COUNCIL AGENDA: 5/19/15
ITEM: 4.2

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: **SEE BELOW**

DATE: April 28, 2015

Approved D. DSyL

Date 5/7/15

COUNCIL DISTRICT: 6

SUBJECT: AUTHORIZATION FOR THE INTERIM DIRECTOR OF HOUSING TO EXERCISE AN OPTION TO PURCHASE PROPERTY AND TO GROUND LEASE THE PROPERTY TO THE SAN CARLOS SENIORS APARTMENTS

RECOMMENDATION

Adopt a resolution:

a) Authorizing the Interim Director of Housing to (i) negotiate and execute an amendment, if necessary, to that certain Option Agreement and Agreement to Ground Lease ("Option Agreement") dated May 1, 2013 ("Option Agreement") to allow for less than 90 days' notice to exercise the option to acquire the real property located at 1535 West San Carlos Street ("Property") from San Carlos Willard Associates, L.P. ("Developer"), an affiliate of Core Development Corporation, for the San Carlos Seniors Apartments ("Development"), (ii) exercise the option to acquire the Property from Developer for $1, and (iii) negotiate and execute such documents and take such actions, including acceptance of the grant deed, to effectuate the City's acquisition of the Property;

b) Accepting the summary of costs and findings of the Summary Report Pursuant to Section 33433 of the California Health and Safety Code for the disposition of the Property to Developer under the terms and conditions of the proposed Ground Lease and approving the Ground Lease; and,

c) Authorizing the Interim Director of Housing to (i) enter into a ground lease with Developer for 85 years for a nominal rent payment of $1 per year payable in advance at closing ("Ground Lease"), and (ii) negotiate and execute such documents and take such actions, including execution of the Ground Lease, to effectuate the ground lease of the Property to Developer.

OUTCOME

Approval of the recommended actions will allow the City to exercise the City Council-approved Option to acquire the Property beneath a newly-built restricted affordable apartment building at minimal cost to the City and concurrently enter into an 85-year long-term ground lease with the Developer. Ownership of the Property will enable the City to control use of the Property in perpetuity and to acquire the Property's improvements at expiration of the Ground Lease.

BACKGROUND

On April 9, 2013, the City Council approved the City's final financial structure for the long-anticipated San Carlos Seniors Apartments, which obtained its first City Council approval in 2002. This Development, located at the northwest corner of West San Carlos Street and North Willard Avenue, offers 94 apartment units at affordable rents for seniors in the Midtown neighborhood (See **Exhibit A**). The apartments provide affordable rents for Extremely Low-Income ("ELI") and Very Low-Income ("VLI") seniors, with 29 ELI apartments restricted to residents at or below 30% of Area Median Income ("AMI"), 31 VLI apartments at 40% AMI, and 34 VLI units at 50% AMI. Current rents range from $556 to $1,137 per month.

The City's final financial structure approved in April 2013 included a construction/permanent loan of up to $6,208,420 and an assignment of the outstanding principal balance of an existing $2,973,834 infrastructure loan from the affiliate San Carlos Townhomes development adjacent to the San Carlos Senior Apartments ("Development"). In addition, in the April 2013 action, the City Council approved the Director of Housing's ability to negotiate and execute all documents in connection with the loans and the option to purchase the subject Property.

All financing closed timely, and the Developer successfully started construction in May 2013 and completed construction in September 2014. Due to extremely strong demand, the apartments were fully leased and occupied within approximately two months, and the City awarded the Development its final certificate of occupancy in January 2015. The Development now is expected to convert to its permanent financing phase no later than August 2015.

The main document regarding the City's purchase of Property is an Option Agreement and Agreement to Ground Lease ("Option Agreement"). The Option is predicated on the City's long-term lease of the ground to the Development for a nominal amount of rent—a structure that is common in multifamily affordable transactions. The Option Agreement allows the City to exercise its option to purchase the Property at least ninety (90) days prior to termination of the Option Period, which is the earlier of (a) on the conversion date of the construction loan to permanent loan, or (b) May 1, 2018.

