing, and shall make adequate provision for the existing and projected needs of <u>all economic segments</u> of the community."[7]

Compliance:

Despite legislative direction to local governments and technical assistance provided by HCD, most cities and counties in California do not have a housing element in compliance with State law. Of 509 cities in California required to have housing elements, as of December 31, 1991, 107 (21%) had adopted elements which HCD found to be in substantial compliance.[8]

However, in the last few years, the number of housing elements reviewed by HCD has increased dramatically. For example, in 1988 HCD reviewed a total of 80 elements, 203 in 1989, and 286 in 1991.[9] In fact, as of this writing (July, 1992), it is estimated that over 30% of all municipalities have adopted state approved elements. This expression of increased local attention to housing issues appears to reflect the seriousness of California's housing problems, changes in housing element law, increased advocacy and litigation on housing element issues-as the federal role in housing policy diminishes, and/or municipalities' compliance with their Comprehensive Housing Affordability Strategy (CHAS) to gain access to federal CDBG and HOME funds.[10]

State Law in Response to Non-Compliance:

This failure of cities and counties to articulate and carry out housing policy seriously hinders the development of needed housing in California. In 1990, the State Legislature recognized the situation in passing anti-exclusionary zoning laws.

Essentially, this law prohibits local agencies from disapproving low- and moderate-income[11] housing developments, or from conditioning project approval in a manner which would make projects infeasible for development, unless certain findings are made.

If the locality's adopted housing element is not in compliance with state law, then development can, under certain circumstances, override local zoning. If such a project is denied approval, or restrictions are placed on it which adversely affect its viability or affordablity, and the decision is challenged in a court action, the burden of proof is placed on the locality that the decision is consistent with the findings. This law however, has not had wide spread application.[12]

Housing Element Litigation:

A locality's non-compliance with housing element law renders its general plan inadequate and leaves the locality exposed to legal challenges which could limit its ability to issue building permits, institute zoning changes, establish a redevelopment project area, or carry out other general policies. Increasingly, housing advocates and neighborhood groups have successfully used housing element litigation to have plans, programs, and even housing projects stalled or stopped.[13]

Litigation by private parties or the Attorney General's Office is the only available enforcement mechanism for housing element law. However, such an implementation is costly. Direct incentives for local governments' compliance is limited to state administered CDBG funds (which only applies those cities with populations of under 50,000). Aside from those mentioned above, there are no serious sanctions for those who do not comply.[14]

Regional Share:

Housing Element Law statutorily mandates councils of governments (COG's), or in areas without COG's, HCD, to prepare regional housing needs plans (RHNP's) for the localities within the region. These regional plans provide cities and counties with a measure of their share of a region's projected need by household income group over the approximately five-year planning period of the housing element.[15]

COG's are voluntary agencies which carry out a broad range of regional planning programs, including housing. A COG's jurisdiction can range from part of a county to multi-county. Given their regional perspective, COG's are well suited for preparing fair growth allocation plans. However, they must rely on the cooperation of the municipalities for the acceptance and implementation of their plans.[16]

Localities are required to provide for their share of the regional housing need within their housing elements. The numerous localities which lack proactive housing policy often rely on this allocation as the core of their housing elements.

State Density Bonus Law:

Adopted in 1980 and modified in 1989, to make affordable housing development more feasible, the Density Bonus Law requires all cities and counties to adopt ordinances which entitle qualified mixed-income housing projects to density bonuses. As of 1990, housing projects of 5 units or more in which for a period of at least 10 years, a minimum of 20% of the units are set aside for low-income households, 10% for very-low income[17] households, or 50% of the units for certain classifications of senior citizens, qualify for a bonus of 25% of the maximum density per the existing zoning. In lieu of the increased density, the municipality may provide the developer with direct financial assistance, fee waivers, or other means of compensation in amounts equivalent to the forsaken benefits attributable to the hypothetical density bonus.[18] [19] Calculating the exact compensation can be a complex process, as it involves mutual agreement of extensive site-planning and financial analysis.[20] A developer which agrees to restrict rents for a 30 year period is entitled to the density bonus and additional concessions such as reducing site development standards or design requirements.[21]

Enforcement of the provisions of the law is subject to the courts. In all cases, by law, the developer carries the difficult burden of establishing the need for the bonus.[22]

Prior to an amendment to the law in 1989, the bonus was aimed at the low- and moderate- income segments. Although adoption was not required, at least 20 jurisdictions utilized the system, typically in conjunction with 80%-20% bond issues[23]. Subsequent to 1989, there has been a significant increase in the number of municipalities adopting density bonus/inclusionary zoning ordinances. However, actual development activity under the amended bonus law has been limited, likely due to the ongoing recession and the newly imposed rent restrictions which target the very low- and low-income population segments.[24]

II. Real Estate Lending Environment

The following discussion summarizes the status of the real estate lending markets from the perspective of the affordable housing developer. As maintained throughout the thesis, access to capital is the most critical element of a successful development.

The Real Estate Credit Crunch:

The real estate "boom" turn bust of the past decade has resulted in substantial financial damage to the lending industry. Various analysts say banks and thrifts could lose as much as 20% of the value of their real estate portfolios, and therefore, almost half of their net-worths. As a result, those lending institutions (banks and insurance companies included) involved in real estate have received increasingly more skepticism from Wall street, where real estate is categorically perceived as a risky business.[25] In addition, several federal regulations were adopted in 1989 under the Financial Institutions Reform and Recovery Enforcement Act (FIRREA), primarily in response to the S&L crises of the late 1980's. FIRREA entailed several regulations including more stringent guidelines on real estate underwriting, loan audits, and loan loss-reserve requirements.[26] [27] The Act also removed thrifts from development lending. Though a minority of lenders continue to solicit real estate business, in general, most have significantly decreased their real estate lending activity in response to the pressure from Wall Street and exhausting demands of federal regulators.[28]

Pressure on the Financing Side - The CRA:

Despite the pressure to stay away from real estate lending, certain commercial banks and thrifts (savings banks, S&L's, and credit unions) are motivated by the CRA regulations to be actively involved in financing low- and moderate-income housing.

The CRA of 1977 affirmed the concept that banks and thrifts, as publicly chartered institutions, have a continuing obligation to help meet the credit needs of the communities in which they do business. In particular, CRA asks lending institutions to actively make efforts to serve low- and moderate-income households in their service areas, which includes extending credit for affordable housing.[29]

Incentive to Respond to CRA:

As of 1989, federal agencies are required to assess CRA records in evaluating applications involving branch transactions as well as mergers and acquisitions made by lending institutions.[30] With the growth of interstate banking and the rise of mergers and consolidations in the 1990's, community reinvestment performance is becoming increasingly important.[31] However, as long as lenders are pressured to stay out of real estate credit, it appears that in general, considerable CRA-related real estate lending will be limited to those institutions actively involved in mergers or acquisitions.

Affordable Housing Lending Consortiums:

Many larger institutions as well as community banks in California are internally staffed to underwrite loans for affordable-housing developments. In addition, two consortiums of lenders in California; SAMCO and CCRC, operate as mortgage banking entities to allow thrifts and banks respectively, to outsource a portion of their community reinvestment lending. These organizations are familiar with the complexity of affordable housing projects and allow member institutions to pool the risk (real or perceived) of affordable housing loans, reducing the exposure of any one institution[32].

Savings Association Mortgage Company (SAMCO):

SAMCO is a mortgage banking organization which pools funds from its California savings and loan member institutions and provides permanent financing for low-income housing. Although SAMCO was founded prior to the CRA, its membership has increased dramatically since 1989 due to the lending industry's need to respond to the regulations set out by FIRREA.

In 1991 SAMCO wrote loan commitments for 1,329 units totaling $37.7 million. Approximately 25% of these commitments were made to projects sponsored by for-profit owners. SAMCO requires 51% of a project's units to be set-aside for households earning 80% or less of area median income. Loan terms are 30 years with a maximum of 75% loan-to-value. SAMCO's interest rates, competitive with the "market", are set at the time of funding. Responding to strong borrower demand, SAMCO is currently engaged in the formation of a secondary market for portions of its loan portfolio.[33]

California Community Reinvestment Corporation (CCRC):

The CCRC was created in 1989 to provide California banks with a vehicle to serve the affordable housing market. Forty-six banks provide the consortium with a total pool of over $100 million to make permanent loans for new construction or substantial renovation.[34]

CCRC requires minimum affordability set-asides of 20% of a project's units for households earning 50% or below area median income, 40% for households earning 60% or below, or 51% of the units reserved for households earning 80% or below the area median income. Loan terms are 10, 15, or 30 years with competitive interest rates.[35]

III. Subsidies

The following is a summary of those federal, State, and local subsidy programs most often utilized in the development of affordable family housing by for-profit developers.

Subsidies Administered at the State Level:

Low Income Housing Tax Credits (Rental Property):

In December of 1991, the US Congress extended the Low-Income Tax Credit Program (LIHTC) for an additional six months, requiring a "final" allocation by June 30, 1992. As has been the case over the course of the program, in fiscal 1991-1992, the State of California allocated 100% of its federal credits, $37.875 million ($1.25 per capita).

Additionally, the State allocated $35 million of its state credits. As of this writing, the House of Representatives has passed an urban-aid bill which will include an extension of the LIHTC. The Senate is expected to approve the same shortly.[36]

The applicable credit rate for new construction is 9% per year (of qualified basis) for 10 years for projects without tax exempt bond financing, and 4% per year for those with tax exempt financing. Credits can be used by the owner or sold up-front with the proceeds of the sale used toward project equity. On a sale basis, tax credits typically generate $.50 in equity for every $1.00 in credits.[37]

Sponsors of 100% restricted projects can expect to finance 40%-50% of development costs by selling 9% credits. IRS regulations limit front-end developer fees to 15% of the project's depreciable basis, 10% for those projects utilizing HUD assistance.[38]

The California State Credit Allocation Committee, the state agency responsible for administering the LIHTC program, was able to give credit reservations to 86 of 152 applicants in the June, 1992 allocation. Approximately 30 of the 152 applications were deemed ineligible or incomplete. Historically, about 1/3 of the applicants have received reservations. Over the past few years, the reservations have been granted approximately 50% to for-profit, and 50% to non-profit sponsors.[39]

Qualifying projects must set aside a minimum of 20% of the project's units for households earning 50% or less than area median income, or 40% of the units for households earning 60% or less of median income. (The actual low-income set-aside ratio is applied to qualifying project costs to determine the "qualified basis" from which the 9% and 4% credit calculations are generated). Rent and utility payments for these tenants are limited to 30% of tenant's gross income. In addition, all applications are required to meet five basic requirements: (1) a demonstrated "housing need" in the local area - i.e., as evidenced by the CHAS study, (2) demonstrated site control (3) enforceable permanent or construction financing commitments for at least 50% of the project's total estimated need, (4) local zoning approvals (a variance or CUP may be in process), and (5) sponsor development and management experience.

