COUNCIL AGENDA: 3/10/15
ITEM: 4.3

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: February 23, 2015

Approved D. DSyL   Date 2/25/15

COUNCIL DISTRICT: 7

SUBJECT: APPROVAL OF AN INCREASE TO THE CONSTRUCTION/ PERMANENT LOAN COMMITMENT FOR THE METROPOLITAN APARTMENTS NORTH PHASE TO REFLECT THE REALLOCATION OF EXISTING DEBT BETWEEN PHASES

RECOMMENDATION

Adopt a resolution:

1. Approving an increase to the construction/permanent loan commitment of up to $2,164,000, to a total of up to $15,045,000 during construction and up to $15,145,000 during permanent, to reflect both the reallocation of existing debt between phases and up to $100,000 in capitalized construction period interest if needed, to 2112 Monterey Road Apartments, L.P., a legal entity related to Charities Housing Development Corporation, for the development of the North Phase of the Metropolitan Apartments ("Development") located at 2112 Monterey Road;

2. Authorizing the Interim Director of Housing to negotiate and execute all necessary loan- and subdivision-related documents for the Development, including all documents necessary to reallocate the existing debt between the new North and South Phase parcels and to effectuate the North Phase transaction and the transfer of the South Phase parcel to 2112 Monterey Road South, L.P. as described in the staff report including any loan and subdivision-related documents and any subordinations, amendments, reconveyances, and consents; and

3. Authorizing a Loan to Value amount in excess of 100%.

OUTCOME

The recommended action will enable Charities Housing Development Corporation ("Developer" or "Charities") to close financing and begin construction of a 71-apartment affordable residential development ("North Phase" or "Development"), which is the first phase of a planned two-phase development to be constructed at 2112 Monterey Road ("Site"). Once constructed, the North Phase apartments will be affordable to Extremely Low-Income ("ELI") and Very Low-Income ("VLI") individuals and families, which, under current area median incomes, would serve households earning up to approximately $22,300 and $47,475 per year.

Approval of this action at the March 10, 2015 City Council meeting is necessary to meet the State's low income housing tax credit closing deadline for this Development and preserve the tax credit award.

EXECUTVE SUMMARY

This memorandum seeks approval for a revised construction/permanent loan amount for the North Phase of the Metropolitan Apartments to reflect an updated reallocation of a portion of existing debt from the entire Site onto the North Phase. It also adds up to $100,000 to the permanent loan amount to capitalize construction-period interest if it is not able to be paid at conversion to the permanent period. These actions bring the 'up to' construction loan amount for the North Phase to $15,045,000 and the total 'up to' permanent loan amount to $15,145,000. The reallocation of existing debt would make the amount currently anticipated to be secured against the South Phase to be approximately $3,503,290 plus accrued interest.

BACKGROUND

Charities Housing Development Corporation, a nonprofit affordable housing developer based in San José, has worked since early 2008 to advance development of the Metropolitan Apartments ("the Met"), a 102-apartment affordable housing complex at 2112 Monterey Road.

As part of the structured financial workout with Emergency Housing Consortium ("EHC"), which the City actively facilitated, Charities agreed to purchase the Site in 2008 at the City's suggestion and since that time has been planning to construct this family rental apartment complex. With purchase of the Site, Charities also agreed to assume the existing debt for the old Markham Terrace. Due to the severely constrained availability of tax credits in this region, the 102 apartments will be built in two phases—71 apartments in the North Phase and 31 apartments in the South Phase.

Approval of the increased loan commitment requested in this Memorandum only pertains to The Met's North Phase. The City Council has not yet awarded a funding commitment for development of the South Phase; however, staff intends to bring forward a funding commitment request in the near future and to change the terms of the existing debt secured on the South Phase.

The development of The Met's North Phase will create 71 apartments—11 studios, 25 one-bedrooms, 13 two-bedrooms, 21 three-bedrooms, and one two-bedroom manager's apartment. Eighteen units will be restricted to ELI households earning up to a maximum of 30% of Area Median Income ("AMI") ($22,300 for the relevant household sizes in 2014), 52 apartments will be restricted to VLI households earning up to a maximum of 45% AMI ($47,475 for the relevant household sizes in 2014), and one manager's apartment will be unrestricted. In addition, 117 parking spaces will be created to serve the North Phase apartments.

