DRAFT MEMORANDUM

To: Marlene Subhashini and Leslie Carmichael, City of Foster City

From: Darin Smith and Chinmay Damle

Subject: Housing Fee Implementation Considerations; EPS #211040

Date: January 24, 2022

Economic & Planning Systems, Inc. (EPS) was retained by the City of Foster City (City) to calculate inclusionary housing in-lieu fees for ownership and rental residential projects. Those analyses are provided under separate cover. In this memorandum, EPS evaluates the competitive and feasibility implications of implementing the inclusionary programs by comparing inclusionary requirements in other jurisdictions and evaluates the effect that different requirements and fee levels could have on new development activity in Foster City.

Key Findings

1. **Foster City has seen significant housing price inflation in recent years.** Rent rates have increased by roughly 33 percent in the past decade, while for-sale home values have more than doubled. To purchase a typical home in Foster City today, a household would need to earn roughly $300,000, nearly double the City's median income.

2. **Foster City's proposed inclusionary standards are somewhat more aggressive than those in comparable jurisdictions within San Mateo County.** Of the neighboring cities to Foster City, most require 15 percent affordable units compared to Foster City's 20 percent. However, like Foster City, it is common for cities to require low and very low income units in rental projects, and moderate income units in for-sale projects.

3. **The City staff suggestion for rental inclusionary housing scenarios is deemed feasible by the model; however the ownership scenarios appear to represent a feasibility challenge.** For rental projects, it appears feasible to require up to 20 percent inclusionary units, including a mix of very low, low, and moderate income units. However, a requirement for for-sale projects to provide 20 percent of units affordable to moderate income units does not appear to be feasible without some adjustment to market circumstances or assumptions. A standard more consistent with those in nearby communities – 15 percent moderate income units – would enhance project feasibility for for-sale developments.

The Economics of Land Use

Economic & Planning Systems, Inc.
1330 Broadway
Suite 450
Oakland, CA 94612
510 841 9190 tel

Oakland
Sacramento
Denver
Los Angeles

www.epsys.com

Context

Foster City is a high-income community in a high-income County and region, and housing costs are of increasing concern for many working households and policymakers. As of 2019, Foster City's median household income of $158,529 was about 14 percent above the San Mateo County median and about 140 percent above the national median. As shown in **Table 1**, income distribution in Foster City is similar to the County.

