

Summary of Findings



Minneapolis

Mixed income housing economic feasibility analysis



**GROUND
SOLUTIONS
NETWORK**

strong communities
from the ground up

Background

Grounded Solutions Network was engaged to explore the financial feasibility of mixed-income housing policies for new multi-family residential development in the City of Minneapolis. We define mixed income housing as primarily market rate developments that include a small share of units that are sold or rented at below market rates to lower income households. There are over 500 cities and counties across the country that either require a share of affordable housing units in any new market project or provide incentives to developers who voluntarily include affordable units.

While we were not engaged to conduct a complete financial feasibility study, we developed a number of prototype project proformas which allow us to compare the likely profitability of projects with no requirements to the profitability of those same projects if they were required to provide a share of units at affordable rents or prices. The goal of this analysis is to enable local policymakers to better anticipate the likely economic impact of including affordable housing units in typical development projects.

In order to understand the market dynamics we reviewed a number of recently published reports including:

- ▶ Annual Report on the Twin Cities Housing Market, multiple years
- ▶ Developing Stories, May 2016
- ▶ Green Line Density Bonus Study: A Primer, March 2015
- ▶ Market Viewpoint Twin Cities Multifamily Market, by Dougherty Mortgage, 2015/2016
- ▶ Minneapolis Housing Needs Study Draft, 2016
- ▶ South West Light Rail Transit Corridor Housing Gaps Analysis, Sep 2014
- ▶ Twin Cities Mixed-income Housing Case Studies by Maria Zimmerman, October 2015



In addition we conducted interviews with local real estate developers and other key stakeholders including:

- ▶ Amy McCulloch, LISC
- ▶ Bob Lux, Alatus
- ▶ Colleen Carey, Cornerstone Group
- ▶ Curt Gunsbury, Solhem
- ▶ Daniel Oberpriller, CPM Companies
- ▶ George Sherman and Brett Webb, Sherman Associates
- ▶ Jeff Washburne, City of Lakes Community Land Trust
- ▶ JeriLynn Young, US Bank
- ▶ Kevin Filter, Oak Grove Capital
- ▶ Mariia Zimmerman, Consultant
- ▶ Mark Jenson, Steven-Scott Management
- ▶ Mark Moorehouse, Dominion
- ▶ Maureen Michalski, Director of Development, Shafer Richardson
- ▶ Michele Schnitker, City of St. Louis Park
- ▶ Stacie Kvilvang, Ehlers
- ▶ Tony Barranco, Ryan Construction
- ▶ Wes Butler, MN Housing

Based on the input from these interviews we identified a set of prototypical development templates which reflect the most common development types currently being built in the Twin Cities. The development prototypes included:

- ▶ **Woodframe rental** – 50 units, 4-5 stories wood construction over concrete parking podium.
- ▶ **High density woodframe rental** – 100 units, 5-6 stories, wood construction over concrete podium
- ▶ **Midrise rental** – 300 units, 12+ stories, concrete construction
- ▶ **Highrise rental** – 300 units, 20+ stories, steel construction
- ▶ **Midrise ownership** - 300 units, 12+ stories, concrete construction
- ▶ **Highrise ownership** – 300 units, 20+ stories, steel construction

We then developed a financial model to evaluate the financial feasibility of each prototype. To do so, we collected detailed data about development costs and revenues from the following sources:

- ▶ Financial proformas for 27 recently completed multi-family real estate developments;
- ▶ Market studies and appraisals;
- ▶ Land value data from the Assessor's office for all recently completed projects in each of the study areas;
- ▶ Rental and operating cost data from the CoStar database for 81 projects developed in the study areas since 2005;
- ▶ Sales prices for townhouse and condominium projects from Redfin and Zillow.

