To: City Council

From: Kristin Retherford, Urban Development Director

Re: MUHTIP Multiple-Unit Housing Incentive Program

Date: August 13, 2021

The following is in response to Council questions and concerns relating to the City's Multiple Unit Housing Incentive Program (MUHTIP). Staff is available to discuss this in greater detail or address any questions.

1. Can we have more than one MUHTIP area in the City?

No. The MUHTIP incentive is allowed under state statute (ORS 307.600 – 307.687) and is limited to a single contiguous geographic area with a focus on transit-oriented infill development. This is why Salem's MUHTIP boundary is located in the core of the City and surrounding the transit center.

2. Why haven't more developers used the MUHTIP program?

Since the City adopted the MUHTIP program in 1976, nine developments have received the MUHTIP tax exemption incentive. In the program's first thirty-nine years, only four developments applied for and received the MUHTIP incentive. Since 2015 however, the City has had five projects apply for and receive this incentive for infill development.

Why is it that use of this program has increased significantly in the last six years?

The financial feasibility of a multi-family project depends on a few key factors: land costs, construction costs, interest rates, regulatory requirements, and rental rates. Regardless of the community, infill multi-family development presents additional challenges. These include the need to assemble smaller parcels with fragmented ownership, the potential for existing environmental contamination, higher construction costs, stricter land use regulations, and more limited financing options, and opposition from neighbors. All of these factors increase the risk and feasibility of projects and have historically driven investment to larger greenfield sites which don't have as many challenges.

In Salem, many of these historic factors have shifted significantly in the last six years resulting in financially viable projects and investor interest:

A. Historic parking requirements. Until very recently, the city required on-site parking for multi-family developments Building on-site parking in an inner-city environment is very costly. Infill lots by nature do not have sufficient land area to meet parking requirements through less-costly surface lots, so structured parking is necessary. This adds a significant amount of cost to infill projects in comparison to more suburban greenfield projects. In the past, a lot of projects looked at development opportunities within the MUHTIP boundary and found that even with the tax incentive they couldn't make the project profitable due to parking requirements and other factors. As the City has implemented more flexible parking standards, this cost burden has been removed from projects and they have become more feasible.

B. Favorable interest rates. For the first ten years the MUHTIP program was in place, interest rates ranged from a low of 8.85 % to a high of 16.63%. Between 1987 to 1997 they ranged from 7.31% to 10.21%. Between 1998 to 2008 the range was from 5.83% to 8.05%. Between 2009 and 2019 the range was 3.65% to o 5.04%, and rates have remained under 4% since 2019. Interest rates for multifamily projects vary from traditional mortgages, but historical mortgage rates are indicative of financial markets during these time periods. For much of the history of the City's MUHTIP program, high interest rates in conjunction with other "negative" factors and risks outweighed the benefit of the MUHTIP incentive.

C. Increased density. Part of the magic formula of financial feasibility includes determining the number of units a project needs to have to generate enough rent revenue to pay for the investment. Too few units and the project won't pay for itself. Because of the costs and risks of doing infill development, it can be challenging to get enough units in an urban infill environment to make a project work. You either need a footprint that is sized appropriately, or you need height, or you need to exchange unit size for more total units. While micro units have been common for some time in larger cities, market interest in this type of housing product has only recently developed in Salem. This has helped make more projects feasible within the MUHTIP boundary.

D. Rental rates. In order to obtain financing, developers have to be able to demonstrate that the market will support rents that are high enough to pay for their land, construction, debt, and operational costs. If rents are too low, they can't get financing for projects. Until recently, this formula just didn't work well in downtown Salem. Between high interest rates, added costs like structured parking, historic district architectural standards, and low rental rates, most projects just weren't financially feasible. While rising rental rates have increased the cost-burden for tenants, they have also changed the financial profile of projects so that they can get financed and be built. This creates a "gotcha" when it comes to affordable housing. There is ultimately an increase in housing supply, but the supply increase is dependent on the higher rental prices.

E. Land supply. The MUHTIP boundary encompasses land that is largely already developed. It also encompasses our Historic District. This Historic District has protections in place that make it appropriately difficult to demolish existing buildings. Outside of the Historic District, there are few undeveloped land parcels within the MUHTIP area, and the ones that exist are on the small for multi-family development and make development financially challenging .

