



KEYSER MARSTON ASSOCIATES

EXECUTIVE SUMMARY

DRAFT INCLUSIONARY HOUSING:

FINANCIAL EVALUATION

Prepared for:

City of Costa Mesa

Prepared by:

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I. EXECUTIVE SUMMARY

A. Background

Keyser Marston Associates, Inc. (KMA) was engaged by the City of Costa Mesa (City) to assist in creating an Inclusionary Housing program. By way of background, over the past 20+ years the KMA Los Angeles office has assisted 36 jurisdictions in the Inclusionary Housing program adoption and updating processes. KMA's analyses reflect a real world perspective based on the firm's core experience in real estate development economics, real estate transactions, and developer negotiations services.

KMA was engaged to prepare an Inclusionary Housing: Financial Evaluation (Financial Evaluation) to identify supportable Inclusionary Housing program requirements for apartment and ownership housing development. The KMA evaluation methodology has been continually evolving over the past 20 years. Each study is tailored to reflect the specific characteristics of the jurisdiction being evaluated.

B. Public Policy Objectives

The first step in designing an Inclusionary Housing program is to identify the factors that will be considered in defining the program's goals. The characteristics of the unmet need for affordable housing in the community are commonly assessed for this purpose. The KMA Financial Evaluation uses information presented in the City's Draft Housing Element (Housing Element) dated March 1, 2023. The Housing Element covers the period between 2021 and 2029.

Inclusionary Housing programs are subject to both statutory parameters imposed by the State Legislature and the rulings in the court cases that have challenged Inclusionary Housing programs over the past 30+ years. Significant statutes and court rulings are summarized below. It is important to understand the constraints and opportunities that are created by these statutes and court rulings.

SAN JOSE CASE

In the 2015 San Jose case, the California Supreme Court ruled that Inclusionary Housing Programs should be viewed as use restrictions that are a valid exercise of a jurisdiction's zoning powers. Specifically, the Court found that Inclusionary Housing requirements are a planning tool rather than an exaction. This is interpreted to mean that an in-lieu fee payment option that is included in an Inclusionary Housing Program, that includes an affordable housing production requirement, is not subject to the AB 1600 nexus requirements imposed by California Government Code §66000 et seq.

While Inclusionary Housing Programs are not subject to AB 1600 requirements, these programs must comply with the following criteria:

1. The requirements cannot be “Confiscatory”; and
2. The requirements cannot deprive a property owner of a fair and reasonable return on their investment.

The court did not provide criteria under which jurisdictions can determine whether proposed price controls are confiscatory and/or they deprive a property owner of a fair and reasonable return. As a result, each jurisdiction is left to create an evaluation methodology that balances the interests of property owners, developers and the jurisdiction’s need for affordable housing. It is KMA’s practice to take a conservative approach in establishing the requirements that comport with the court’s ruling.

ASSEMBLY BILL 1505

Assembly Bill (AB) 1505 amended Section 65850 of the California Government Code and added Section 65850.01. This legislation provides jurisdictions with the ability to adopt programs that impose Inclusionary Housing requirements on apartment development projects.

Section 65850.01 does not place a cap on the percentage of units that can be subject to income and affordability restrictions. However, Section 65850.01 (a) gives HCD the authority to review the restrictions imposed by an Inclusionary Housing Program on apartment developments if it requires that more than 15% of the units to be restricted to households earning less than 80% of the area median income (AMI), and if one of the following conditions applies:

CALIFORNIA GOVERNMENT CODE SECTION 65583 (A)

California Government Code Section 65583 (a) (Section 65583 (a)) requires the City to analyze potential and actual constraints being placed on the development of housing. If the City chooses to impose a greater than 15% affordability requirement and/or a deeper affordability standard than 80% of AMI on apartment development, HCD can require the City to demonstrate that the Inclusionary Housing requirement does not create a constraint to housing development.

Section 65583 (a) requires the City to analyze potential and actual constraints being placed on the development of housing. Within that context, it is important to recognize that the requirements imposed by an Inclusionary Housing Program can only be expected to fulfill a small portion of the unmet need for affordable housing in Costa Mesa.

