

## FINANCING STRUCTURE – AFFORDABLE HOUSING DEVELOPMENT

### *Development Structure*

To develop the affordable rental apartments at Bay Village, the Stanford Affordable Housing Team will form a 501(c)3 non-profit organization and plans to enter into three partnership agreements.

First, we have worked with Mike Wiley and Andrea Papanstassiou at Mid-Peninsula Housing Coalition (MPHC) extensively on the design and financing structure of Bay Village. Based on their review of our initial proposal, MPHC has indicated that they would be willing to enter into a joint venture with us to develop and subsequently manage the affordable housing component of Bay Village.

Second, we have worked with Bob Johnston and Todd Flynn at Smart Growth Capital to develop Bay Village's retail and townhome components. A newly formed venture started by long-time Bay Area real estate developers, Smart Growth Capital's mission is to develop in-fill, transit-oriented properties with a mix of uses throughout the Bay Area. Bay Village's smart growth orientation makes it the type of project this new venture plans to develop. Smart Growth Capital has therefore agreed to serve as our for-profit developer partner for Bay Village, building the townhome and retail components. Upon completion, Smart Growth Capital plans to sell the townhomes to individual homeowners and the retail component to an experienced retail operator. See the following section "Financing Structure – Townhomes and Retail Development" for a financial analysis of Smart Growth's opportunity at Bay Village.

Third, Bay Village's affordable housing units have been structured to qualify for the 4% Low-income Housing Tax Credit Program (LIHTC). Based on the projected economic benefits of this structure, Merritt Capital has agreed to serve as our limited partner. The joint venture between MPHC and the Stanford Housing Team will serve as the general partner, retaining 0.01% of the tax credit proceeds, while Merritt Capital will serve as the limited partner and purchase 99.99% of the tax credit proceeds.

### *Development Costs*

- ❖ Sources & Uses. The total project cost is approximately \$12.9 million. The Sources and Uses of Funds are shown in Figure 1, broken down into the Predevelopment, Construction, and Permanent financing periods.

### *Uses of Funds*

- ❖ Land Cost Analysis. The current owner of the site, Westlake Development Co. has not put the land up for sale, so it is not possible to determine the precise cost of land. In order to determine a reasonable price, we therefore relied on two outside sources:
  - First, we spoke to the Foster City Community Development Agency, who estimated fair market value for the site to be \$2.2 million per acre, or **\$50.51 per square foot** based on comparable land prices in the area.
  - Second, we used an August 2002 land appraisal done by All Bay Valuation Appraisers and Consultants for a 50-unit complex being developed by Mid-Peninsula

Housing Coalition called San Mateo Rotary. The average price per square foot was \$56.30 for the five properties included in the appraisal, but excluding the two outliers, the price was **\$54.30 per square foot**. The appraisal was based on data from 2001 and 2002 when the economy was stronger than it is today and for properties which already had entitlements required for development. We therefore determined that the prices for 1050 Shell Boulevard should be lower than those for the appraised properties.

Based on this analysis, we determined that Foster City's estimated price of **\$50.51 per square foot** was reasonable. (See Figure 2 for the land cost analysis).

