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Oregon LOCUS Testimony on the Inclusionary Housing Proposal before the Portland Planning and Sustainability Commission

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Oregon LOCUS appreciates the opportunity to provide testimony to the City of Portland's Planning and Sustainability Commission on inclusionary housing policy, specifically the recommendations proposed by the Portland Housing Bureau (PHB.) Oregon LOCUS is the newly-formed local affiliate of Smart Growth America's LOCUS: a coalition of responsible real estate developers and investors. Our members include developers of mixed-use and multi-family properties throughout Portland's central city, neighborhood centers, and transit corridors.

Oregon LOCUS is committed to working with the City to achieve a successful Inclusionary Housing program that produces the greatest number and range of affordable housing units possible, without negatively impacting the overall housing supply and the City's growth goals.

As proposed, the Portland Housing Bureau's Inclusionary Housing Program Recommendations do not yet achieve a workable program. Oregon LOCUS proposes an alternative that will increase the amount and range of affordable housing units and maintain existing levels of housing production.

Oregon LOCUS approached our alternative by trying to retain policies PHB prioritized, including a voluntary 60% MFI element that is more attractive than the required 80% MFI element.

Three things became very clear: 1) no more than a 15% inclusion rate at 80% MFI is possible, given the conceivable offsets, without significant negative impacts to housing supply, 2) inclusionary requirements depend on the right offsets, and without them the requirements must be suspended, and 3) the inclusionary program should ramp-up over time to ensure the needed offsets are available and that institutional equity investors and lenders, national and international sources of capital that our housing production market is heavily dependent upon, can adjust to the program and will continue to finance multifamily projects and produce more housing—affordable and market.

An inclusionary housing alternative built on a development-reality foundation:

At the September 13, 2016 Panel of Experts meeting the Panel discussed the range of potential impacts of the Inclusionary Housing policy recommendations on future housing supply. The Panel requested that the development community provide pro formas to the Portland Housing Bureau to measure the impact of the Inclusionary Housing policy on the market. In response, Oregon LOCUS developed an Inclusionary Housing Pro Forma Impact Model to provide this level of information and analysis to the City and the Panel.

How our model works:

Oregon LOCUS' Inclusionary Housing Pro Forma Impact Model ("Model") quantifies the economic impact that the Portland Housing Bureau's Inclusionary Housing policy, as proposed, has on the very same Rental Housing Prototypes ("Prototype(s)") used by David Paul Rosen & Associates ("DRA") in its Inclusionary Housing Economic Analysis provided to the City, using sixteen actual projects that were recently constructed, are under construction or are in pre-construction in a range of market areas within the City of Portland. Specifically, we have modeled pro forma impact to Stacked Flats (3 Story Wood-Frame Construction), Podium (5 Floors of Wood-Frame Construction over 1 Floor of Concrete Construction), Metal Stud (8 Story of Light Gauge Steel Construction), and Concrete High Rise (15 Story Steel and Concrete Construction).

Overview of Inputs

At a high level, the Model projects the net operating income at completion ("NOI") of each Prototype based on current market conditions, taking into consideration market rents and operating expenses given the typical configuration of each. It next outlines the total development cost ("Total Cost") for each Prototype, which is inclusive of land, hard cost (construction costs – inclusive of labor and materials), and soft costs (architecture, engineering, permitting, etc.)

Source of Assumptions

The assumptions used in projection of NOI and Total Cost for each Prototype were based on input from Oregon LOCUS' developer and investor members, which include land owners such as Downtown Development Group; developers of institutional-grade high-rise and podium apartments such as Gerding Edlen Development, Holland Partner Group, American Assets Trust, Wood Partners, and Mill Creek Residential; and small scale developers of stacked flats and podium apartments including Urban Development + Partners, Urban Asset Advisors, and Mainland Northwest.