3. Why have we seen more MUHTIP projects in recent years?

a) Favorable interest rates;
b) Higher rents;
c) Market acceptance of smaller units;
d) Changed parking requirements; and
e) Larger urban renewal grants. In 2016 the Riverfront Downtown Urban Renewal Agency began providing larger grants to projects (increased from a maximum grant of $300,000 to $749,000 if criteria are met). This additional funding change has provided the financial boost needed to make projects financially feasible downtown.

4. Case studies.

a) Koz on State Street/Nishioka Building (142 units) – 260 State Street

Tax exemption period expires in 2031.

This property is in the Historic District. Fire destroyed the previous building on the site. The Nishiokas owned a parcel and the Urban Renewal Agency owned the adjacent parcel. The development required the assemblage of both parcels. The Nishiokas spent many years trying to make a project work on this site. Ultimately, they brought in an experienced development firm as partners. The project eventually worked in this location because:

- A developable parcel was created as the result of a fire.
- Assemblage was possible due to the URA's ownership of the adjacent lot.
- The zoning requirement of 1:1 parking was waived and subsequently eliminated. This meant the project didn't have to pay for costly structured parking.

- Interest rates were at historic lows.
- Rental prices in Salem had risen in recent years and there was market demand for small units.
- The project was awarded a URA grant for $749,999.
- The project received the MUHTIP property tax exemption.

Would the project have happened without the URA grant or the MUHTIP exemption. The long history of no-to-low development in this area prior to the URA grant program indicates that these programs are critical in making infill multi-family housing projects feasible in the downtown core.

Regarding MUHTIP, property taxes are an ongoing operational cost. As operational costs increase, so do rents. The MUHTIP incentive provides ten years for a project to stabilize financially and temporarily eliminates one major operational cost that drives higher rents. Does it help the developer? Certainly. Does it also help tenants? Yes. Further, it supports more housing in total, which the community desperately needs, and specifically, more infill housing at the City's center.

b) <u>The Court Yard Apartments (40 units) – 211 Court Street NE)</u>
Tax exemption period expires in 2030.

This project has significantly fewer units than the Koz project, but the units are larger and have higher rental rates.

- The site had been owned by the developer's family for many years. This provided significant owner-equity in the project which is not an option for most projects.
- The zoning requirement of 1:1 parking was still in place. Because the site is a smaller infill parcel, more units would have required costly structured parking. The number of units was limited by this factor.
- Interest rates were at historic lows.
- Rental prices in Salem had risen in recent years and there was market demand for small units.
- The project was awarded a URA grant for $749,999.
- The project received the MUHTIP property tax exemption.

This project was developed before market support for micro-units had been evidenced. Given the requirement for on-site parking, had the developer not already owned the site, it's possible this project would not have been feasible even with the URA grant and MUHTIP.

c) <u>South Block Apartments (178 units, Phases I & II) – 315 Commercial Street SE</u>
Tax exemption period expires in 2025 & 2027 (Phases I & II respectively).

This 2014/2015 project was the first new multi-family rental housing development in the MUHTP boundary in about 25 years.

- The site was available due to demolition of the Boise Cascade mill on the riverfront.
- The City assisted financially in environmental remediation and other aspects of the project.
- Interest rates were becoming increasingly favorable as was the economy following the recession.
- Rental prices in Salem were rising.
- The project is outside the RDURA and was not eligible for an RDURA grant, but it did receive City support in other ways.
- The project received the MUHTIP property tax exemption.

This was a pivotable project for Downtown Salem. At the time it was developed, there were no comparable housing projects to indicate whether or not a large multi-family project was viable in downtown. There was no established market and no comparable developments for comparison. Also, the site was a brownfield. All of this means that the developer took on significant risk in undertaking this project. The project has been a great success and has paved the way for other new projects by demonstrating the demand for rental housing in the downtown core and providing a comparable for lenders to consider when financing other projects. The MUHTIP incentive was critical in offsetting the financial risks of this project.

These case studies illustrate the unique hurdles faced by developments that can vary based on site characteristics, the developer, and other factors. What may or may not be financially feasible in one location or for a specific developer may be different for another.

