EXECUTIVE SUMMARY
INCLUSIONARY AFFORDABLE HOUSING REAL ESTATE FINANCIAL FEASIBILITY ANALYSIS
AFFORDABLE HOUSING NEXUS ANALYSIS
CITY OF ENCINITAS

OVERVIEW

The City engaged Keyser Marston Associates, Inc. (KMA) to prepare an Inclusionary Affordable Housing Real Estate Financial Feasibility Analysis (feasibility study) and Affordable Housing Nexus Analysis (nexus study). The feasibility study evaluates the ability of market-rate residential development to sustain existing and potential updated inclusionary housing requirements. The analysis evaluates typical development projects Citywide with in-depth focus on six (6) Housing Element Update "R-30" Sites. The nexus study analyzes the linkages between development of new market-rate residential units and residential care facilities and the resulting increased need for affordable housing. The nexus analysis determines the maximum affordable housing fees that could be imposed on these developments in a manner consistent with the Mitigation Fee Act.

FEASIBILITY ANALYSIS OF CITYWIDE INCLUSIONARY REQUIREMENT

The feasibility analyses identified seven (7) residential prototypes in the City, ranging from R-3 to R-15 zoning for for-sale developments, a mixed-use development project, and R-20 garden-style rental apartments. KMA prepared base case financial pro forma models for each prototype, with and without an affordable housing density bonus, as well as sensitivity tests of the economic impacts of potential modified inclusionary set-asides and targeted household income levels. The KMA pro forma analyses demonstrated that a 5% increase in the Citywide inclusionary set-aside requirement has a relatively minor impact on development feasibility.

Based on the representative market-rate developments analyzed, KMA concludes that increasing the Citywide inclusionary requirement, from the current 10% Very Low income or 15% Low Income, to 15% Very Low Income or 20% Low Income, is financially feasible. A period of adjustment may be needed for the market to absorb the new inclusionary requirements, as developers consider how to incorporate new requirements and evaluate alternative means of compliance.

FEASIBILITY ANALYSIS OF "R-30" OVERLAY ZONE SITES INCLUSIONARY REQUIREMENT

KMA also tested development alternatives for six (6) Housing Element Update "R-30" Sites:

- 08a/08b Rancho Santa Fe Parcels
- AD1 Sage Canyon
- AD2 Baldwin & Sons Properties
- 07 Jackel Property
- 12 Sunshine Garden
- AD11 Manchester Avenue West

For these six (6) "R-30" Sites, KMA prepared financial pro formas for base case scenarios (existing zoning) and upzone ("R-30") scenarios, allowing for 30 units per acre plus a possible affordable housing density bonus totaling approximately 40 units per acre. Key findings from the KMA pro forma analyses indicate:

- The feasibility of increased inclusionary requirements on the "R-30" Sites varies depending on the development potential under their existing zoning.
- In most cases, it is feasible to increase the City's existing inclusionary requirement, from the current 10% Very Low Income or 15% Low Income, to 15% Very Low Income or 20% Low Income. The notable exception is the 07 Jackel Property, due to the potential for visitor-serving development under its base zoning, which was found to be financially more attractive than residential.
- Three of the "R-30" Sites (08a/08b Rancho Santa Fe Parcel, AD1 Sage Canyon, and AD2 Baldwin & Son Properties) could support a further increase in the inclusionary requirement to 20% Very Low Income or 25% Low Income.

AFFORDABLE HOUSING FEE LEVELS

The City may consider the establishment of an affordable housing fee that is applied to new residential construction and/or residential care facilities. KMA used three approaches to determine possible fee levels: (1) maximum fee levels supported by the nexus study; (2) the funding level required for the City to develop affordable housing in an off-site location; and (3) the economic impact on the developer to provide affordable housing on-site.

- *Approach #1 – Nexus Study Maximum Fees* – Based on current case law, a nexus study is not required to implement an inclusionary requirement or to establish in-lieu fees that are alternatives to including affordable units on-site. However, since some projects may not have a practical ability to include affordable units on-site, especially small projects and single-unit developments, making the fee the primary compliance option available, the nexus study was prepared as a secondary "backup" legal support measure for in-lieu fees. The nexus study determined maximum affordable housing fees for residential development and residential care facilities that may be applied consistent with the Mitigation Fee Act (California Government Code § 66000 et seq.) as follows:
  - The maximum supported affordable housing fee for market-rate residential ranges from $32 to $66 per SF of living area.
  - If the City adopted one single, per-SF fee for all market-rate housing, the study supports a maximum fee of $32 per SF.