- ❖ Land Allocation and BMR In-Lieu Payment. The total site is 5.85 acres, of which approximately 2.0 acres will be allocated to affordable housing, 3.5 acres to the townhomes and 0.3 acres to the retail. MPHC and the Stanford Team (the affordable housing developers) will only purchase approximately 1 of the required 2 acres, with the other acre being donated by Smart Growth Capital. This donation fulfills Smart Growth Capital's inclusionary zoning requirement, which is described in Foster City's Housing Element revised December 2001. The Housing Element states that any developer of 10 or more housing units in Foster City must reserve 20% of those units for Below Market Rate (BMR) housing (See Table 1.0). As Smart Growth Capital plans to build 57 townhomes at Bay Village, its BMR requirement is 11 units. Rather than reserve 11 units for BMR, Smart Growth Capital has instead elected to make an "in lieu" land donation to the affordable housing developers in exchange for MPHC's building Smart Growth Capital's required affordable units within its rental complex. This payment, valued at **\$2.1 million**, covers 9 of the 11 required units with the other two required units being townhomes built by Smart Growth Capital and reserved for BMR households (See Figure 3 for a calculation of the BMR in-lieu donation to the affordable housing component and Figure 4 for a breakdown of the land costs between the affordable units, townhomes and retail).
- ❖ Hard Costs. The hard construction costs paid by the affordable developer are \$6.2 million, or **\$122 per square foot**. The development includes 44,936 square feet of rental apartments and 5,475 SF of common area space, including the day care center (indoor and enclosed outdoor area), community room, lobbies, a computer room and restrooms (the breakdown of hard costs is shown in Figure 6). We have reviewed these estimates both with Mid-Peninsula Housing Coalition and with DPR Construction Inc.
- ❖ Soft Costs. Soft costs for the affordable units at Bay Village are \$1.9 million and are based on similar projects done by Mid-Peninsula Housing Coalition as well as the Permits and Fees Required by Foster City. (A breakdown of soft costs is found in Figure 1, Sources & Uses. A list of required Permits and Fees is shown in Figure 7).
- ❖ Financing Costs. Financing Costs will be explained below.

#### *Sources of Funds*

- ❖ Predevelopment Period
  - CalHFA Predevelopment Finance Program – As Bay Village incorporates CalHFA tax-exempt bonds in the permanent financing, it also qualifies for

CalHFA Predevelopment Financing. This type of financing is inexpensive (at a 3% interest rate). However, there is a limit of \$250,000 per project.

- Low-income Investment Fund Predevelopment (LIIF) Program – The remaining predevelopment funds are from the LIIF predevelopment financing program. These funds carry a higher interest rate at approximately 7.5%. (See Finance Figure 8 for a summary of predevelopment sources of funds).

❖ Construction Period

- BMR Equity / Donated Land – The \$2.1 million payment from Smart Growth Capital to purchase the land will be paid in the construction period.
- 4% Tax Credit Equity – The affordable units at Bay Village qualify for 4% tax credit financing as more than 20% of the units are reserved for households at less than 50% AMI. As required by our construction lender, Bank of America, 25 percent of the tax credit equity, or \$582,968 must be paid by Merritt Capital during construction. (The calculation used by the tax credit investor to determine proceeds is shown in Figure 9).
- Affordable Housing Program Funds (AHP) – The Federal Home Loan Bank of San Francisco offers the AHP subsidy to housing developments in which at least 20% of the units are reserved for low-income households at 50% AMI or below. Only members of the Federal Home Loan Bank can submit requests for funding, and Bank of America has agreed to sponsor the application for Bay Village. Bay Village will be eligible for \$8,000 subsidy per unit for a total of \$376,000 in AHP funds, which will be used to offset construction costs (See Appendix I for the AHP Scorecard).
- Tax-Exempt Construction Loan – Bay Village Apartments will use the California Housing Finance Agency (CalHFA's) Loan to Lender program to finance \$8 million of construction costs. Under this program, the Agency lends to a commercial bank at 3% and the commercial bank in turn lends to a developer at 5%, a lower rate than is available with traditional taxable construction loans. We have worked with Tina Ilvonen, a consultant to CalHFA, to ensure that our financing meets the Agency's requirement for the Loan to Lender Program.
- Taxable Construction Loan – The remainder of the construction period requirements will be financed through a traditional taxable construction loan of approximately \$1.4 million at a rate of 6.25%. Bank of America will serve as the taxable construction lender. (See Figure 10 for the tax-exempt and taxable construction loan information).

❖ Permanent Financing Period

- 4% Tax Credit Equity – Upon the completion of construction, receipt of the Certificate of Occupancy and initial lease-up, Merritt Capital will pay out the remainder of the approximately \$2.3 million of tax credits to serve as a source of permanent financing.
- CalHFA Tax-Exempt Bonds – A portion of the construction loan will be taken out with CalHFA 40-year tax-exempt bonds. We have worked with Tina Ilvonen to confirm that the proposed bonds for Bay Village's affordable housing units

meet with CalHFA's underwriting standards. Using the required Loan to Value and Debt Service Coverage Ratios, the affordable units at Bay Village can support approximately \$3.7 million in tax-exempt bonds at an interest rate of 5.6% (See Figure 11).

