Prepared by

BEACON ECONOMICS

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Assessing San Jose's Inclusionary Housing Ordinance

REPORT EMBARGOED UNTIL 10:30AM PST ON WEDNESDAY OCTOBER 30, 2019

About Beacon Economics

Founded in 2007, Beacon Economics, an LLC and certified Small Business Enterprise in California, is an independent research and consulting firm dedicated to delivering accurate, insightful and objectively based economic analysis. Leveraging unique proprietary models, vast databases and sophisticated data processing, the company's specialized practice areas include sustainable growth and development, real estate market analysis, economic forecasting, industry analysis, economic policy analysis and economic impact studies. Beacon Economics equips its clients with the data and analysis required to understand the significance of on-the-ground realities and to make informed business and policy decisions.

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Executive Summary

The City of San Jose is a part of a region that has been home to rampant house price and rent inflation. Since 2010, house prices in the City of San Jose and Santa Clara County have doubled. Nationally, the price of houses increased by 39% over this period. Over the same period, rents in San Jose have increased by 47%, compared to 43% in Santa Clara County and 16% for the whole nation. Such increases put a strain on households across the income spectrum, but especially the lowest earning members of a community.

Against this backdrop, on January 12 2010, the City of San Jose adopted a law intended to make housing in the city more affordable, the Inclusionary Housing Ordinance (IHO). The law requires all developments in San Jose of more than 20 new, additional, or modified dwelling units to provide 15% of housing on-site that is affordable to income qualified buyers and renters. For for-sale buildings, units should be available for purchasers at or below 120% Area Median Income (AMI). For rental units, 9% of units should be available for renters at or below 80% of AMI and an additional 6% of units should be available for renters at or below 50% of AMI. The IHO implementation was stalled due to a legal challenge until the California Supreme Court resolved the matter with regard to “for sale” buildings in 2015. With the passage of AB 1505 in September 2017, the IHO was then implemented for rental buildings.

In-lieu of this requirement, a developer can provide affordable housing units at an alternative location or pay a fee. For off-site units, a developer must provide an equivalent to 20% of the number of units in the proposed development. For these off-site units, the same 120% AMI requirement applies to for-sale homes. For rental units, 12% of off-site units must be set aside for renters at 60% of AMI, with the additional 8% for renters at 50% of AMI. For the period July 1, 2019 to June 30, 2020, the in-lieu fees are $192,946 per inclusionary for-sale unit and $125,000 per inclusionary rental unit.

The city has set the target of producing 10,000 new affordable housing units by 2022.

In light of ongoing challenges in the housing market, the City of San Jose’s Housing Department has proposed a number of reforms to IHO, which are sensitive to the development feasibility of both market rate and affordable housing production.