The proposed actions are the final authorizations that staff needs to effectuate the City Council's approvals in both June 2011 and April 2013 of a ground lease structure for this Development. While the City Council approved the Option Agreement itself in its April 2013 action, it is necessary for the City Council to authorize the Interim Director to exercise the option to Ground

Lease given the results of the 33433 study, which requires a public hearing, in order to convey the Property for use of the Development. City Council approval is also required for the Ground Lease agreement itself.

ANALYSIS

Property Purchase and Ground Lease

All parties involved in this 9% Low Income Housing Tax Credit deal structured their construction and permanent approvals and documents with the expectation that the ground lease would take effect at conversion to permanent financing. The Ground Lease is substantively the same as the draft ground lease which was attached to the Option Agreement, approved by the City Council, and underwritten by all parties.

Under the Ground Lease, the Property will be leased to the Development for 85 years at the rate of $1 per year paid in full at the start of the lease period. At the end of the lease period, both the Property and the building on it will be owned by the City. Specifically, the Developer's primary responsibilities under the Ground Lease are as follows:

1. Prepay the ground rent with a payment of $85 upon the execution of the Ground Lease.
2. Operate the Development for affordable housing purposes in accordance with the Ground Lease.
3. Comply with the affordability covenants that will restrict occupancy of 94 of the apartments for a period of 85 years.
4. Provide on-going property management services.
5. Pay all taxes, operating expenses, insurance costs, utility expenses, charges, and impositions associated with the Property and Development during the term of the Ground Lease.
6. Maintain the Development in good repair and tenantable condition.
7. Indemnify the City from all claims, loss, damage, injury, actions, and liability of every kind arising from the Developer's use of the Property.
8. Upon expiration of the Ground Lease, convey fee title to the City for all improvements on the Property and demolish the building if the City so requests.

Effectuating a ground lease structure for affordable rental developments is advantageous to the City. The Property was last appraised on April 1, 2013, at which time the as-is market value of the land was appraised at $4,210,000. Based on local land value escalation trends, City staff estimates that the land value has increased at 10% per year since that time, which would indicate a current market value of $5,298,000. While it is expected that, after 85 years of operation, the building will be of nominal value, the Property itself is expected to have significant value. At the end of the lease, the City can decide whether to continue its use for affordable housing or repurpose the site.

<u>33433 Summary Report</u>

While redevelopment agencies have been dissolved, the redevelopment law still applies to Successor Housing Agencies as they develop and administer affordable housing. Prior to the disposition of any property acquired with tax increment funds for development, Section 33433 requires that a summary report disclosing the financial aspects of the transaction be prepared and made available for public inspection at least two weeks prior to the date of the public hearing. A Summary Report Pursuant to Section 33433 of the California Health and Safety Code ("33433 Report"), dated March 30, 2015, was prepared by Keyser Marston analyzing the costs and benefits related to the disposition of the Property to the Developer under the Ground Lease (See **Exhibit B**). The 33433 Report will be published in the Post Record on May 5th and May 12th as required under Code.

Section 33433 also requires that the City make a finding that the consideration to be received by the City, as Housing Successor for the Property, is not less than the fair market value or the fair reuse value of the Property. The 33433 Report concludes that the Property has a nominal reuse value until expiration of its recorded affordability restrictions. The City acquired the property for the value of $1. The City will also receive repayments under the Ground Lease and from its subordinate loans over time, and will receive full consideration for the Property upon expiration of the Ground Lease. Given these facts, the 33433 Report concludes that "the consideration to the City is not less than the fair reuse value of the land based on the current use and with the affordability and other covenants provided under the Ground Lease." The Property will also be used to provide restricted affordable housing and will eliminate blight. Therefore, the terms under which the Property will transfer satisfy the requirements of Section 33433.

<u>Amendment to the Option Agreement</u>

The Option Agreement provides for a 90-day notice period to exercise the option to acquire the Property prior to the conversion of the construction loan to a permanent loan. Given the current timing, the earliest that the exercise of the option would be effective would be mid-August. However, there is a possibility that the conversion could occur prior to mid-August, 2015, if the 90-day notice requirement for exercise of the option is less than 90 days, such that exercise could occur in June or July. Therefore, in order to accommodate a potential early conversion, staff requests authorization for the Interim Director to negotiate and execute an amendment to the Option Agreement to shorten this notice period. Shortening the notice period to allow early exercise of the option may reduce some of the financing costs to the Developer, which would benefit all parties in the transaction.