History

The structure formerly located on the 2.86-acre Site was a dilapidated motel—The Rodeway Inn—that was originally built in the 1930s. It had been rehabilitated multiple times and converted to affordable SRO apartments by EHC Lifebuilders in the mid 1990s, then known as the Monterey Glen Apartments or the Markham Terrace Apartments. Despite refinancing and rehabilitation proposals by various developers in the early 2000s, in the 2005-07 timeframe, staff agreed that further rehabilitation of the apartments was economically unviable—therefore, Charities purchased the Site with plans to demolish the old building and construct a new apartment complex.

The City made two loans in the 1990s to enable the previous apartments to offer affordable rents. The two old loans still secured on the site are $3,043,290 in federal HOME funding, plus interest accrued, and $220,000 in federal Community Development Block Grant ("CDBG") funding. (Business term changes to these loans will be brought to the City Council in conjunction with a future funding commitment to the South Phase.)

A series of City funding approvals to enable the Site's complete redevelopment with The Metropolitan Apartments has also resulted in loans that currently are secured on the Site, as described below.

On January 27, 2009, the City Council approved a $500,000 predevelopment loan commitment to Charities to support its project planning on the Site, as part of several actions regarding EHC's financial workout. Further, on August 4, 2009, the City Council approved a funding commitment of up to $6,280,000 to Charities for Site acquisition.

The City closed its acquisition/predevelopment loan for up to $6,780,000, incorporating both the January and August commitments, on December 24, 2009. This amount later was increased to $6,880,000 under the Director of Housing's delegation of authority on February 14, 2011, to cover additional Site carrying costs, primarily real estate taxes.

Despite its best efforts to secure the Site, Charities was concerned that the old apartments' deteriorated physical condition constituted a safety hazard to the neighborhood and to squatters on the Site, so in mid-2010, the City allowed Charities to draw acquisition/predevelopment loan funding to pay for demolition of the building. The Site has remained vacant since that time.

In order to proceed with construction, a City construction/permanent commitment is required to obtain tax credits from the State and debt and equity commitments from the private sector. While waiting for a full City funding commitment, Charities obtained both zoning and site development permits to build both the North and South Phases of The Met. In February 2010, the City Council approved a Planned Development Zoning (PDC09-015) for the entire Site. In July 2011, the Director of Planning, Building and Code Enforcement approved a PD Permit (PD11-011) for 102 apartments. In June 2014, the Director of Planning, Building and Code Enforcement approved a Tentative Map (PT-015) to subdivide the lot into two parcels and an amendment to the PD Permit (PDA11-011-01) to allow construction to occur in two phases. As of the time this Memorandum was submitted, the approval of the final parcel map is pending with Public Works, but is expected shortly.

The City's anticipated construction/permanent commitment was delayed due to funding shortfalls caused by the 2008 financial market problems and the elimination of redevelopment. On June 16, 2013, the City Council approved a performance-based loan (also known as a conditional grant) commitment of up to $240,000 ($80,000 per year for 3 years) to pay for costs incurred by Charities for holding and maintaining the property. This loan closed in August 2013.

Finally, on June 17, 2014, the City Council approved the commitment of a construction/ permanent loan of $12,981,000 for the North Phase of the Metropolitan Apartments at 2112 Monterey Road and authorized a loan to value ratio in excess of 100%. The construction/ permanent loan will be used to repay the City's acquisition/predevelopment loan principal plus interest, and will provide additional funds to be used during construction. The June 17, 2014 approval also authorized an increase to the City's existing acquisition/predevelopment loan by $250,000, changing the principal amount from $6,880,000 to $7,130,000.

Anticipated start of construction

The City Council's June 2014 construction/permanent loan commitment for the North Phase enabled Charities to successfully compete for scarce 9% low income housing tax credits in the State Tax Credit Allocation Committee's second round of 2014. Given the timing of this award, the State's deadline to close this transaction and submit all evidence is no later than March 23, 2015. The closing for the North Phase, therefore, is currently anticipated to occur early in the week of March 16, 2015. The approval of the recommendations of this Memorandum is required for closing to occur and for the tax credit award to be retained. Staff has been told that no extensions of the closing deadline are possible.