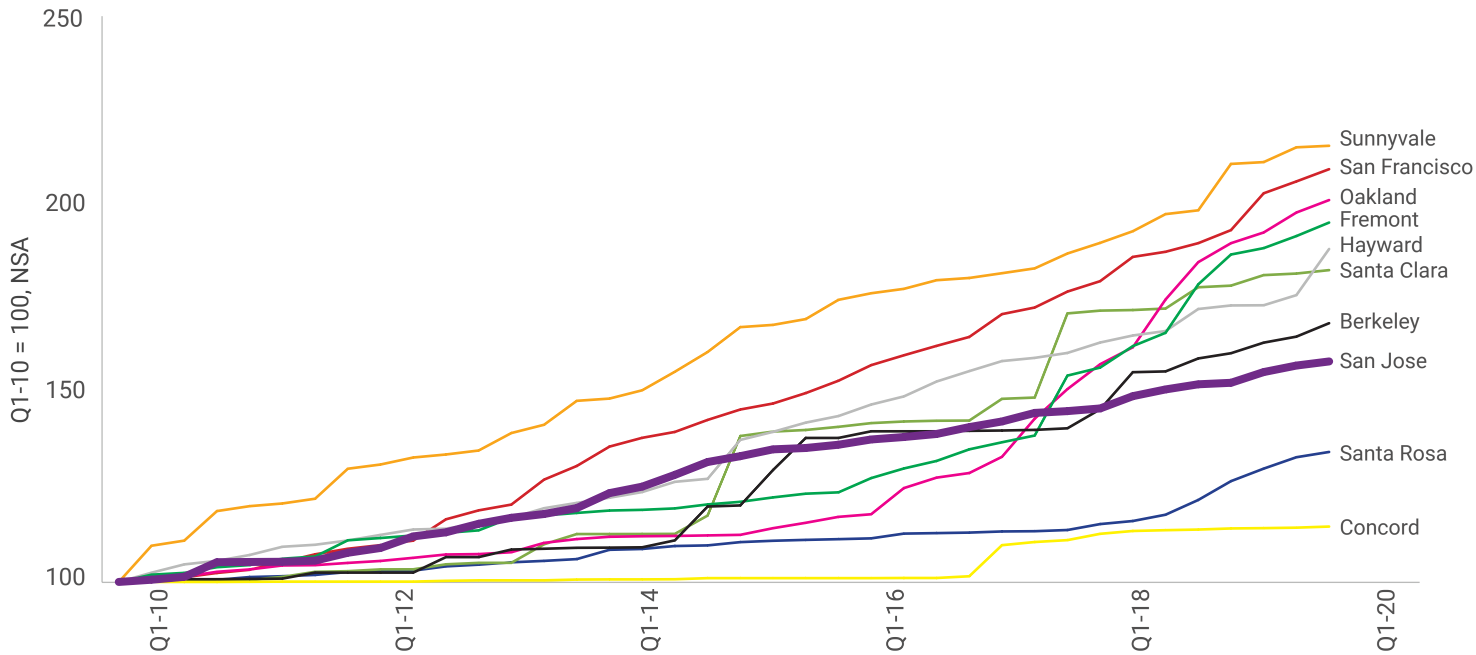
In the following report, Beacon Economics (“Beacon”) assesses the implications of the city’s IHO. The following report considers recent trends in the supply of affordable and market-rate housing in the city, how much money has been generated in fees under the law, how IHO affects the financial feasibility of multifamily development projects across the city and potential ways in which IHO can be reformed.