Projects being financed with tax-exempt bonds automatically receive a federal-credit reservation upon satisfying the five basic threshold requirements (if evidence of a bond allocation is produced in lieu of No. 3 above). All other projects, including tax-exempt bond projects, applying for state-credits are subject to a competitive ranking system. This system gives preference to projects serving residents with the lowest incomes, to projects serving qualified residents for the longest time period (30-55 years), and to those projects where local agencies or the project owner makes significant financial contributions (minimum of 15% and 30%

respectively) to the project. With fierce competition for the credits in California, most projects which receive credit reservations have nearly perfect profiles in terms of the ranking criteria.[40]

California Rental Housing Construction Program (RHCP):

In a response to cutbacks in Federal subsidies, in 1988, California voters approved initiatives for the issue of $550 million in general obligation bonds to provide financing for the construction and rehabilitation of rental housing for the very-low income. The last of these funds was allocated in June of 1992. Although an additional issue is being proposed in the State Senate, the fiscal problems in California may prevent an extension of this program any time soon.[41]

Funds are eligible for any costs associated with project development. The loan term is 40 years at a rate of 3% simple interest. Payments may be deferred for the economic feasibility of the project. Principle and interest is due 30 years from funding. Under the RHCP, for a term of 40 years, at least 30% of all units must be held affordable[42] to low- and very-low income persons and at least two thirds of assisted units set-aside for very-low income persons.[43]

The competition for these funds has been fierce. In a typical round of funding, approximately 25% of applicants have received allocations. Projects are ranked in a competitive system with preference given to those containing more family (three- and four- bedroom) units and a high level of municipal involvement. In terms of the funding record, non-profit sponsors have received the majority of the allocations.[44]

Tax-Exempt Mortgage Revenue Bond Financing:

Tax exempt bond financing is administered by the California Debt Limit Allocation Committee. This department receives an annual "state ceiling" from the federal government on "private activity bonds". Private activity bonds are issued for a variety of public purposes, including construction and permanent financing for multi-family rental housing. In 1992 it is anticipated that only $48.9 million, or 6% of a total State ceiling of $786 million will be committed for multi-family housing production, as compared to $272 million (19%) in 1991 and $163 million (11%) in 1990.[45] During the last few years, all residential development bond financing requests have been addressed.[46]

In most cases, the local government having jurisdiction over the project combines efforts with the project sponsor, on a project to project basis, to apply to the State for an allocation. Once approved, the municipality issues the bonds at the local level. In terms of project criteria, a minimum of 20% of a project's units must be set aside and restricted for households earning less than 50% of area median income. In those years when bond requests exceed the State allocation, projects are ranked in terms of their affordability characteristics and term, the sponsor's financial stake in the project, and the needs of the project's locale.[47]

As a result of the tax-exempt status of the bonds, fixed interest rates are generally at least 2% below conventional mortgage rates. "Lower floater" bonds, bearing variable interest rates which adjust on a weekly basis, are more popular in the current credit climate with rates varying in the 1.5% to 2.5% range. Sponsors typically have the option to change these to fixed rate obligations on a bi-annual or annual basis. Most bond issues are for 10-15 year terms. The costs associated with issuing bonds make it economically unfeasible to use this type of financing for small projects.[48]

Before the bonds can be sold to investors and prior to the approving government agency finalizing the allocation, the bonds must have credit enhancement to provide them with a rating required by the syndicator. Credit enhancement is achieved through the issuance of a stand-by letter of credit from a commercial bank, third party mortgage insurance, surety bonds, or other third party guarantees[49].

Credit enhancement has become the most difficult element of bond financing. HUD does not have a program to insure variable rate bonds, currently the most economically attractive. Pension funds are concerned with the IRS issue of Unrelated Business Income.[50] Consequently, banks remain a primary source of credit enhancement. However, it has become increasingly more difficult to attract interest in this area: FIRREA calls for banks to account for LOC's in their balance sheets and therefore, to set-aside capital reserves for LOC's. Prior to 1989, LOC's were essentially underwritten as off-balance sheet assets.[51] Additionally, letters of credit do not present banks with CRA credits as clearly defined as within the context of strait construction or permanent loans.[52] Finally, as with strait mortgages, as a result of the standards imposed by FIRREA, banks have had to become more conservative in underwriting real estate related LOC's.

Subsidies Administered at the Local Level:

Sources of Local Funds: California municipalities access housing funds through several sources. A limited amount of federal HUD funds are allocated to cities and counties directly as well as through the State HCD. These include Community Development Block Grants (CDBG's), Section-8 rental subsidies, and funds through the new HOME program.

Larger pools of funds are raised locally through tax increments from redevelopment districts. Cities with redevelopment areas are allowed to "freeze" the tax-base of these areas and collect any subsequent increase in property taxes that result from development activity. State law, which has recently become more stringent, calls for cities to use a minimum of 20% of their tax increment funds to promote affordable housing. A city which fails to do so within a five year period, by law, is required to relinquish such funds to its County, which in turn, distributes the funds to other cities.[53]

Other sources of local funds include operating surpluses of redevelopment agencies and housing authorities, hotel-tax and commercial development linkage programs, grants, and bond issuance fees[54] [55].

Uses of Local Funds: Because municipalities are given freedom in terms of developing housing policy development to meet the needs of their locale, locally administered subsidy programs tend to vary in terms of project restrictions and application processes. Depending upon the city or county in question, housing programs are administered through the Housing Authority/Commission or Redevelopment Agency; both in the case of most larger cities. The following describes commonly found local programs targeted to family affordable-housing projects.

Acquisition Financing:

Local funds are often made available to provide for-profit and non-profit sponsors with funding necessary to purchase sites and prepare plans for affordable housing development. These funds typically take the legal form of subordinated, non-recourse mortgages. In actuality, to allow for maximum leverage, the residual character of their repayment obligations result in these funds appearing more as equity than debt.[56]

Construction Financing:

In addition to tax-exempt bond financing, which will typically absorb nearly all of a project's debt capacity, local funds are often available in smaller increments to fill the gap between the total project cost and its primary source of debt and investors' equity. These funds are also termed as subordinated debt and offer highly discounted interest rates and lenient repayment terms.

Single-Family Home-Purchaser Subsidies:

Local funds are often committed to a single-family home project to be used to subsidize first-time moderate-income home purchasers.

These funds are used to provide qualified purchasers with grants toward down-payments or "silent" second-mortgages. Grants are typically in the area of 2% of the total purchase price-40% of a down payment. Second mortgages range in the area of 5%-20% of purchase price. These loans typically carry no debt-service requirements and are repaid only upon the borrower selling the home within a specified time period. Cities also issue tax-exempt bonds to fund first-time homebuyers with discounted interest rates.[57]

Municipal Development Fee Reductions and Density Bonuses:

In response to cutbacks in federal housing subsidies, many cities are beginning to provide incentives for affordable housing development through the waiving of certain development fees and offering of density bonuses.[58] The City of San Diego for example, is in the process of developing an inclusionary zoning ordinance which will provide qualified projects with density bonuses, deferral of certain City Fees, narrower street-width, and smaller parking-stall size requirements in an effort to lower development costs.[59]

CHAPTER TWO

SAN RAFAEL APARTMENT HOMES

A PROJECT STUDY OF A MIXED-INCOME MULTI-FAMILY RENTAL DEVELOPMENT OF THE IRVINE COMPANY & BRIDGE HOUSING

The information presented in the following case study was obtained through interviews and written information provided by Raymond Watson, Vice Chairman, The Irvine Company and Richard Lamprecht, Vice President-Development, Irvine Pacific, Newport Beach, California.

SAN RAFAEL APARTMENT HOMES

General Description

Despite a massive slump in the area's real estate market, construction began in May of 1992 on a 15.1 acre site for Orange County's first new low-income rental housing project since 1989. San Rafael is being developed by a partnership consisting of the Irvine Company and Bridge Housing Corporation, a San Francisco based non-profit housing developer. The project reaches new ground in that it is both the Irvine Co.'s first joint-venture with a non-profit development firm and Bridge's first venture outside of the Bay Area.

Scheduled for completion in April of 1993 at an estimated total cost of $41.3 million, San Rafael will provide 134 units to very low-income households, 20 units to low-income households, 30 units to moderate-income households and 198 units at market-rates. The majority of the project's financing will come from a tax-exempt mortgage revenue bond issue approved by the Irvine City Council in the summer of 1991.

Site Location

San Rafael is located within the 833-acre planned suburban community of Westpark-Irvine's newest residential village and is bordered by Harvard Avenue to the north, San Juan to the east and San Leon to the southwest. The site is conveniently located near the San Diego Freeway (I-405) and Santa Ana Freeway (I-5), offering convenient access to many employment areas throughout Orange County. Shopping centers, entertainment, restaurants, the University of California, Irvine, and recreational facilities are in close proximity to the project.

Project Program

Upon completion, the project will consist of 28 two- and three- story wood frame and stucco buildings containing 382 apartment units at a density of 25 units per acre. Ten floor plans will range in size from 660 square feet one-bedroom flats to 1,365 square feet three-bedroom townhomes:

# BR's	Type	Sq. Ft.	# Units	Mix
1	Flat	660	44	11%
1	Flat	690	84	22%
2	Flat	1,040	24	6%
2	Flat	1,020	22	6%
2	Flat	1,090	48	13%
2	Flat	1,100	24	6%
2	TH	1,180	38	10%
2	TH	1,155	38	10%
3	TH	1,315	30	8%
3	TH	1,365	30	8%
		Totals	382	

Project amenities will include washer/dryer furnished in 66% of all units, on-site laundry facility, two large heated swimming pools, two outdoor whirlpool spas, garages, fitness center, and large tot lot play area.