Methodology Overview

To quantify the economic impact on the previously discussed range of multi-family housing development Prototypes, the Model primarily utilizes the Income Approach, specifically the Direct Capitalization Method. NOI divided by Construction Cost establishes the Yield on Cost; in other words the annual percent return the project will generate on the project's total development cost. Yield on Cost is the typical measure of viability used by developers, their equity partners, and their lenders in making the development "go/no-go" decision, as it allows these market participants to compare the potential return of the project at hand to various alternatives, including government bonds, corporate

bonds, mutual funds, publicly traded stocks, and private investments in other companies or income producing assets.

Yield on Cost for the Prototypes was calculated in the model using current market assumptions (income and construction cost), as described above, in a status quo scenario. The resulting Yields represent “market clearing yields” necessary to attract equity and debt capital to move a project forward.

Next, Yields on Cost were calculated for the mandatory 80% MFI and voluntary 60% MFI inclusionary housing program as proposed by PHB. If the resulting Yields on Cost for each Prototype are less than those calculated in the status quo scenario, then the difference represents a viability gap. Investors measure yield in terms of basis points (bps), which are equal to one hundredth of one percent (1 bps = 0.01%), so the size of the basis point gap determines a multifamily deal that can be financed and one that cannot.

Outputs

First, we tested each Prototype in the model against the voluntary and mandatory program as proposed by PHB to measure yield degradation.

Table 1. City of Portland Yield Degradation by Product Type

Prototype	Status Quo Yield	Voluntary 60% MFI Yield	Yield Degradation	Mandatory 80% MFI Yield	Yield Degradation
Stacked Flats (3 Story)	6.01%	5.67%	34 bps	5.47%	54 bps
Podium (6 Story)	5.85%	5.45%	40 bps	5.17%	68 bps
Metal Stud (8 Story)	5.66%	5.59%	7 bps	5.21%	45 bps
Concrete (15 Story)	5.46%	5.38%	8 bps	5.00%	46 bps

Next, we translated yield degradation to dollar amount gaps in Total Cost in nominal dollars per unit.

Table 2. City of Portland Dollar Viability Gap by Product Type

Prototype	Status Quo Yield	Voluntary 60% MFI Yield	Viability Gap/Unit	Mandatory 80% MFI Yield	Viability Gap/Unit
Stacked Flats (3 Story)	6.01%	5.67%	\$16,667	5.47%	\$26,551
Podium (6 Story)	5.85%	5.45%	\$22,207	5.17%	\$37,651
Metal Stud (8 Story)	5.66%	5.59%	\$ 4,226	5.21%	\$28,612
Concrete (15 Story)	5.46%	5.38%	\$ 5,857	5.00%	\$33,717

Calibration of Results

In addition to modeling assumptions into the Prototypes based on direct experience of Oregon LOCUS members, we collected sixteen individual pro formas representing nearly \$1.1 billion of housing

development, totaling over 2,600 units delivered, under construction or in preconstruction in Portland's urban core.

These pro formas were added to the Model, reflecting the current 80% and 60% MFI recommendations and any "viability gaps" between real projects that worked and how they performed under the IH program proposed were identified.

Transparent Model Design and Use in Analysis of the Inclusionary Housing Program

Because the model is constructed within Microsoft Excel, any of the pro forma inputs and policy assumptions (i.e. inclusion rates, affordability level requirements, and an array of offsets and incentives) can be changed to observe the impact on project viability expressed in terms of (a) degradation of yield on project cost; (b) dollar impact on total development cost; and (c) dollar impact on annual net operating income. This allows viability gaps to be closed with additional offsets, a reduction in the inclusionary rate or a combination of both.

The PHB Inclusionary Housing Program Results: the 60% MFI element largely appears to work, but not for Mixed Use or <5.0 FAR Zones

The 60% MFI element in PHB's proposal appears to have very little viability gap, with one important exception. The PHB recommendations only include a property tax abatement on *affordable* units in Mixed Use Zones and those with less than 5.0 FAR; zones with 5.0 or greater FAR include a full abatement (all units). The resulting viability gap is \$16,667 to 22,207, depending on what's built. When the model for the PHB 60% MFI option for those lower FAR zones was run with a residential tax abatement on *all* units, along with the CET exemption on affordable and SDC waiver on affordable, the viability gap was closed.