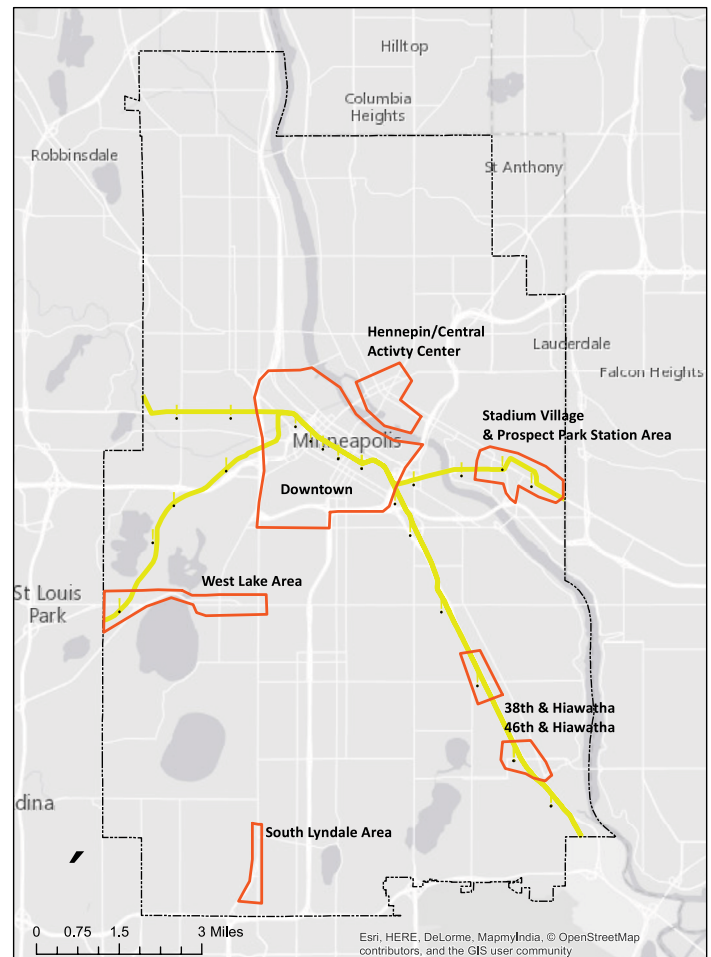


Due to the wide variety in the economics between different projects and different locations, these data sources sometimes differed in important ways. The prototype models that we produced realistically reflect actual projects being built in the market but they are not necessarily “average”. Many real projects will differ from these prototypes in terms of cost, rents unit configuration and many other factors. The prototypes allow us to evaluate the impact of potential affordable housing requirements and incentives on several realistic projects but they are not intended to represent the impact on all actual or potential projects.

Once we built initial prototype models, we convened a focus group of 7 local development industry stakeholders to evaluate and critique the models. We received very thoughtful feedback from this group and we made a number of changes to the prototypes so that they would more closely reflect typical projects in Minneapolis today.

We then adjusted these general prototypes to reflect economic differences between neighborhoods. The neighborhood study areas outlined in Figure 1 were identified by city staff as a representative cross section of place-types where significant market rate development is occurring and/or opportunity exists for future development.

Figure 1: Map of Neighborhood study areas



In order to adjust the general prototypes to each area we primarily adjusted the land costs, capitalization rates and rents or sales prices. In order to enable our team to compare the economic conditions facing developers in different areas of the city, we held most factors constant even though in some cases that may not be perfectly realistic. For example, we kept the construction cost and total project size the same in each area even though developers are likely to offer slightly more expensive amenities in some areas than others. The one exception we made to this rule of thumb for comparability was an adjustment to the unit mix and unit sizes in the Stadium Village area to reflect that projects built near the University, serving primarily students, tend to have smaller units than most projects in other neighborhoods.

Evaluating Feasibility

The real estate development industry uses a number of different metrics to gauge the financial feasibility of potential projects. No one measure is appropriate for all purposes. In order to compare different prototypes and potential policy alternatives we have used the two key feasibility metrics described below.