EVALUATION AND FOLLOW-UP

The Housing Department posts periodic production reports on the status of its subsidized new developments to its website, www.sjhousing.org. Staff will include the status of the San Carlos Seniors Apartments in this report until the end of the fiscal year in which the development converts to permanent financing.

POLICY ALTERNATIVES

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

Alternative:	***Deny the requested actions.***
Pros:	The transaction would be simplified were the Developer to retain ownership of the Property.
Cons:	The City will benefit from owning the Property under a purchase and ground lease as it will enhance the Development's feasibility, will support the City's ability to control affordability over the long-term, and will enable the City to receive the Property, including the building, at the end of the lease term. In addition, all financing was approved assuming a ground lease structure, and to deny this approval would create the need for several parties to restructure approvals and edit documents, which would delay conversion, would add to development costs, and could ultimately add significant costs to the City as gap lender.
Reason for not recommending:	The recommended actions facilitate the construction financing closeout of the San Carlos Seniors Apartments, which already are helping to meet the demand for rental homes for San José's extremely low- and very low-income seniors.

PUBLIC OUTREACH

This Memorandum will be posted on the City's website for the May 19, 2015 City Council Agenda. In addition, notice that the 33433 Report would be heard at the May 19, 2015, City Council meeting will be published in the Post Record on May 5 and May 12 to advertise to the public as required under State law.

COORDINATION

This Memorandum has been coordinated with the Office of the City Attorney and the City Manager's Budget Office.

FISCAL/POLICY ALIGNMENT

This action is consistent with the City's *General Plan 2040*, Chapter 4, policies H-1.2 to H-1.4 to facilitate the provision of housing sites that respond to the needs of all economic segments of the community including seniors, and to encourage housing for Seniors in neighborhoods that are accessible by public transportation. In addition, this action is consistent with the City's recently amended *General Plan 2040* Goal H-2 to increase, preserve and improve San Jose's affordable housing stock and to increase its supply such that 15% or more of the new housing stock developed is affordable to low-, very low-, and extremely low-income households. This action is also consistent with the City's *Housing Element 2014-23 Workplan Item #1* to increase the supply of affordable housing, and with the City's *Consolidated Plan 2010-15 Goal* #1 to assist in the creation of affordable housing for lower-income and special needs households which includes seniors.

COST SUMMARY/IMPLICATIONS

There is no cost implication of these requested actions as there is no cost to the City for this transaction.

CEQA

Mitigated Negative Declaration, File No. PDC02-102.

/s/
JACKY MORALES-FERRAND
Interim Director of Housing

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

Attachments:

Exhibit A: Property Location
Exhibit B: Summary Report Pursuant to Section 33433

<u>Exhibit A</u>
Property Location

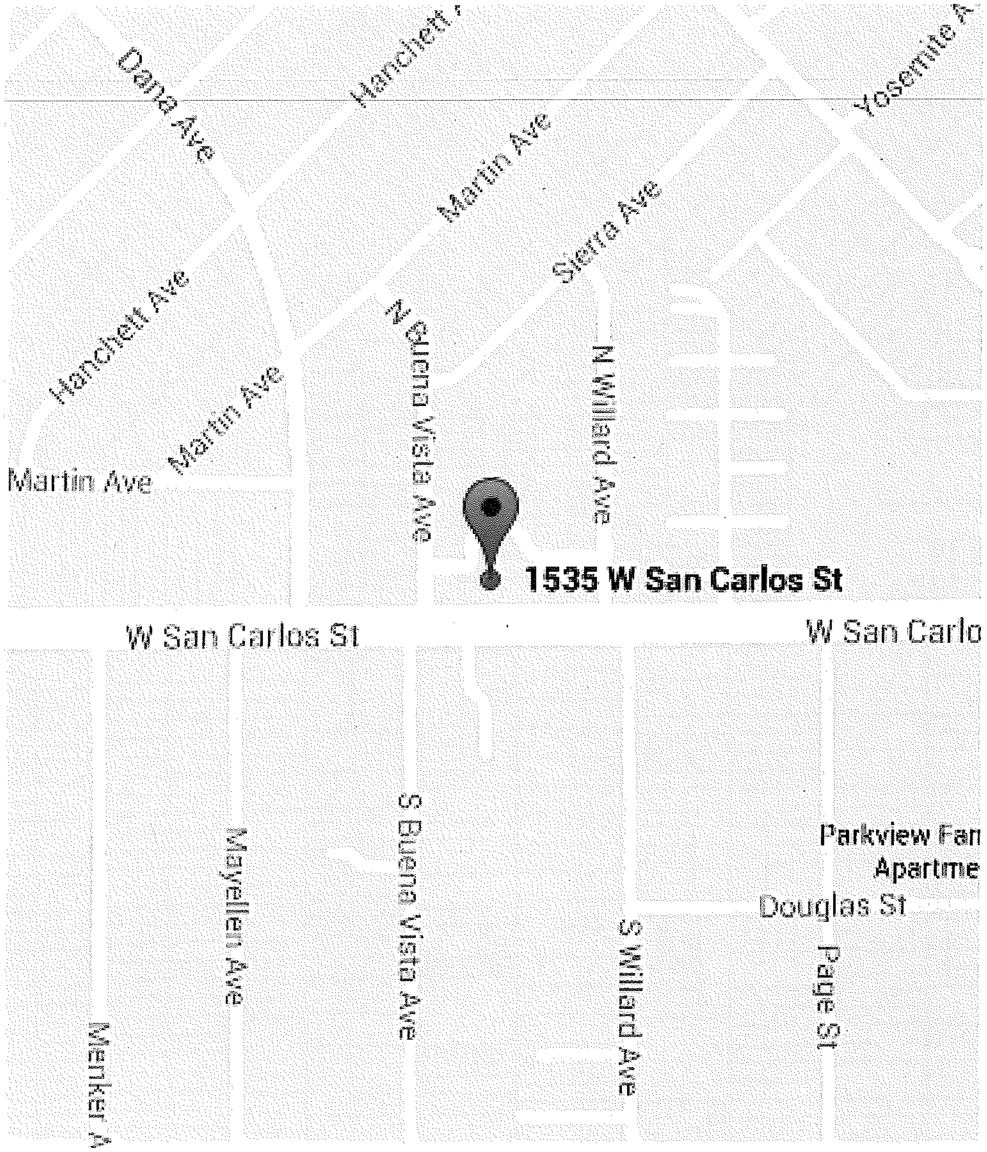

Exhibit B

Summary Report Pursuant to Section 33433

**SUMMARY REPORT PURSUANT TO
SECTION 33433
OF THE
CALIFORNIA HEALTH AND SAFETY CODE
ON
THE GROUND LEASE BY AND BETWEEN
THE CITY OF SAN JOSE
AND
SAN CARLOS WILLARD ASSOCIATES, L.P.**

I. INTRODUCTION

The California Health and Safety Code, Section 33433, requires that if a Housing Successor of a former redevelopment agency wishes to sell or lease property to which it holds title and if that property was acquired in whole or in part with property tax increment funds, the Housing Successor must first secure approval of the proposed sale or lease agreement from its local legislative body after a public hearing. A copy of the proposed sale or lease agreement and a summary report that describes and contains specific financing elements of the proposed transaction shall be available for public inspection prior to the public hearing. As contained in the Code, the following information shall be included in the summary report:

1. The cost of the agreement to the Housing Successor that is to be funded from property tax increment, including land acquisition costs, clearance costs, relocation costs, the costs of any improvements to be provided by the agency, plus the expected interest on any loans or bonds to finance the agreement;

2. The estimated value of the interest to be conveyed or leased, determined at the highest and best use permitted under the redevelopment plan;

3. The estimated value of the interest to be conveyed in accordance with the uses, covenants, and development costs required under the proposed agreement with the Housing Successor, i.e., the reuse value of the site;

4. An explanation of how the sale or lease of the property will assist in the elimination of blight; and

5. The purchase price or sum of the lease payments that the lessor will be required to make during the term of the lease. If the sale price or total rental amount is less than the fair market value of the interest to be conveyed or leased, determined at the highest and best use consistent with the redevelopment plan, then the Housing Successor shall provide as part of the summary an explanation of the reasons for the difference.