Political Context

As most of the state, Orange County experienced significant economic growth during the mid and late 1980's. The city of Irvine in particular, in combining efforts with the Irvine Co. and the business community, was successful in attracting a substantial employment base during this time period. Residential development also occurred at a relatively slower pace. This phenomenon was due in part to local politics.

Throughout most of the 1980's, until the local election of 1990, a majority of City Council, including Mayor Larry Agran, vocally supported a slow-growth movement on new development, while silently supporting job growth. The result has been a growing disparity between jobs and population, approximately 150,000:110,000 as of this writing. With demand far outweighing the supply of housing, prices and rents have been driven up to levels far out of the affordability range of thousands of Irvine workers. Median apartment rents and single-family home prices in Irvine are approximately $900-$1,050 per month and $250,000, respectively.

In 1989 the City of Irvine's housing element was due for revision as required every five years by the State. During this same time period, the City was also receiving criticism from the Southern California Council of Governments for its failure to provide its allocated regional share of affordable housing. Agran's group pushed for what the Irvine Co. argued were dramatic, and economically unfeasible housing policy goals. This group pressed for the majority of 25% of the city's housing stock to be affordable to very low-income households, including the adoption of a rigid inclusionary zoning ordinance. According to the Irvine Co., almost all of the city's rental housing stock would require heavy subsidies.

Although the Irvine Co. was intent on providing affordable elements to its upcoming projects, management knew Agran's "goal" to be unrealistic from a financial perspective and rallied support from the Chamber of Commerce and the BIA to argue for its cause. Agran's group responded by denouncing the Irvine Co. for "opposing low-income housing".

With the election of a new mayor to office, the political climate switched directions in the midst of the debates. Consequently, City Council adopted a housing element with less stringent objectives. The new element calls for 1% of the city's housing stock to be affordable to households earning 30% or less than the county's median income (currently $52,200), 11.5% to those earning 50% or less, and 12% affordable to those earning 80% or less of area median income. Additionally, a flexible inclusionary zoning ordinance was put in place as part of the housing policy.

Motivation to Develop Affordable Housing

The Irvine Co. views San Rafael not only as response to the demands of local government and capital market conditions, but also as a profitable means to continue developing a balanced portfolio of housing.

As discussed, in an effort to meet the goals of its housing element, the City of Irvine is conditioning zoning approvals on inclusionary provisions for affordable housing. By restricting a greater number of units for very low-income households within San Rafael than required by the City, the Irvine Co. receives "credits" for inclusionary requirements, transferable to other sites within Westpark. Satisfying these requirements for other sites will enable the Irvine Co. to either sell or develop these parcels more profitably when market-rate development becomes more viable.

The state of the real estate and banking industry has resulted in most lenders being reluctant to underwrite any new development loans for commercial or market-rate residential projects. As is the case with San Rafael, the Irvine Co. believes lenders are somewhat less reluctant to extend credit (in this case credit-enhancement) to affordable housing projects, where market risk is relatively low.

Third, Donald Bren, Chairman of the Irvine Co., strongly supports the continued development of multi-family rental product for the company's portfolio. The availability of favorable tax-exempt bond financing combined with financial subsidies for San Rafael result in a yield competitive with that which could be achieved through developing a 100% market-rate project with conventional financing. The insatiable demand for the restricted units significantly lowers the project's market-risk, resulting in a relatively attractive risk-adjusted rate of return.

Finally, of 10,000 apartments in the Irvine Co.'s portfolio, 2,500 are affordable-subsidized under Section-8 or other bond programs. Ray Watson, Vice-Chairman of the Irvine Co., is in favor of continuing to show his and the Irvine Co.'s commitment to providing a balanced housing stock.

Decision to Joint-Venture with Bridge Housing

Although the Irvine Co. has developed and owns a significant number of subsidized rental units independently, the status of the local political situation and Bridge's successful track-record of accessing scarce subsidies led to the decision to bring Bridge into a partnership.

Though the housing element was adopted prior to negotiating zoning approvals for the subject site, the Irvine Co. judged Bridge's involvement in the development to increase its credibility in dealing with the local agencies for project entitlements.

In terms of citizen opposition from "Not in My Backyard" (NIMBY) factions, the Irvine Co. had previously established a successful track record of developing subsidized housing within the context of the community. However, Bridge's experience in dealing with a wide variety of citizen groups could only be of benefit in the event of citizen opposition.

In terms of financing, the local, state and federal subsidies are becoming more scarce during the current depressed economic and fiscal times. The Irvine Co. believed non-profit participation within the partnership would allow it greater access to funds such as Community Development Block Grants and subsidized loans from the Orange County Housing Authority.

Land Lease

The Irvine Co. leased the 15.1 acre site to the joint-venture partnership (described below) for 35 years on a subordinated basis. As consideration, it will receive annual payments from excess cash flow in an amount equal to 8% of the current land value of $9.5 million. Lease payments accrue in the event cash flow is insufficient to satisfy the obligation.

By leasing the site to the partnership, the Irvine Co. avoids property tax reassessment of a sale, avoids sharing appreciation with outside-equity partners (which have not been involved in the project to date), and avoids extra legal work involved in structuring an option and sale transaction.

Partnership Structure

As mentioned, the partnership represents Bridge's first direct involvement outside the northern California market and the Irvine Co.'s first joint-venture with a non-profit developer. The two parties began discussions in late 1989 and came to a mutual agreement of the partnership structure in the summer of 1990. As described below, Bridge essentially plays the role of a consultant to assist the Irvine Co. with the public approvals and financing. The following summarizes the agreement:

Within the partnership, the Irvine Co. is responsible for day-to-day project planning and management duties. Its legal capacity is that of co-general partner (1% ownership interest) and sole limited partner (98% ownership interest). In addition to managing the project, the Irvine Co. pledges its fee title to the land as collateral for the bond financing and provides all required equity capital. In return, it receives tax-credit and depreciation benefits and any residual cash flow after debt-service in the form of ground-lease payments.

As discussed above, the Irvine Co's. primary motivation in approaching Bridge was to gain from the non-profit's political appeal and its accessibility to subsidies. Consequently, Bridge's responsibilities as "managing general partner"[60] (1% ownership interest) lay in the areas of public approval processing and obtaining funding. Bridge may also play a part in the management of the property upon completion of construction. In essence, Bridge takes the role of a consultant. In return for its involvement in the pre-development phase, Bridge will receive a developer' fee in the amount of $300,000.

Entitlements

As discussed, the subject site is one of the last few remaining parcels available for development in Westpark. Originally, the 15.1 acre site had been subdivided into three parcels, two commercially and one residentially zoned. In December of 1990, after completing Environmental Impact Reports (EIR's) and negotiating with the Planning Commission and City Council, the Irvine Co. received zoning approvals on all remaining parcels within Westpark. This "master" zoning approval included a flexible inclusionary requirement for affordable housing, which allows for the transfer of inclusionary credits. The Irvine Co. negotiated this zoning with the intention of fulfilling all of the lower-income requirements on the San Rafael site to allow for maximum flexibility in developing or selling the other Westpark parcels.

A site plan for San Rafael was developed with McLarand, Vasquez and Partners Architects and submitted for a Conditional Use Permit (a site plan approval) under the Bridge/Irvine Co. partnership in January of 1991. The as-of-right zoning for this particular site allowed for up to 31 units per acre without a density bonus. However, an overall allowable maximum density for Westpark, negotiated prior to the submittal of the site plan, precluded the Irvine Co. from attaining more than the 25 units per acre currently under construction.[61]

Aside from typical site-planning issues, the negotiation between the partnership and the Planning Commission was focused on defining the magnitude of the affordable element which would satisfy requirements for all remaining residential sites in Westpark. Although the baseline calculations were broadly determined during the prior zoning negotiations, according to the new housing element, the actual City-required affordable housing mix depends upon the amount of financial subsidies a project ultimately receives. Consequently, the negotiations focused on defining the logistics of this complicated process. The Partnership obtained a CUP in June of 1991 from the Planning Commission. The final affordability restrictions were determined several months later, after all subsidies were obtained.

Development Budget

Hard Construction Costs	
Common Area	$ 2,140,000
Direct-Sitework	1,057,000
Direct-Buildings	18,487,000
Total Hard Costs	$22,484,000
Soft Construction Costs	
Indirect-Buildings	$ 2,728,000
Indirect-Sitework	1,515,000
Marketing	350,000
Finance	2,470,000
Developer Fee-Bridge	300,000
Developer Fee-Contractor	515,000
Total Soft Costs	$ 7,878,000
Contingency (3%)	929,000
Total Project Cost	$31,291,000
Total Cost per Sq. Ft.	$80.88

Financing Program

Summary of Sources:

(1) Tax-Exempt Mortgage Revenue Bonds	(Debt)	$28,000,000
(2) Orange County Housing Authority	(Debt)	1,350,000
(3) City of Irvine CD Block Grant	(Debt)	700,000
(4) Irvine Co. Tax Credit Purchase	(Equity)	1,750,000
(5) Land at Market Value	(Equity)	9,550,000
Total Capital		$40,350,000

(1) Tax-Exempt Bond Financing:

$28 million, 12 year term, 1st year "lower floater" status, years 2 - 12 fixed at 7.5% interest, credit enhanced by Sumitomo Bank, 1% origination fee, .075% annual guarantee fee.

In an effort to support the drive for affordable housing, the City Council approved a $28 million tax-exempt bond issue one month after the project received a CUP. The approval was expected as a result of informal discussions which had occurred with the City during project planning. However, to vote on the issue, the City Council required that all non-administrative land-use approvals be in place. With the bond issue approved, the condition of the real estate lending market resulted in the Partnership requiring several months to obtain a commitment to provide credit-enhancement. After six months, the Partnership received a commitment from Sumitomo Bank to provide a letter of credit. This would be Sumitomo's first involvement in the affordable housing market. One of the few remaining banks with a high credit rating, Sumitomo was attracted to the project as an onslaught to providing assessment-district financing to the Irvine Co.. The Irvine Co. agreed to pledge its fee interest in the land, valued at approximately $9.5 million, as additional collateral. Sumitomo conditioned its commitment on the provision that all other capital sources be committed to the project.