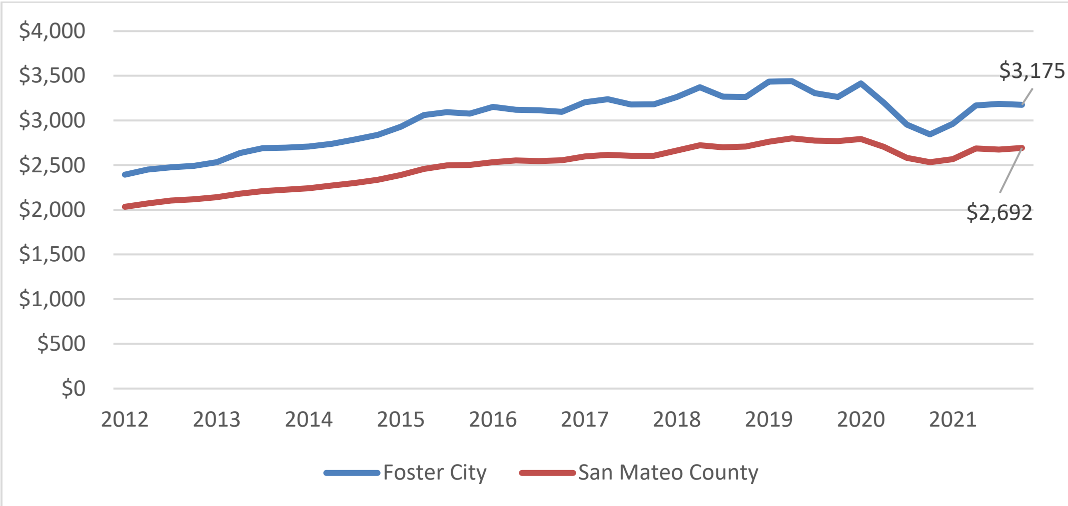
Table 1 Household Income Distribution

Household Income Range	Foster City	San Mateo County	United States
Less than $10,000	2.80%	2.30%	5.80%
$10,000 to $14,999	1.10%	1.90%	4.00%
$15,000 to $24,999	2.60%	4.10%	8.30%
$25,000 to $34,999	2.90%	3.50%	8.40%
$35,000 to $49,999	5.70%	6.40%	11.90%
$50,000 to $74,999	5.70%	10.20%	17.40%
$75,000 to $99,999	7.70%	8.70%	12.80%
$100,000 to $149,999	18.50%	16.90%	15.70%
$150,000 to $199,999	15.80%	12.70%	7.20%
$200,000 or more	37.20%	33.30%	8.50%
Median Household Income	**$158,529**	**$138,500**	**$65,712**

Source: ACS 2015-2019 Estimate

Since 2012, rental rates in Foster City were consistently higher than in the County. Rental rates dipped starting 2020, the same time as the COVID-19 pandemic, however have begun to rebound. As of the fourth quarter of 2021, the average effective rent for apartments in the City was roughly $3,200 per month, as shown in **Figure 1**. The rental rate in the City has been consistently higher than the County average, with the average effective monthly rent for apartments in the County at close to $2,700. In both the City and County, rents have increased roughly 33 percent over the past decade.

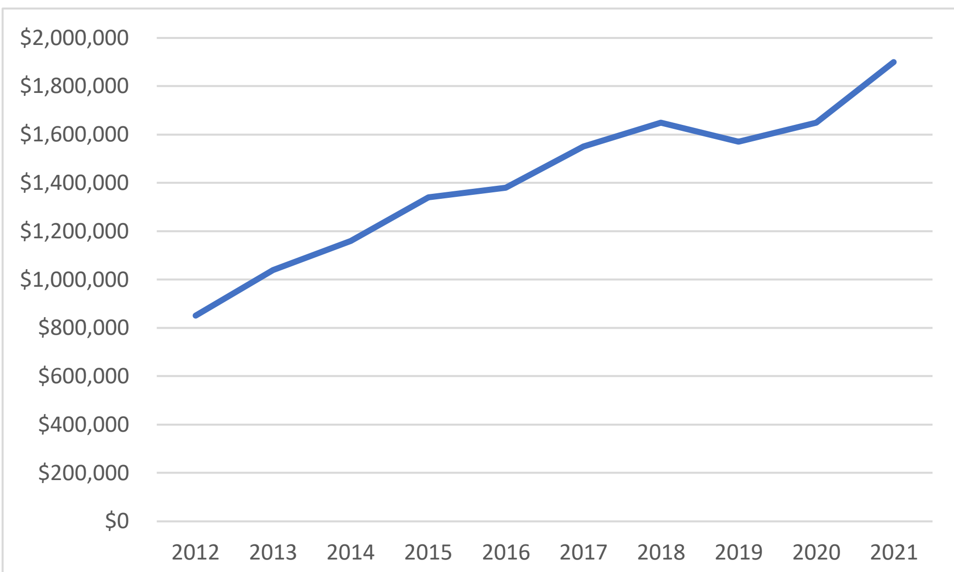
Figure 1 Average Rent per Multifamily Unit, 2012-2021



Source: CoStar, Economic & Planning Systems

For-sale housing values have increased even more dramatically in Foster City. In 2012, Zillow data indicates that typical home values were roughly $850,000, and this figure had increased to $1.9 million by 2021 – more than double the value from a decade earlier. To purchase a typical home today, a household would need to earn roughly $300,000 annually, about twice as much as the City's median household income shown on **Table 1**.[1]