C. Financial Analyses

Each unit in a market rate project that is required to fulfill income and affordability restrictions creates an impact on the project economics. This is called the “Affordability Gap”, which is defined as difference between the achievable market rate rent or sales price and the allowable rent or sales price for each “Inclusionary Unit”. This Financial Evaluation uses pro forma analyses to estimate the Affordability Gaps generated at varying income and affordability levels.

KMA created prototype apartment and ownership housing developments for analysis purposes. The prototypes can be generally described as follows:

Development Prototypes	
Apartment Development and Ownership Housing Development	
Apartment Development	Ownership Housing Development
Base Zoning Standards	Townhomes
Section 65915 Density Bonus	Live / Work Units
	Condominiums

The prototype projects were created using the following resources:

1. The Housing Element; and
2. Residential projects identified in KMA’s market surveys.

KMA used pro forma analyses to estimate the Affordability Gaps created by the Inclusionary Housing alternatives being tested. The results were then evaluated to identify requirements that balance the interests of the property owner, the developer, and the City’s unmet need for affordable housing.

D. Findings

SUPPORTABLE INCLUSIONARY HOUSING PRODUCTION REQUIREMENTS

Apartment Development

Apartment development analyses have been prepared for Inclusionary Housing requirements set at the low income and very low income levels.

Rent Estimates

The rent estimates that were used as part of the Affordability Gap analyses are presented in the following table:

Projected Rents Apartment Development Prototypes			
Number of Bedrooms	Market Rate	Low Income	Very Low Income
0	\$2,410	\$1,576	\$951
1	\$2,970	\$1,800	\$1,085
2	\$3,660	\$2,003	\$1,199
3	\$4,400	\$2,208	\$1,315

Affordability Gap Estimates

The weighted average Affordability Gaps per Inclusionary Unit are estimated as follows for the apartment development prototypes:

Estimated Affordability Gaps Per Inclusionary Unit Apartment Development Prototypes	
Low Income Unit	\$273,000
Very Low Income Unit	\$414,000

Supportable Inclusionary Housing Requirements – Apartment Development

Based on the results of the pro forma analyses, KMA concluded that the following Inclusionary Housing requirements can be supported by apartment development projects:

Supportable Inclusionary Housing Requirement Base Zoning Prototype	
Low Income	10%
OR	
Very Low Income	7%

Based on all the factors considered in the apartment development evaluation, KMA has concluded that a 10% low income Inclusionary Housing obligation can be supported. Given the conservative approach taken by KMA, it is reasonable to conclude that a requirement of this magnitude is not confiscatory and that it will not deprive a property owner of a fair and reasonable return on their investment.

It is important to consider that some developers may wish to mitigate the financial impact created by the imposition of Inclusionary Housing requirements by using the density bonus provided under California Government Code Section 65915 et seq. (Section 65915). Moreover, in many cases it will be advantageous for a developer to provide very low income units to fulfill the Density Bonus requirements. The results of the KMA analysis indicate that the imposition of a 15% very low income requirement can be supported by projects that can provide the additional units on a cost effective basis.¹

Ownership Housing Development

Inclusionary Housing programs generally set the affordability requirements for ownership housing development at the moderate income level. This is done as a reflection of the fact that higher income households are likely to have more discretionary income to devote to the ongoing costs associated with home ownership than that of lower income households. For reference purposes KMA also prepared analyses based on a low income requirement.

Sales Price Estimates

The sales price estimates that were used as part of the Affordability Gap analyses are presented in the following tables:

Projected Market Rate Sales Prices Ownership Housing Development Prototypes			
Number of Bedrooms	Townhomes	Live / Work Units	Condominiums
2	\$846,000	\$959,000	\$806,000
3	\$1,148,000	\$1,208,000	\$1,027,000

¹ The affordable housing requirements for Section 65915 density bonus projects are calculated as a percentage of the units allowed by a site’s base zoning standards.