For 5.0+ FAR zones where high rise is developed, PHB proposes using a full tax abatement, CET exemption on affordable units, and SDC waivers on affordable units. This results in a small gap of 8 bps, so a modest additional offset, such as BDS fee exemption should work. There is no gap for podium development.

Bottom line: With a *full* residential abatement, the viability gap can be closed for the PHB 60% MFI voluntary option; with a *partial* abatement, there is a significant viability gap in Mixed Use Zones and less dense zones, which will limit affordable and overall housing development.

In meeting Portland's growth goals and housing needs, Portland *also* needs a viable 80% MFI mandatory element in the inclusionary housing program to ensure the maximum number of housing units are developed at a range of affordability needs.

The PHB Inclusionary Program Results: the mandatory 80% MFI element cannot be achieved with a 20% inclusion rate without significant negative impacts to overall housing development and undercut the number of affordable units built.

Even with the proposed offsets for the PHB 80% MFI requirement (CET waiver on the affordable units, a *full* tax abatement on residential units for 5.0+ FAR zones) there is still a viability gap of \$33,717 per unit. In Mixed Use zones and zones with <5.0 FAR, the PHB proposal only allows abatement on the

affordable units, widening the viability gap to \$37,651 per unit. This gap is true whether stacked flats or podium units are developed.

None of the 16 proformas used in the Oregon LOCUS model would have penciled under the proposed PHB 80% MFI element—nearly \$1.1 billion of housing development and over 2,600 housing units delivered, under construction or in preconstruction in Portland *would not have been developed*.

Bottom line: The PHB proposal for a required 20% inclusion rate at 80% MFI results in a viability gap in all zones and types of development that will severely reduce housing development.

Oregon LOCUS Alternative Recommendation:

Oregon LOCUS supports implementation of an inclusionary housing program that produces the most affordable housing possible, while continuing to have robust overall housing development that will meet Portland’s growth goals.

Oregon LOCUS offers an alternative inclusionary housing program, calibrated to do just that:

- **For the voluntary 60% MFI option, provide a ten-year tax abatement for *all* residential units for *all* zones, in addition to the other offsets in the PHB’s 60% MFI recommendations, and retain the 10% inclusion rate.** This will address the viability gap in the Mixed Use and lower FAR zones, and help ensure those zones can absorb the 60% of projected growth targeted by the Planning and Sustainability Commission.
- **For the mandatory 80% MFI option, reduce the inclusion rate to 15% for the 80% MFI mandated element of the inclusionary housing program and better calibrate the offsets to market and investor realities;** as a part of the calibration, the Oregon LOCUS recommendation includes developers absorbing 10 bps of the viability gap to ensure the voluntary 60% MFI is more attractive. For a typical high-rise residential tower, 10 bps equates to approx. \$1.8 million in value, and approx. \$830,000 for a typical podium project).
 - Ten-year tax abatement for 10 years on *all* residential units in *all* zones.
 - CET and SDC waived on *affordable* units, *all* zones.
 - SDC waivers on *all* units for high rise and zones above 5.0 FAR, using State Building Codes definition of high rise to trigger the offset in Title 30. This will require raising the current 60% MFI cap on SDC waivers; alternatively, the inclusion rate could be lowered.
 - BDS fees waived on *affordable* units for high rise and zones above 5.0 FAR, using State Building Codes to trigger the offset in Title 30.
- **The offsets in the inclusionary housing program must be available for the inclusion requirements to be enforced.** This point is critical, and we believe that PHB is in agreement with this concern. Without the needed offsets, inclusionary housing requirements will significantly reduce housing development. Nor is it constructive to implement a program with offsets that run out quickly or are not available from the outset. Because the inclusionary requirements are contained in Title 33 code, while the offsets are largely contained in Title 30

code, it is important that both codes clearly include the interdependency of the requirements and offsets.