- Multifamily Housing Program (MHP) - With 4% tax credits and CalHFA tax-exempt bonds, it is also possible to receive funds through the California Department of Housing and Community Development under Proposition 46, often called MHP. While this is a competitive funding program, we believe that the affordable housing units at Bay Village are well positioned to receive \$4.4 million in MHP funds (See Appendix I for an MHP Scorecard). The affordability requirements for MHP are stricter than for the other funding sources used for Bay Village, with 35% of the units reserved for households at 35% or below State Median Income. This program allows for a 50 year deferred interest loan in which interest payments are based on an annual rate of 0.42% but accrue at a 3% annual rate. (The calculation of loan limits for Bay Village under the MHP program is shown in Figure 11).

❖ Other Contemplated Funding Sources

- State of California 9% Tax Credits – The 9% tax credits provide greater equity than the 4% tax-credits, but are also more competitive. Mid-Peninsula Housing Coalition has told us that next year, unlike in past years, San Mateo County will not receive a reserved allocation for the 9% tax credits. This change makes acquiring the funds more difficult for projects, such as Bay Village, located in the County.
- City Redevelopment Funds – We also have not asked Foster City to contribute any money to the Bay Village project. Mid-Peninsula Housing Coalition has advised us that the California State budget deficit is going severely limit the allocation of redevelopment funds. They therefore recommended that we structure the project without relying on state, city or county direct funding aid. We had sufficient equity to finance our Bay Village affordable units by leveraging 4% tax credits and the BMR in-lieu payment from Smart Growth Capital.

*Operating Statement / Cash Flow*

- ❖ Rents. Generally with affordable housing projects, rent can be set by taking 30% of pre-tax income and allocating it towards base rent plus utilities. However, in San Mateo County, AMI is sufficiently high that this methodology generates rents above what a typical low- or moderate-income household can afford to pay. San Mateo County's average median income for a family of four is \$113,000 (up from \$86,300 last year). Using the standard 30% of income for rent calculation, this income indicates that a family of four at 100% AMI should be able to spend \$2,828 per month on rent. A family of four at 50% or 55% AMI should be able to pay \$1,555 or \$1,414 in rents plus utilities per month

Realizing that the 30% of income standard generated rents higher than most of our targeted residents could afford, the Stanford Housing Team aimed to reduce rents at Bay Village to below the 30% standard. To determine the appropriate rental rates, we examined market rates in Foster City and the BMR rates at other Foster City rental complexes, where data was available. We then priced Bay Village rents for the 50% AMI and 55% AMI units to be below market and either below or comparable to other BMR rents in neighboring complexes. It is worth noting that there are very few 3-bedroom BMR rental units available in Foster City and that Bay Village adds 16 units of this type. At Bay Village, rents for the 35% SMI units are set at the 30% of the state income level, which is already quite low at \$60,300 for a 4-person household at 100% of the state median. (Figure 12 shows the breakdown of rents at Bay Village compared to other BMR units and the market).

- ❖ Other Cash Flow Assumptions. We based the rest of our cash flow assumptions on comparable projects developed and managed by Mid-Peninsula Housing Coalition and underwriting standards required by CalHFA. (Key cash flow assumptions are summarized in Figure 13 and cash flow for the first 10 years of operation is shown in Figure 14).

## FINANCING STRUCTURE – TOWNHOME AND RETAIL DEVELOPMENT

Simultaneous with the construction of the affordable housing development, Smart Growth Capital plans to build 57 3-bedroom townhomes and 15,000 square feet of retail space. With the help of Smart Growth Capital and SummerHill Homes (who acted as an advisor to us on the townhome component of Bay Village), the Stanford Housing Team has analyzed the economics behind this for-profit development. With an aggregate return of 11.9% (after netting out the \$2.1 million in-lieu payment to the affordable developer), the townhome and retail developments are sufficiently profitable to meet most for-profit real estate developer's requirements. As stated in their commitment letter, (enclosed in Appendix A) Smart Growth Capital is excited about the prospect of developing Bay Village and SummerHill Homes has indicated that the Bay Village development fits their development criteria as well. (A summary of overall profitability for the townhome and retail development is shown in Figure 15).