The study findings are as follows:

Trends in Permitting Activity

1. Since 2010, the supply of multifamily building permits in San Jose has lagged behind the rate of supply in other large cities in the Bay Area. Only the cities of Santa Rosa and Concord issued multifamily housing permits at a slower rate than in the City of San Jose.

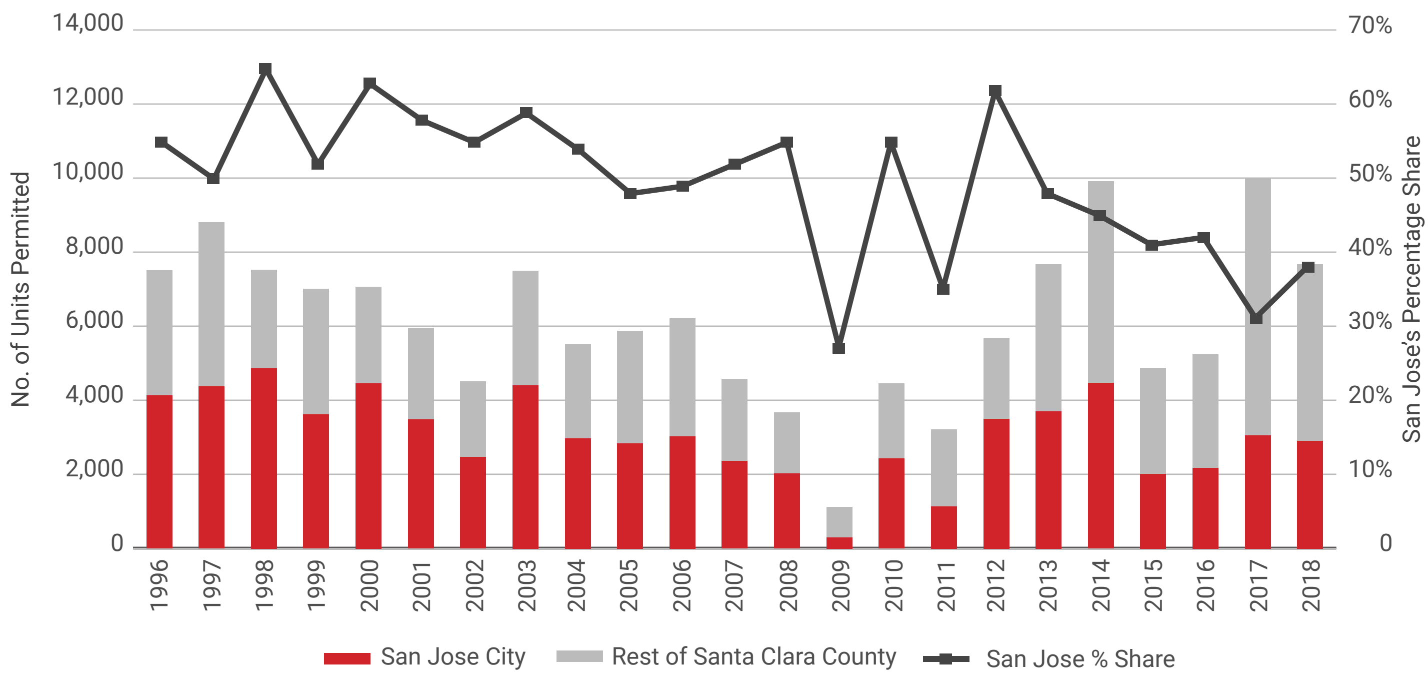
Indexed Cummulative Housing Permits Issued
City of San Jose and Large Bay Area Cities