Figure 2 Foster City For-Sale Home Values, 2012-2021



Source: Zillow, Economic & Planning Systems

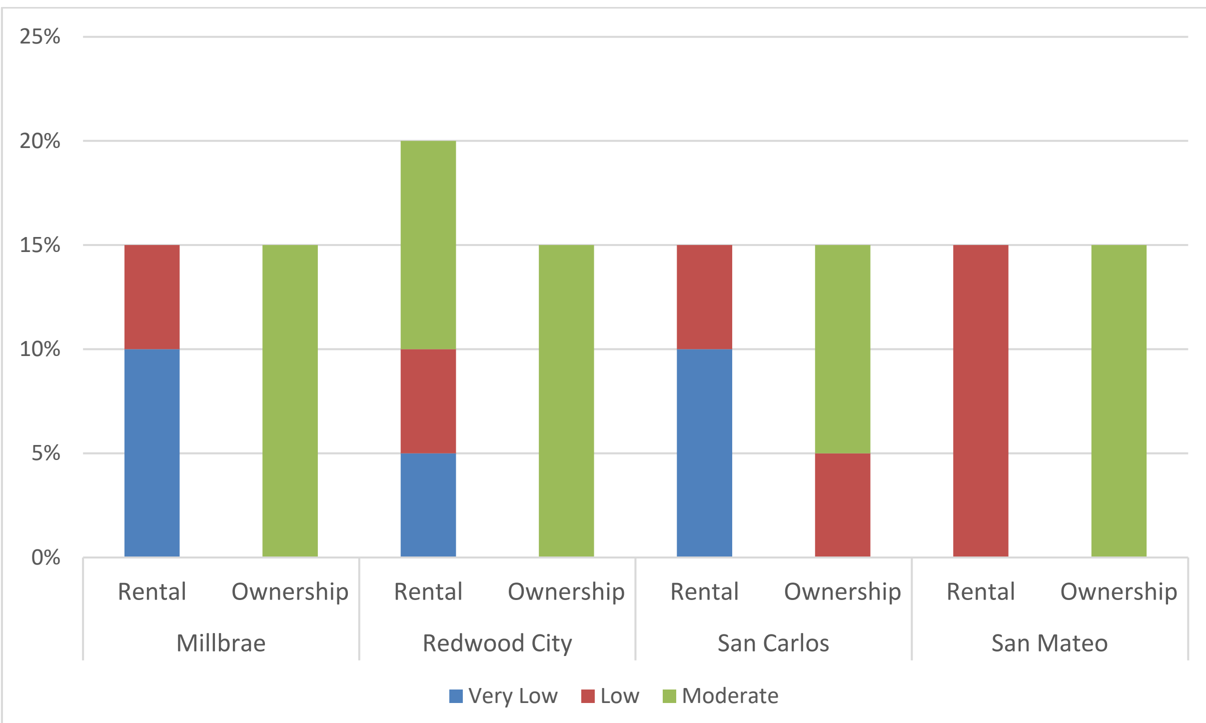
[1] Even with a 20 percent down payment on a $1.9 million home, annual mortgage principal and interest plus insurance and taxes would exceed $100,000 per year. Assuming a household pays 35 percent of gross income toward housing costs, the household would need to earn roughly $300,000.

Increasing housing costs reflect the combination of rising demand and relative lack of supply, compounded by high costs of construction. Accordingly, lack of housing at all affordability levels is a concern not only locally, but also regionally, and has been an increasing focus of State policy and legislation.

Survey of Comparable Jurisdictions

EPS conducted a survey of inclusionary requirements in comparable jurisdictions in San Mateo County. Inclusionary requirements adopted by these jurisdictions vary based on local policy preferences, including factors such as the number of units in the development or the type of housing (i.e., rental, condominium, townhome, or single family). The household income level required for new inclusionary units also differs. In looking at the inclusionary requirements across all of the surveyed jurisdictions (**Figure 2**), the lowest total inclusionary requirement is 15 percent, and the highest requirement is 20 percent. The median inclusionary requirement for both rental and for-sale projects is 15 percent, and often jurisdictions require a mix of income levels within that 15 percent requirement.

Figure 2 Inclusionary Requirement Comparison



Feasibility Testing

Under separate cover, EPS has produced in-lieu fee calculations for rental and ownership projects, using an affordability gap analysis approach as it relates to specific inclusionary requirements recommended by City staff:

- ***Rental (Citywide)*** – 20 percent inclusionary including 5 percent Moderate (110 percent of Area Median Income [AMI]), 5 percent Low (80 percent AMI), and 10 percent Very Low (50 percent AMI)

- ***Rental (Overlay)*** – 15 percent inclusionary including 7 percent Low (80 percent AMI), 4 percent Very Low (50 percent AMI), and 4 percent Extremely Low (30 percent AMI)

- ***For-Sale (Citywide)*** – 20 percent all at Moderate Income (110 percent AMI)