5. What public benefits are currently considered in qualifying projects for the MUHTIP incentive?

a) Projects must include at least two dwelling units. (Given recent changes in state law to encourage greater density in historic single-family zones, the MUHTIP incentive could be used within the boundary to incentive new development or redevelopment of single-family homes or lots to duplexes, triplexes, etc.)

b) Projects must include one or more of the following:

- Units at sales prices or rental rates which are accessible to a broad income range of the general public;

- Recreation facilities;
- Open spaces;
- Common meeting rooms;
- Day care facilities;
- Facilities supportive of the arts;
- Facilities for the handicapped;
- Service or commercial uses which are permitted and needed at the project site but not available for economic reasons
- Special architectural features;
- Dedication of land or facilities for public use;
- Development or redevelopment of underutilized or blighted property;
- Provision of pedestrian-oriented design features;
- Extra costs associated with infill or redevelopment projects, such as land assembly, environmental cleanup, demolition, and infrastructure replacement or expansion;
- Development in structures that may include ground level commercial space;
- Development on sites with existing single-story commercial structures;
- Development on existing surface parking lots;
- Leadership in Energy and Environmental Design (LEED) Certification by the Green Building Council of the project;
- Provision of parking spaces within the structure; or
- Provision of amenities and/or programs supportive of the use of mass transit.

6. Can the City's MUHTIP program require more public benefits?

Absolutely. Projects currently have to meet only one of the listed public benefits. This could be increased to two or three public benefits. Affordability could also be added to the list of public benefits.

Requiring affordability for all projects would likely result in unintended consequences that would not actually benefit the public. As illustrated, each development has its own unique factors that impact if the project will be financially feasible.

There are operational costs associated with an affordability requirement beyond just the rent price. A project must have leasing staff trained and tasked with assessing income thresholds as well as ongoing monitoring and reporting. The City will also need staff devoted to working with the developer each year on this requirement to monitor their performance. This creates added developer and city operational costs. Developers will most likely offset this expense by increase rents slightly on other units. At best, it would be extremely challenging for smaller projects to take on these tasks or be able absorb the lost revenue and increased expenses across other units. At worst, the projects would be determined to not be financially feasible and just wouldn't get built.

Staff recommends leaving the criteria as they currently stand. However, should Council desire to add affordability criteria or increase the number of criteria a project must meet, Staff recommends exempting affordability criteria for projects under 100 units. For projects over 100 units, staff recommends that the developer have the option of:

- Providing 15% of the units at rents affordable to households at 80% Average Median Income or less for the duration of the incentive; or
- Meeting 2 or more of the public benefit criteria.

Why a minimum of two public benefits and not more? It is expected that the nation will be entering a longer-term inflationary cycle given recent Congressional approval of a $1 trillion infrastructure package, ongoing COVID-related supply chain disruptions, and a national labor shortage. This makes it extremely difficult for developers and lenders to estimate project costs and operational expenses. Added project risks make it less likely that projects get built. The need for more multi-family housing is not going away and additional requirements would limit the value of MUHTIP as an incentive to offset these risks and new development challenges.

7. Is the MUHTIP incentive needed?

In Staff's opinion, yes, the MUHTIP incentive is needed and provides a benefit to the community. It supports infill development and higher density development as opposed to lower-density sprawl on greenfield properties closer to the urban edge. Land supply is less constrained on greenfield sites and it is easier to achieve economies of scale when developers are able to work with a clean, suburban site. Infill development, such as within the MUHTIP boundary, is more challenging to work in due to more congestion and other constraints as well as environmental, historic, and other issues that occur with previously-developed properties. However, while these developments can come with more risk and cost for developers, they benefit the community by reducing sprawl, encouraging land re-use, connectivity to public transport, and greater pedestrian access to jobs, goods, and services. Infill development also helps increase the supply of much needed housing in the community.

Also, as mentioned above we've been experiencing inflation in the construction market over the last year or two, and more inflation is on the horizon given recent Congressional approval of a $1 trillion infrastructure package, ongoing COVID-related supply chain disruptions, and a national labor shortage. MUHTIP and other incentive programs are necessary to help offset these increased costs and project risks.