Affordable Sales Prices Ownership Housing Development Prototypes		
Number of Bedrooms	Moderate Income	Low Income
2	\$439,900	\$203,300
3	\$465,800	\$210,400

Affordability Gap Estimates

The weighted average Affordability Gaps per Inclusionary Unit are estimated as follows for the ownership housing development prototypes:

Estimated Affordability Gap Per Inclusionary Unit Ownership Housing Development Prototypes		
	Moderate Income	Low Income
Townhomes	\$571,800	\$819,700
Live / Work Units	\$630,700	\$876,700
Condominiums	\$483,200	\$731,100

Supportable Inclusionary Housing Requirements – Ownership Housing Development

Based on the results of the pro forma analyses, KMA concluded that the following Inclusionary Housing requirements can be supported by ownership housing development projects:

Supportable Inclusionary Housing Requirement Ownership Housing Development Projects		
	Moderate Income	Low Income
Townhomes	8%	5%
Live / Work Units	7%	5%
Condominiums	8%	6%

Given the magnitude of the Affordability Gaps associated with the provision of low income ownership housing units it is KMA’s opinion that the Inclusionary Housing requirement should be set at the moderate income level. This will maximize the number of affordable ownership housing units that are produced, while minimizing the Affordability Gaps between the market rate sales prices and the “Affordable Sales Prices”.

SUPPORTABLE IN-LIEU FEES

KMA converted the Affordability Gaps associated with the supportable Inclusionary Housing obligations into the in-lieu fee payments that would be required to fulfill the affordable housing requirements on site within a proposed residential development. The resulting in lieu fee amounts are presented in the following table:

Supportable In-Lieu Fee Payment Amounts Per Square Foot of Leasable or Saleable Area in a 100% Market Rate Project	
Apartments	\$27.60
<u>Ownership Housing</u>	
Townhomes	\$27.40
Live / Work Units	\$25.60
Condominiums	\$25.10

Due to the fact that the in-lieu fee payment is an optional method of fulfilling the Inclusionary Housing obligation, the amount of the fee does not have to track with the Affordability Gaps associated with providing Inclusionary Units. The City may wish to consider applying a premium to the in-lieu fee payment amount to discourage its use, or they may wish to apply a discount to the in-lieu fee when the policy objective is to obtain funding sources for use in assisting dedicated affordable housing projects.

E. Next Steps

The Financial Evaluation is meant to assist the City in creating an Inclusionary Housing program that is not confiscatory and that does not deprive property owners of a fair and reasonable return on their investment. This analysis is focused on the Inclusionary Housing requirements that can be imposed given the City’s current zoning standards.

As the next step in the process, KMA will be preparing additional financial analyses based on the rezoning activities proposed in the Housing Element. It is a fundamental assumption that increasing the allowable density will enhance the value of development sites. Recognizing this, it is KMA’s recommendation that affordable housing requirements be imposed as part of the rezoning activities. To provide context for the affordable housing requirements that can reasonably be imposed, KMA will prepare value enhancement analyses of prototype apartment developments under the following proposed density standards:

Value Enhancement Tests Based on Rezoning Standards Proposed in the Housing Element		
Five Acre Site		
	Density (Units / Acre)	Total Number of Units
Scenario 1	35	175
Scenario 2	40	200
Scenario 3	50	250
Scenario 4	90	400

After receiving input from the City Council, KMA will prepare the additional scenarios, and finalize the Financial Evaluation. This will include KMA recommendations for specific requirements to be imposed if the City chooses to move forward with an Inclusionary Housing Ordinance.

