



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: February 27, 2023

Approved

Date

3-9-23

COUNCIL DISTRICT: 3

**SUBJECT: MASTER PRE-LEASE WITH PMI PARTNERS LLC FOR THE PACIFIC
MOTOR INN LOCATED AT 455 SOUTH SECOND STREET**

RECOMMENDATION

Adopt a resolution authorizing the Director of Housing to execute a master pre-lease, with an option to purchase, apartments built by PMI Partners LLC (a joint venture of PATH Ventures, a California nonprofit public benefit corporation, and Westbank, a private developer) located at 455 South Second Street in the circumstance that an affordable housing development is unable to secure financing.

SUMMARY AND OUTCOME

The proposed development at the Pacific Motor Inn site allows for a unique collaboration between the City, PATH Ventures, and WestBank. The alliance between City, non-profit and private entities will leverage state Homekey dollars to create an over 400-unit mixed-income community near transit and downtown amenities. In the near term, the existing hotel will be operated as interim housing with wrap around services targeting individuals experiencing homelessness. Ultimately, the site will be redeveloped to include a mid-rise affordable housing development including 72 units of permanent supportive housing and up to 48 additional affordable apartments. A high-rise building with approximately 350 units of market-rate housing will also be constructed, yielding a total of 470 units on-site.

PATH will redevelop the hotel site into a 120-unit mid-rise affordable development. PATH will need to successfully apply for tax credit financing to build the 120-unit project. In the unlikely event that PATH Ventures is not able to secure financing for the affordable housing development or a new nonprofit is unable to replace PATH Ventures, PATH Ventures will exit PMI Partners LLC (PMI Partners). Thereafter, PMI Partners (WestBank) will repay the Homekey funds to the state and will proceed with the design and construction of both the mid-rise affordable building and the high-rise market-rate building. Westbank must be certain about its ability to build,

including financing the project, in partnership with the City prior to proceeding with the project. The recommended action authorizes the Director of Housing to execute a master pre-lease with an option to purchase the mid-rise building for affordable housing.

This recommendation is coming to the City Council for consideration for two primary reasons:

- 1) Transparency – The financing options related to the Pacific Motor Inn proposal are complex. This memorandum provides details regarding options that may need to be deployed to move forward with the redevelopment of the site.
- 2) Certainty – Bringing forward the key terms of a lease at this point in time will allow all parties to move forward knowing the framework for this future agreement. This will allow plan for the redevelopment of the site to move forward with certainty.

BACKGROUND

Homekey is a state grant program administered by the California Department of Housing and Community Development (HCD). The program's objective is to provide interim or permanent housing options for persons experiencing homelessness and who are also at risk of COVID-19. It aims to achieve this by providing grant funding to eligible applicants to quickly acquire, rehabilitate, or master lease a variety of housing types.

On October 5, 2021, the City Council approved actions authorizing the City Manager to apply for three Homekey grants. The three Homekey grant application sites are the Pacific Motor Inn, Arena Hotel, and the City-owned property located at the intersection of Branham Lane and Monterey Road. HCD announced a grant award for the Pacific Motor Inn in December 2022.

On December 13, 2022, the City Council approved actions authorizing staff to: accept a Homekey grant award of \$19,868,250 from HCD; enter into a Standard Agreement with HCD; and provide a funding commitment of \$25,026,939 of Measure E funds and up to \$19,868,250 in state Homekey funds directly to PMI Partners to fund the acquisition, rehabilitation, operations, and services for the Pacific Motor Inn.

ANALYSIS

The Pacific Motor Inn development (Project) includes multiple phases and options based on the success of the anticipated phases moving forward. The purpose of this section is to describe the proposed development phases and alternative development strategies for the site.

Proposed Development Phases

Acquisition Phase

The acquisition phase will commence as PMI Partners purchases the Pacific Motor Inn for a total of \$18,165,500 funded through \$16,556,250 in Homekey funds from HCD and \$1,609,250 in Measure E funds from the City.¹ PMI Partners and the City will enter into a Standard Agreement with HCD to ensure 72 units are made available to homeless individuals for 15 years.

Additionally, the City will place an affordability restriction limiting rents to 30% of the Area Median Income for extremely low income households on the site for 15 years.

Interim Housing Phase

During the interim housing phase of the Project, PMI Partners will contract with PATH Ventures to operate the Project as an interim housing site with robust supportive services, targeting individuals who are experiencing homelessness or who are at risk of homelessness. The existing 71 rooms will be reserved for Homekey eligible residents and one room will be the on-site property manager's unit. The City will enter into a contract with PATH to fund operations during the interim housing phase.