Source: Construction Industry Research Board, California Homebuilding Foundation, Analysis by Beacon Economics

2. At the same time, San Jose's share or the number of permits issued in Santa Clara County has been falling, from 62% of the total in 2012 to 38% in 2018.

San Jose and Rest of Santa Clara County



Source: Construction Industry Research Board, California Homebuilding Foundation, Analysis by Beacon Economics

Assessing the Inclusionary Housing Ordinance

3. Based on Beacon's analysis of development fees in place across the city , the Inclusionary Housing Ordinance can be a significant increased cost to development in the city. That said, there are many factors that impact the feasibility of development, especially in the downtown area.

- On average, IHO adds around 5% to the cost of a development in the city. In a margin sensitive industry, this additional fee renders many development projects financially untenable.
- IHO fees are the single biggest city fee, accounting for between 4.7% and 5.2% of the cost of a development in most parts of the city.

Development Fees in the City of San Jose

City Fees	W. San Carlos & N. 1st	Stevens Creek	South & East	Downtown (Incentive)	Downtown (Non-Incentive)	North San Jose
Affordable Housing (IHO)	5.0%	5.0%	5.2%	0.0%	4.7%	4.8%
Park Impact in-Lieu Fees	3.1%	2.7%	2.3%	2.3%	2.2%	5.6%
Construction Tax	1.3%	1.3%	1.3%	0.6%	1.1%	1.2%
Traffic Impact Fees	0.2%	0.0%	0.1%	0.0%	0.0%	1.7%
Development Services Fees	1.3%	1.3%	1.4%	1.3%	1.2%	1.3%
City Fees, Total	10.9%	10.2%	10.2%	4.2%	9.3%	14.7%