Ownership

For townhouse and condominium projects we measure project profitability by comparing the total revenue from unit sales (after expenses) to the total cost of development. This total profit divided by the cost of development provides a simple measure to compare the profitability of ownership projects. All other things being equal a project where the projected profit is a high percentage of the development cost will be more attractive to developers. For ownership projects in the Minneapolis we assume that projects where the profit is at least 15% of the development cost will be feasible.

Rental

While we also calculate profit as a percent of development cost for rental projects, the local developers we engaged consistently suggested that Yield on Cost would provide a better measure of profitability for rental projects. Yield on Cost is calculated by dividing the projected annual Net Operating Income (NOI) for a project by the projected Total Development Cost (TDC). The resulting number provides a rough measure of whether the future cash flow from a project will be high enough to justify the expense of development. For rental projects in Minneapolis we assume that developers will expect a Yield on Cost of at least 6%. Any lower and projects may not be feasible.



Feasibility Under Current Conditions

In order to evaluate the impact of potential mixed income housing policy options we first must establish a baseline understanding of the current financial feasibility of market rate development with no affordable housing units.

Minneapolis has a relatively strong housing market as evidenced by the continued strong demand for new multi-family residential development. The cost of construction of new multi-family properties has been rising rapidly but the rents and sales price available in Minneapolis have been sufficient to support significant amounts of new development in recent years - though this development has been highly concentrated in a few high demand/high cost locations.

There is some evidence that the local market is softening. Vacancy rates have been rising¹. Many of the local developers we spoke with mentioned that slower lease ups for several recent projects have contributed to a more conservative outlook on the part of real estate investors. When investors perceive greater risk the cost of capital is likely to rise and the number of feasible projects may decline.

Even if there is a slowing in the pace of development in the near future, the longer-term outlook for residential development in Minneapolis seems strong.

In the downtown area, for example, four of the five project prototypes we studied are strongly profitable[Table 1]. Only highrise ownership projects appear to be infeasible in the current market.

Table 1: Comparison of Prototypes – Downtown

	Downtown High-Density Woodframe Rental	Downtown Midrise Rental	Downtown Highrise Rental	Downtown Midrise Ownership	Downtown Highrise Ownership
Land Price					
Per Acre	\$1,750,000	\$4,000,000	\$12,000,000	\$4,000,000	\$8,000,000
Per Unit	\$17,500	\$19,867	\$40,000	\$20,000	\$26,667
Hard Costs	\$110	\$145	\$160	\$150	\$170
Hard Costs including Parking	\$146	\$177	\$192	\$173	\$196
Rent Price					
Studio	\$1,391	\$1,597	\$1,597	\$278,100	\$319,815
1BR	\$1,545	\$1,906	\$2,060	\$298,700	\$343,505
2BR	\$2,369	\$2,421	\$3,502	\$504,700	\$580,405
3br				\$1,009,400	\$1,160,810
Average Rent/Price Per Foot	\$2.30	\$2.38	\$2.65	\$389.73	\$387.52
Average Unit Size	765	824	843	1,210	972
Yield on Cost	6.84%	6.98%	6.72%		
Profit as a Percent of Cost				37.81%	12.17%
Minimum Profitability	6.00%	6.00%	6.00%	15.00%	18.00%
Feasibility	Feasible	Feasible	Feasible	Feasible	Not Feasible

¹ Market Viewpoint, Twin Cities Multifamily Market 2015-16, Dougherty Mortgage LLC, 2016.

Neighborhood Study Areas: However, among the neighborhood study areas we examined, the market conditions are quite different. In the downtown and West Lake areas, rents are quite high and demand for new development seems very strong, and as a consequence we see that development in these areas is highly profitable. By contrast, in the lower density, less urban neighborhoods like South Lyndale and even the two blue line transit areas, rents appear to be too low to support new multi-family development. More challenging for the development

of mixed income housing policy are the ‘in between’ areas Hennepin Central, Stadium Village and Prospect Park where development is profitable enough that it is happening consistently but where rents are more marginal. Our modeling shows that rents in these areas today are just high enough to support new construction. The higher end projects underway in the area currently suggest that there may be reason to expect higher rents in the future, but the current rents may not be high enough to support new affordable housing requirements [Table 2].

