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Memo Regarding the IZ Policy Roundtable

To:
Barney Heath, City of Newton Planning & Development Director; James Freas, Deputy Director; Amanda Berman, Director of Housing & Community Development

From:
Kyle Talente, RKG Associates, Inc. Vice President & Principal

Re:
Response Summary: IZ Roundtable with Housing Advocates, Feb. 19, 2019

On Tuesday, February 19, 2019, RKG Associates (RKG) joined staff from the City of Newton's Planning & Development Department and a number of housing advocates from the city to discuss the proposed Inclusionary Zoning ordinance and the financial feasibility analysis and model that RKG developed for the City in 2018. The purpose of this roundtable was to dive further into the questions and concerns raised by the advocates about the current proposal, specifically as they relate to RKG's financial feasibility analysis and model, and to discuss possible solutions for overcoming these concerns.

At the request of the City of Newton's Planning & Development Department, RKG is providing a response to questions/requests for clarification generated from this meeting. Please let me know if RKG can be of further assistance to the City as it considers changes to the Inclusionary Zoning policy.

Q: <u>What is the IZ policy's connection to land values in Newton, and why does that matter?</u>

While often a point of public debate, real estate development is a for-profit business. Developer/investors acquire land with the intent to build (or redevelop) the property into a land use that will generate a market-acceptable rate of return (defined by the marketplace). Several factors within the real estate development process are established by the local supply and demand equilibrium. These include the price of materials to build (i.e. the price of a brick), the cost to prepare the land for development (i.e. grading), and the income potential (whether potential rent levels or sale prices) of the new development. In other words, these revenue and expenditure factors are pegged to basic economics. The main 'variable' in the cost/revenue paradigm that a developer has some greater degree of control over is the price they are willing to pay for the land.

Changes in regulation can benefit or adversely impact the value of land (reflected in the price a developer is willing to pay for the land), depending on whether those regulations increase revenue potential (i.e. more density) or create greater cost burdens (i.e. requiring higher-cost building materials). Because most factors are fixed to the larger marketplace, developers/investors will adjust their price offers for the land accordingly.

Newton's Inclusionary Zoning policy reduces the income potential of residential development by placing price restrictions on some of the units being constructed (the required affordable units). Current market value levels for land in the City have normalized to the existing policy, as it was implemented over fifteen years ago. Any considerations to change the IZ policy could cause land to increase in value (i.e. if the City were to reduce unit/subsidy requirements) or decrease in value (i.e. if the City were to increase unit/subsidy requirements).

Making a change to the policy that will substantially reduce revenue potential most likely will reduce land values in the City. If the reduction reaches levels considered too burdensome for developers/land owners, development could be disrupted for a period of time. The greater the impact, the more likely that disruption will last longer.

Given the paradigm described above, a change in the IZ policy that reduces potential revenue, thereby lowering the price a developer would potentially offer for land, means that the cost of the policy is carried more by the existing landowners than by developers. For developers, the cost is essentially just an additional item to be calculated into the project pro forma prior to purchasing the land. However, for the landowner, the cost represents a lower land value, effectively acting as a tax on land.

The potential chilling effect on development comes when landowners become unwilling to accept a lower price for their land and refuse to sell, holding out for some potential future increase in value. This same paradigm is in effect related to all requirements placed on development, not just IZ ordinances, and they act cumulatively.

Again, the greater the negative impact on land values, the more likely that disruption in residential development will last longer. In terms of inclusionary zoning, a slowdown in market-rate development also equals a slowdown in the creation of affordable units throughout the city.

Q: What is a "reasonable" amount to push to add in the middle-income units on top of the existing policy? Is it 2.5%? Is it 5%?

This is a hard question to answer. Our research shows that adding a 2.5% increase in inclusionary units at 110% **on top** of the City's existing policy (7.5% requirement at 50% AMI + 7.5% requirement at 80% AMI for rental) could impact land values by as much as 10% for smaller projects (20 or fewer units) to 2% for larger projects (150-250 units). These outcomes are consistent with RKG's similar efforts in other communities in Massachusetts and throughout the U.S.

LAND VALUE IMPACT FROM EXPANDING CURRENT IZ POLICY		
Unit Count	**Adding 2.5% at 110% AMI**	**Adding 5.0% at 110% AMI**
20 Units	10.7% Impact	10.7% Impact (no new units)
35 Units	6.1% Impact	6.7% Impact
50 Units	3.4% Impact	5.4% Impact
75 Units	5.6% Impact	7.7% Impact
105 Units	3.5% Impact	4.1% Impact
150 Units	1.9% Impact	4.0% Impact
205 Units	1.9% Impact	3.8% Impact
250 Units	2.6% Impact	4.7% Impact
400 Units	2.7% Impact	4.7% Impact

NB - Assumes no payment for partial units

Is a 10% impact 'reasonable'? Some property owners may be willing to absorb that cost while others may not. To make this impact more relatable to our clients, we ask, "Would you be willing to sell your house tomorrow if it was worth 10% less than it was today without any changes to the structure itself?"

Ultimately, it is a policy decision for the City in terms of how far it wants to push the market.