This report outlines the salient parts of the Ground Lease (Lease) to be entered into by and between the City of San José (City) and San Carlos Willard Associates, L.P. (Developer). This report is being prepared due to the fact that property tax increment funds from the former Redevelopment Agency of the City of San Jose (RDA) were used to provide financing to the Developer for the development of 94 affordable residential units on the subject property. The City of San Jose has elected to become the Housing Successor and retain the housing functions and the encumbered assets of the former redevelopment agency, including completing the purchase and ground lease of the property.

This report is based upon information in the proposed Lease and is organized into the following five sections:

1. **Summary of the Proposed Lease** – This section includes a description of the property and the major responsibilities of the City and the Developer.

2. **Cost of the Lease to the City** – This section outlines the cost of the Lease to the City for costs that have been funded with tax increment funds. It presents the terms of the property conveyance, and sets forth the net cost of the Agreement to the City.

3. **Estimated Value of the Interest to be Conveyed** – This section summarizes the value of the property to be leased to the Developer.

4. **Consideration Received and Reasons Therefore** – This section describes the value of the payments to be made by the Developer to the City. It also contains a comparison of the purchase price and the fair market value at the highest and best use consistent with the redevelopment plan for the interests conveyed.

5. **Provision of Very Low, Low, or Moderate Income Housing** – This section demonstrates how the lease of the property will provide housing for Very Low-, Low-, or Moderate-Income persons.

6. **Elimination of Blight** – This section demonstrates how the Project satisfies the blight elimination criteria imposed by Section 33433 through the provisions of housing for Very Low- to Moderate-Income persons.

II. SUMMARY OF THE PROPOSED LEASE

A. Description of the Property and Project

Property

The property is 40,420 square feet (.93 acres) and is located at the northwest corner of West San Carlos Street and North Willard Avenue in central San Jose. The property is currently owned by the Developer. As partial consideration for the City's provision of a construction/permanent loan in the aggregate amount of $6,208,420 to assist in the development of the subject Project, the Developer granted the City an option to acquire title to the property at no cost to the City, provided that the City ground leases the property back to the Developer concurrently with the acquisition.

Developer

The Developer is San Carlos Willard Associates, L.P., a California limited partnership. Members of the limited partnership are as follows:

- AOF/Pacific Affordable Housing Corporation, a California nonprofit public benefit corporation, which is serving as the Managing General Partner;
- CORE Willard, LLC, a California limited liability company, which is serving as a Co-General Partner;
- Roem SC, LC, a California limited liability company, which is the also a Co-General Partner; and
- RJHOF 26-San Carlos, L.L.C., a Florida limited liability company, which is the limited partner.

Project Description

The Developer completed construction of the Project in January 2015 as evidenced by the final certificate of occupancy. The Project consists of 95 rental apartments, 4,378 square feet of ground level commercial space, and 72 parking spaces. The apartment building will be four stories, with the parking and commercial space located on the first floor and the residential units on the upper three floors. Excluding the garage, the Project's gross building area is 86,786 square feet.

The unit mix consists of ninety one (91) one-bedroom units and four (4) two-bedroom units, with an estimated average rentable area of 617 square feet. All of the units are subject to age restrictions. Ninety four (94) of the units are restricted affordable units, with thirty four (34) units restricted to households earning no more than 50% of the Area Median Income (AMI), thirty one (31) units restricted to households earning no more than 40% of the AMI and twenty nine (29) units restricted to households earning no more than 30% of the AMI. The one unrestricted unit is occupied by the on-site manager.

