KEYSER MARSTON ASSOCIATES
ADVISORS IN PUBLIC/PRIVATE REAL ESTATE DEVELOPMENT

July 7, 2015

Ms. Leslie Little
Assistant City Manager for Community Development
City of Morgan Hill
17575 Peak Avenue
Morgan Hill, CA 95037

Re: Affordable Housing Program Analysis and Options

Dear Ms. Little:

Thank you for requesting this proposed scope of work from Keyser Marston Associates, Inc. (KMA) to analyze economic issues relating to the affordable housing criteria of the City's Residential Development Control System (RDCS) and present options that the City may wish to pursue to enhance the effectiveness of its affordable housing program. The following scope is a draft. We anticipate refining the scope once you have had a chance to review and provide comments on this draft to ensure that scope addresses each of your specific concerns.

1. Calculate Cost of Providing 8% On-site Affordable Units

The RCDS enables for-sale residential developments to receive 13 to 15 points if 8% of the project's units are deed restricted affordable units for Low to Moderate-income households. The requirements vary by product type. In summary the requirements are as follows:

	Condominiums	Townhouses	R-2 SFD & R-1 7000	R-1 9000 & above lot size
13 points	4% of units at 70% AMI and 4% at 90% AMI	4% at 73% AMI and 4% at 100% AMI	4% at 76% AMI and 4% at 110% AMI	4% at 80% AMI and 4% at 120% AMI
14 points	6% at 70% AMI and 2% at 90% AMI	6% at 73% AMI and 2% at 100% AMI	6% at 76% AMI and 2% at 110% of AMI	6% at 80% AMI and 2% at 120% AMI
15 points	8% at 65% AMI	8% at 70% AMI	8% at 75% AMI	8% at 80% AMI

We will meet with City staff to identify actual projects to serve as case studies for each of the four product types. We will obtain market data on each project, including the range of market rate prices by unit size, and calculate the difference between the market rate prices and the maximum allowable prices for affordable units permitted under the City's program. The delta between market rate prices and affordable prices is the cost of providing one on-site affordable unit. Using this data, KMA will prepare a matrix showing the cost of providing 8% on-site affordable units to achieve the range of points for each product type. This will provide an understanding of the relative cost to a condominium project versus the cost to a large lot single family home development. As part of this effort, we will also review the City's formula for determining maximum affordable prices. We will compare the formula to those used by other jurisdictions.

2. Compare the Cost of Providing On-site Units to the In-Lieu Fee Schedule

The City's current in-lieu fee is $150,000 per affordable unit. KMA will compare the cost of providing on-site units to the in-lieu fee. This analysis will provide an understanding of:

- the financial impacts to a developer of paying an in-lieu fee relative to providing units on-site.
- circumstances in which it is financially beneficial to applicants to pay fees instead of building on-site and vice versa; and
- adjustments that would need to be made to the in-lieu fee amount in order for the fee amount to be equal to the cost of providing on-site units.

From this analysis, we could also analyze the magnitude of fee revenue that could be generated if the city switched to a fee program with fee levels more in line with full cost recovery. The City could use the fee revenues to provide down payment assistance, extend affordability covenants on tax credit projects that are due to expire, assist in the construction of units that are needed in the community, provide home improvement loans or assistance with escalating HOA dues, etc.

3. Optional – Evaluate Cost of Providing On-site units Affordable at Above Moderate Income Levels, such as at 150% of AMI and 180% of AMI

Market rate home prices have been escalating at a much faster rate than income levels, resulting in a growing need for housing that is priced above Moderate income prices but less than market rate prices. This price range is often referred to as "workforce" housing and priced at 150% to 180% of AMI. The price differential or "gap" between market rate prices and workforce prices is obviously less than the gap between market rate prices and moderate or low income prices. At your request, we will calculate the gap associated with these workforce prices or other desirable price levels.

4. *Optional – Evaluate Economic Challenges to BMR Homeowners from Rising HOA Dues, Maintenance Costs, Stagnant Wages and Inability to Use Home Equity to Fund Improvements*

Based on our phone conversation, it is our understanding that the owners of BMR units in Morgan Hill are, in some cases, struggling to continue to pay HOA dues as they increase over time and adequately maintain aging units. These issues are common for BMR programs, especially as the stock ages, and are more acute for Low income homeowners than for Moderate income homeowners because of the reduced amount of disposable income of Low Income households. Funding long term maintenance is also an inherent problem of deed-restricted affordable housing programs. Owners of market rate units often take-out home equity loans to fund large maintenance costs, such as replacing flooring, kitchens, bathrooms, etc. This funding source is not really available to BMR owners because of the long-term price controls on the units, which severely limit equity appreciation for the homeowner. Without an ability to fund improvements or rising HOA dues, BMR owners often turn to the City for financial assistance and relief. Redevelopment funds were commonly used for these purposes, but are no longer available given the dissolution of Redevelopment agencies in 2012.

Using data available on Morgan Hill's BMR stock, we will quantify and present the challenges being faced by the BMR homeowners and, by extension, the City's affordable housing program.

5. *Optional – Evaluate the Economics of a Shared Appreciation Program and Compare to the Economics of Long Term Deed Restrictions*

An alternative to long term price and income restrictions is "shared appreciation." While specific terms vary among programs, the hallmark of shared appreciation programs is that units are resold on the open market at market rate prices and the homeowner shares in a portion of the appreciation of the unit. The cited benefits of these types of programs include: they provide BMR owners with a greater opportunity to benefit from appreciating home prices and potential to move-up into market rate housing; they provide a mechanism for enabling homeowners and the city to tap into the equity of the home for long-term maintenance, they are less burdensome and costly for the city to monitor and implement, and they provide the city with funds to continue to operate an affordable housing program. The key disadvantage of shared appreciation is that the stock of affordable units diminishes over time and the city's share of resale proceeds is typically insufficient to fully replace the sold unit with another new affordable unit.

We will evaluate the magnitude of resale proceeds that the homeowner and city would receive under a range of assumptions regarding the escalation of home prices and the split of appreciation between the city and the homeowner. We will compare the returns/revenues to the amount that would be generated with long term deed restrictions.

6. Miscellaneous Task 6

At the City's direction, KMA will evaluate other issues. Possible examples include: collaborating with Julius Nyanda regarding homebuyers' need for down payment assistance, distilling the attributes of the existing BMR stock and residents prevalence of mortgage encumbrances in excess of permitted amounts.

Budget Estimate

The following is a rough estimate of the cost to undertake these analyses. We will refine the budget as we refine the scope.

Task 1: Calculate cost of providing 8% affordable units on-site	$7,500
Task 2: Compare cost of providing on-site units to paying in-lieu fee and the potential magnitude of fee revenue	$3,000
Optional Task 3: Evaluate cost of providing on-site workforce housing units priced above Moderate Income	$3,000
Optional Task 4: Evaluate and present challenges to homeowners from rising HOA dues and insufficient funds for maintenance	$4,500
Optional Task 5: Evaluate the economics of a shared appreciation program and compare with the economics of long-term deed restrictions	$8,500
Task 6: Miscellaneous	$6,000

We look forward to discussing this draft scope with you in detail and how it could be modified to address your specific needs.

Thank you again for contacting us about this assignment. We would be delighted to assist you in this evaluation to improve the efficacy of Morgan Hill's affordable housing program.

Sincerely,

KEYSER MARSTON ASSOCIATES, INC.

Debbie M Kern

Debbie M. Kern