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700 South Flower Street, Suite 2995, Los Angeles, CA 90017
T: 310-581-0900 | F: 310-581-0910 | www.hraadvisors.com

MEMORANDUM

To:	Craig Weber & Priya Mehendale, Los Angeles Department of City Planning
From:	HR&A Advisors, Inc.
Date:	July 26, 2021
Re:	Summary of Key Considerations for Implementing 99-Year Affordability Covenants in the Hollywood Community Plan Implementation Overlay District (CPIO)

HR&A Advisors, Inc. (HR&A) has prepared the following memorandum on behalf of the Los Angeles Department of City Planning (LADCP) to address certain housing stabilization policies of interest to decision makers. In particular, this memorandum addresses challenges and opportunities to requiring 99-year covenants (vs. current 55-year covenants) for affordable housing in mixed-income projects receiving density bonuses.

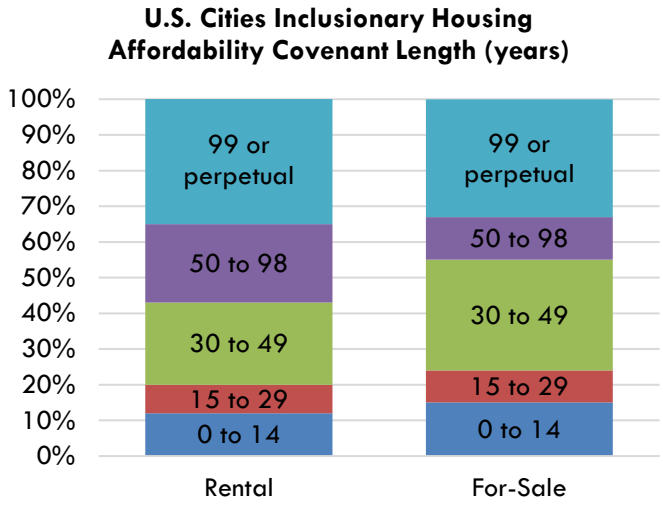
To evaluate these issues, HR&A first reviewed relevant professional literature and then facilitated two roundtable discussions via videoconference on June 23, 2021, and June 24, in which LADCP staff participated, and engaged in separate follow-up conversations with additional experts to understand the implications of these policies. The two dozen participants in these sessions represent the entire development process, and included local and regional affordable housing developers, market-rate/mixed-income developers, housing policy experts, City of Los Angeles (the "City") and other local government housing and planning officials, affordable housing funders/lenders, and land use lawyers.

The following is a summary of comments and observations derived from a combination of this research and HR&A's more than 40 years of experience developing, testing, and implementing related housing policies and programs.

Affordability Covenants Overview

Mixed-income projects receiving density bonuses or certain other City land use development incentives are typically required to enter into a covenant obligating the developer to maintain a certain number (usually a small percentage) of "set-aside" units as affordable for lower-income households. These covenants specify both the number and type of units, affordability levels (i.e., for extremely low-, very low-, low-, or moderate-income households), and duration of the affordability requirements, which is generally for a term of 55 years. These covenants are drafted and administered by the Planning and Land Use Division of the Los Angeles Housing + Community Investment Department (HCIDLA), signed by the project owner, HCIDLA, the City Attorney and City Clerk, and then recorded against the land title with the County Assessor's office by HCIDLA.

Fifty-five-year covenants for inclusionary housing and density bonus programs are common in California pursuant to State or local regulatory requirements. However, as shown in the chart at right, many U.S. cities have shorter covenant periods, and some have much longer covenant terms. According to research conducted by the Lincoln Institute of Land Use policy, 36 percent of surveyed jurisdictions nationally have 99-year or perpetual covenants, but this is more common outside of California.