The commercial space is currently unleased. Additional amenities include a community room with a kitchen, a computer room and a common use laundry.

B. City Responsibilities

The City's responsibilities under the Lease are to ground lease the property to the Developer for a period of eighty-five (85) years. The lease rate will be $1 per year, with the lease payment to be prepaid at the execution of the lease. The improvements on the property, including the 95 rental units and the 4,081-square foot commercial space, will be owned in fee by the Developer for the 85-year term of the lease. Upon expiration of the lease, the City shall receive fee title to all of the improvements on the property at no cost.

The City has previously provided a construction/permanent loan in the aggregate amount of $6,208,420 to the Developer to help fund a portion of the Project's $29 million of development costs. The loan shall be repaid from a portion of the Project's residual receipts. As partial consideration for the City's loan, the Developer will transfer title to the property to the City at no cost concurrently with the execution of the ground lease. A condition of the no-cost conveyance of title to the property from the Developer to the City is that the City will lease the property to the Developer for an 85-year term at the rate of $1 per year.

C. Developer Responsibilities

The Developer's primary responsibilities under the lease include the following:

1. Prepay the ground rent with a payment of $85 upon the execution of the ground lease;
2. Use the Project for affordable housing purposes in accordance with the lease;
3. Comply with the affordability covenants that will restrict occupancy of 94 of the units for a period of 85 years;
4. Provide on-going property management services;
5. Pay all taxes, operating expenses, insurance costs, utility expenses, charges, and impositions associated with the property and Project during the term of the lease.
6. Maintain the Project in good repair and tenantable condition.
7. Indemnify the City from all claims, loss, damage, injury, actions, and liability of every kind arising from the Developer's use of the Property.
8. Convey fee title to all improvements on the property upon the expiration of the ground lease's 85-year term.

While not an obligation of the lease, per the requirements of the promissory note executed between the City and the Developer on May 1, 2013, the Developer is obligated to share 65% of the Project's annual Net Cash Flow over the ground lease term to be applied toward repaying the City's $6.2 million loan for the development of the Project and the remaining balance on a separate loan provided for the development of the San Carlos Townhome project.[1]

[1] As of March 29, 2013, the outstanding balance of the Townhome Loan was $2,973,834.

III. COST OF THE AGREEMENT TO THE CITY

This section presents the total cost of the Agreement to the City that will be funded with Low and Moderate Income Housing Funds (which were distributed to the City prior to the dissolution of the redevelopment agency) or funds from the Low and Moderate Income Housing Asset Fund. These funds are collectively referred to as "Low/Mod Fund".

The "net cost" of the Project after consideration of the revenues that will accrue to the Low/Mod Fund, if any, is also evaluated. The net cost can be either an actual cost, when expenditures exceed receipts, or a net gain, when revenues created by implementation of the Agreement exceed expenditures.

A. Estimated Cost to the City (Low/Mod Fund)

The costs to the City's Low/Mod Fund resulting solely from this transaction relate to the acquisition of the site by the City. Given that the Developer will convey title to the site to the City at no cost to the City, the cost to the City resulting from this transaction is $0. The $6.2 million loan provided by the City to the Developer resulted from a prior action by the City and is not the subject of this Summary Report.

B. Revenues to the City

Under the terms of the Lease, the City will receive the following revenues:

1. *Base Ground Lease Revenues* – A prepayment of $85 for the 85-year ground lease.

2. *Reversion Value of the Property* – Upon the expiration of the lease in 85 years, the income restrictions will terminate and the City will hold title to the entire property, including the improvements. While it is expected that after 85 years of operation, the building will be of nominal value, the land will have significant value. It is estimated that the land will escalate in value commensurate with the discount rate of 5% per year. Under this assumption, it is estimated that the net present value of the site will be equivalent to its estimated current fair market value of $5,298,000.

C. Net Cost to the City (Low/Mod Fund)

The net cost to the City resulting from this transaction is the difference between the City's costs funded with Low/Mod Funds and any revenues. Given that the cost to the City is $0 and the City will receive an estimated $5,298,085 of revenue, the net cost to the City is $0 but the net benefit to the City is a positive $5,298,085.

