Creating More Affordable Housing in Chicago

The Home Builders Association of Greater Chicago (HBAGC) supports increasing the availability of affordable housing in the City of Chicago and strongly encourages private sector involvement in its creation. Providing diverse housing options for city residents strengthens our neighborhoods and enriches our city.

The City of Chicago's "Bouncing Back: Five Year Housing Plan 2014 – 2018" offers many new and compelling ideas which can serve to add significant numbers of new and renovated units to the affordable housing pool. Of particular interest are:

- ✓ The importance of engaging the talent and resources of the private sector in addressing the need for high quality, cost-efficient affordable housing;
- ✓ The renovation of existing housing stock and reclaiming two – to – four unit buildings from foreclosure; and,
- ✓ The City's initiative to convene development experts to find ways to reduce development costs.

HBAGC fully supports these initiatives and others described in the 2014-2018 Five-Year Housing Plan. The association believes that the private sector should play a leading role in the creation of affordable housing.   We further believe current ARO policies can be improved to stimulate the creation of affordable housing with no new subsidies, at no new cost to taxpayers.

The vast majority of housing for Chicago's work force, fixed income seniors, wounded veterans, young teachers, police officers, etc., is provided by private investors and owners at less than the cost of comparable government sponsored and subsidized new construction units.

The "Bouncing Back: Five Year Housing Plan 2014 – 2018" references a Joint Center for Housing Studies at Harvard University report which found that more than seventy-five per cent "of all affordable rental housing is provided by non-subsidized operators."

These non-subsidized private sector operators are able to create affordable housing at significantly lower costs than the subsidized entities whose cost structures are anything but affordable. "Bouncing Back: Five Year Housing Plan 2014 – 2018" estimates that the cost to produce a subsidized affordable unit "can easily top $350,000." (Ref. page 27, section 4.5). The Chicago Rehab Network reports even higher average costs of $418,035 per unit (Ref. CRN Analysis of the 4th Quarter, 2013 Housing Report, page 6, Table 5).

More recently, an announced 94-unit apartment development at Parkside of Old Town will cost $41 million or $436,000 per unit according to a report in Crain's Chicago Business. Subsidies covering more than half of the development costs come from TIF, Federal grants and the sale of tax credits.

The HBAGC believes that current housing policy and financing structures actually work against the creation of affordable housing. We further believe that increasing the burden on private sector developers through some proposed negative changes to the ARO ordinance will actually work against the goals of "Bouncing Back: Five Year Housing Plan 2014 – 2018." This paper explores those potential unintended consequences and offers some alternate proposals to stimulate the creation of truly affordable housing for all.

The Home Builders Association of Greater Chicago believes that:

- ✓ Private sector developers are willing and able to produce affordable housing at lower costs than other subsidized development organizations if given access to low-cost land, financial incentives and other available subsidies.
- ✓ Current housing policies actually work against the creation of affordable housing.
- ✓ Increasing the burden on private sector developers by increasing ARO fees or mandating on site affordable housing in market rate developments without financial incentives will have the unintended consequence of reducing production of affordable housing.

- **How the Current ARO Works with Rental Developments**

Chicago's current Affordable Requirement Ordinance (ARO) requires developers who request rezoning for buildings having ten or more units* to either include affordable units totaling 10% to 20% of the development or pay $100,000 per required ARO unit to the Affordable Housing

Opportunity Fund (AHOF). By way of example, in a 100-unit rental building, at least ten rental units would have to qualify as ARO units, or the developer must pay $1,000,000 (10 X $100,000) into the AHOF.

(Defined as units that can be rented to tenants making no more than 60% of AMI, or $30,420 for a family of one, $34,800 for a family of two, and $43,440 for a family of four. See attached ARO Fact Sheet for more information.*)

Paying the "in lieu" fee into the AHOF is beneficial because these funds are used to build more affordable units off-site in neighborhoods where the need for affordable housing is greatest, and more funds are available to provide subsidized rents for low-income families.

When developers of ARO-impacted projects choose to pay the $100,000/unit "in lieu" fee, it is usually because the actual construction costs and restricted rental income for ARO units in the new development substantially exceeds the "in lieu" fee. This combination of construction costs and lower than market rental rates diminishes the investment value of the building, which in turn, impairs the ability to obtain project financing. Allowing developers access to incentives, subsidies or other financial benefits to recover the cost of mandated units could preserve the investment value of the building and thus improve ability to obtain project financing.

- **How the Current ARO Works with For-Sale Developments**

For sale developments subject to the ARO ordinance, including single family, condo or town house developments of ten or more units, must restrict sales prices on 10% of the units to no more than $195,000 per unit regardless of the cost of development. The Home Purchase Assistance Program fund provides a subsidy to buyers of up to $40,000 (and more if you are a Chicago teacher or police officer).