To gain federal tax-exempt eligibility, the Partnership was required to set aside at least 20% of the units (77) for households earning 50% of area median income or less, for a term of 10 years. In setting aside 35% (143) of the units for very low-income households, the eligibility requirement was satisfied.

(2) Orange County Housing Authority Development Loan:

$1.35 million, 20 year term, 4% fixed interest rate, interest payments deferred years 1-3, principle payments deferred years 1-7.

The Orange County Housing Authority accessed surplus funds from its operating reserve to provide this construction and permanent loan. The processing time of approximately eight months ran concurrent with project approvals. The Authority's allocation was not contingent on other financing commitments. Additionally, it did not impose specific affordability restrictions on the project, but relied on those required to obtain tax-exempt bonds and low-income tax credit allocations.

(3) City of Irvine - Community Development Block Grant:

$700,000, 10 year term, 3% interest rate, principal and interest payments deferred years 1-5.

Although these federal funds are very scarce nationally, the City of Irvine was in a unique position of needing to seek out eligible project sponsors in order to allocate its share of the block grant funds. As a result, the Partnership was able to obtain the block-grant commitment upon receiving project approvals. The processing time was under six months and also ran concurrent with project approvals. The city of Irvine depended upon the affordability restrictions set forth in the bond financing and low-income tax credit allocation guidelines.

(4) Federal Low-Income Tax Credit Allocation:

$625,000 annual credits for 10 years, based on 4% of approximately $15 million in qualified basis.

Because the San Rafael was financed with tax-exempt bonds, the Partnership received its 4% federal credit reservation without having to enter a competitive ranking process. The Irvine Co. contracted with Merrill Lynch to syndicate the credits. However, at this time, it appears that the Irvine Co. will hold them internally. In the event the Irvine Co. decides to sell the tax credits, the "market value" would be in the range of $2.23 million to $2.62 million, based on an internal rate of return on the annual benefits of approximately 25%.

Rental Income Summary

Affordability Summary

Floorplan	Bedroom Count	Total Units	Units Affordable V.L.	Low	Mod.-2
A	One	44	15	2	3
B	One	84	29	4	7
C	Two	32	11	2	8
D	Two	22	8	1	2
E	Two	48	17	3	4
F	Two	16	6	1	1
1	Two	38	13	2	3
2	Two	38	13	3	3
3	Three	30	11	2	2
4	Three	30	11	2	2
	Totals	382	134	20	30
	Percent of Total		35%	5%	8%

Rental Summary

Floorplan	Bedroom Count	Market	Rent Levels V.L.	Low	Mod.-2
A	One	$ 885	$525	$840	$1,260
B	One	885	525	840	1,260
C	Two	1,035	591	945	1,417
D	Two	1,035	591	945	1,417
E	Two	1,050	591	945	1,417
F	Two	1,050	591	945	1,417
1	Two	1,225	591	945	1,417
2	Two	1,225	591	945	1,417
3	Three	1,325	656	1,050	1,575
4	Three	1,325	656	1,050	1,575

Projected First Year Income and Expense Summary:

Revenue	
*Net Rental Income	
Market Rent Units	$2,411,000
Income Restricted Units	1,501,000
Other Income	20,000
Total Revenue	3,932,000
Operating Expenses	
Management and Administration	347,000
Advertising and Promotion	50,000
Maintenance - Buildings	305,000
Maintenance - Grounds	158,000
Utilities	125,000
Property Tax/Mello Roos	320,000
Assessment District	85,000
Management Fee	154,000
Total Operating Expenses	1,544,000
(As % of Total Revenue)	39.3%
Net Operating Income:	$2,388,000

* Based occupancy rate of 99% for low-income units and 95% for moderate and market-rate units.

Profitability:

In analyzing the financial feasibility of San Rafael, the Irvine Co. measured the projected financial outcome of the San Rafael in its current program against that of a 100% market-rate rental project of the same physical characteristics. The examination concluded that the mixed-income program would be equally as profitable as a market-rate program. The following summarizes this analysis:

Profitability Analysis

	Current Project	100% Market Rate
Project Investment:		
Land at Market	$9,550,000	$9,550,000
Building Costs	28,600,000	28,600,000
Finance Costs	2,600,000	2,500,000
Lease-Up Costs	600,000	1,000,000
Total Investment	41,350,000	41,650,000
Project Financing:		
Conventional Loan	0	26,500,000
Land (Equity)	9,550,000	9,550,000
Tax-Exempt Bonds	28,000,000	0
Subsidized Loans	2,050,000	0
Total	39,600,000	36,050,000
Cash Required	1,750,000	5,600,000
Financial Ratios:		
Overall Yield	6.3%	7.9%
Return on Cash (Avg. Yrs 1-5)	9.1%	9.7%
Internal Rate of Return		
Pre-Tax	12.5%	13.3%
After-Tax	15.7%	15.0%

Profitability measures are based on the following additional assumptions:

(1) Occupancy rates of 99% for very low- and low-income units, 95% for moderate-income and market-rate units
(2) Annual income and expenses increase at 4%
(3) Conventional financing at 9.5% interest rate
(4) Holding period of 30 years; zero reversionary income
(5) Equity = land at market plus cash contributed
(6) Irvine Co. utilizes 100% of tax-credits

As evidenced above, the mixed-income program is projected to achieve an after-tax yield greater than that from the hypothetical market-rate project. This is primarily attributable to the high level of low-cost financial leverage and tax-credit benefits attainable under the mixed-income program. Though difficult to quantify, the affordable nature of San Rafael results in a reduced exposure to market associated risk, increasing the project yield on a risk-adjusted basis. Additionally, the satisfaction of inclusionary requirements for other developable parcels within Westpark will have a positive effect on the overall profitability of the Irvine Company.

Looking Back

The Irvine Co. is generally pleased with the progress of the San Rafael project. In hindsight, it would have become more familiar, earlier in the process, with the financial intricacies of the tax credit; specifically, the accounting of the "qualified basis" calculation. In the writer's opinion, one of the most strategic decisions made in the course of the development process was that of bringing Bridge Housing to the project. In the tense political climate, the Irvine Co. could only benefit from the added credibility that an experienced non-profit brings in dealing with the public officials.

CHAPTER THREE

<u>WINFIELD HILL</u>

A PROJECT STUDY OF A MIXED-INCOME SINGLE FAMILY HOME/MULTI-FAMILY RENTAL DEVELOPMENT OF MARTIN DEVCON PROPERTIES AND BRIDGE HOUSING CORPORATION

The information presented in the following case study was obtained through interviews and written information provided by William Fleissig, of Martin Devcon Properties, San Jose, California.

WINFIELD HILL

General Description

In a push to narrow the widening gap between local housing costs and personal income, the San Jose City Council voted overwhelmingly in June of 1992 to approve the nearly $50 million Winfield Hill mixed-income residential project in Almaden Valley. Winfield Hill is an undertaking of Martin-Devcon Properties and the non-profit Bridge Housing Corporation. Martin-Devcon is joint venture of The Martin Group and Devcon Construction, Inc. The Martin Group, has become one of the largest development companies in the Bay Area with a total portfolio exceeding $1 billion. Devcon, the largest construction firm in Santa Clara County, has been a major factor in the growth of Silicon Valley. Aimed at easing the city's affordability crisis, the project is targeted to families and individuals earning from $15,000 to $70,000 annually. The development consists of 84 single family detached homes priced between $215,000 and $240,000 and 144 rental units renting from $400 to $800 per month. Approximately 20% of the homes will be subsidized and set-side for moderate-income families. All 144 apartment units will be set-aside for very low- and low-income households.

Site Location

The Winfield Hill Site is located on Winfield Boulevard in the Almaden Valley area of south San Jose (Santa Clara

County), a prestigious residential neighborhood. The site is directly across from Lake Almaden Park, and a four minute walk to the Almaden Light Rail Station. A major shopping mall and four schools are located within a two mile radius of the site. The intersection of Routes (85) and (87) is situated under 1.5 miles from the site, offering convenient access.

Project Program

Upon completion, the project will contain both single-family detached and a multi-family rental components, the single-family element being the focus of this discussion. Overall, the project density will be 19.5 units per gross acre.

The singe-family element will consist of 84 detached homes on 7.25 acres (12 units per gross acres). Homes will range from 1,300 to 1,425 square feet situated on private, 3,760 square foot lots. Targeted for first time buyers, all units will feature 3 bedrooms, 2.5 baths, and 1 or 2 car garages. This portion of the project will be built in phases of approximately 20 units, depending on market conditions, with the first phase scheduled to break ground in March of 1993 and to become available for occupancy in July of 1993.

The multi-family rental element will contain 144 apartments on approximately 4.5 acres (32 units per gross acre). One, two, and three bedroom units will be marketed to low- and very low- income renters. A play area, community house, swimming pool, and possibly a day care facility will be shared by renters and home owners. The multi-family element will built in one phase which is scheduled to break ground in March of 1993 and become available for occupancy in March of 1994.

Political Context

In the San Francisco Bay Area, San Jose included, housing affordability problems are among the worst in the nation. The high-tech boom of Silicon Valley in the early 1980's resulted in substantial employment growth and demand for housing in Santa Clara County and throughout the Bay Area. Although Bay Area prices were high prior to this period of growth, the increased demand for housing combined with extremely restrictive growth and land-use regulations imposed by many communities, pushed home prices and rents to even higher levels.

The city of San Jose has been relatively responsive to the affordability crisis. However, up until recently, most of its efforts have been geared toward providing for the moderate income-households (80%-120% of area median income), as opposed to low- and very low-income households. In an effort to respond to this situation as well as to growing concerns about traffic congestion, in the spring of 1991 the city council adopted a Housing Initiative Study conducted by the San Jose

Planning Department, which called for promoting mixed-income housing development in close proximity to transit stations. Additionally, the initiative called for the dispersion of low-income housing outside of its traditional city core location. This theme carried over into the city's recently adopted housing element of its General Plan. The end result of this policy was a local government very much in support of mixed-income housing development on the urban fringe, such as the Winfield Hill project.

Motivation to Develop Affordable Housing

As discussed, both The Martin Group and Devcon Construction are from commercial development backgrounds. In becoming involved in affordable housing development, both firms are responding to a severe slowdown in the commercial development sector and tightening capital market conditions.