Source: City of San Jose; Analysis by Beacon Economics

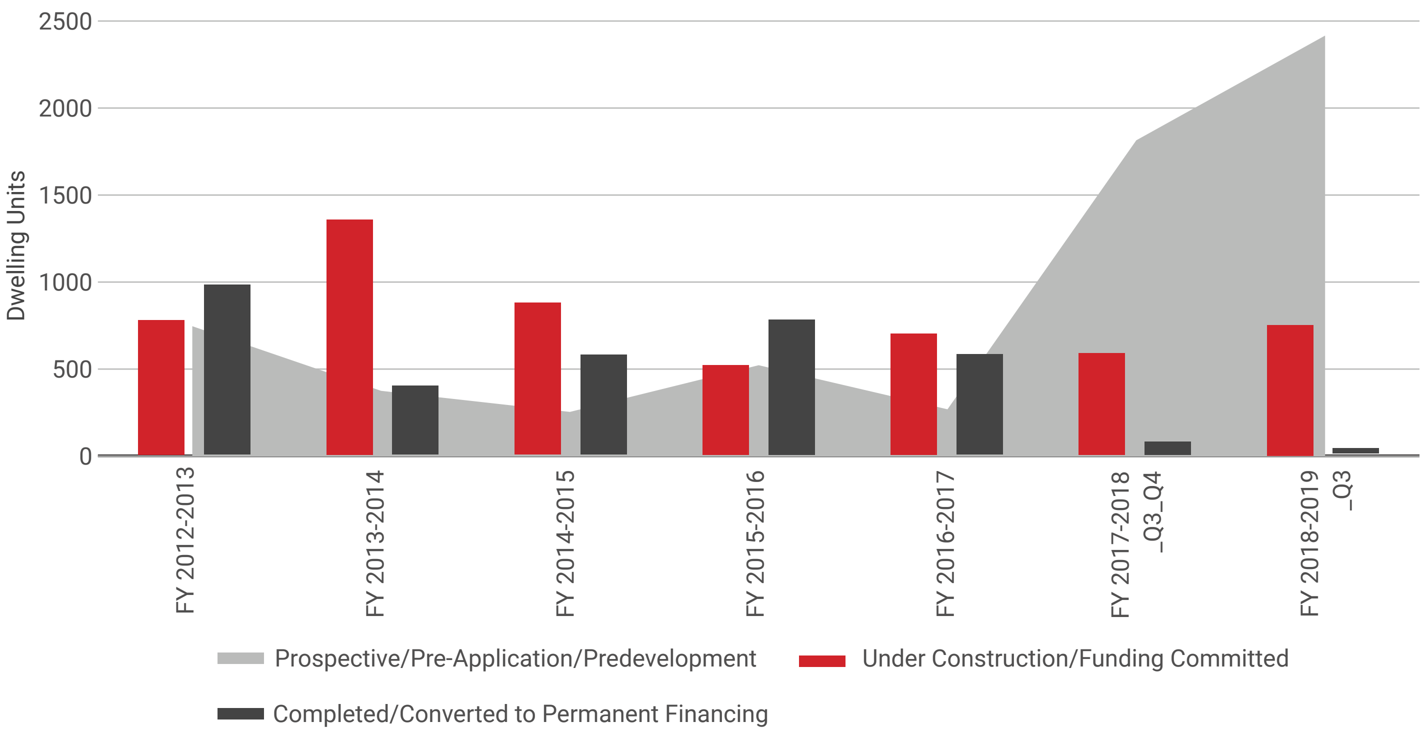
- Beacon analyzed 33 potential development projects across the city, to determine how IHO affects the financial feasibility of projects. According to this analysis, 27 projects are financially infeasible under IHO – the fees reduce developer margins to the point where the projects become infeasible. When IHO fees are removed from the analysis, 13 more projects become feasible. In other words, by making development more expensive, IHO reduces the supply of market rate housing in the city.

4. The IHO makes the supply of market rate housing less feasible. At the same time, the current IHO has not yet significantly contributed to the city's production of affordable housing and it has raised little income for affordable housing production.

- As the chart below reveals, the number of complete affordable housing projects has fallen since the peak in 2014, while the number of projects under construction and which have been converted to permanent financing has fallen also.
- Since 2012, 316 affordable housing units have been completed in the city. A further 2,256 units have been converted to permanent financing.

- Since 2017, the construction of 107 affordable housing units has been completed. No projects have been converted to permanent financing over this period. If this rate of development were to continue, we would expect construction to be completed for around 150 more affordable housing units by 2022.

Indexed Cummulative Housing Permits Issued
City of San Jose and Selected Bay Area Cities



Source:City of San Jose Affordable Housing Production Report, Analysis by Beacon Economics

- Since the Inclusionary Housing Ordinance's inception, about $3.2 million in in-lieu fees have been collected. This was collected from one project. This implies the IHO fee collected was either from a for-sale project of 96 to 97 units or a for-rent project of about 128 units. The city is subsidizing no more than $125,000 per affordable unit. Based on this current revenue, we can expect the city to partly finance approximately 26 new affordable housing units.