### *Townhome Component*

- ❖ Townhome Size – Smart Growth Capital plans to build 57 three-bedroom, three-bath townhomes. Thirty-three townhomes will have a 1,600 square foot layout and the remaining 24 will have a 1,475 sf layout. SummerHill Homes has used similar design for a recent development in San Jose called Georgetown that has proven quite successful.
- ❖ Sales Prices – The Stanford Housing Team and Smart Growth Capital analyzed the for-sale townhome market in Foster City by gathering information about recent townhome sales. According to our research, the average price for a 3-bedroom, 2.5-bathroom townhome in Foster City is \$585,000. There was not much information available on 3 bedroom, 3-bathroom townhomes. We also learned from SummerHill Homes that the 3-bedroom, 3-bath Georgetown homes they developed are selling for between \$495,000 and \$540,000. Industry experts, however, have told us that Foster City is considered a more desirable place to live than San Jose, so comparably built townhomes in Foster City will probably sell at a premium to those in San Jose. We therefore determined that the 1,475 sf unit would sell for \$550,000 and that a 1,600 sf unit would sell for \$600,000.

To fulfill their inclusionary zoning requirement, in addition to donating land to the affordable housing developer, Smart Growth Capital plans to reserve two 1,475 sf units for BMR purchasers. These two units will be priced at \$385,000 (which is the uppermost limit where most first-time mortgage programs can be accessed and is within the range of affordability for a household at 80% average median income. A more detailed breakdown of townhome profitability is shown Figure 16).

- ❖ Development Costs – The total development costs for the 57 townhomes is \$26 million. Smart Growth Capital plans to contribute approximately 25% of the project costs (or \$6.2 million) with the remainder of the project being funded through a construction loan. While the Stanford Housing Team did not speak to any construction lenders about this project, we used rates similar to the taxable construction loan for the affordable component. In addition, SummerHill Homes indicated this rate of 6.25% was standard for the residential development. (A breakdown of Sources and Uses of funds for the townhome component is shown in Figure 17 and a breakdown of townhome hard costs is shown in Figure 18).

### *Retail Component*

- ❖ Sales Price – As stated earlier, the Foster City Community Development Agency requires that some retail be maintained at 1050 Shell Boulevard. Based on advice from Terranomics (the retail brokerage firm for Marlin Cove and Metro Center), we developed an operating statement for six 2,000 sf stores and a 3,000 sf post-office. As Smart Growth Capital plans to sell the retail component of Bay Village upon completion, we then backed into a sales price of \$2.6 million using a 9% cap rate on year 2 net operating income. Based on a 20-year hold period, the unlevered return for the buyer is 8.8%, using conservative occupancy, rent and expense assumptions. Smart Growth Capital will make an equity investment in the retail component and manage its construction (in conjunction with the affordable developers). Smart Growth Capital understands that there is only minimal profitability on the retail component (profits are only \$40,000 or 1.5%), but is willing to build the retail anyway as it conforms with its smart growth vision and the profits on the townhomes are sufficiently large to compensate for the retail. (Figure 19 shows the expected profitability and their derivation of the sales price for the retail component at Bay Village).
- ❖ Development Costs – The total development costs for the retail is \$2.5 million. As with the townhomes, Smart Growth Capital will fund approximately 25% of the project costs with equity (\$620,000) and the remainder through a construction loan. (A breakdown of Sources and Uses of funds for the retail development is shown in Figure 20 and a breakdown of townhome hard costs is shown in Figure 21).
- ❖ Retail Operating Statement – The Stanford Housing team built an operating statement for the retail component at Bay Village using information provided by Terranomics. (The projected operating statement for the retail component is shown in Figure 22).