- The nexus study also established the maximum affordable housing fee for residential care facilities of $48.70 per SF.

- *Approach #2 – Off-Site Affordability Gap* – This approach determines how much the City would need to receive from a market-rate residential developer in order to produce affordable rental housing in an off-site location. KMA findings indicate the following:

    - KMA estimates affordability gaps of $271,000 per Very Low Income unit and $242,000 per Low Income unit. Under the City's existing inclusionary requirement, the Very Low Income gap figure equates to $27,100 per market-rate unit (10% times $271,000); the Low Income gap figure translates to $36,300 per market-rate unit (15% times $242,000).

    - To fund the creation of 15% Very Low Income units in an off-site location (5% increase over existing requirements), the City would need to receive a fee of between $10.16 to $49.27 per square foot (SF), depending on the size of the market-rate unit, or an average of $23.50 per SF.

    - To fund the creation of 20% Low Income units in an off-site location (5% increase over existing requirements), the City would need to receive between $12.10 to $58.67 per SF, depending on the size of the market-rate unit, or an average of $28.00 per SF.

- *Approach 3 – Economic Impact of Including Units On-Site* – This approach uses the feasibility analysis to estimate fee levels that are approximately equivalent to the economic impact to market-rate developments of incorporating inclusionary units on-site. Findings consider the cost of setting aside the affordable units, as well as the offsetting density bonus benefit to the project. KMA findings indicate the following:

    - The economic impact of including 15% Very Low Income units on-site (5% increase over existing requirements) is estimated to range from $0 to $34.50 per SF, or an average of $20.18 per SF living area of market-rate development. (Some prototypes are estimated to have zero economic impact from providing affordable units on-site due to the fact that the density bonus benefits are found to outweigh the costs of providing the affordable units. The two development prototypes found to have zero economic impact of including affordable units on-site are excluded in calculating the $20.18 per SF average, as these projects would not be expected to utilize a fee option.)

    - Including 20% Low Income units on-site (5% increase over existing requirement) results in an economic impact to market-rate developers ranging from $0 to $45 per SF, or an average of $30.54 per SF of living area. (The $30.54 per SF average excludes one prototype estimated to have zero economic from including units on-site because this project type is assumed to be unlikely to utilize an in-lieu fee option.)

KMA Fee Level Recommendation

In view of the above approaches, and assuming the City proceeds with the 5% increase to existing inclusionary requirements found to be supportable, the City may wish to consider an in-lieu fee of approximately $20 per SF of living area for market-rate residential development and a consistent fee of $20 per SF of floor area for residential care facilities, based on the following key findings:

- The nexus study supports a *maximum* fee of $32 to $66 per SF for residential and $48.70 for residential care facilities.

- The funding level required for the City to create affordable housing off-site averages approximately $23.50 per SF across all of the prototypes analyzed, or $19 per SF for for-sale prototypes, excluding higher off-site costs for apartment projects from the average. (Due to the smaller average unit sizes of apartments compared to for-sale projects, funding levels required to create affordable units off-site translate into a higher per-SF cost measured against the market-rate apartments, although costs are the same on a per-unit basis.)

- The economic impact of incorporating affordable housing on-site averages to about $20 per SF with the 15% Very Low inclusionary requirement.

- A fee less than the maximum nexus-supported level allows the City to collect the required amount to build off-site affordable units while maintaining fees at a feasible level that is roughly in balance with the cost of including units on-site.

- If the City would like to maintain a focus on on-site affordable units, the City may wish to continue to require a discretionary approval to utilize the in-lieu fee option for projects of seven or more units.

The City may also wish to consider allowing for a sliding scale of the $20 per SF fee for projects with six or less units in order to enhance project feasibility.

In order to mitigate affordable housing impacts -- and fund affordable housing -- over a long term and respond to economic cycles, the City should consider a potential annual escalator that could be used to adjust fee levels over time, such as the Construction Cost Index (CCI).