Charities is required to obtain a final parcel map to split the Site into two parcels—in order to enable phasing—prior to construction closing. Public Works staff is actively cooperating with Charities to meet the State's deadline.

ANALYSIS

Change in allocation of existing loan between phases

The chart below illustrates the previous allocation methodology for existing loans on the Site and the revised methodology:

Existing City Loan	Principal Amount	Previous allocation		Revised Allocation	
		North	South	North	South
The Met's Acq/Predev loan	$6,880,000	$4,816,000	$2,064,000	$6,880,000	$0
The Met's Predev increase	$250,000	$250,000	$0	$250,000	$0
The Met's Operating Loan	$240,000	$0	$240,000	$0	$240,000
Markham Terrace HOME loan	$3,043,290	$0	$3,043,290	$0	$3,043,290
Markham Terrace CDBG loan	$220,000	$0	$220,000	$0	$220,000
totals	**$10,633,290**	**$5,066,000**	**$5,567,290**	**$7,130,000**	**$ 3,503,290**
plus new 2014 commitment needed for construction loan		**$7,915,000**	**N/A**	**$7,915,000**	**N/A**
= total City's 'up to' construction loan amount		**$12,981,000**	**N/A**	**$15,045,000**	**N/A**
plus an 'up to' capitalization of construction-period interest, if needed		**$0**	**N/A**	**$100,000**	**N/A**
= total City's 'up to' permanent loan amount		**$12,981,000**	**N/A**	**$15,145,000**	**N/A**

In the original allocation, the City and Charities determined that the construction/permanent loan commitment amount that the City Council approved in June 2014 should be split between the North and South phases according to the percentage of apartments in each phase (70%/30), so the loan of $6,880,000 was to be split 70% ($4,816,000) to the North Phase and 30% ($2,064,000) to the South Phase when the new parcels became finalized. The $250,000 increase to the predevelopment funding approved at that time was to be fully attributed to the North Phase.

The City's construction loans are always structured to pay off existing City predevelopment and acquisition financing. Therefore, the City's construction/permanent amount approved in June 2014 was determined by adding $4,816,000 (existing loan) plus $250,000 (increase in existing loan) plus $7,915,000 (the new funds needed to complete construction) for a total construction/permanent amount of up to $12,981,000.

In order to meet City Council sunshine deadlines, staff finalized its recommendations approximately six weeks before the State's tax credit application deadline. However, in that intervening period, Charities' financial consultant determined that a different loan allocation would be more financially beneficial to both phases to maximize the likelihood of obtaining tax credits from the State. City staff concurred with that decision.

The revised allocation reflects 100% of the City's entire acquisition/predevelopment loan balance of $7,130,000, plus accrued interest, to be assigned to the North Phase. Therefore, the revised construction/permanent commitment amount for the North Phase is $7,130,000 plus $7,915,000 needed for construction, for a total of $15,045,000 during construction.

In addition, this request allows an approval of up to $100,000 in uncollected construction interest to be added to the approved permanent loan amount in case there are insufficient funds to pay it in full at conversion to the permanent period. If needed, capitalization would bring the total up to permanent loan amount of $15,145,000, as shown above.

To clarify, the only City funds that will be newly-disbursed for construction is the $7,915,000 that already was committed by the City Council as part of the construction/permanent approval in June 2014. The $7,130,000 previously disbursed for the acquisition/predevelopment loan will be paid off by the new construction loan amount, and it will be part of the permanent loan amount of $15,145,000 and will be repaid through a portion of net cash flow during the permanent period.

<u>It is important to note that this approval does not involve the request of any new cash for the North Phase as compared to the June 2014 approval.</u> It simply reflects the accounting protocol of the allocation of the entire Site's existing acquisition/predevelopment loan to the North Phase. Security for the Met's $240,000 operating loan and security for the approximately $3.3 million in preexisting loans for the now-demolished Markham Terrace Apartments (all of which are now secured on the entire Site) will be moved to the South parcel.