Preparation for Redevelopment Phase

In preparation for the redevelopment phase, PMI Partners will contract with Westbank to seek entitlements for the two buildings on the site. One building will be designed as a high-rise, market-rate residential building. The second building will be designed as a mid-rise, affordable residential building. After entitlements are approved for the site, PATH Ventures will seek financing for the affordable housing development. PATH Ventures may apply for funding to the California Debt Limit Allocation Committee and/or Tax Credit Allocation Committee multiple times.

Redevelopment Phase

In the redevelopment phase, Westbank will purchase the market rate portion of the site from PMI Partners. Once this payment is made, the affordability restriction will be lifted from the market-rate portion of the site. Westbank will move forward with the construction of the market-rate residential building. PATH Ventures will move forward with the development of the affordable, mid-rise development. Per the Standard Agreement documenting the requirements tied to the Homekey funds, HCD has agreed that City may release the existing affordability restriction requiring interim housing for a term of 15 years and place a new affordability restriction requiring rents and incomes restricted to households at or below 60% Area Median Income for a

¹ City Council authorization on December 13, 2022

<https://sanjose.legistar.com/LegislationDetail.aspx?ID=5949590&GUID=811C2514-DC44-4D4E-A20A-FF058C49CE72&Options=&Search=>

55-year period. The affordable development will include 72 permanent supportive housing units, as required by the Homekey program.

Worst Case Scenario Development Strategies

In the unlikely event that PATH Ventures is not able to secure financing for the affordable, mid-rise development, and another entity is not able to move into the partnership, PATH Ventures will withdraw from PMI Partners. Following the exit, PMI Partners will pay the HCD \$16,556,250 and the City \$1,609,250 for a total of \$18,165,500 (Table 1 below) in Project Homekey and Measure E funds used for the acquisition of the hotel. Any unspent funds disbursed from the Homekey grant to PMI Partners held in an operating reserve or services reserve by the City will also be returned.

Table 1 – Acquisition Funds Used to Purchase the Pacific Motor Inn

	Homekey Funds	City (Measure E)	Total
Acquisition	\$16,556,250	\$1,609,250	\$18,165,500

After the Project Homekey and Measure E funds are repaid to the City, the HCD Project Homekey affordability restriction requiring that the site be operated as interim housing for a 15-year period will be rescinded and released from the title.

Master Pre-Lease for the Mid-Rise Building

In a situation where PATH Ventures exits the development, one strategy to allow development to move forward is that PMI Partners LLC with Westbank as its sole remaining member will begin the construction of both the market-rate, high-rise building and the affordable mid-rise building. The City will enter into a master pre-lease with Westbank that will take effect once the construction of the mid-rise building is complete and in the event that PATH is unable to secure construction financing. The Master Pre-Lease document is included as an attachment.

The elements of the master pre-lease are described below:

- **Lessor and Lessee**– The lessor of the completed mid-rise residential building will be PMI Partners and the lessee will be the City of San José.
- **Site Description** – A mid-rise building located at 455 South Second Street with approximately 120 residential units and other improvements
- **Pre-Lease Payment** – The formula for the lease payment will be equal to 6% of the total development cost of the mid-rise residential building. Based on current per-unit construction costs, it is assumed the total cost will be \$800,000 per unit or an estimated amount of \$96,000,000. In this scenario, the annual lease payment would be \$5,760,000.
- **Transparency** - Total development cost will be documented and transparent to the City. All costs will be made available for review by the City, while maintaining confidentiality for the documents and materials.

- **Inflation Factor** – The annual lease payment amounts will be increased by the Consumer Price Index every three years to account for inflation over time.
- **Termination Conditions** – If PATH moves forward with the original intended development, the lease is terminated; if Westbank is no longer the developer, the City will have the option to terminate the agreement.
- **Term** – The term will be 55 years.
- **Upfront Payment** – The City may elect to commit an upfront payment approximate estimate of \$10,000,000 in order to buy down the annual lease payments or purchase price. The amount of the upfront payment will be determined by the City. The larger the upfront payment, the lower the annual lease payments will be, allowing rents to be further reduced.
- **First Right of Refusal** – If the lessor fails to pursue construction for more than six weeks, the lessee will have the first option to acquire the site, subject to approval of the lessor's lender.

It is unknown at this time what the total cost of development for the mid-rise building will be. Westbank is motivated to seek strategies to keep and has a track record of keeping the cost of development lower than is typical for affordable housing development. This development will be a pilot to test alternative approaches to development in an effort to reduce overall development costs.