Source: "Achieving Lasting Affordability through Inclusionary Housing," Lincoln Institute of Land Policy

Affordable housing developments financed with the federal Low-Income Housing Tax Credit (LIHTC) program and certain other state and local funding programs, also require long-term affordability covenants, and a 55-year term is also common under these financing programs. The first LIHTC projects to be developed in California were required to meet only basic threshold criteria, and thus followed the Internal Revenue Code requirements for use of tax credits, which then included a minimum 15-year affordability covenant, which is now 30 years. Some of these projects converted to market rate in the early 2000s, although roughly 75 percent remain affordable.[1] Changes to the State of California's Tax Credit Allocation Committee (TCAC) guidelines for implementing the LIHTC program now require 55-year affordability covenants.

Concern has been expressed by City Planning Commissioners and others that while a 55-year term seems like a long time, the City is already facing expiration of covenants imposed in the 1970s, in addition to expiring 30-year affordability covenants imposed on private, market rate housing financed through certain federal programs as recently as the 1980s, with actual or potential loss of precious affordable housing resources. In total, the City's draft Housing Element 2021-2029 cites 6,356 units with an affordability restriction expiring between 2021 and 2026, and an additional 3,056 units with restrictions expiring between 2026 and 2031. Roughly 59 percent of units with restrictions expiring before 2026 have affordability requirements associated with HUD Project-Based Section 8 Rental Assistance; only 31 units with requirements expiring in that period have restrictions associated with Density Bonus or other land use restrictions, although this number grows to 250 units with restrictions expiring between 2026 and 2031. Accordingly, interest within the City has arisen about evaluating whether a longer 99-year affordability covenant can be required for both market-rate mixed income and LIHTC developments.

Considerations for 99-Year Affordability Covenants for Mixed-Income Projects

The Los Angeles development market includes many developers who are in effect "merchant builders" who purchase land and subsequently entitle, construct, stabilize (i.e., fully lease) and sell completed projects. These merchant builders fundamentally have a short-term horizon, and even buyers of recently completed

[1] See "The Tax Credit Turns 30; Lessons learned from the first 30 years of the Low-Income Housing Tax Credit program and implications for public policy" by the California Housing Partnership Corporation (December 2017).

projects or developers who plan to hold projects for a longer period are unlikely to discount the value of a project measurably due to a 55- or 99-year affordability covenant.

This is because when calculating potential return on an investment, investors value near-term revenues more highly than equal nominal amounts of future revenues, because of the time-value of money – i.e., a dollar received in a future year has less purchasing power than a dollar received today, due to price inflation over time. Although not a calculation every developer makes, this time-value consideration is typically performed using an Internal Rate of Return (IRR), which uses a discount rate to calculate the value of a cash flow over time to represent it in today's dollars, so that the return can be compared with other uses of investment capital. Developer and investor IRR targets vary, but often exceed a "blended" IRR of 15 percent that accounts for debt and equity costs. An investor using a 15 percent IRR to value a project would discount a dollar of revenue 55 years into the future to a present value of less than one-half of one cent. As such, the incremental increase in rents associated with the expiration of a 55-year affordability covenant would have almost no impact on a developer's valuation of a project.

Furthermore, even developers and investors who are not merchant builders frequently sell projects after a period much less than 55 years; typically, a seven to 10-year investment hold period. As such, the typical multifamily rental building in Los Angeles is likely to turn over multiple times before the expiration of a 55-year affordability covenant. Multiple mixed-income developers confirmed the above and indicated that they anticipated no financial feasibility issues with a 99-year covenant for affordable units within mixed-income projects, at least from the perspective of the initial project developer. In the course of our evaluation, we identified one other jurisdiction in Los Angeles County (Santa Monica) that has recently begun to require 99-year requirements in its deed restrictions applied to mixed-income developments subject to inclusionary housing type zoning regulations.

However, developers we interviewed also noted that the useful life of typical wood-frame multifamily building that predominates in the multifamily market may vary between 50 and 75 years, after which substantial capital investment may be necessary to replace roof or utility systems or make other costly repairs. The scale of this investment will vary, but developers expressed concerns that even longer-term covenants would need to be designed in such a way to allow for financing of future redevelopment of the mixed-income building. Affordability covenants run with the associated land and are binding on all current and future owners of the site. HR&A recommends that LADCP explore the issue of how affordability covenants are treated with the HCIDLA and Los Angeles City Attorney's office, particularly in the event of demolition and/or Ellis Act removal.