In terms of the capital markets, financing for acquisition and development of commercial and market-rate residential projects is scarce. The Martin Group believes this situation will persist for several years but believes projects containing affordable housing elements will attract lenders seeking to receive CRA credits.

In terms of risk, the insatiable demand for affordable housing eliminates the market-oriented risk associated with most development. Likewise, affordable housing projects carry relatively heavy political risk during the pre-development stage in terms of obtaining entitlements. The Martin Group is in favor of "exchanging" the "back-end" market risk for the "front-end" political risk. According to Martin, the financial consequences associated with a failed completed project are typically much more severe than those associated with a failed proposed project. Additionally, in contrasting urban infill sites to outlying suburban sites, The Martin Group believes the former to carry significantly less political risk, and will continue to concentrate its efforts in this area.

views its entrance into the affordable housing business as not only a response, but part of a solution to the commercial property market problems plaguing northern California. believes that over the long-term, its contribution to an affordable housing stock will at least in part, help to create demand for commercial construction through its positive effect on local employers and the economy.

Decision to Joint-Venture with Bridge Housing

As of this writing, The Martin Group is working in partnership with Bridge Housing on six developments in the Bay Area. The Martin Group believes the non-profit status that Bridge brings to the partnership to be a necessary element to Martin's involvement in affordable housing development.

In terms of financing, Martin Devcon judges a non-profit status to offer an advantage in accessing federal, state and local funds, necessary in funding any affordable housing project. As discussed in further detail below, the joint-venture partnership, Winfield Partners, financed the entire land acquisition and pre-development expenses of $8.25 million with funding from San Jose's tax-increment pool. This local subsidy allows Martin Devcon 100% project financing.

With regard to entitlements, although Martin Devcon played an active role in the public approval process associated with Winfield Hill, it recognizes the credibility Bridge generally has with local governments as an experienced non-profit with a proven track-record. As outlined below, the city of San Jose was in support of the housing that Winfield Hill would offer. Consequently, although Bridge was actively involved in obtaining project entitlements, its role in this process was less crucial than that associated with projects in other locales.

Bridge's Motivation to Joint-Venture

Before outlining the structure of the Winfield Hill Partnership, it is important to briefly note Bridge's motivation behind the joint-venture arrangement:

In an environment where demand far outweighs supply of affordable housing, Bridge's primary goal is to provide the communities of the Bay Area with the greatest number of units possible through leveraging its resources. Since the work involved in completing small projects is virtually equal to that associated with larger developments, the easiest way to achieve this goal is through building large-scale projects.

At the local level, for the same reasons as Bridge, municipalities responding to the affordability crisis and State housing element law are also in favor of producing large blocks of housing. However, they recognize from a political standpoint that communities are significantly more receptive to projects which act to disperse the lower-income households among other segments of the population. As a result, local officials are promoting large-scale, mixed-income developments.

The above considered, Bridge's goals are most efficiently achieved within the context of a mixed-income development by partnering with a financially sound for-profit developer ultimately responsible for the moderate and/or market-rate portion of a project. The financial strength of the partner will typically allow it to access financing on a scale that Bridge is unable to independently. Although not stipulated under the Winfield Hill agreement, in certain cases, the for-profit partner may carry the majority of a project's risk in guaranteeing construction financing for the entire project.

The following is a brief outline of the Martin-Devcon/Bridge partnership agreement.

Partnership Structure

Prior to taking control of the Winfield site, Martin-Devcon had been pursuing other projects with Bridge in Santa Clara County. As mentioned, The Martin Group and Bridge are involved in several developments together and consequently have had the opportunity to become familiar with each other's operations. Consequently, partnership agreement evolved with the progress of the project.

As mentioned, Martin-Devcon's primary motivation for partnering with Bridge was to gain access to subsidies and foster the public approval process. With these and Bridge's goals under consideration, the partnership agreement was structured to allow the partnership (Winfield Partners) to obtain the local subsidies and project entitlements as a single entity. After this is achieved, the partners are required to take sole responsibility for their respective project elements.

Technically, the partnership agreement reads to the affect that "the partners will jointly develop and master-plan the project through the time at which a Planned Development permit (PD) is issued." The PD is issued upon the city giving its final approval of the subdivision map, the last approval required before the site can be legally subdivided. According to the agreement, the site will then be divided into two parcels, Martin-Devcon taking title to the single-family home site, and Bridge taking title to the multi-family rental site.

Upon "separation", each party therefore has the responsibility of independently raising required additional financing for, and managing its piece of the development. A stipulation was included to allow the parties, under certain conditions, input into site-plan modifications made by the other party subsequent to the separation of the project. Additionally, a joint-use agreement will be executed outlining the responsibilities of each party (Bridge and the future homeowner association) with regard to the maintenance and use of the common areas. Although many of Bridge's mixed-income joint-venture agreements call for the for-profit partner to subsidize Bridge's low-income element from profits derived from the for-profit's portion of the project, the Winfield agreement relieves both parties from any further financial obligation to each other upon separation.

Site Acquisition

Martin-Devcon approached the previous land-owner in July of 1991 and reached agreement on a letter-of-intent in September, 1991. The Seller is a partnership which obtained the site from Avon Corporation with entitlements to build 360 elderly care units. The final purchase price agreed upon was $7.8 million. As part of this agreement, the general partner of the selling party is entitled to one third of the residual profits of Martin-Devcon's single-family home project. A contingency period into April of 1992 was agreed upon, at which time Martin/Devcon would begin to deposit non-refundable installments of $20,000 per month with the Seller until closing. Apparently, the Seller was responsible for debt service of $40,000 per month on the land. The sale is scheduled closed in July of 1992.

Entitlements

The approval process for Winfield Hill involved both land-use entitlements as well as approvals for the allocation of the local subsidies. The project received a negative environmental declaration, relieving the requirement for an EIR. Although the project fit within the existing zoning, the City required Planning Commission and City Council approval for Winfield Hill because of its PUD format. The following discussion, outlined chronologically, relates to both funding and land-use issues. A technical description of the local subsidies appears in the "Sources of Funds" section below.

As described above, the City Council adopted a Housing Initiative Study in the spring of 1991 which called for the development of low- and very low-income housing within a mixed-income context, dispersed outside downtown, in close proximity to transit stations. To implement this, in late August of 1991, the Housing Department published a Notice of Funding Available (NOFA) for such projects. City Council would allocate $20 million in subsidized loans at discounted rates through negotiations, to be leveraged, and used for land acquisition and pre-development expenses.

Martin-Devcon obtained control of the site in September of 1992. Upon producing a project program which fit within the existing zoning and directly responded to the Housing Initiative Study and the NOFA, Winfield Partners submitted its proposal to the Housing Department in September of 1991. In February Winfield received a "reservation of funding" for what was essentially 50% of the city's available funds-San Jose's largest development loan ever. In essence, this reservation set the requested funds aside until the project was presented to, and voted on, by City Council.

From the inception of the project, Winfield involved the highest level of review-staff in numerous planning meetings. The initial plan submitted to staff called for 292 units or 25 units per gross acre. The General Plan called for high density housing (12-25 units per acre). Additionally, the transit-close location and mixed-income program made the project eligible for Transit Corridor Zoning and Affordable Housing Density Bonuses, resulting in an allowable density of up to 40 units per acre. However, various site-planning constraints set forth in the City's development standards resulted in planning staff recommending to reduce the proposed density. With the project financially feasible at a lower density, Winfield Partners accepted most of the staff recommendations, aware of the importance of staff support in future hearings with the Planning Commission and City Council.

With broad-based support of the planning staff, the Housing Department, the Chamber of Commerce, the local Manufacturer's Association, the media, and the Almaden Valley Association (an umbrella organization of the project area's homeowner associations), Winfield Partners did not expect any opposition at the Planning Commission hearing. However, the homeowner's association of the adjacent "Willow Creek" subdivision appeared at the hearing to present its opposition to the mixed-income project, under the guise of wanting to preserve open space. The Planning Commission attempted to appease the opposition by lowering the project density. This change would only undermine the City Council's original objectives and increase the cost of the housing. Shortly thereafter, the City Council overturned this decision. In early June of 1992, the Council voted 7-2 to approve the project in its entirety and in late June, 11-0 to allocate the city funding. The City Council viewed the project as a direct response to the goals and objectives of the City's housing policy.

Development Budget

The remainder of the discussion will be focused on the strategy behind the development of the single-family home portion of the project, being managed by Martin Devcon. The following is a preliminary breakdown of project costs:

Development Costs

Description	Per SF	Per Unit	Total
Land - 7.25 Acres			
@ $15.38/SF	$42.50	$ 57,857	$4,860,000
Construction			
Building	52.50	72,037	6,015,188
Site/Off-site	17.50	23,809	2,000,000
Contingency (5%)	3.50	4,771	400,759
Total Construction	73.50	100,189	8,415,947
Indirect Costs			
* A/E	1.83	2,500	210,000
City Fees	11.40	15,500	1,302,000
Other Ind.'s.	0.61	833	70,000
Total Indirect Costs	13.84	18,833	1,582,000
Soft Costs			
* Legal/Acct.	0.44	595	50,000
* Security/Maint.	0.66	893	75,000
Insurance/Bonds	0.88	1,190	100,000
* Title/Closing	1.00	1,369	115,000
Developer Overhead	4.38	5,952	500,000
Property Taxes	1.09	1,488	125,000
Other Soft Costs	1.09	1,488	125,000
Total Soft Costs	9.54	12,976	1,090,000
Selling Costs (3%)	5.15	7,024	590,000
Models/Sales Center	1.14	1,548	130,000
Financing Costs Excluding Land			
Const. Loan Pts @ 1%	1.00	1,488	125,000
Interest Exp. @ 10%	6.35	8,631	725,000
Total Financing Costs	7.44	10,119	850,000
Total Project Cost	**172.50**	**235,000**	**17,517,947**

Interest - assumes 4 phases of app. 20 units over 1.5 years.

* Shared with Bridge Housing

Financing Program

<u>Acquisition and Development Financing</u>	
San Jose Housing Commission - Acquisition (2nd)	$ 4,860,000
Plaza Bank of California - Construction (1st)	<u>12,658,000</u>
Total Capital	17,518,000
<u>Permanent Homebuyer Financing</u>	
San Jose Housing Commission "Silent Second" Loans	<u>$1,250,000</u>

San Jose Housing Commission Acquisition Loan:

These funds accessed under the $20 million NOFA were raised through the City's tax-increment districts. Due to the high-tech boom of the 1980's, the City of San Jose is one of the state's most successful communities in raising tax-increment funds from redevelopment districts. The city established redevelopment areas not only downtown, but also in its growing high-tech industrial areas where property taxes grew as a result of new development.