Having estimated the costs to construct new housing of various types, and the prices at which they could be sold or rented at both market rate and below-market rate pricing, this analysis assesses the economic implications of the City's potential inclusionary program. The analysis, shown on **Tables A-1 and A-2** in the Appendix, details how the rental inclusionary requirements and the ownership/for-sale inclusionary requirements can affect development feasibility. Each table evaluates scenarios with differing inclusionary requirements. These scenarios show how different proportions of inclusionary units at different income levels can affect the average revenue or value per unit in the project. Implicit in these comparisons is the idea that construction costs per unit for each building prototype are essentially equivalent regardless of the inclusionary requirement and allowable rents or sale prices, and thus the impact of each inclusionary alternative on the economics of the project can be understood through the changes in average unit revenues.

Appendix Table A-1 shows the feasibility scenarios for rental inclusionary requirements. For this analysis, EPS considers a project to be financially feasible if the "yield on cost" (annual net operating income as a proportion of the overall development costs) is equal to or greater than 4.2 percent. This figure is selected because developers constructing a new rental project generally require the "yield on cost" to exceed market-based "capitalization rates" by at least 0.75 to 1.00 percentage points – with "capitalization rates" representing the metric used by an investor to purchase an existing rental property that has achieved stabilized occupancy. For transactions of apartment buildings built near Foster City in recent years, real estate data company CoStar indicates that capitalization rates have been roughly 3.3 percent, so EPS adds 0.90 percentage points to that figure to represent a feasible yield on cost.

In each scenario, a low-density (35 dwelling units/acre) and high-density (60 dwelling units/acre) prototype is used. The first scenario represents a scenario in which the City does not have any inclusionary requirement as if the developers do not build any affordable units within their projects, and the yield on cost is shown to be 4.5 percent, thus representing a feasible project. Both the Citywide and Overlay zone scenarios achieve yield-on-cost metrics at 4.2 percent at each assumed density, and thus represent returns that just meet the feasibility standards EPS believes are appropriate for new apartment construction in Foster City. The hypothetical scenarios in which a development might pay the in-lieu fees rather than providing any affordable units yield a similarly feasible return. In addition, EPS has modeled several other potential inclusionary scenarios with different mixes and income levels, some of which also appear to reach the feasibility target.

EPS concludes that the Citywide and Overlay inclusionary standards can be considered feasible, although some projects with higher costs or lower market-value characteristics than EPS has assumed may face feasibility challenges. That said, some feasibility improvements might be achieved, for instance, by building additional market-rate units available to them through the State's density bonus law, or by activating the concessions and waivers that law entitles them to get.

Appendix Table A-2 shows the feasibility implications for ownership inclusionary requirements. For townhome ownership housing, EPS asserts that the feasibility threshold measurement is a profit margin in which the average sales price exceeds development costs by 14 percent, which in EPS's experience is the minimum expected by investors and lenders. For condominium ownership housing, EPS believes the feasibility threshold would be somewhat higher, because condominium developers are less able to ration the pace of construction (the entire building must be built at once, whereas townhomes can be constructed in smaller groups) and condominiums also face certain pre-sale requirements before typical buyers can qualify for federally supported mortgages. As such, EPS asserts that the feasibility threshold measurement for condominiums is a profit margin in which the average sales price exceeds development costs by 16 percent.

In each inclusionary scenario, a low-density townhome (17 dwelling units/acre) and higher-density condominium (35 dwelling units/acre) prototype is used. The first scenario represents a hypothetical in which the City does not have any inclusionary requirement and thus the developers do not build any affordable units within their projects nor have any obligation to pay an in-lieu fee. Under these assumptions, a townhome project is estimated to achieved a profit margin of 20 percent and a condominium project is estimated to achieved a profit margin of 17 percent, both above EPS's minimum standards required for feasibility. The second scenario reflects City staff's preferred standards and those used in EPS's in-lieu fee calculations, in which a hypothetical 100-unit project would be required to provide fees sufficient to subsidize 20 moderate income units at 110 percent of AMI. This scenario achieves a profit margin of only 12 percent for a townhome project and 14 percent for a condominium project, and thus represents a project that faces a feasibility and financing challenge. The third scenario assumes the developer does not build the affordable units required (20 percent moderate), but rather is allowed to pay the in-lieu fee calculated by EPS at roughly $83,548 per townhome market-rate unit and $63,673 per condominium market-rate unit. This in-lieu fee option increases the development costs per unit, but also increases the average home price because all the units would be market rate. Still, the profit margin for a townhome project is estimated at 13 percent, falling just short of the feasibility metric established by EPS, and the project margin for a condominium project is estimated at only 9 percent. The final scenario assumes the City adopts an inclusionary standard at 15 percent moderate-income units – similar to that in Millbrae, Redwood City, and San Mateo – and the resulting profit margin improves upon the 20 percent requirement by meeting the feasibility threshold at 14 percent for a townhome project and falling just short at 15 percent for a condominium project.