Option to Purchase the Mid-Rise Building

In addition to the master pre-lease alternative, the City would maintain an option to purchase the mid-rise residential building from PMI Partners. The key terms of the purchase agreement for the mid-rise building are described below (included the Master Lease Pre-Lease Document attachment):

- **Site Description** – A mid-rise building located at 455 South Second Street with approximately 120 residential units and other improvements.
- **Purchase Price** – The purchase price will be equal to the total development cost times 1.15, reflecting a 15% return for PMI Partners to construct the building which is currently estimated to be \$96,000,000. Total development cost will be documented and transparent to the City. Any upfront payment would be credited towards the purchase price.
- **Timing of Purchase** – The purchase may take place at the end of construction or within the first three years following the final certificate of occupancy.

The option to purchase will provide the City an alternative to the master pre-lease. The City will evaluate available funding and target populations to determine the best alternative at that time.

Climate Smart San José Analysis

The recommendation in this memorandum aligns with one or more Climate Smart San José energy, water, or mobility goals. The recommendation furthers the goals of Climate Smart by facilitating the creation of low-income housing close to jobs and transit, which would reduce vehicle miles traveled and greenhouse gas emissions.

EVALUATION AND FOLLOW-UP

If the development is able to obtain its financing and moves forward, its progress will be reported in the Housing Department's information memoranda regarding the use of the Director of Housing's Delegation of Authority under the Municipal Code. During the life of the Project, while it operates as an interim housing facility, performance metrics will be included in the Housing Department's annual Homeless Report. If the project is unable to move forward, the Housing Department will issue an information memorandum informing the City Council. If the Housing Department moves forward with either the master pre-lease or to exercise City's option to purchase the site, the Housing Department would return to the City Council with a funding request.

COST SUMMARY/IMPLICATIONS

1. **ESTIMATED COSTS:** On December 13, 2022 (Item 8.4) City Council approved acceptance of a \$19.9 million HomeKey 2.0 grant to be received directly by PMI Partners. This action also approved the commitment of \$25 million of Measure E funds, subject to appropriation over a seven-year period, as the City's matching requirement to the HomeKey 2.0 grant award. Of this amount \$5.8 million has been appropriated in FY 2022-2023 to serve as a capital match (\$1.6 million) and for the rehabilitation of the Pacific Motor Inn property (\$4.2 million). Allocation of the remaining \$19.2 million in Measure E funding for operating and maintenance costs of Pacific Motor Inn will be brought forward as part of future budget processes.
2. **FISCAL IMPACT:** The actions recommended in this memorandum will allow staff to negotiate with PMI Partners. Staff will return to City Council following conclusion of negotiations, if needed, for budget appropriations as part of the budget process.

BUDGET REFERENCE

The table below identifies the funds and appropriations funding the actions described in this memorandum.

Fund #	Appn #	Appn Name	Total Appn.	2022-2023 Adopted Operating Budget Page	Last Budget Action (Date, Ord. No.)
001	224R	Measure E – Project HomeKey 2.0 (40% ELI)	\$38,613,686	N/A	2/28/2023 Ord. No. 30885

COORDINATION

This memorandum has been coordinated with the City Manager’s Budget Office, City Attorney’s Office and the Office of Economic Development and Cultural Affairs.

PUBLIC OUTREACH

This memorandum will be posted on the City’s Council Agenda website for the March 21, 2023 City Council meeting.

Outreach was undertaken for this item in addition to the agenda posting described above. These outreach efforts are described below.

The Housing Department hosted a series of public meetings via Zoom to share details and answer questions about the City’s Homekey applications and solicit input. The first public meeting was held on October 1, 2021 and focused on the City’s overall Homekey strategy. The meeting included a presentation from the Santa Clara County Office of Supportive Housing regarding the regional approach to the Homekey program. On October 25, 2021, another public meeting was held to discuss this specific interim housing project proposal. The meeting included staff from the Housing Department and PATH. Each agency provided a presentation followed by a project-specific question and answer session.

COMMISSION RECOMMENDATION/INPUT

No commission recommendation or input is associated with this action.

CEQA

Exempt from CEQA Review, File No. ER21-159, Public Health and Safety Code Section 50675.1.4.

HONORABLE MAYOR AND CITY COUNCIL

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PUBLIC SUBSIDY REPORTING

The item does not include a public subsidy as defined in government code section 53083 or 5308.1 or in the City's Open Government Resolution.

/s/

JACKY MORALES-FERRAND

Director of Housing

For questions, please contact Rachel Vander Veen, Assistant Director (408) 535-8231.

ATTACHMENT

Attachment – Master Pre-Lease Document