As discussed, this particular NOFA was published to respond to the Housing Initiative Study. It called for funds to be leveraged; their use restricted to site acquisition and pre-development expenses. Winfield Partners received an allocation of $8.25 million to provide for the land purchase of $7.8 million and $450,000 in pre-development expenses. Upon division of the two sites, Martin-Devcon and Bridge would will each, independently, carry its pro-rata share of the debt, $4.86 million and $3.39 million respectively. Depending upon the availability of City funds, between 17-25 homes will be restricted to moderate-income families, defined in San Jose as earning 110% or less than area median income of $59,500 (for a family of four).

The note to Martin-Devcon is designed to allow the developer to leverage the construction costs and the City to participate in project profits. Additionally, a $1.25 million portion of the debt will be credited to Martin-Devcon (resulting in an outstanding loan of $3.61 million) and used to subsidize the moderate-income purchasers.

Payment on the note is due after the primary lender is satisfied in full. Interest will accrue at a rate of 6% only upon the pro-rata use of City funds during construction. Assuming average sale prices of $235,000 per unit, the primary lender will be likely paid from the sale proceeds of the first 50 of the 84 homes. The $3.61 million debt to the City will likely be repaid with the proceeds from the sale of the following 20 units.

In terms of participation in profits, the City is entitled to 40% of the net proceeds after Martin Devcon receives a development fee in the amount of approximately $1.8 million. This fee is payable from proceeds only after the loans from the City and primary lender are satisfied. Accordingly, this will likely result in the City receiving 40% of the sale proceeds of the last 4-5 units, or approximately $470,000 at the completion of the project.

Plaza Bank - Construction Financing:

According to Martin Devcon, the commercial banking community has shown considerable interest in providing construction financing for Winfield Hill. Plaza Bank, the first bank approached, expressed immediate interest in the project. Based in Detroit (as Comerica, Inc.), Plaza Bank's primary focus in construction financing is single-family housing priced at the affordable end of the market. According to Plaza Bank, its interest in the project originates in the site's sound location, the involvement of the City-both in terms of subsidies and general support, and third, the potential for CRA credits, regarded as an "extra benefit". According to Martin Devcon, CRA credits, earned in serving moderate-income households, and the limited market-risk associated with affordable housing are the key factors involved in attracting lenders.

In underwriting the $12.6 million loan, Plaza Bank applied the following general requirements: First, hard equity of 15-20% of total project cost is required. This is achieved with the City's "loan" of $4.86 million dollars or roughly 27% of costs. Second, Plaza Bank's maximum loan to appraised value is 70-75%. The $12.6 million loan represents approximately 60% of project value. Third, the bank requires the project to be phased with funding for each phase released upon 50% of the units of a prior phase being sold. Winfield Hill will be phased in increments of approximately 20 units or two cul-desacs per phase, in addition to 3-4 models. Last, repayment of 115%-125% of the loan amount allocated to a house is required upon a closing. The interest rate on said loan will be floating at 1.5% over prime rate.

San Jose Housing Commission - Silent Second Mortgages:

As mentioned, the City is crediting Martin Devcon for $1.25 million of the $4.86 million (resulting in an outstanding loan of $3.61 million dollars) which will be used to subsidize moderate-income purchasers with "silent" second mortgages. These second mortgages, limited to $73,000 per unit, are expected to average $50,000 and will carry no monthly payment obligation. Two options exist in the event a borrower sells a home to a household earning greater than moderate area income: Either the City will participate in the property appreciation, or, the borrower will be required to pay the principle loan amount, with interest, upon the sale.

Sales Revenues and Profitability Projections

The following is a snapshot of an estimate of the project's revenue stream, although the project will be built over several phases:

	Model 1	Model 2
Size (SF)	1,300	1,425
Cost	$205,154	$211,716
Sale Price	$225,000	$245,000
Profit	$ 19,846	$ 33,284
Total Units	41	43
Gross Profit	$813,686	$1,431,212

Total Gross Profit	$2,244,898
Less Estimated City Share	$470,000
Sub-Total	$1,774,898
Less 33% to Land Seller	$585,716
*** Net Profit to Martin Devcon**	**$1,189,181**

* Not including $500,000 received as developer overhead.

Looking Back

As of this writing, Martin Devcon is generally pleased with the proceedings of the project. In hindsight, more attention would have been given to working with the "not in my backyard" constituency and the Planning Commission.

Broad based support led the developers to believe there would not be any opposition at the Planning Commission hearing. In hindsight, Martin Devcon believes that it could have gained support from the Willow Creek residents by informally involving these people early in the planning stages of the project. To the developer's surprise, the Planning

Commission was not educated or influenced by the Housing Department's recent studies and affordable housing policy. The developers proceeded with the Commission assuming the opposite, to find a very frustrating situation. Looking back, they would have put forth a concerted effort to educate the people of the Planning Commission on the project and its response to the objectives of the City's goals.

CHAPTER FOUR

<u>NORMONT TERRACE</u>

A PROJECT STUDY OF A MIXED-INCOME MULTI-FAMILY CONDOMINIUM AND APARTMENT DEVELOPMENT OF THE RELATED COMPANIES OF CALIFORNIA IN ASSOCIATION WITH THE HOUSING AUTHORITY OF THE CITY OF LOS ANGELES

The information presented in the following case study was obtained through interviews and written information provided by William Witte, Principal, The Related Companies of California.

NORMONT TERRACE

General Description

In November of 1989, the Housing Authority of Los Angeles (HACLA) awarded a partnership of The Related Companies and D&S Development Co. the Exclusive Right to Negotiate a Disposition and Development Agreement (DDA) with HACLA for the redevelopment of its Normont Terrace public housing site in the Harbor City community of Los Angeles. The Related Companies is a national commercial and residential development firm with substantial experience in low-income housing development. Its affiliate, The Related Capital Corporation, is the largest tax-credit syndicator in the country.

The 35.4 acre site contains 400 two-story apartments constructed in 1942 as wartime housing. The April, 1989 Request For Proposals (RFP) issued by HACLA sought a proposal which would replace the 400 units at no cost to the Housing Authority. Because the buildings are structurally unsound and obsolete, the current tenants support demolition and redevelopment of the site. Upon completion, the $80 million dollar mixed-income project will include 800 units; 400 for-sale condominiums with an average price of $135,000, affordable to most moderate-income households, and 400 units to replace the existing housing stock-to be rented to very low-income households at monthly rents ranging from $640 for one-bedroom units to $1,081 for four-bedroom units.

Site Location

The Normont Terrace Site is located in a what is currently a predominantly hispanic, lower working-class neighborhood in the South Bay of Los Angeles, at the intersection of Pacific Coast Highway (PCH) and Vermont Avenue in Harbor City. The site is less than one half mile west of the PCH exit on the Harbor Freeway (110), offering direct freeway access to downtown Los Angeles and to the San Diego Freeway (405).

The site represents the last major residential development opportunity along the desirable PCH corridor which connects the South Bay beach communities with West Los Angeles and Los Angeles International Airport on the northwest, and Long Beach and San Pedro on the southeast. It is within a five-mile radius of the prestigious communities of Palos Verdes and Rolling Hills and of major shopping centers on PCH and in Torrance. Additionally, the site is within a 20-minute drive of the major South Bay employment centers, including UCLA/Harbor and Kaiser Permanente (across the street) Medical Centers, the Ports of Los Angeles and Long Beach, and the heart of the Los Angeles aerospace industry.

Project Program

Site planning for the project is in the preliminary stages. Conceptually, Related envisions a gated community of 40 to 80 unit clusters. All buildings will be integrated into a project with a single identity in which open-space and project amenities will be shared by owners and renters alike.

The unit-mix of the rental component will consist of 60 one-bedroom units, 210 two-bedroom units, 100 three-bedroom units, and 30 four-bedroom units. The condominium unit-mix is not yet defined but will likely contain a majority of two- and three-bedroom units.

Amenities will include at least three swimming pools, three tot-lot play areas, and community and child-care facilities. One association will oversee the operational management of the entire project.

Motivation to Develop Affordable Housing

The Related Companies has vast experience in all segments of the development business. Within the residential sector, it has been successful in responding to changing economic conditions through altering its projects between the luxury and low-priced end of the spectrum. Additionally, Related has a long history of dealing with the complexities of mixed-income programs as well as in the public arena.

As a result, management was confident in Related's ability to undertake this complex project and viewed Normont Terrace as a unique opportunity within a sluggish development climate. It believes the national attention it expects to gain in connection with the undertaking may result in opportunities to apply the skills, unique to a project of Normont's nature, in other locations.

Political Context

With the ultimate goal of recouping some value from its inventory, in 1987, HACLA conducted a study of its of older properties. The unique location and site characteristics of Normont Terrace presented HACLA with an opportunity to achieve its financial objectives. It believed the superb location and large-scale development potential of the site would allow the City to replace what is essentially an unlivable, fully occupied housing project without any financial investment. Upon making this determination, HACLA began working with project residents to gain feedback on its findings. Primarily working, poor families, the residents were very supportive of the project, provided they received compensation for their temporary relocations.

Request for Proposals:

In April of 1989, HACLA issued an RFP for the Normont Terrace site within which three primary conditions were set-forth:

The project sponsor was to; (1) replace all 400 rental units for existing residents, (2) finance the entire project without local funding (although the discounted land represented a substantial concession) and (3) provide for all temporary resident relocations. Additionally, HACLA supported the integration of income-classes within a mixed-income proposal.

Response to Request For Proposals:

Apparently due to the project's size, complexity and the conditions of the RFP, only four bidders responded to the RFP. In addition to the Related/D&S joint-venture, HACLA received proposals from Lincoln Properties, PSC Development Co. (an affordable housing development firm from Salt Lake City), and an independent developer from Los Angeles. HACLA reduced the competition to PSC and Related. D&S eventually dropped out of the Related joint-venture due to internal financial problems.