In addition to market improvements that may increase unit values and/or decrease development costs, these profit margin metrics could potentially be improved to the extent that developers utilize State density bonus law to achieve additional market-rate units and/or concessions and waivers that can reduce development costs or enhance values. Also, it is important to note that EPS has held fixed the price per acre of developable land for all residential projects. Land markets routinely adjust to reflect changes in regulatory or market circumstances, and the imposition of an impact fee and/or inclusionary standard that negatively affects project feasibility can be expected to place some downward pressure on the prices that landowners can expect to achieve. As such, it is possible and even likely that some landowners would reduce their asking prices in recognition of the impact of the City's inclusionary standards, in which case the hypothetical projects tested herein may achieve the return targets that EPS expects represent feasibility.

Appendix A

Table A-1 Rental Inclusionary Scenario Feasibility Test Results

			Citywide Scenario		Overlay Zone		In-Lieu Fee		In-Lieu Fee		Alternative 1		Alternative 2		Alternative 3		Alternative 4	
	No Inclusionary		20% Inclusionary - Very Low, Low, and Moderate		15% Inclusionary - Extremely Low, Very Low, and Low		Based on Citywide Scenario Requirements		Based on Overlay Zone Scenario Requirements		20% Inclusionary - Very Low and Low		20% Inclusionary - Extremely Low and Very Low		20% Inclusionary - Very Low, Low, and Moderate		20% Inclusionary - Extremely Low, Very Low, Low, and Moderate	
Assumptions																		
Unit Type	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**	**Low-Density**	**High-Density**
Base Density (units/acre)	35	60	35	60	35	60	35	60	35	60	35	60	35	60	35	60	35	60
Number of Units	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Cost Per Unit (excl. Developer Fee) [1]	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397	$743,673	$733,397
In-Lieu Fee [2]	$0	$0	$0	$0	$0	$0	$48,210	$48,210	$48,210	$48,210	$0	$0	$0	$0	$0	$0	$0	$0
Cost Per Unit	**$743,673**	**$733,397**	**$743,673**	**$733,397**	**$743,673**	**$733,397**	**$791,883**	**$781,607**	**$791,883**	**$781,607**	**$743,673**	**$733,397**	**$743,673**	**$733,397**	**$743,673**	**$733,397**	**$743,673**	**$733,397**
Revenues (Net Operating Income)																		
Market Rate Units																		
NOI Per Unit [3]	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150	$33,150
% of Total Units	100%	100%	80%	80%	85%	85%	100%	100%	100%	100%	80%	80%	80%	80%	80%	80%	80%	80%
Number of Total Units	100	100	80	80	85	85	100	100	100	100	80	80	80	80	80	80	80	80
110% AMI (Moderate Income)																		
NOI Per Unit	$29,768		$29,768		$29,768		$29,768		$29,768		$29,768		$29,768		$29,768		$29,768	
% of Total Units	0%		5%		0%		0%		0%		0%		0%		6%		5%	
Number of Total Units	0		5		0		0		0		0		0		6		5	
80% AMI (Low Income)																		
NOI Per Unit	$29,339		$29,339		$29,339		$29,339		$29,339		$29,339		$29,339		$29,339		$29,339	
% of Total Units	0%		5%		7%		0%		0%		10%		0%		7.0%		5.0%	
Number of Total Units	0		5		7		0		0		10		0		7		5	
50% AMI (Very Low Income)																		
NOI Per Unit	$14,935		$14,935		$14,935		$14,935		$14,935		$14,935		$14,935		$14,935		$14,935	
% of Total Units	0%		10.0%		4%		0%		0%		10%		10%		7.0%		5.0%	
Number of Total Units	0		10		4		0		0		10		10		7		5	
30% AMI (Extremely Low Income)																		
NOI Per Unit	$5,361		$5,361		$5,361		$5,361		$5,361		$5,361		$5,361		$5,361		$5,361	
% of Total Units	0%		0%		4%		0%		0%		0%		10%		0%		5%	
Number of Total Units	0		0		4		0		0		0		10		0		5	
Weighted Avg. NOI/Unit	**$33,150**	**$33,150**	**$30,969**	**$30,969**	**$31,043**	**$31,043**	**$33,150**	**$33,150**	**$33,150**	**$33,150**	**$30,947**	**$30,947**	**$28,550**	**$28,550**	**$31,405**	**$31,405**	**$30,490**	**$30,490**
Yield on Cost	**4.5%**	**4.5%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**4.2%**	**3.8%**	**3.9%**	**4.2%**	**4.3%**	**4.1%**	**4.2%**