In general, all experts consulted advocated for consistency across programs to avoid complexity, conflict, or a disincentive for developers to use certain programs. Although it appears unlikely that a 99-year covenant would have a major impact on project feasibility, LADCP should ensure that lengthening an affordability covenant for one program (e.g., TOC) does not disincentivize its use in favor of another program (i.e., State Density Bonus). As with other policies anticipated in this memorandum, HR&A also recommends that such policies be implemented Citywide, rather than in individual community plans.

Conclusion: 99-year affordability covenants are feasible for mixed-income projects, although end of building useful life issues should be anticipated and resolved. Any policy changes should be adopted on a citywide basis, in coordination with HCIDLA to provide clarity and consistency for developers.

Considerations for 99-Year Affordability Covenants for 100% Affordable Projects

HR&A also explored the potential of requiring 99-year affordability covenants for 100 percent affordable LIHTC projects. In general, there was resistance to the concept for several reasons described below, although at least one example was identified where some of the issues with a 99-year covenant were resolved (again, in Santa Monica [2]). LIHTC projects often rely on different forms of subsidy, debt, and tax incentives that each come with different obligations (including affordability covenants). The primary issues this raises for a 99-year covenant include:

1. Ability to Refinance & Renovate: As with other real estate development projects, LIHTC projects are refinanced multiple times over the course of their useful life. Many LIHTC projects rely on debt that defers interest payments until a later date; in some cases, developers "re-syndicate" or pursue additional tax credits to perform capital improvements and/or pay off accrued interest, which come with additional affordability covenants. In other cases, owners of LIHTC projects nearing the end of an affordability covenant anticipate relying on an increase in rents as affordability covenants expire to pay off accrued interest. Flexibility with the end-of-term affordability level (e.g., permitting an increase to 80% of Area Median Income) may help solve these issues.
2. Term of Loans & Tax Conflicts: Several affordable housing finance experts indicated that low-cost public debt and equity that many LIHTC projects rely on as part of the overall capital stack often have loan maturity terms of 55 years, in parallel with affordability covenants. These experts suggested that even longer-term loans might be treated for tax purposes as grants, causing tax issues for LIHTC project investors and limiting interest from some third-party lenders.
3. Consistency Across Programs & Sources of Funding/Debt: As mentioned above, affordable housing developers, financiers, and housing officials expressed concern about introducing a requirement inconsistent with other sources of funding: the California's Tax Credit Allocation Committee requires 55-year affordability covenants (although does not prohibit longer covenants) and most cities, counties and third-party lenders have developed consistent requirements. A different requirement for the City of Los Angeles might make it more challenging for LIHTC developers to secure other funding sources, unless other lenders agree to inconsistent terms, particularly ones like terms of affordability that affect project underwriting.
4. Moderate-Income Projects: There is increasing interest in developing 100 percent moderate-income (80 to 120% of Area Median Income) buildings, which are generally built without significant public subsidy. In certain cases, experts noted that projects built with public subsidy in the form of funding or discounted public land have been subject to affordability covenants of various terms. However, most experts agreed that because these projects largely rely on private debt and expectation of near-term refinancing, longer affordability covenants might stifle interest and innovation in this growing sector of affordable housing development.

[2] That City and its most prolific affordable housing developer, Community Corporation of Santa Monica, and EAH Housing, have successfully completed five LIHTC transactions with 99-year affordability covenants, and have resolved some of the issues discussed in this section.

Conclusion: 99-year affordability covenants for 100 percent affordable LIHTC projects appear to be more challenging to implement than for mixed-income developments, in part because of the large number of impacted parties in each transaction, each with a different set of regulations and interests. Therefore, implementing longer-term affordability covenants would require substantial coordination across public entities, with LIHTC developers and with third-party funders to avoid confusion or delay development of much-needed affordable housing. Any policy changes should be adopted on a citywide basis, in coordination with HCIDLA to provide clarity and consistency for developers.