PSC proposed to build 1,150 rental units financed with tax-exempt bonds to be guaranteed by FHA mortgage insurance. Related proposed to build 1,200 units; 800 condominiums integrated with 400 apartments, replacing the existing stock. The apartments would be financed with tax credits and a conventional mortgage; the condominiums with conventional construction financing taken-out with individual mortgages. The residents preferred PSC's rental proposal fearing

Related's condominium sales would bring "rich people" to the project. However, aware of FHA's financial problems at the time, HACLA recognized the risk associated with PSC's financing plan. It believed Related's proposal to be more complex, but also more feasible, and granted Related the Exclusive Right to Negotiate a DDA in November of 1989.

The Disposition and Development Agreement:

Project Program: After almost three years of negotiations with HACLA, The Related Companies expects the agreement to be signed by August of 1992. As discussed, the original proposal consisted of 1,200 units; 800 condominiums and 400 assisted apartments dispersed among the condominium units. Negotiations have been lengthy, at least in part, due to certain implications of HACLA's conditions.

In terms of integration, HACLA wanted to optimize the degree to which renters were dispersed among condominium owners. However HACLA was intent on replacing the 400 rental units in a timely manner. Additionally, under tax credit regulations, projects are required to be placed in service within three years of a credit allocation. However, construction financing arrangements for the condominium component call for phasing this for-sale element at the pace of absorption. To avoid exposure to potential delays in the condominium phasing, which puts the tax credit funds and the public housing replacement product at risk, HACLA will allow integration to occur to a lesser degree; on a building by building basis. The 400 apartments will be built in a single phase, the condominium phasing as determined by the construction lender and response from the market.

The reduction from 800 to 400 condominium units resulted from a variety of issues. HACLA was in favor of a less dense project. It offered Related a commitment for project-based Section-8 subsidy rental subsidies for the apartments in return, at least in part, for a less dense project. In conducting further market research, Related found that the marketability of the 800 units would suffer from the high density (33 per acre). Additionally, by lowering the density, the project would no longer require costly subterranean parking. Related believes the cost savings and risk mitigation resulting from the lower density outweigh the potential incremental profits of the higher density.

Project Based Section-8 Subsidy: As mentioned, HACLA has agreed to allocate a portion of its allowable project-based Section-8 funds to the rental component of Normont Terrace. All units will receive 5 year contracts at HUD-restricted rental rates. Although HACLA and HUD would guarantee Related a 15 year project-based Section-8 rental subsidy, most contracts are now issued for 5-year terms, with two 5-year extensions.

Partnership With Tenant's Association: As part of the DDA, Related will enter into a general partnership with the current project's tenant association, a registered non-profit organization. The association's legal status is that of "managing general partner". Strategically, this achieves two objectives. First, granting residents a voice in the operational management of their buildings will translate into a "pride of ownership" which should result in more respect for, and better maintenance of, the property. Second, the non-profit participation within the general partnership qualifies the low-income rental component for property tax exemption under California law.

Ground Lease: In the context of its condominium program, Related was in favor of purchasing the land in fee. However, HACLA believed that the public would have a more positive perception of the City's dealings if it held title to the land under a lease agreement, notwithstanding the significant discount inherent in the ground lease.

HACLA will lease the site to Related for a period of 99 years on a subordinated basis. In return, Related will prepay $1 million to HACLA and $1 million to the tenants to be used for social services at the commencement of construction. Additionally, Related will be responsible for all tenant relocation expenses, projected to be $1.5 million. Attributing all land-related costs to the condominiums results in an expense of $10,000 per unit, approximately $20,000-$30,000 per unit "under market"[62].

Profit Distribution: The DDA calls for HACLA and the existing tenants to participate in project profits. According to the agreement, after the distribution of preferred returns to any third-party limited partners, the profit will be distributed 70% to Related, 25% to HACLA, and 5% to the tenant association.

Entitlements

An EIR and Tract Map approval for the project will be required. Because the project has enjoyed broad-based support from local officials, a number of steps have been taken to expedite the approval process.

Zoning:

In terms of Zoning, no further approvals are required. The site is covered by the City of Los Angeles' Wilmington/Harbor City Interim Control Ordinance, which effectively downzoned the area when adopted in 1988. To accommodate the proposed project density, the Ordinance was amended in June of 1990, during DDA negotiations, to allow for increased residential density within the affected area, however, only for mixed-income developments. This action served to give as-of-right zoning approval to the project and limit future condominium competition in the area to small, more expensive projects.

Environmental Review:

A proposed project in the City of Los Angeles which requires the processing of a full EIR through the Planning Department ordinarily requires 18 months for the EIR to be certified by the Planning Commission. However, the Planning Commission has agreed to allow the Housing Authority to act as the lead agency for processing the EIR for Normont Terrace. With no other EIR's to process, HACLA expects certification within 8 months of the execution of the DDA.

Tract Map:

Because the site is, and will be publicly owned, and affordable housing is at stake, expedited processing of the preliminary tract map application is also expected. Although formal actions by staff are not allowed prior to the certification of an EIR, Related will begin working informally with staff upon signing the DDA.

Waiver of City Fees:

Discussions with City officials has led Related to believe that there will be an opportunity for the waiver of certain city fees. This will be further investigated during the processing of entitlements. Related's development budget (below) does not account for any waiver at this time.

Because the redevelopment will remove what most area residents consider a blighted element from the community, little if any opposition to the proposal is expected. Accordingly, all entitlements are expected to be approved within 12 to 16 months of the execution of the DDA.

Preliminary Development Budget

Description	Market-Rate Condominium Units	Condominium Per Unit	Low-Income Rental Units	Low-Income Per Unit
Land	$1,000,000	$2,500	$0	$0
Relocation	750,000	1,875	750,000	1,875
NTCC Payment	1,000,000	2,500	0	0
Total Land, etc.	2,750,000	6,875	750,000	1,875
Direct Costs				
Demolition	300,000	750	300,000	750
Common Area	1,750,000	4,375	1,750,000	4,375
Sitework & Grading	1,300,000	3,250	1,300,000	3,250
Off-site Costs	1,400,000	3,500	1,400,000	3,500
Construction	21,500,000	53,750	21,500,000	53,750
Contractor Fee (5%)	1,210,000	3,025	1,210,000	3,025
Contingency (5%)	1,210,000	3,025	1,210,000	3,025
Total Direct Costs	28,670,000	71,675	28,670,000	71,675
Indirect Costs				
Fees & Permits	3,400,000	8,500	2,400,000	6,000
Arch. & Eng.	900,000	2,250	900,000	2,250
Soils, Geology	65,000	163	65,000	163
Property Taxes	250,000	625	0	0
Legal, Accounting	400,000	1,000	100,000	250
Ins., Taxes, License	250,000	625	125,000	313
DRE, H.O. Ass. Dues	200,000	500	200,000	500
Total Indirect Costs	5,465,000	13,663	3,790,000	9,475
Finance Costs				
Construction Int.	3,000,000	7,500	1,900,000	4,750
Loan Fee (1.5%)	650,000	1,625	450,000	1,125
Perm. Loan Fee (4%)	0	0	750,000	1,875
Tax Credit App. Fee	0	0	165,000	413
Total Finance Costs	3,650,000	9,125	3,265,000	8,163
Developer O.H. & Fee	1,133,550	2,834	3,150,000	7,875
Total Costs	**41,668,550**	**104,171**	**39,625,000**	**99,063**

See note[63] for notes on cost calculations.

Financing Program

As of this writing, Related is not far enough into the pre-development phase to begin the application process for its financing. However, based on its experience in the affordable housing industry and preliminary discussions with capital sources, Related has determined the character of its financing program. For the purpose of financing, the condominium and rental elements will be treated individually.

Low-Income; Rental Component:

40%-50% of costs to be financed with tax credits, the remainder through a loan insured by FHA or FNMA.

As mentioned, the apartments will qualify for low-income tax credits. 100% of the 400 units will be set-aside for households earning under 50% of area median income. As Related will apply for 9% credits, the project will be ranked in a competitive application process. As result, in order to compete, Related will agree to restrict rents for 55 years. Related expects to receive 9% credit allocations on a substantial qualified basis. Depending upon the market for credits at the time of sale, the credits should generate equity from corporate investors in an amount equal to 40%-50% of development costs ($16.6 million - $20.8 million). Under this structure, Related and the tenant association will retain a 1% interest in the project as the general partner, the credit investors a 99% interest as limited partners. Upon completion, Related will most likely continue to manage the apartments in exchange for property management fees.

The remainder of the low-income component of the development costs will be financed with a conventional construction loan. According to Related, projected first-year operating-income will adequately carry the required debt at a 1.10 coverage ratio, assuming an interest rate in the range of 9%. The permanent financing will likely be obtained through

FNMA or FHA. The primary issue to resolved with regard to this instrument is the mortgage insurance. According to Related, a HUD associated entity is apt to be the only third party provider of mortgage insurance comfortable enough with the current Section-8 program (of 5 year contracts-discussed above) to underwrite the mortgage guarantee. Hence, FHA appears to be the most likely source of insurance-essential to underwrite the first mortgage.

Condominium Component:

Construction financing for the condominium will probably be obtained through conventional sources. Developer equity of approximately 20% of project costs ($8 million-including all payments to HACLA and the tenant association) is likely to be required by the construction lender. Priced at approximately $135,000 per unit, Related believes purchasers will be able to qualify for attractive permanent loans through first-time homebuyer programs offered by FHA, VA, or FNMA.

Sales Revenues and Profitability Projections

The following is a snapshot of an estimate of the condominium project's revenue stream, although this portion of the project will be built over several phases:

* Total Sales Revenues	$54,500,000
Less Marketing Costs (6%)	3,264,000
Gross Revenues	51,136,000
Less Costs	(41,668,550)
Gross Profit	9,467,450
Less HACLA Share (25%)	(2,366,862)
Less Tenant Assoc.Share (5%)	(473,373)
**** Net Profit to Related Co's.**	**6,627,215**

* Assuming average sale price of $136,000
** Not including developer fees of $4,283,000

It is estimated that this profit will be generated on a cash investment of approximately $8 million. However, assuming construction commences 18 months from the execution of the DDA, depending upon absorption, Related should complete the phased condominium project 5-6 years from the execution of the DDA.