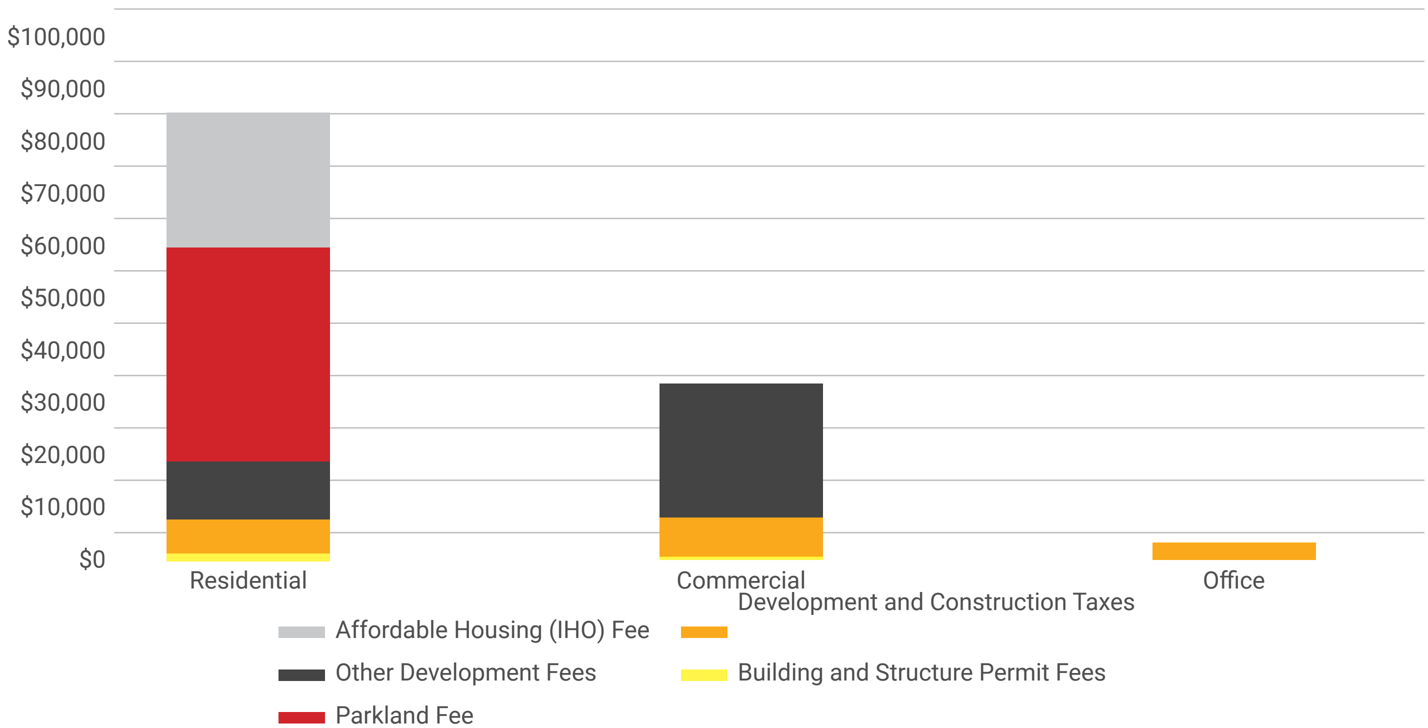
5. Other communities in the region have introduced Inclusionary Housing Ordinances, but San Jose's IHO is unique because it places fees on large projects (i.e. those developments of more than 20 units). San Francisco's IHO applies to developments of more than 10 units, and in the cities of Santa Clara, Cupertino and Oakland, the IHO applies to projects of at least one unit.

- In the City of San Jose, to avoid IHO fees, developers are incentivized to build developments of smaller units, compared to peer cities in the region. When developers are incentivized to build smaller projects, this suppresses the supply of new housing units in the community. The city's proposed recommendation to extend the IHO to developments of 5 units or more will help to address this challenge.

6. San Jose is also different from its peer cities because it does not have a commercial linkage fee, which is another mechanism for raising income for affordable housing. However, the city is currently looking at a new commercial linkage fee structure that is sensitive to the development feasibility of commercial projects. However, this has not yet been implemented. Consider the following chart, which compares the fees applied to 90-unit developments in the City of San Jose, across different types of development.

- On a per unit basis, development fees are higher on residential development, even without the Inclusionary Housing Ordinance. Not only is the burden of raising income for affordable housing placed on large compared to small residential projects, but large residential developments bear the cost compared to similar sized commercial developments.