(Eligible ARO buyers must earn no more than 100% of AMI, or $50,700 a year for a single person, $58,000 a year for a couple, and $72,400 a year for a family of four. See attached ARO Fact Sheet,)*

Again, relying on the City's estimate of development costs, creation of affordable for-sale units without a subsidy can be challenging if not economically impossible. The "Bouncing Back: 2014-2018 Five Year Housing Report" states, "These high costs make the construction of affordable housing extremely difficult to achieve at the necessary scale" (Ref. page 27, section 4.5).

- **How Proposed ARO Amendments Could Work Against the Creation of Affordable Housing**

HBAGC fully supports the creation of affordable housing but is concerned that some suggested changes in the ordinance that could substantially increase the “in lieu” fee or mandate inclusion of units in all ARO eligible developments will adversely affect the creation of affordable housing.

The current ordinance allows an annual CPI-U* adjustment to the $100,000 “in-lieu” fee, but to date the City has chosen not to utilize this authority. The HBAGC is concerned that any sharp increase in the fee will have the unintended result of reducing total fees collected as a byproduct of projects being cancelled.

(*According to the US Bureau of Labor Statistics, Chicago’s CPI-U in 2013 was 1.2%.)

Requiring higher ARO “in lieu” fees will lower investment returns on projects and make them less attractive to lenders and investors. As a result, many projects will not get built if they no longer meet minimum requirements for financing and developers seek more profitable opportunities outside of Chicago. Furthermore, mandating the inclusion of ARO units, without any cost recovery or subsidy, will have a much greater negative financial impact on both rental and for-sale residential development.

Financial impact examples at the end of this report show how the ARO can adversely affect investment value and thus stop development. Further, these financial impact examples demonstrate how higher ARO costs are shifted to other tenants or buyers to subsidize cost of ARO units.

Mandating the inclusion of affordable units in market rate developments creates another dilemma in that no ARO fees are captured under this scenario. As a result, the opportunity to leverage those fees into additional affordable units or rental assistance to families is lost in favor of fewer, more costly units.

- **Creative Options and Strategies to Stimulate Creation of New Affordable Housing**

The HBAGC fully supports the creation of affordable housing through all channels including new construction, preservation, adaptive re-use, housing assistance programs and other vehicles. In addition to the ideas contained in the 2014-2018 Five Year Housing Plan, HBAGC urges City officials to consider a variety of other creative options and strategies for stimulating affordable development throughout Chicago, such as:

- ✓ Fully Engage Private Sector - Create new incentives, options, and programs for private sector solutions.
- ✓ Eliminate Regulatory Obstacles - Examine current policies which, although well-intended, work against the creation of affordable housing and actually increase development costs.
- ✓ Enable Innovative Partnerships - Make it easier for private capital and multi-family developers to collaborate with smaller local builders and non-profit developers to produce affordable housing. For example, recast ARO-in-lieu fees as donations to qualified not-for-profit developers under the Illinois Affordable Housing Tax Credit (IAHTC).
- ✓ Auction 1000 City-Owned Lots – Offer a portion of City's inventory of 9500 residential lots to private and nonprofit developers through an auction process. Require development within a certain period of time or the lots revert back to the city. This will help spur neighborhood development, increase the tax base, and create jobs. Direct proceeds to Affordable Housing Opportunity Fund (AHOF) which supports affordable housing development and rental subsidies.
- ✓ Linked Development – Allow developers to build ARO units off-site in neighborhoods seeking new affordable development in lieu of contributing to the ARO fund. Other major cities successfully do this now, like San Francisco.
- ✓ Density Bonuses – Increase the number of zoning districts which qualify for FAR bonuses, and explore creating new density bonus options throughout the City. Such bonuses have proven effective in other cities to encourage inclusion of affordable units in new developments. Los Angeles gives 30% density bonuses for 5% ARO unit inclusion.
- ✓ Design Considerations - Allow developers to utilize creative and efficient unit designs that are less expensive to build like micro units, smaller units, etc.
- ✓ Building Codes – Examine building code modifications to eliminate costly and unnecessary regulations that increase construction costs.
- ✓ Adjust ARO Unit Percentages to Match "In Lieu" Fee – For example, 3% inclusionary ARO units in rental projects equals the $100,000 in lieu fee when applied to the current development cost of mid and high rise housing at $300,000+ per unit.
- ✓ Offer New Property Tax Reductions - Reduce real estate taxes for market rate projects with inclusionary affordable units to offset the lower ARO rents. Tax reduction provides economic incentive for ARO units while still generating a net addition to existing tax

base. This would allow 5-10% ARO units in market rate buildings. New York City relies heavily on this to stimulate new apartment construction.