CHAPTER FIVE

CONCLUSION

The following discussion is based on the material presented in the preceding four chapters and discussions with development professionals, public-sector housing specialists and real estate lending professionals listed in the "notes" section following the conclusion.

The primary goal of the research was to determine the role of the for-profit developer within the affordable- family housing industry in California. As affirmed by the three case studies and by discussions with developers, lenders and housing specialists at the state and local government levels, affordable housing development, under certain conditions, does represent a profitable opportunity. Additionally, in contrast to commercial- industrial or market-rate residential development, the risks associated with market demand for affordable housing are minimal. Success within this arena, however, involves working through a complex system concerning local- and state-level public agencies as well as various suppliers of capital. The participants within this system are directly and indirectly linked; pressured, motivated and limited, by federal and state regulations Wall Street, special interests, and/or community groups. To effectively interact within this framework, the developer must be knowledgeable of, and sensitive to, these connections.

To successfully work through the institutional "maze", local government support is critical. Though essential within all development practice, local support is especially important for affordable housing projects in overcoming opposition from local citizen groups and more importantly, in the midst of the credit-crunch, to arrange delicately layered financing programs. Structuring these financing packages, the most difficult component of an affordable housing development, often hinges on the granting of substantial concessions at the local level.

Relationship of Local Concessions to Financing Strategy:

The following discussion demonstrates the importance of these local subsidies in the context of the developer's financing strategy. There appear to be widely accepted models associated with each of three project program types:

(1) Multi-Family Rental; 100% Low-Income:

Within a program of 100% restricted units, developers typically restrict all units for households earning 60% or less than median income to qualify for a maximum 9% tax credit allocation. Syndication proceeds from these credits will typically generate equity in an amount equal to 40%-50% of project costs. Operating income will support construction and permanent first mortgages in the range of 30%-40% of total project costs. The remaining "equity" may take the form of subordinted-deferred local loans, local cash or land write-downs, and/or equity contributed by the developer.

(2) Multi-Family Rental; Mixed-Income:

In the context of a mixed-income program, project sponsors aim to restrict 20%-40% of the units to qualify for tax-exempt bond financing and 4% tax credits. In addition to allowing for income to support a substantial bond issue, limiting the restricted units to a 40% ratio seems to be a response to a threshold set by tax-credit investors. A mix exceeding 40% restricted units is believed to reduce the marketability of the market-rate units. The share of proceeds generated from tax-exempt bond issues (60%-75% of project costs) is inversely related to that generated from the sale of 4% tax-credits (10%-20%), as increased rent restrictions which generate tax-credits decrease the amount of debt a project is able to support. The remaining "equity" funds, as detailed above, will take the form of local concessions and/or cash contributions of the project sponsor.

(3) Moderate-Income Single- & Multi-Family Homes:

In locales where land is too expensive to support affordable (to moderate-income) single-family home or condominium development, affordability is typically enhanced through municipalities providing land write-downs, discounted site acquisition loans, and/or silent-second mortgages for qualified home-buyers. Construction financing is obtained through conventional sources.

Reflecting on these financing models, it can be seen that local concessions are integral to successfully financing a development. The competitive application process for 9% tax credits calls for preference to be granted to projects receiving either 15% of total costs in local subsidies or 30% in developer cash contributions. Consequently, without the local subsidies, to compete for tax-credits, a developer is requiried to contribute equity in an amount too great to result in an acceptable rate of return, given HUD's restrictions on developer fees and limited project cash flow, due to the magnitude and longevity of rent restrictions. Likewise, mixed-income, bond financed projects require local support to formally approve the tax-exempt issue. Finally, sponsors of subsidized single-family home or condominium projects receive 100% of their financial incentives at the local level.

Gaining Local Support:

The following are the primary areas of concern in gaining project support at the local level:

Local Housing Policy:

As discussed in Chapter Two, State-level housing specialists have been implementing policy to promote support of affordable housing production at the local level. However, most cities have yet to initiate truly pro-active policy. From the developer's perspective, it is critical to operate within communities where local policy supports low-income family housing. The risks associated with waging a "battle" for what is essentiallly an as-of-right project in a hostile political environment will ultimately lead to a lost "war", via costly delays, litigation, and/or capital deficiencies due to the lack of local subsidies.

Project Scale:

In terms of project size, most municipalities which are responding to the affordability crisis are in favor of producing large blocks of housing. However, they recognize that communities are more receptive to projects which act to disperse the lower-income households among other segments of the population. As a result, local officials are generally promoting large-scale, mixed-income developments.

From the developer's perspective, large-scale projects (often referred to as 50 units and greater) are favorable not only politically, but also in terms of efficiency. Regardless of project size, the framework within which all subsidized development sponsors work invovles an extremely tedious and lengthy pre-development process. The cost and effort of obtaining subsidies and approvals within this system is too great to distribute across a relatively small project.[63] Where profit margins are lower, relative to those historically "earned" in market-rate development, adequate volume is necessary to justify the effort and risk involved during the "front-end" of the development process. Lending institutions also favor larger projects, frequently offering explicit pricing incentives for larger-scale developments.

Public/Private Partnership Format:

Public perception of for-profit development in subsidized housing may be the single greatest barrier to entry into this business segment. In general, government appears to judge non-profit organizations to be more suitable for this arena. Officials contend that the "sole interest" of these organizations-providing quality affordable housing, is direclty aligned with those of the public. The belief is that for-profit operators are not able to provide maximim affordability while meeting their yield requirements. In terms of funding, governments tends to believe that subsidizing for-profit developers merely increases their profit margins.

Although there are valid arguments against these perceptions[64], to gain local support and access to critical local subsidies in the current environment, it has become increasingly important (subsequent to the media-inflated HUD scandals) that for-profit firms enter into "public"- private partnerships. As can be seen by the partnership structures discussed within the three case studies, these can vary in scope from consulting agreements to full-scale equity-sharing arrangements. By pairing up directly with municipalities as The Related Co's. did with the Los Angeles Housing Authority, or with private non-profit development firms such as Bridge Housing, as did Martin Devcon and The Irvine Co., for-profit firms are able to benefit from their partner's political appeal and access to essential subsidies.

In an environment where demand far outweighs supply of affordable housing, the primary goal of the non-profit developer and the public housing agency is to penetrate the affordable housing need as deeply as possible. Responding to community preference in developing mixed-income projects, the goals of these organizations are most efficiently met by partnering with financially sound for-profit developers ultimately responsible for the moderate and/or market-rate portion of a project. The financial strength of the for-profit partner will typically allow it to access financing on a scale that the non-profit organization is unable to independently.

Profitability - Is it Worth the Effort?:

In contrast to traditional commercial/industrial and market-rate residential development, the risks associated with market demand of the final affordable housing product are minimal. Most of the risk associated with affordable housing development is involved during the predevelopment process; working within the maze. Substantial time and capital is involved in packaging a project for land-use approvals and capital commitments, neither of which are gaurenteed. However, the magnitude of this "front-end" exposure is minimal relative to the market-associated, financial risks of a completed market-rate speculative project.

In terms of profitability, to maintain the necessary levels of affordability required to compete and qualify for scarce and essential subsidies, profit margins tend to be relatively lower than those traditionally "expected" from market-rate, speculative development. In fact, competetion for subsidies to fund the lower-income components of mixed-income developments, such as tax credits and (what were) RHCP funds, often results in affordability restrictions of such magnitude that these components are not justifiable from a profitability perspective. However, to gain local support for a project in its entirety, and respond to the needs of the public, the lower-income component is a necessity.

The San Rafael, Winfield Hill, and Normont Terrace projects represent creative examples of profitable incorporation of lower-income elements into mixed-income developments. The Irvine Co., partnering with Bridge Housing was able to structure financing and land use programs which allowed the Irvine Co. to satisfy the inclusionary requirements for several Westpark sites while earning an acceptable return on the subject site. In the case of Winfield Hill, the partnership with Bridge called for the private non-profit to independantly manage the development of the lower-income element, allowing Martin Devcon to develop the more profitable single-family element. Accessing City funding precluded the need for Martin Devcon to contribute any hard equity. In exchange for replacing a Los Angeles low-income public housing project, essentially without profit, The Related Companies will earn a generous return from its condominium development, primarily as a result of its attractive ground lease with the Housing Authority.

In summary, as can be seen within the context of three case studies, and as conveyed through discussions with various professionals connected to the affordable housing development business, for-profit opportunity does exist in this segment of the industry. However, succeeding in this arena involves an in depth knowledge of, and ability to negotiate, a complex institutional maze. The institutional and political sophistication necessary for the negotiation is far in advance of the principles associated with the "traditional"

development process.

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"Moderate-income" households are defined as those households, adjusted for family size, earning less than 120% of area median income. However, in certain instances, local governments have limited this category to 110% or 100% of area median-income.

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25. Benjamin Williams, Vice President, First Union Bank, Raleigh, North Carolina, July 22, 1992

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30. David Nahas, Chief Lending Officer, SAMCO, Santa Clara, CA June 11, 1992

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42. "Affordable" typically refers to a rent level which would, together with utility payments, constitute 30% of household income.

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44. Mary Hardin, Project Consultant, Bridge Housing Corp., San Francisco, CA, July 23, 1992

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60. The title of "managing general partner" was given to Bridge for presentation purposes in gaining entitlements and subsidies.

61. It is important to note that during the rezoning negotiations, the Irvine Co. instructed city planning staff to conduct the EIR for the site as if a 25 percent density bonus would be utilized. This would serve as a precaution to avoid future litigation and/or delays in the event the bonus was to

be utilized.

62. "Under-market, as compared to similar units in the area. However, it is worthy to note that the integration of the condominiums among the low-income housing most definitely has a negative effect on marketability, and therefore, price.

63. Mary Tustin, Vice President and Jeffrey Loustau, Project Manager, The John Stuart Company, San Francisco, CA, June 7, 1992

64. Several private sector and public sector housing specialists agree that there is a trend among several community-based non-profit housing developers to spend significantly more funds per unit as compared to other experienced larger non-profits and for-profit firms. They attribute this to a general lack of appropriate development experience to successfully negotiate with contractors and other third party consultants, less attention to the "bottom-line", participation in small projects; removing economies of scale, and generous project amenities. Additionally, there is concern about smaller non-profit's financial ability to deal with unexpected cost over-runs without access to immediate resources.

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