Table 2: Neighborhood comparison – High Density Woodframe Rental

	Blue Line Station Areas High-Density Woodframe Rental	Downtown High-Density Woodframe Rental	Hennepin High-Density Woodframe Rental	South Lyndale High-Density Woodframe Rental	Stadium High-Density Woodframe Rental	West Lake High-Density Woodframe Rental
Land Price						
Per Acre	\$666,667	\$1,750,000	\$1,083,333	\$833,333	\$1,638,889	\$1,680,556
Per Unit	\$6,667	\$17,500	\$10,833	\$8,333	\$16,389	\$16,806
Hard Costs	\$110	\$110	\$110	\$110	\$110	\$110
Hard Costs including Parking	\$146	\$146	\$146	\$146	\$150	\$146
Rent Price						
Studio	\$1,013	\$1,391	\$1,215	\$945	\$1,148	\$1,337
1BR	\$1,125	\$1,545	\$1,350	\$1,050	\$1,275	\$1,485
2BR	\$1,725	\$2,369	\$2,070	\$1,610	\$1,955	\$2,277
3br						
Average Rent/Price Per Ft.	\$1.68	\$2.30	\$2.01	\$1.56	\$2.11	\$2.21
Average Unit Size	765	765	765	765	689	765
Yield on Cost	5.31%	6.84%	6.22%	4.91%	6.09%	6.60%
Minimum Profitability	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Feasibility	Not Feasible	Feasible	Feasible	Not Feasible	Marginal	Feasible

Table 3: Neighborhood comparison – All prototypes

	Blue Line Station Areas	Downtown	Hennepin	South Lyndale	Stadium	West Lake
Rental (Yield on Cost > 6%)						
Woodframe Rental	5.41%	6.51%	6.16%	4.94%	5.44%	6.31%
High-Density Woodframe Rental	5.31%	6.84%	6.22%	4.91%	6.09%	6.60%
Midrise Rental	5.36%	6.98%	6.30%	4.96%	6.25%	6.73%
Highrise Rental	N/A	6.72%	6.22%	N/A	6.02%	6.50%
Ownership (Profit>15% of Cost)						
Midrise Ownership	N/A	37.81%	23.29%	N/A	23.70%	32.78%
Highrise Ownership	N/A	12.17%	1.22%	N/A	0.51%	8.17%
Key	Feasible	Marginal	Not Feasible	N/A = Not Analyzed		

Feasibility of Affordable Housing Requirements

There are over 500 cities and counties across the country that either require a share of affordable housing units in any new market project or provide incentives to developers who voluntarily include affordable units. These programs are quite varied in terms of the share of new housing units that they require to be affordable and the income level that the affordable units serve.

In order to provide a general understanding of the economic impact of affordable housing requirements or incentives we imagined a simple 15% affordable housing requirement applied to all new residential development in Minneapolis.

For rental projects, the affordable units would be priced to be affordable to households earning no more than 60% of Area Median Income. For homeownership projects the affordable units would target households at 80% of Median Income. These programs often provide an exemption for projects with fewer than 25 units and sometimes also allow an exemption for projects that can demonstrate that compliance would not be financially feasible. Because this type of requirement will have significant economic impacts on proposed projects,

it is common for the requirement to be phased in over several years. A phase in period avoids adding a large unanticipated cost to projects that are underway and gives developers of future projects time to anticipate the cost of affordable housing requirements when they prepare project budgets and negotiate land prices.