- ✓ Provide Greater Flexibility - Give Developers flexibility to choose among a mix of inclusionary ARO units, ARO fees and/or other incentives that will allow the City to meet ARO goals while also helping developers to recover development costs. This would incentivize developers to put in 5-15% ARO units without stifling new construction.

The City Chapter of HBAGC looks forward to being a vital and integral part of finding a broad-based affordable housing solution for the City of Chicago and offers its resources to assist the Chicago City Council Committee on Housing and Real Estate in their consideration of the City's 2014-2018 Five-Year Housing Plan and potential changes in the Affordable Requirements Ordinance.

What Are The Potential <u>UNINTENDED CONSEQUENCES</u> of ARO Changes?

- **<u>Projects Cancelled</u>**

If the proposed substantial increases in ARO "in lieu" fees or the mandatory inclusion of ARO units in all projects are enacted, the unintended consequences would be the cancellation of many projects proposed on sites subject to the ARO. This affects the development of thousands of units because many neighborhoods that do not command "top of market rents" like Streeterville and River North are barely feasible today. Projects in neighborhoods like the South Loop, Chicago Avenue west of Wells, Cabrini Green, West Town, East Village, Bucktown, Wicker Park, West Loop, United Center, and other areas on the South, West and North sides, where rents are 10-30% lower, would see project investment returns fall substantially below the yield required to get bank and investor capital. Most potential projects in these areas would struggle to be financed and as a result, many would be cancelled.

- **<u>City Loses Tax Revenue</u>**

If 3,000 units representing $900 Million in capital investment were cancelled over the next 3-5 years because of cost-prohibitive changes to the ARO, the city would see a reduction of more than $9 Million per year in future annual real estate taxes for schools, City programs, parks, police/fire, infrastructure, etc. Millions more in fees, sales taxes, etc. would be lost.

- **<u>City Loses Construction and Permanent Jobs</u>**

If construction is stopped on those 3,000 units, the City of Chicago and its residents would lose thousands of high paying construction jobs and hundreds of permanent jobs to manage, operate and maintain those buildings.

- **<u>Not-For-Profit Developers Lose Subsidies They Need to Create Affordable Housing and Low Income Families Lose Rental Subsidies.</u>**

If those 3,000 units aren't built, no ARO fees are paid into AHOF Fund and no new ARO units are created on site. As much as $30,000,000 of "in-lieu" ARO fees could be lost or as many as 100 affordable dwelling units will not be built. Those AHOF funds could have been used to help non-profit housing developers to build new housing. Losing those AHOF funds also will seriously impact the City's ability to provide rental subsidies for 1,000s of needy Chicago families.

Financial Impact on Multi-Family RENTAL Market

The “in lieu” fee of $100,000 per required ARO unit (10% of the total units) increases the overall cost per unit by $10,000 when spread evenly across all units. This is effectively an ARO development “tax” of $10,000 or 3.33% on an unit costing $300,000+ to build. Mandating inclusion of 10% affordable units in market rate buildings (where units cost $300,000 to build) effectively triples the ARO development tax to $30,000/unit.

Furthermore, rents for ARO units barely cover operating expenses and real estate taxes, and as a result, affordable units have almost no economic value.

Some Basics:

- Rents less expenses and real estate taxes equals net operating income (NOI).
- NOI divided by the total project cost is the “free and clear return” also referred to as the rate of capitalization or cap rate.
- A project’s “free and clear return” needs to be high enough to pay a mortgage payment (interest and principal) and provide a return on the cash equity invested.
- In today’s low interest rate environment a free and clear return of 6.5% or better is the minimum return that banks, pension funds, or insurance company lenders/investors require to invest capital in a project.

Here’s what the math looks like for a 300 unit building built for $300,000 per unit:

Cost to build	$90,000,000
Mortgage Amount:	$58,500,000
Cash Equity Invested	$31,500,000
NOI	$5,850,000 (6.5% NOI on cost)
Mortgage payments	$3,984,000 (interest and principal)
Net cash return:	$1,866,000
Return on Equity	$1,866,000 return on $31,500,000 equity = 5.93%

What happens if 10% of a market rate project's apartments are ARO units with rents at $850/mo versus $2,250/mo?

Option A: 10% Affordable Units

1.	270 market rate units at $2,250 X 12 months =	$7,290,000
2.	30 affordable rate units at $850 X12 months =	$ 306,000
	Subtotal projected income	$7,596,000
	X95% occupancy =	$7,216,000 total collections

Option B: 100% Market Rate Units

1.	300 market rate units at $2,250 X 12 months =	$8,100,000
	X95% occupancy=	$7,695,000 total collections

The difference between A and B is $479,000 in lower collections.