- **Recalibrate the PHB in-lieu fee to reflect the 15% inclusion rate in our alternative**, resulting in a fee range of \$17.25-23.00 per rentable square foot of residential development. This fee should only apply to *rentable* residential areas and not related common living areas or include parking or commercial square footage.
- **Ramp up the inclusionary housing program over time.** This will help reduce investor jitters and provide a predictable path so that needed offsets that may not be adequate for full implementation, such as tax abatements, can be secured.
 - *Start with 3% inclusion rate for mixed use zones and zones with base FAR below 5.0 and a 10% inclusion rate for zones with base FAR above 5.0 for 60% MFI; and a 3% inclusion rate for mixed use zones and zones with base FAR below 5.0 and a 11% inclusion rate for zones with base FAR above 5.0 for 80% MFI with the offsets as proposed in the PHB recommendations; the 3% rate at 60% and 80% MFI is necessary to address viability gap caused by the partial abatement in the current PHB proposal, and ensures the voluntary program remains more attractive than the mandated program during the ramp up.*
 - *Significantly raise the \$3 million cap on tax abatements.* The current cap covers approx. 1,100 units of housing outside urban renewal areas. As this abatement is needed for *all* residential units in order to successfully ramp up the inclusion rate, the cap needs to be raised to \$10 million to ensure this critical offset tool will be available for development outside URAs. We won't achieve the housing we need if we hit the cap. That said, Oregon LOCUS is aware that these discussions involved multiple jurisdictions and will take time. The ramp up provides that time.
 - *Set a low in-lieu fee as a safety valve during the initial program implementation.* A range of \$7.18-10.67 per rentable square foot of residential space is equivalent to the 10 bps of developer responsibility in the Oregon LOCUS alternative. The fee would also ramp up to the \$17.25-23.00 range over time to reflect the PHB in-lieu fee calibration at a 15% inclusion rate. This fee should only apply to *rentable* residential areas and not related common living areas or include parking or commercial square footage.
 - *Ramp up to 10% inclusion for 60% MFI and 15% inclusion for 80% MFI, as the needed offsets are secured and the investors acclimate to the inclusionary housing program, likely three-five years.* These increasing inclusion rates can be set in Title 33 and adjusted during RICAP.
- **Do not predicate new development on off-site option approvals.** Although Oregon LOCUS has not had adequate time to develop an alternative off-site recommendation, we offer two important observations: 1) new development should not trigger construction of two projects at the same time, when there are different financing and development requirements involved. Instead, the offsite option should allow a five-year performance window for the offsite development, with penalties for non-performance, and 2) any offsite option for *existing*

buildings should be considered separately from the inclusionary housing program at this time, given the income certification miss-match between the 80% MFI in MULTE projects and the 60% MFI rate in the PHB proposal. While Oregon LOCUS appreciates the desire to retain affordable housing that may be coming off the income restriction of the limited term MULTE program, the potential for unintended consequences is high. Since an offsite option for existing development is not a required element for an inclusionary housing program, it is far more prudent to take more time with this option and introduce it at a later time.

Conclusion: A well-calibrated inclusionary housing program can be a valuable tool to provide additional affordable housing, without negatively impacting the overall housing development that meets Portland's growth goals. By starting with a moderate program that ramps up over the predictable period of time, and ensuring the right offsets and safety valves are available there, Portland can create a successful, meaningful inclusionary housing program. With the Oregon LOCUS alternative, the housing market keeps producing more housing—affordable and all ranges. **It is the number of new affordable units produced that should be measured, rather than the highest inclusion rate.** A lower rate with strong overall production will do more to build affordable housing than an aggressive inclusion rate and reduced production.