



KEYSER MARSTON ASSOCIATES

INCLUSIONARY HOUSING: FINANCIAL EVALUATION

Prepared for:

City of Costa Mesa

Prepared by:

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I. EXECUTIVE SUMMARY

A. Background

The City of Costa Mesa (City) recently received California Department of Housing and Community Development (HCD) approval of its the Sixth Cycle Housing Element (Housing Element). ¹ The Housing Element includes numerous implementation strategies including:

1. An evaluation of the potential for imposing Inclusionary Housing obligations on specific sites; and
2. Amending zoning code standards in defined areas throughout Costa Mesa.

Keyser Marston Associates, Inc. (KMA) was engaged by the City to prepare an Inclusionary Housing: Financial Evaluation (Financial Evaluation) to assess the viability of enacting an Inclusionary Housing program. Fundamental to this analysis is the assumption that the City will tie the zoning code amendments to the creation and adoption of an Inclusionary Housing Ordinance (Ordinance).

By way of background, over the past 20+ years the KMA Los Angeles office has assisted 37 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.

The KMA Financial Evaluation identifies supportable Inclusionary Housing program requirements for apartment and ownership housing developments. The fundamental purpose is to identify Inclusionary Housing requirements that balance the interests of property owners and developers against the City's need for affordable housing. The KMA evaluation methodology has been continually evolving over time. Each study is tailored to reflect the specific characteristics of the jurisdiction being evaluated.

¹ The Housing Element covers the period between 2021 and 2029.

B. Public Policy Objectives

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. These statutes and court rulings are described in Section 2 of this Financial Evaluation. It is important to understand the constraints and opportunities that are created by these statutes and court rulings.

C. Inclusionary Housing Program Design

In 2015, the California Supreme Court ruled in *California Building Industry Association v. City of San Jose*, 61 Cal 4th 435 (*San Jose*) that Inclusionary Housing Programs should be viewed as use restrictions that are a valid exercise of a jurisdiction's zoning powers. However, the *San Jose* ruling also imposed the following limitations to the requirements that jurisdictions can impose:

1. Inclusionary Housing requirements cannot be confiscatory; and
2. Inclusionary Housing 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 evaluate these limitations. 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 evaluating potential requirements in order to comport with the court's ruling.

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 Financial Evaluation uses information presented in the Housing Element for this purpose.

D. Financial Analyses

The Financial Evaluation considers the impacts created by the structure of the proposed Ordinance:

1. Zoning code amendments are proposed to be enacted in defined overlay areas within Costa Mesa. The Financial Evaluation analyses the impact the amended standards could potentially have on the values supported by the impacted properties.
2. An Inclusionary Housing Ordinance establishes affordable housing obligations that will be imposed on residential development. The Financial Evaluation estimates the difference between the achievable market rate rent or sales price and the allowable rent or sales price for each “Inclusionary Unit”. This difference is called the “Affordability Gap”.

Working in conjunction with the City staff, KMA created prototype apartment and ownership housing developments for analysis purposes. The apartment prototypes are described in the following table:

Area	Base Zoning Density	Existing Use of the Site
North Costa Mesa	60 Units Per Acre	Vacant Business Park Land
Harbor Mixed Use	40 Units Per Acre	Improved Auto Property
Mesa West	40 Units Per Acre	Improved Industrial + Retail
19 West	40 Units Per Acre	Improved Industrial + Retail
SoBECA	50 Units Per Acre	Improved Industrial
Corridors	60 Units Per Acre	Improved Auto Property

The ownership prototypes analyzed in the Financial Evaluation are described in the following table:

Area	Base Zoning Density	Existing Use of the Site
North Costa Mesa	25 Units Per Acre	Vacant Residential Land
Harbor Mixed Use	15 Units Per Acre	Improved Warehouse
Mesa West	17 Units Per Acre	Improved Auto Property
19 West	20 Units Per Acre	Improved Warehouse
SoBECA	16 Units Per Acre	Improved Warehouse
Corridors	16 Units Per Acre	Improved Motel

The apartment and ownership housing development prototypes were used to test the impacts associated with the following development characteristics:

1. Site size;
2. Achievable density;
3. Maximum allowable height;
4. Parking requirements; and
5. Value of the development site:
 - a. The value supported prior to any amendment to the zoning code standards; and
 - b. The value created by the amendment to the zoning code standards.

The Financial Evaluation methodology can be described as follows:

1. KMA surveyed the market to compile information pertaining to:
 - a. Land and improved property sales values;
 - b. Common densities of apartment and ownership housing developments;
 - c. Unit mixes in apartment and ownership housing developments; and
 - d. Apartment rents and ownership housing sales prices.
2. City staff identified density and height standards that would be appropriate for application in the various overlay areas. The impacts created by the application of the California Government Code Section 65915 et seq. (Section 65915) density bonus were considered in creating the standards applied in this Financial Evaluation.
3. KMA prepared pro forma analyses to determine the following:
 - a. The land value supported by a 100% market rate apartment or ownership housing development.

- b. The magnitude of the value enhancement created by the identified modifications to the zoning code standards.
- c. The share of the value enhancement that can reasonably be committed to the provision of “Inclusionary Units” within a market rate residential development.

It is the City’s intention to create an Inclusionary Housing program that provides sufficient incentives to create opportunities for new housing development to occur. The findings of the KMA financial analysis were used to create benefits and incentives that offset the financial impacts created by the imposition of affordable housing requirements.

E. Findings

APARTMENT DEVELOPMENT

KMA concluded that the City could reasonably offer the following Inclusionary Housing production options for apartment developments:²

Recommended Inclusionary Housing Production Options Apartment Development					
Density Range	Low Income Units	+	Very Low Income Units	=	Total Obligation
0 to 39 Units Per Acre	6%	+	0%	=	6%
<u>40 to 59 Units Per Acre</u>					
Low Income Only	11%	+	0%	=	11%
Very Low Income Only	0%	+	7%	=	7%
Low & Very Low Income	6%	+	3%	=	9%
<u>60+ Units Per Acre</u>					
Low Income Only	19%	+	0%	=	19%
Very Low Income Only	0%	+	12%	=	12%
Low & Very Low Income	11%	+	5%	=	16%

² Only one option is provided for the lowest density category due to the limited requirement that is supported.

OWNERSHIP HOUSING DEVELOPMENT

The KMA analysis of ownership housing developments identified Affordability Gaps that range from \$557,000 to \$745,000 per moderate income unit. Given the magnitude of the gaps, it is KMA's recommendation that developers be permitted to pay a fee in lieu of producing affordable housing units. It is further our recommendation that the in-lieu revenue be used to create a first time homebuyer program that provides assistance to households who wish to purchase an existing home in Costa Mesa.

The Financial Evaluation is meant to assist the City in creating an Inclusionary Housing program that provides sufficient incentives and benefits to offset the impacts created by the affordable housing requirements being imposed. By definition, a program that is set up in this manner is not confiscatory and it does not deprive property owners of a fair and reasonable return on their investment.

F. Preliminary Recommendations

Based on the results of the Financial Evaluation, and to provide context to the City Council's decision making process, KMA has prepared general policy recommendations for consideration. These recommendations are presented in a memorandum that accompanies this Financial Evaluation. The topics covered include:

1. The minimum project size that would be subject to the Ordinance requirements;
2. The income and affordability standards to be imposed on apartment and ownership housing developments;
3. The covenant periods to be imposed on apartment and ownership housing developments;
4. Alternative means of fulfilling the Inclusionary Housing obligations; and
5. Recommended administrative procedures.