If the NOI of 6.50% (no ARO) is reduced by $479,000, the new NOI is $5,371,000, yielding a 5.97% free and clear return on the $90 million cost and a $1,387,000 return on equity of only 4.4%. No bank, pension or insurance investor would finance a project with an initial yield on equity of only 4.4%.

That reduction in free and clear returns from 6.5% to 5.97% renders the project un-financeable.

Practically speaking, any proposed development that currently falls below the 6.5% yield (where some are approaching today), would not go ahead. In some cases for long-term landowners whose land cost is much lower, or for those developers who have prime locations in higher rent neighborhoods like River North, some projects might still be feasible.

The ARO tax on rental income:

The $479,000 reduction in annual rent collections, or $1,597 per unit if spread across all 300 units, is effectively an "ARO Tax" on income of $1,597 per unit, which must be absorbed by the market tenants to meet minimum investment returns. To put this increase in perspective, current real estate taxes are about $3,000 per unit and the ARO "rental tax" of $1,597 is effectively a 53% increase in taxes per unit.

Couple this 53% ARO tax increase with the potential additional 35%-70% increase in city property taxes to solve underfunded pension obligations, and it is easy to see how the financial viability of new rental residential construction will be severely impacted.

Financial Impact on FOR-SALE Market

The impact on the For-Sale market is best illustrated with financial models showing economic impacts of ARO Fee versus inclusion of on-site affordable units.

Example 1. Financial Impact of In-Lieu Fee on a For-Sale 50 Unit Condominium Development

Sales			
	Units	$35,500,000	
	Parking	$ 1,957,000	
		$37,457,000	Total Revenue
Costs			
	Land	$ 4,626,000	
	Hard Costs	$21,000,000	
	Interest	$ 471,000	
	Closing costs	$ 2,193,000	
	ARO Fee ($100k x5)	$ 500,000	
	Other soft costs	$ 3,078,000	
	Total	$31,868,000	Cost of Sales
	Profit	$ 5,589,000	Gross Profit
	% of sales	14.9 %	(Risk reward range 15-20%)

Although the developer's profit is reduced by the $500,000 ARO in-lieu fee, the total profit meets the developer's (and lender's) minimum profit target.

Using the analysis above but incorporating the actual delivery of affordable units on site yields the following outcome:

Ave Sales Price	$ 749,140	
ARO price	$ 195,000	
ARO cost	***$ 554,140***	
X 5 units	$ 2,770,700	(vs. $500k ARO fee = 554% hike in ARO cost)

Revised ARO inclusion budget

Sales			
	Units	$32,729,300	(5 ARO units @ $195,000)
	Parking	$ 1,957,000	(assumes all parking is sold)
		$34,686,300	
Costs			

Land	$ 4,626,000	
Hard Costs	$21,000,000	
Interest	$ 471,000	
Closing costs	$ 2,193,000	
ARO Fee	$ 0	(No ARO fee required when units included)
Other soft costs	$ 3,078,000	
Total	$31,368,000	
Profit	$ 3,318,300	
% of sales	9.5 %	(Compared with 14.9% above) (Far below investment threshold of 15%)

In this example, selling affordable condominium units reduces sales revenue by $2,770,700 and costs are unchanged. The developer's profit is reduced by $2,450,700, well-below the 15% target. Such a low margin will cause the developer not to take the development and sales risk to develop the project.

Example 2. Financial Impact of In-Lieu Fee on a 14-unit Attached Single Family Development

Sales			
	Units	$13,300,000	
Costs			
	Land	$ 3,605,000	
	Hard costs	$ 5,500,000	
	Interest	$ 185,000	
	Closing costs	$ 768,000	
	ARO fee (x2)	$ 200,000	(City requires rounding up ARO fee)
	Soft costs	$ 1,083,000	
	Subtotal	$11,341,000	
	Profit	$ 1,959,000	
	% of sales	14.7%	(Risk reward min 15%)

Impact of ARO Inclusion:

Ave sale price	$ 950,000
ARO price	$ 195,000
ARO cost per unit	$ 755,000

X 2 ARO units	\$ 1,510,000	(lost sales vs. \$200k ARO fee)
		(ARO cost increase of 755%)

Revised ARO Inclusion Budget – 14 Unit Attached Single Family Homes

Sales			
	Units	\$11,790,000	(2 units @ \$195,000)
Costs			
	Land	\$ 3,605,000	
	Hard costs	\$ 5,500,000	
	Interest	\$ 185,000	
	Closing costs	\$ 768,000	
	ARO Fee	\$ 0	(No fee required when units are included)
	Soft costs	\$ 1,083,000	
	Total	\$11,141,000	
	Profit	\$ 649,000	
	% of sales	5.5%	(Versus 14.7% with ARO "in lieu" fee)