From the City's perspective, the full allocation of the entire Site's existing acquisition/ predevelopment loan to the North Phase is acceptable for several reasons.

- First, the change in existing loan allocation methodology resulted in a successful application for tax credits, which are highly-competitive and difficult to obtain. Thus, new affordable apartments will now be built to support San José workers and will support our local economy instead of another jurisdiction's.
- Second, it allows Charities—a San José-based nonprofit affordable housing developer—to finally move forward on a transaction that it has worked since 2008 trying to advance. This reduces this Development's strain on Charities' financial health. As Charities owns and operates seven other affordable rental properties in San José, housing 565 apartments supported by loans from the City, it is in the City's interest to support the organization's ongoing financial viability.
- Third, development of this empty site is positive for the neighborhood as it will remove the attractive nuisance of the now vacant lot and, once completed, will house tenants who will support local businesses in the Monterey Corridor.

- Finally, repayment of the City's largest existing loan that is secured on the entire Site—the existing acquisition/predevelopment loan—is now accelerated under the revised allocation, as the North Phase will be constructed sooner than the South Phase. This, in turn, will result in repayments to the City sooner than under the former allocation methodology.

Loan-to-value

As stated in the June 2014 funding approval, an appraisal that will be prepared for the senior lender shortly before construction closing is expected to result in a combined loan-to-value ratio ("LTV") that significantly exceeds 100%, which is the City's LTV policy threshold. The appraisal is not yet available as of the time of submitting this Memorandum. The 100% LTV policy is intended to reduce the City's risk of loss associated with the loan; however the deep affordability of the Development—required to obtain the 9% tax credit allocation—both increases needed public subsidy and decreases the Development's market value leading to an increased LTV. Thus, an elevated LTV is not uncommon for public lenders in the affordable housing industry. However, a high LTV is considered acceptable by City staff since operating income is expected to be at least 1.15 times permanent mortgage debt service payments, which is a common standard of financial feasibility and is being used by the senior lender, Bank of America.

Ultimately, the security for a City predevelopment/acquisition loan is that the development gets built with construction funding and moves into permanent operations, during which time the City starts to receive its loan repayments. This is particularly true for affordable housing developments as the use of public funds creates requirements for affordably-restricted apartments to be created on a particular location. Therefore, a site cannot be easily liquidated if the development does not proceed. As this approval will enable the North Phase to close construction, the City's repayment potential will be considerably enhanced as the City's loan will be repaid from a portion of the Development's operating net cash flow.

Approval of these actions will allow the Interim Director of Housing to negotiate the loan terms and execute construction/permanent loan documents for the Development, as well as negotiate and execute amendments to existing loan documents for the South Phase. As the Site is expected to be subdivided and the South Phase conveyed to a new Charities affiliate, 2112 Monterey Road South, L.P., these approvals will include lender approvals, assignments and changes to the legal descriptions and other changes related to the subdivision for this Development and its forthcoming companion development on the South Phase.

Economic development benefits

Taking actions to further this Development will benefit San José economically in four ways. First, the Development's location across the street from the Plant, with more than 50 stores, restaurants, and services, makes this an ideal location for housing affordable to retail workers. Second, according to a 2009 study by the National Association of Homebuilders (NAHB) on the economic benefits to local areas for multifamily low-income housing tax credit-funded construction, 71 units of family housing are estimated to generate over $5.7 million of local benefits in the first year and approximately $1.5 million each year thereafter. Third, according to the NAHB metrics, it is also anticipated that proceeding with and completing the development of the North Phase will create 127 local jobs in San José in the first year, directly and indirectly, and 27 local jobs each year thereafter. Fourth, the Developer expects to pay City development fees of approximately $1.6 million in order to proceed with construction, and will pay the Housing Department approximately $700,000 in outstanding interest, for a total of $2.3 million paid to the City at construction closing.

EVALUATION AND FOLLOW-UP

The Housing Department posts quarterly reports on the status of its subsidized construction developments to its website, www.sjhousing.org. If approved, the Metropolitan Apartments - North Phase would be included in these reports. The Interim Director's determination of final business terms under her Delegation of Authority also will be reflected in a 3rd Quarter 2014 Information Memorandum regarding these types of actions.