SUMMARY TABLE #1

**APARTMENT DEVELOPMENT SUMMARY
INCLUSIONARY HOUSING: FINANCIAL EVALUATION
COSTA MESA, CALIFORNIA**

	Base Zoning Prototype: 20 Units / Acre Density	\$65915 Density Bonus Prototype: 30 Units / Acre Density
I. <u>Project Description</u>		
A. Site Area (Sf)	217,800	217,800
B. Density (Units/Acre)	20	30
C. <u>Unit Mix</u>		
Studio Units	10	15
One-Bedroom Units	30	45
Two-Bedroom Units	50	75
Three-Bedroom Units	10	15
Total Units	100	150
D. <u>Total Leasable Area</u>		
Square Feet	98,850	148,275
Per Unit	989	989
E. Parking Spaces Per Unit	2.0	0.8
II. <u>Development Costs</u>		
Total	1 \$57,019,000	\$68,586,000
Per Unit	\$570,000	\$457,000
Per Square Foot of Leasable Area	\$577	\$463
III. <u>Market Rate Rents Per Unit</u>		
One-Bedroom Units	\$2,970	\$2,970
Two-Bedroom Units	\$3,660	\$3,660
Three-Bedroom Units	\$4,400	\$4,400
IV. <u>Stabilized Net Operating Income</u>		
Market Rate Alternative	\$2,862,000	
Low Income Alternative	\$2,724,000	
Very Low Income Alternative	\$2,720,000	
Density Bonus Alternative		\$3,980,000
V. <u>Property Acquisition Cost Reduction</u>		
Low Income Alternative	13%	
Very Low Income Alternative	13%	0.0%
VI. Market Rent Increase to Offset Impact	4.8% - 5.7%	0.0%
VII. <u>Supportable Inclusionary Housing Requirement</u>		
Low Income Alternative	10%	
Very Low Income Alternative	7%	
Density Bonus Alternative		15% VL
VIII. In-Lieu Fee Per Square Foot of Leasable Area	2 \$27.60	

¹ The development cost estimates are based on the pro forma analyses for the Market Rate Alternative in each scenario.

² Based on a 10% Low Income Standard.

SUMMARY TABLE #2

**OWNERSHIP HOUSING DEVELOPMENT SUMMARY
INCLUSIONARY HOUSING: FINANCIAL EVALUATION
COSTA MESA, CALIFORNIA**

	Townhome Prototype	Live/Work Prototype	Condominium Prototype
I. <u>Project Description</u>			
A. Site Area (Sf)	130,680	108,900	87,120
B. Density (Units/Acre)	20	16	25
C. <u>Unit Mix</u>			
Two-Bedroom Units	24	20	20
Three-Bedroom Units	36	20	30
Total Units	60	40	50
D. <u>Total Saleable Area</u>			
Square Feet	104,400	74,000	77,000
Per Unit	1,740	1,850	1,540
E. Parking Spaces Per Unit	2.0	2.0	2.0
II. <u>Development Costs</u>			
Total	1 \$52,152,000	\$36,871,000	\$42,070,000
Per Unit	\$869,000	\$922,000	\$841,000
Per Sf of Total Saleable Area	\$500	\$498	\$546
III. <u>Market Rate Sales Price Per Unit</u>			
Two-Bedroom Units	\$846,000	\$959,000	\$806,000
Three-Bedroom Units	\$1,148,000	\$1,208,000	\$1,027,000
IV. <u>Net Revenue</u>			
Market Rate Alternative	\$58,242,000	\$40,956,000	\$44,348,000
Moderate Income Alternative	\$55,541,000	\$39,274,000	\$42,597,000
Low Income Alternative	\$55,863,000	\$39,298,000	\$42,438,000
V. <u>Property Acquisition Cost Reduction</u>			
Moderate Income Alternative	15.0%	13.0%	15.0%
Low Income Alternative	13.0%	13.0%	16.0%
VI. <u>Market Price Increase to Offset Impact</u>	3.7% - 4.3%	3.7% - 3.8%	3.9% - 3.6%
VII. <u>Supportable Inclusionary Housing Percentage</u>			
Moderate Income Alternative	8%	7%	8%
Low Income Alternative	5%	5%	6%
VIII. <u>In-Lieu Fee Per Sf of Total Saleable Area</u>	\$27.40	\$25.60	\$25.10

¹ The development cost estimates are based on the pro forma analyses for the MARKET RATE ALTERNATIVE in each scer