Q: <u>RKG has said, "The more value you take away from the land, the more you are likely to chill development." But how long does it take to rebound?</u>

It is not possible to determine this answer. It depends on the investment motivation of developers, the unique situation for each parcel of land, and other policy/regulation impacts imposed by the City. Most developers in high-demand communities like Newton know that they will be asked to provide public benefits as part of the entitlement process. Many of these costs are generally known (i.e. the IZ policy) or somewhat predictable (the I&I process). The price a developer is willing to pay for land takes these potential costs into consideration. If the local jurisdiction substantially increases the cumulative cost of these benefits, the market reaction oftentimes is development slowdown (or even stoppage). However, sometimes efficiencies can be found through negotiating other benefits or finding additional sources of funding (i.e. 28 Austin Street's Workforce Housing loan through MassHousing). All that said, it is RKG's understanding that the City's last change to the IZ policy in 2003 likely was a significant contributing factor in decreasing the delivery of units through the IZ policy for close to fifteen years.

Q: <u>Why does the IZ policy model built by RKG appear to present a different scenario than what we are seeing on the ground, a la Washington Place and Austin Street?</u>

It is not possible to create a 'one-size fits all' policy in a jurisdiction with such a diverse housing market as Newton. Every location, ownership situation, and project are different; and the developer/land owner will react differently to policy changes like the one that was discussed with the housing advocates at the roundtable (7.5% at 50% of AMI, 7.5% at 80% of AMI, plus 2.5%+ at 110% or 120% of AMI). Our research shows that larger projects can better absorb more affordability requirements because there are more market rate units to spread the impact across. That said, there will always be exceptions to the rules.

RKG Associates is not familiar with the Washington place project per se, so we cannot definitively explain that situation. However, RKG was involved in the market and financial feasibility analysis on behalf of the City when it was considering 28 Austin Street. Our analysis showed the project worked at 25% of affordability at 80% of AMI for two primary reasons. First, the City was selling the land at a cost level below market average, reducing the out-of-pocket costs for the developer. Second, removing the 50% of AMI requirement increased the profitability of those units, which offset some of the cost for the additional units at 80% of AMI.

That said, the final agreement at 33% created a financial hardship for the project that would have made the development financially infeasible, and our analysis proved this. Given this increased requirement, the developer sought public funding through MassHousing's Workforce Housing Program to 'fill the gap' created by that agreement, returning the project to financial feasibility. Ultimately, this was a unique project that does not 'fit the mold' of the typical project in Newton.

Q: <u>Why shouldn't Newton build a policy around these large anomaly projects – what would that mean for smaller, more "typical" projects?</u>

S*houldn't* really is not the correct terminology. We would phrase it as, "What are the risks that Newton may incur by using these anomalous projects to set our overall policy?" **From our perspective, using the top-producing projects that have unusual circumstances to set the City's policy may have the unintended consequence of making those outliers the only projects able to be built.** We understand how it can be frustrating to set policies to the 'middle' projects and not stretch to the edges of the marketplace. However, the City needs to be realistic about where most of its projects will fall within the development prism. Any community as diverse as Newton that sets a 'one size fits all' policy runs the risk of disrupting all but the prototype project. When this prototype is atypical to the market, it can stifle investment, and in turn, development altogether.

RKG has helped communities create 'sliding scale' policies that set different thresholds for different projects based on the idiosyncrasies of the community. Our work in Somerville helped influence the City to consider different affordability requirements based on the size of the project.

Q: Is the data built into the model outdated at this point? Should we even refer to the model a year after it was originally built?

This was a topic of discussion during the advocate meeting on February 19. A datapoint was thrown out that the model's rent assumptions were not accurate because there was a project developed that had rents at and above $6,000 a month in Newton. The City inquired to Washington Place following this meeting to understand their expected price points. They reported a target rent rate of $3.75 per square foot for the project, which is consistent with RKG's estimates used in the IZ model built last year. I bring this example up to highlight that one year likely is not a long enough period to make real estate assumptions invalid. That said, there may be assumptions that are inconsistent with market realities (rent thresholds included) two or three years from now.

Regardless. The model is not intended to test market conditions. It was built to understand the impact of changing the City's IZ policy on the profitability of a project. All variables such as rent thresholds, land cost, development cost, and other community benefit requirements need to be held constant to understand the impact of an IZ change. In other words, the market inputs to the model (i.e. land price, rent level) do not need to be recalibrated often for the model to serve its intended purpose of understanding financial impact of changing the City's IZ policy.

Q: <u>As we re-assess the ordinance every 3-5 years, what indicators should we be looking for to understand what effects there are on the market and what adjustments we should consider?</u>

Simply put, changes in production levels. This means overall production of housing as well as production of units under the IZ policy. Secondary analyses should track land sale activity and sales prices of land (on a per residential unit) basis to see how the policy has (or has not) impacted the marketplace.

It is our understanding that the City's intent of having an IZ policy is to ensure the City retains opportunities for households at different income levels to find quality housing in Newton. If this policy causes development to slow/stop, then it is reasonable to say it has not met its intended purpose.