Our prototype analysis suggests that a 15% affordable housing requirement could be readily absorbed by projects in Downtown and West Lake. Profits for all of our prototypes are high enough in this area that it is likely that developers would proceed with projects similar to our prototypes even if they were required to provide 15% affordable units. Over time it is likely that this requirement would reduce the rate of land price increases in these areas so the cost of providing affordable units would not be born by developers alone.

Note: Our analysis looks only at economic feasibility and does not constitute legal advice. We have not reviewed or analyzed any applicable Minnesota laws in connection with the report findings or stated policy options.

Table 4: Feasibility of prototypes assuming 15% affordability requirement

	Blue Line Station Areas	Downtown	Hennepin	South Lyndale	Stadium	West Lake
Rental (Yield on K75:Q80 > 6%)						
Woodframe Rental	5.28%	6.12%	5.87%	4.86%	5.22%	5.95%
High-Density Woodframe Rental	5.16%	6.43%	5.92%	4.81%	5.83%	6.22%
Midrise Rental	5.14%	6.48%	5.93%	4.80%	5.91%	6.27%
Highrise Rental	N/A	6.18%	5.78%	N/A	5.63%	5.99%
Ownership (Profit>15% of Cost)						
Midrise Ownership	-7.88	18.90%	7.34%	N/A	8.18%	14.85%
Highrise Ownership	N/A	-2.64%	-11.25%	N/A	-11.46%	-5.84%
Key	Feasible	Marginal	Not Feasible	N/A = Not Analyzed		

In South Lyndale and in the Blue Line Station Areas, a 15% affordable housing requirement would also be likely to have little impact on the level of development. While an affordable housing requirement would negatively impact feasibility in these areas, our analysis suggests that projects like our prototypes would not be feasible even in the absence of an affordable housing requirement.

Where a blanket 15% requirement is more problematic is in the middle market areas including Hennepin Central, Stadium Village and Prospect Park. In these areas several prototype projects that are feasible currently may not be feasible with a 15% affordable housing requirement. It is possible that rising rents/prices or reductions in land values could make a 15% requirement feasible for many project types in these areas in the near future. However, the best data available to us about current conditions suggests caution in these areas. Significant incentives would be necessary to ensure that affordable housing requirements didn't overburden development in these transitional areas.

Policy Implications

This economic analysis suggests that a single citywide affordable housing requirement with no offsetting incentives might not be the most effective policy. Mandatory policies with no offsetting incentives are quite rare. Many communities with economic conditions similar to Minneapolis' have developed mixed income housing policies that attempt to produce affordable units where market conditions permit without overburdening more sensitive projects or areas.

Alternatives which Minneapolis might consider given the economic feasibility findings would include:

- A Single citywide mandatory requirement
- B Geographically targeted program that applies requirements only in the strongest market locations
- C Voluntary program that offers a greater range of incentives in exchange for affordable units
- D A mandatory city wide program coupled with incentives – some of which could be geographically targeted so that they are available only to projects in areas where incentives are needed.
- E A mandatory program that is gradually phased in over many years in order to allow land markets time to adjust

Among the more than 500 inclusionary housing policies identified by Grounded Solutions Network², more than 80 percent are structured as mandatory requirements and most apply to all residential development throughout a jurisdiction. A smaller number are structured as voluntary programs where developers may choose to provide affordable housing in exchange for certain incentives. These programs commonly offer planning incentives such as density bonuses or reduced parking requirements and/or financial incentives such as tax abatements or Tax Increment Financing (TIF). However the distinction between these voluntary and mandatory programs is not as clear cut as it sometimes seems because nearly all of the mandatory programs also offered many of these same incentives to help offset the cost of providing the mandated affordable housing. Additionally, some of the voluntary programs deny zoning variances or other common incentives to developments that do not “voluntarily” provide affordable housing.

Table 5 on the next page summarizes programs in a number of comparison jurisdictions.