Development Fees per Unit



Source: City of San Jose, Analysis by Beacon Economics. Numbers relate to the north San Jose area

Context for Reform

San Jose's Inclusionary Housing Ordinance does not exist in a vacuum, according to National Association of Realtor's "Barriers to Apartment Construction Index" (April 2019)", San Jose has the highest barriers to apartment construction in the nation.

- Out of the 58 metro areas studied by the National Association of Realtor's San Jose metro scored:
- Least favorable in community involvement
- 2nd least favorable in affordable housing requirements and entitlement process complexity
- 3rd least favorable in infrastructure constraints

- 4th least favorable in construction costs and land availability
- 13th least favorable in environmental restrictions
- 16th least favorable in political structure complexity

In Summary

The city's IHO ordinance is well-intentioned, but since its inception:

1. The supply of market rate housing in San Jose has lagged behind other large cities in the region
2. The supply of new affordable housing has been limited
3. Little income has been generated for new affordable housing
4. IHO fees render many development projects financially infeasible
5. San Jose use of IHO is applied more narrowly than peer cities in the region

Recently Propsed IHO Reforms

The city has recently proposed reforms to the Inclusionary Housing Ordinance. These changes include:

- Expanding the law to smaller projects (those of more than 5 units).
- Ensuring that affordable housing units are available to lower income members of the community than is the case under the present law.
- A mixed compliance option, which includes 5% affordable units (100% AMI) and a fee of $18.26 per square foot. This mixed compliance option could be provided, in-lieu of the $43 per square foot fee.
- Replacing the current in-lieu fee with a per square foot fee. For the next three years:
    - No fee would apply to downtown developments
    - The fee for West Valley, Willow Glen and Cambrian will be set at $43 per square foot
    - For all other areas of the city, the fee will be set at $18.26 per square foot
- After three years, a $43 per square foot will be applied to all developments in the city of more than 5 units.
- The following charts compare the city's current IHO fees with the proposed changes.
- In the first scenario, the $18.26 per square foot fee (which will be in effect for most areas of the city for the next three years) is compared to the current $125,000 fee for rental units.

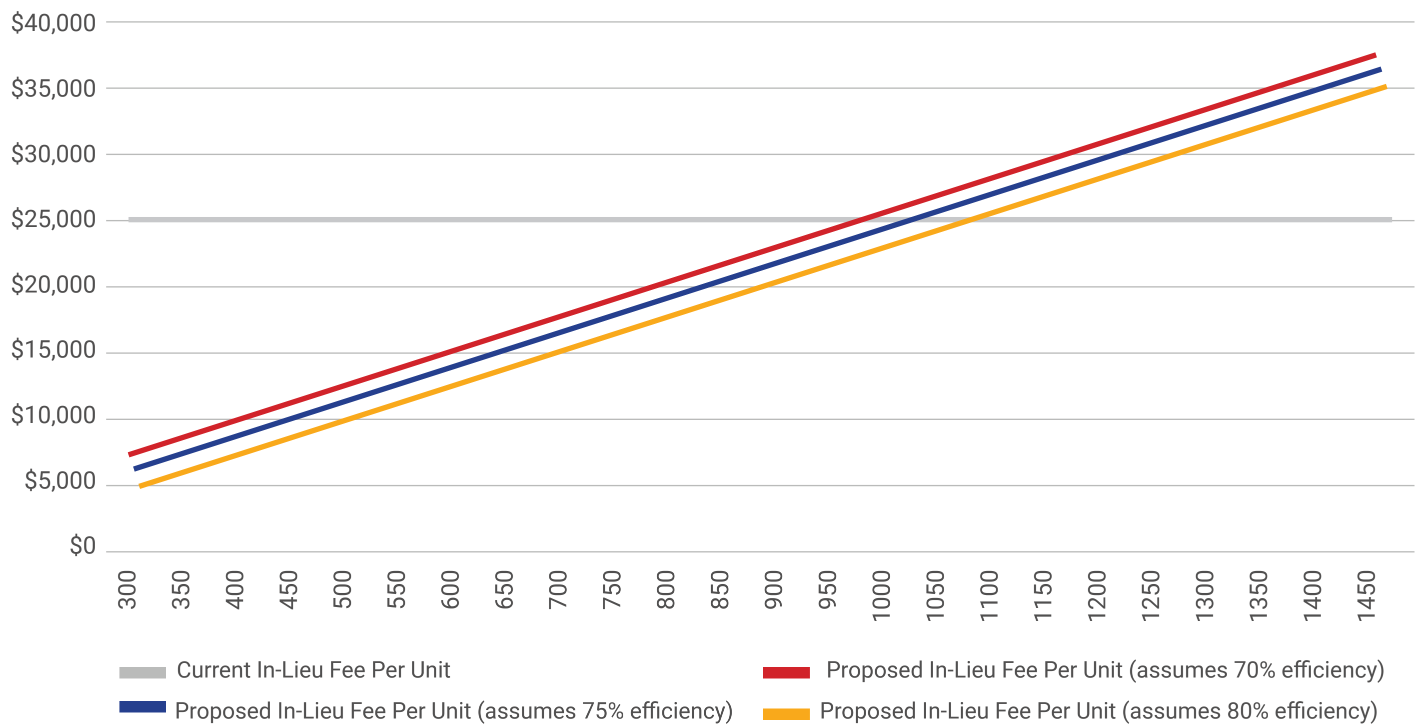
- Three efficiency scenarios are considered, ranging from 70%-80% (which refers to the proportion of a building's rentable area, i.e. its livable areas, excluding elevators, lobbies, hallways and so on). The chart below compares the IHO fee associated with the development of different sized dwelling units.