[1] Development costs for 35 unit/acre "low density" units are consistent with those used in the EPS in-lieu fee report. For "high-density" projects at 60 units/acre, construction costs are slightly higher due to structured parking but land costs per unit are lower due to greater density, and the net result is a slightly lower total cost
[2] The in-lieu fee is based on the aggregate subsidy required to produce the number of affordable units prescribed under each of the scenarios that the City wants to explore (Citywide and Overlay Zone).
[3] NOI per unit for market-rate units assumed rents at $4,250/month, operating costs at 30% of gross income, and 5% vacancy losses.

Sources: CoStar; Economic & Planning Systems

Table A-2 Ownership Inclusionary Scenario Feasibility Test Results

	No Inclusionary		20% Inclusionary - Moderate		In-Lieu Fee based on 20% Moderate		15% Inclusionary - Moderate	
Assumptions								
Unit Type	**Townhomes**	**Condominium**	**Townhomes**	**Condominium**	**Townhomes**	**Condominium**	**Townhomes**	**Condominium**
Base Density (units/acre)	17	35	17	35	17	35	17	35
Number of Units	100	100	100	100	100	100	100	100
Standard Cost per Unit [1]	$1,162,884	$872,753	$1,162,884	$872,753	$1,162,884	$872,753	$1,162,884	$872,753
In-Lieu Fee [2]	$0	$0	$0	$0	$83,548	$62,673	$0	$0
Cost Per Unit	**$1,162,884**	**$872,753**	**$1,162,884**	**$872,753**	**$1,246,432**	**$935,427**	**$1,162,884**	**$872,753**
Value Per Unit								
Market Rate Units								
Value Per Unit [3]	$1,397,197	$1,017,900	$1,397,197	$1,017,900	$1,397,197	$1,017,900	$1,397,197	$1,017,900
% of Total Units	100%	100%	80%	80%	100%	100%	85%	85%
Number of Total Units	100	100	80	80	100	100	100	85
110% AMI (Moderate)								
Value Per Unit	$907,946		$907,946		$907,946		$907,946	
% of Total Units	0%		20%		0%		15%	
Number of Units	0		20		0		15	
Weighted Value/Unit	**$1,397,197**	**$1,017,900**	**$1,299,346**	**$995,909**	**$1,397,197**	**$1,017,900**	**$1,323,809**	**$1,001,407**
Surplus/(Gap) Per Unit	**$234,313**	**$145,147**	**$136,463**	**$123,156**	**$150,765**	**$82,473**	**$160,925**	**$128,654**
Profit Margin	**20%**	**17%**	**12%**	**14%**	**13%**	**9%**	**14%**	**15%**

[1] Standard Cost per townhome unit is consistent with those assumed in the EPS in-lieu fee study, but excludes the developer fee because this table is intended to calculate the profit margin that would mirror the developer fee in the in-lieu fee study. Condominium construction costs are similar but roughly 11% higher than apartment costs per square foot, due to higher levels of finish and increased indirect costs for financing and construction defect insurance.
[2] The in-lieu fee is based on $48.21 per square foot, consistent with EPS's in-lieu fee study.
[3] Market-rate pricing reflects a 1,733 square foot 3BR townhome sold at $806/SqFt and a 1,300 square foot 3BR condominium sold at $783/SqFt. The pricing metrics for both prototypes are consistent with averages for recent attached product in and around Foster City.

Sources: Zillow; Economic & Planning Systems