IV. VALUE OF THE INTEREST TO BE CONVEYED

A. Reuse Value

The reuse value of the Property is directly a function of the development economics of the specific Project required in the Agreement. The Lease Agreement requires the Developer to lease the units in accordance with the affordable housing restrictions that have been recorded on the property's title. Pursuant to these restrictions, all of the units (except for the manager's unit) will be restricted to Extremely Low to Very Low Income households, as follows:

Extremely-Low Income units (30% of Area Median Income)	29 units
Very Low-Income units (40% of Area Median Income)	31 units
Very Low-Income units (50% of Area Median Income)	34 units

The average monthly rental rate is approximately $775, compared with an average market rate level of approximately $2,000. Because of the deep affordability requirements and the lack of income from the commercial space, the Project's income stream is sufficient to support only 17% of the Project's development costs. The project has been funded with a combination of low income housing tax credits, the City loan, a conventional loan, a contribution from the Developer and other funds, as follows:

Funding Sources	Total Project	% of Total
City of San Jose Loan Funded with Low and Moderate Income Housing Asset Funds	$6,208,420	21%
Permanent Loan	$5,035,000	17%
Deferred Developer Fee	$800,000	3%
LIHTC, Limited Partner	$15,164,844	52%
City of San Jose Waiver of Impact Fees	$1,964,600	7%
Total Funds/ Development Costs (Ex. land)	**$29.2 million**	**100%**

Given the deep affordability restrictions and the Project's development costs, the Project's economics do not support a purchase price for the site or significant annual ground rent. Therefore, the site's fair reuse value is nominal.

Upon the expiration of the affordability covenants and ground lease in 85-years, the City will hold title to the Project and will be able to sell it a fair market value.

B. Estimated Value at Highest and Best Use

The property was last appraised on April 1, 2013. Given that the property is subject to permanent rent restrictions, the appraisal determined that the property's highest and best use was to be developed with the proposed 95-unit affordable housing project. The appraisal evaluated the property's "as is" market value, which it determined to be $4,210,000. Based on land value escalation trends, City staff has estimated that the property's land value has increased 10% per year, indicating a current market value of $5,298,000.

V. CONSIDERATION RECEIVED AND REASONS THEREFORE

Under the terms of the Agreement, the Developer will ground lease the property (excluding the improvements) from the City for a nominal prepayment of $1 per year of the lease. The City will receive full consideration for the land upon the termination of the affordability covenants and ground lease. These terms are consistent with the Reuse Value of the property.

The property has a nominal reuse value given that 94 of the units that have been developed on the property are restricted to Extremely Low to Low Income households. As discussed in Section IV, with restricted rents less than 40% of market rate rents, these affordability restrictions limit the Project's ability to generate cash flow sufficient to fund the Project's development costs. Given that the Project's income stream is sufficient to support only 17% of the Project's development costs, the Project cannot support an up-front payment for land or a traditional ground rent payment.

Since the property has a nominal reuse value and the City will receive full consideration for the land upon expiration of the Ground Lease, the consideration received by the City is not less than the fair reuse value of the land based on the current use and with the affordability and other covenants provided under the Ground Lease.

VI. PROVISION OF VERY LOW, LOW, AND MODERATE INCOME HOUSING

The Project will provide 94 permanent housing units for Extremely Low to Very Low- Income households for 85 years. The incomes of occupying households and the rental rates charged to the households will be restricted as follows:

Extremely-Low Income units (30% of Area Median Income)	29 units
Very Low-Income units (40% of Area Median Income)	31 units
Very Low-Income units (50% of Area Median Income)	34 units

VII. BLIGHT ELIMINATION

The Project consists of the development of 94 housing units for Extremely Low- to Very Low-Income households. The units will be subject to affordability restrictions for 85 years. In accordance with California Redevelopment Law, as portrayed in the California Health and Safety Code Section 33433, the conveyance of property that results in the provision of housing for Low- or Moderate-Income persons satisfies the blight elimination criteria imposed by Section 33433. Thus, the Project fulfills the blight elimination requirement.