- Under a per square foot fee scenario, the IHO fee per unit would change according to the size of a unit. In the chart below, the yellow, blue and orange lines represent the change in the per unit fee as the per square foot size of a unit changes. The grey line represents the current IHO fee, which is fixed at $25,000 per unit no matter the size of a unit. When the yellow, blue and orange lines are below the grey line, the per unit fee is lower than the current fee. When the yellow, blue and orange lines are above the grey line, the per unit fee is higher than the current fee.

- Compared to the current fee, the $18.26 fee reduces the IHO burden for units of less than 1,000 -1,100 square feet, depending on the efficiency scenario. For example, a 700 square foot unit would generate a per unit fee of between $15,997.50 and $18,260. In effect, this would mean that the proposed temporary per square foot fee structure would incentivize the development of smaller units, which could add additional units within a certain development space.

Current vs. Proposed In-Lieu Fees by Dwelling Unit Size

Scenario 1: Per Sq/ft $18.26



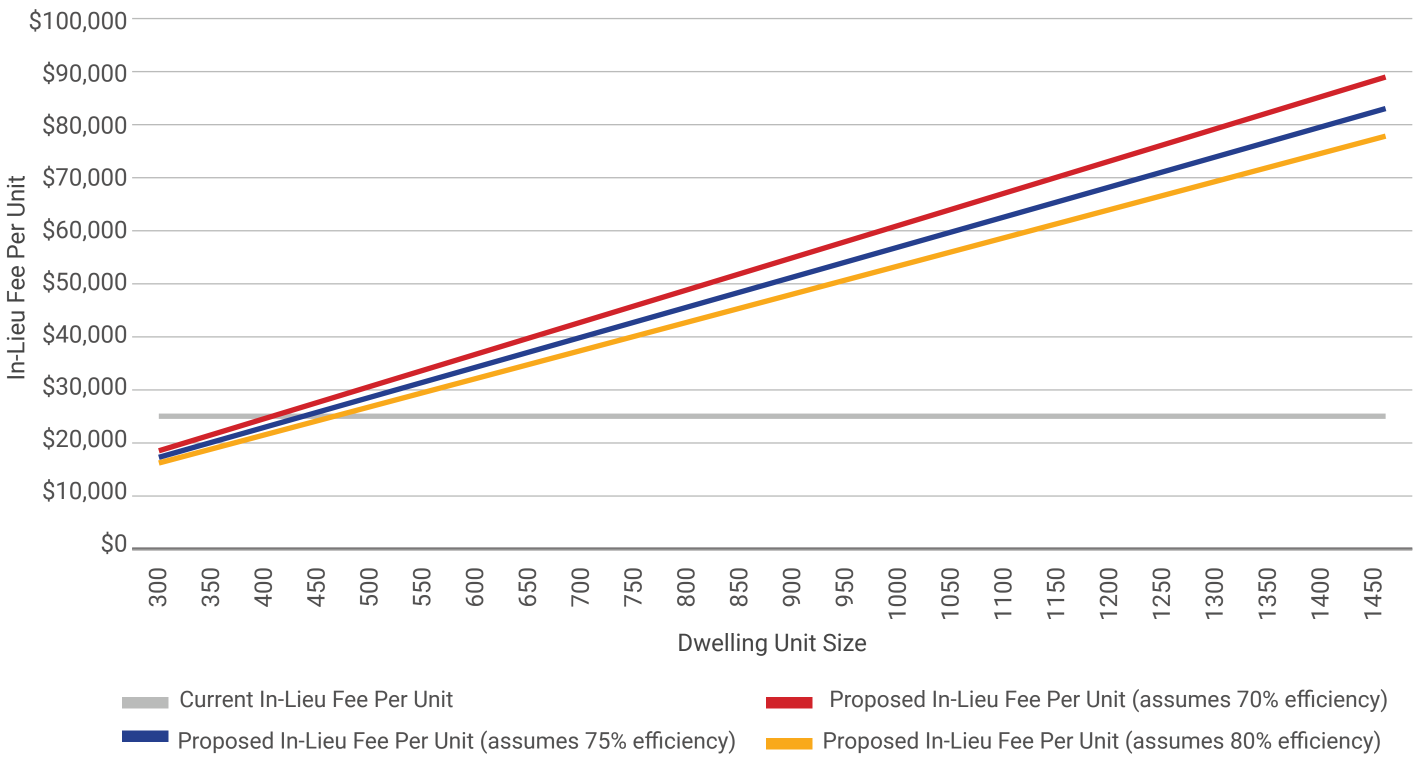
Source: Analysis by Beacon Economics based on city released figures

- In the second scenario, the $43 per square foot fee (which will be in effect after three years) is compared to the current $125,000 fee for rental units.

- Again, three efficiency scenarios are considered, ranging from 70%-80%.

- Compared to the current fee, the $43 square foot fee increases the IHO burden for units of more than 450-500 square feet, depending on the scenario. For example, a 700 square foot unit would generate a fee of between $37,625.00 and $43,000.

Current vs. Proposed In-Lieu Fees by Dwelling Unit Size
Scenario 2: Per Sq/ft $43



Source: Analysis by Beacon Economics based on city released figures

- Spreading the IHO fee across a broader range of development sizes could help to ease the burden on larger developments, and potentially generate more income for affordable housing. This can be accomplished through a smaller fee structure on high-density projects.

- At the same time, the $43 fee per square foot fee that will come into effect does not alleviate the current problems associated with the current IHO fee and will increase the fee burden on most development projects.

Recommendations

As currently constituted, San Jose's IHO will have the effect of suppressing the supply of market rate housing, while failing to produce significant levels of affordable housing. To improve this situation, a number of reforms emerge from this study:

1. The city could reduce the IHO fee on large development projects and apply a smaller fee more broadly to all residential development types in the city. This will have the effect of making larger development projects financially viable, helping to boost the supply of market rate housing in the city. A smaller fee applied to a larger base of users has the potential to raise more income for affordable housing. The city could also consider a variable fee structure that reduces the IHO fee on high-density developments compared to lower-density projects.

2. The city could reduce the IHO fee and introduce a small commercial linkage fee. Commercial linkage fees are less disruptive to housing markets because they do not directly impact the cost of producing housing.

3. One of the perverse effects of the IHO is that, to make housing more affordable, it makes the cost of new housing more expensive. To raise income for affordable housing, there are better ways to raise income. The city could consider a small tax on land – on a per parcel basis. This would place the burden of providing affordable housing on every property owner, not just new property owners.

4. A lack of housing supply is the true source of San Jose's housing crisis. Introducing measures to reduce barriers to new development, such as reducing fees and the complexity of the entitlement process, would make the city more hospitable to new housing development.

5. Finally, the city can help to increase the supply of housing through the zoning code. Up zoning, density bonuses and restricting the supply of single family housing can help to boost the city's housing supply, placing downward pressure on house prices.

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