PUBLIC OUTREACH

This memorandum will be posted to the City's website for the March 10, 2015, meeting.

POLICY ALTERNATIVES

To arrive at this proposal, staff considered the following options:

Alternative:	***Deny or delay the requested funding commitment.***
Pros:	The City Council could defer action to a future City Council meeting to better understand the request or could deny this request.
Cons:	Delaying approval of this action would very likely force the Development to miss its construction closing deadline required by its 9% tax credit award and would force Charities to surrender the highly-competitive tax credits. Forfeit or return of the tax credits would also cause negative points to be assigned to Charities for other deals, and could jeopardize future tax credit allocations from the State for other City projects. This action does not commit additional cash to the Development; rather, this action reflects an accounting methodology change, so there is no viable alternative to award these funds to another development. Since 2009, the City has disbursed $7,130,000 in Low and Moderate Income Housing Funds for acquisition and predevelopment, plus $160,000 to fund operating costs, to The Met as a whole. To deny or delay this action would prevent the Development from helping to meet the City's production goals and deny residents of badly

needed affordable housing. It would also prevent construction from being completed in the near-term, which is the City's source of repayment for most of the funds already disbursed, thereby greatly increasing the City's risk. Finally, as the City has already spent Low and Moderate Income Housing Funds on this Site, affordable housing must go forward due to use restrictions for this funding source.

Reason for not recommending: The proposed Development will help to meet the local demand for deeply affordable housing for ELI and VLI households, helping the City to fulfill its affordable housing goals. Timely approval of this Development's financing will assist this housing Development to start construction after several years of delays.

COORDINATION

This Memorandum was coordinated with the City Attorney's Office and the City Manager's Budget Office.

FISCAL/POLICY ALIGNMENT

This expenditure is consistent with the City's Envision 2040 General Plan, the City's 2007-14 Adopted Housing Element and the City's 2014-23 Draft Housing Element in that it provides a range of housing opportunities across income groups; the City's current Housing Investment Plan in that it increases the supply of affordable housing; and the City's Consolidated Plan 2010-15 in that it provides apartments for very low- and extremely low-income residents.

COST SUMMARY/IMPLICATIONS

1. **ESTIMATED COSTS OF COMMITMENT:**

USES	AMOUNT
Acquisition, demolition and predevelopment soft costs (already disbursed)	$7,130,000
Other hard and soft construction costs (to be disbursed)	$7,915,000
Capitalization of up to $100,000 in construction-period interest (non-cash)	$100,000
TOTAL 'UP TO' PERMANENT LOAN AMOUNT	**$15,145,000**

2. **SOURCE OF FUNDING:** Fund # 448 - Multi-Source Housing Fund.

3. **FISCAL IMPACT:** No ongoing fiscal impact.

BUDGET REFERENCE

The table below identifies the appropriation proposed to fund the commitment recommended as part of this memorandum. The amount of funds to be newly disbursed during construction—up to $7,915,000—remains unchanged from the City Council's June 2014 approval.

Fund #	Appn #	Appn. Name	Total Appn	Amt. for Contract	2014-2015 Adopted Budget (Page)	Last Budget Action (Date, Ord. No.)
448	0070	Housing Loans and Grants	$10,000,000	$7,915,000	XI-68	6/17/2014 Ord. 29431

CEQA

Mitigated Negative Declaration File Nos. GP08-07-04 and PDC09-015.

/s/
JACKY MORALES-FERRAND
Interim Director of Housing

For questions, please contact Jacky Morales-Ferrand, Interim Director of Housing, at 408-535-3855.

Attachments

ATTACHMENT 1

Anticipated Development Timeline
The Metropolitan Apartments -- North Phase

City Council Approval of Construction/Perm Funding Commitment	June 2014
Low Income Housing Tax Credit Application	July 2014
Low Income Housing Tax Credit Award	September 2014
City Council Approval of Amended Funding Commitment	March 2015
Close of Financing and Start of Construction	March 2015
Construction Completion	Mid-2016

ATTACHMENT 2

Site Map
Metropolitan Apartments -- North Phase