8. What other factors should be considered relating to incentives, affordable housing, and homelessness?

A 2019 report on homelessness in Oregon prepared for The Oregon Community Foundation by ECONorthwest (Attachment 1) concluded that a "dysfunctional, undersupplied housing market is the root of Oregon's homeless crisis". "The underproduction of housing has contributed to the region's rising rents which in turn has increased the severity of the homelessness crisis." The report found that in Oregon between 2010 and 2016, 63 new housing units were built for every new 100 households being formed and that continuation of this trend will result in further increasing rents and low vacancy rates. This results in further homelessness: a 10% increase in rent leads to a 13.6 increase in the rate of homelessness.

It recommends that strategies for reducing homelessness should support broad housing production goals and associated rent and vacancy rate targets. A supply strategy would start with a top-line production goal which would require returning to annual production levels that keep pace with household formation while simultaneously adding production to address the legacy of decades of underbuilding.

The report also references historic role of federally-funded housing subsidies and finds that federal resources have diminished and are not sufficient to meet current needs. To offset federal resources, the report finds that "Local revenue-raising efforts are important steps. To ensure that those resources go as far as they can, local governments should evaluate opportunities for additional incentives, such as state-enabled tax abatement programs, fee waivers or reductions, and land write-downs for affordable units." Additionally, long-term subsidies and programs are more effective than shallow, temporary subsidies which the report claims are promising but unproven.

Local governments should also identify and remove regulatory barriers that drive development costs up or unintentionally reduce the number of units possible on a site. These include costly parking requirements, building height and bulk restrictions, design guidelines, and requirements for ground-floor non-residential uses. Salem has already eliminated many of these types of requirements.

A 2019 World Economic Forum report titled "Making Affordable Housing a Reality in Cities" (Attachment 2) addresses at length the supply-side challenges in developing affordable housing. One of the key challenges identified is securing financing for affordable housing and the importance of government tax incentives, grants, and exemptions to private developers to develop certain types of properties. Other key factors to increasing the supply of affordable housing include land banking, mixed-use development to ensure neighborhoods have a mix of income levels and proximity to jobs and services, minimizing bureaucracy, engaging in public-private partnerships, and using emerging construction technologies and materials, and taking care when using rent controls or inclusionary zoning so as not to negatively impact developers and landlords in a way that would restrict the future supply of rental properties.

An article by Parrott and Zandi (Attachment 3) addresses the impacts of the homebuilding collapse in 2009. During that year, nationally builders constructed only 550,000 homes, which was the lowest pace on record. "High-end homes and apartments recovered first due to the faster rebound in demand by wealthier households and stronger profit margins in this market. Homes that low- and moderate-income households can afford to rent or buy has lagged significantly, and only in the year or two before the pandemic have rent prices begun to justify private sector investment in this market."

The article identifies materials and labor, lending, and land as the drivers of this shortfall in housing production. All of these have been in short supply since the financial crisis. These project elements drive up building costs and reduce profit margins. This, in turn, has funneled new projects towards the high end of the housing market where the profit margin is greater, and has exacerbated the shortage of new projects at a lower price point which have lower profit margins.

The increase in lumber prices has bee particularly dramatic since the recession; close to 10% per annum since the housing bust and nearly double from 2019 to 2020. Trade disputes and the pandemic have also had an adverse impact on the costs of aluminum, steel, concrete, fiberglass, plumbing fixtures and appliances. Labor has been challenged by the difficulty homebuilders have had in maintaining a consistent labor force and attracting high school graduates into the trades. This has also been impacted by immigration policies. In the past, this labor gap was largely filled by immigrants. This has also impacted labor costs throughout the supply chain, including transportation and distribution and costs could be further exacerbated by the new infrastructure package.

Additionally, construction financing was been tight for several years following the recession, particularly for smaller banks that work with smaller lenders. But the biggest impediment has been land prices, which have soared in recent years. Parrott and Zandi state that "There simply is not enough buildable land to meet the demand in many areas, and the costs associated with securing and developing the land that is available too often push builders' total costs above what they could get from the sale of an affordable property. The cost of land has soared to an estimated 55% of the total price of the median-priced home nationwide, and upwards of 70% in high opportunity areas such as Seattle and San Francisco."