² Hickey, Robert, Lisa Sturtevant, and Emily Thaden. 2014. “Achieving Lasting Affordability through Inclusionary Housing.”

Table 5: Programs in comparable jurisdictions

Jurisdiction	Requirement	Applies to
Denver	Housing Linkage fee of \$0.4 to \$1.7 per foot depending on type of project	All residential and commercial development of any size citywide
Seattle	Mandatory percentage of units affordable at 40-65% of median (required % varies by area)	All multifamily residential and commercial projects in areas that the city has upzoned
Austin	Multiple voluntary incentive programs (Bonus density, fee waivers, etc)	Multifamily properties in targeted zones - incentives are more valuable in some zones than others
Portland	Currently considering a proposal to require 20% of units at 80% of median income	All multifamily development citywide with 20 units or more
Washington DC	Mandatory 8-10% at 80% of median	Projects citywide with 10 or more units in certain higher density zones in the city
Chicago	Mandatory 10% at 60% of median	Projects citywide with 10 or more units that receive zoning changes or public land
Santa Fe	Mandatory 15% at 80% of median for rental and 20% at 100% for ownership	All projects above 2 units, projects below 11 units pay a fee instead of providing units

The Non-Profit Housing Association of Northern California found that voluntary programs in California produced significantly fewer homes than mandatory programs. Many voluntary programs have been designed in such a way that the value provided by their incentives is frequently less than the ‘cost’ of providing affordable housing. California jurisdictions, for example frequently offer only modest density bonuses in exchange for expensive affordable homes. It is no surprise that many of these programs have not generated many affordable units.

Even where incentives are more valuable, including affordable homes makes projects more complex and many developers will choose to forgo the incentives. By requiring affordable housing in every new project, communities ensure a high degree of participation.

However, mandatory requirements, even when they come with valuable incentives, can be controversial. Many developers resent the addition of even more local planning requirements. Building and leasing or selling appropriate affordable units requires care and attention and often comes with a significant regulatory burden.

The pros and cons of mandatory requirements

Pros	Cons
High level of participation	Risk of overburdening projects and reducing the level of market development
Generally produce more total affordable housing units	Greater level of concern and resistance on the part of developers and land owners.
Responsibility is shared across all projects	More challenging enforcement



Perhaps more importantly, mandatory requirements involve some risk of overburdening development and reducing the pace of new building. In a voluntary program, if the incentives are not sufficient for project feasibility the consequence is that developers will not opt in to the program and fewer affordable homes will be built. In a mandatory program, if the incentives are not significant enough for projects to be feasible, developers only choice is not to build new projects at all.

For this reason, every city with a mandatory requirement must pay careful attention to financial feasibility. There has only been limited research into the economic impact of inclusionary housing but there has been no evidence so far of any community setting inclusionary mandates at a level that dramatically reduced the rate of homebuilding – suggesting that cities have generally taken this risk seriously and proceeded with appropriate caution.

The most rigorous study to date was conducted by researchers at the Furman Center at New York University. They studied inclusionary programs in the Boston and San Francisco metropolitan areas. In the towns around Boston, they found that inclusionary requirements may have modestly decreased the rate of housing production resulting in about 2% higher prices relative to nearby towns without inclusionary requirements. The same study found that in the San Francisco area inclusionary programs had no impact on production or prices, suggesting that it is possible to develop inclusionary programs that don't impact market development. These same programs were also able to create more affordable units than their counterparts in the Boston area. The researchers attributed the difference to the greater flexibility and more significant incentives built into the San Francisco area programs.

Land Economics:

While inclusionary housing programs directly impact the cost of development, they indirectly impact the price of developable land. When we increase the costs that developers face, we necessarily lower the amount that they are willing to pay for land. Understanding how these requirements impact land values is vital for designing policies that appropriately allow communities to share in the benefits of new construction without stifling development.

The term “residual land value” refers to the idea that landowners end up capturing whatever is left over after the other costs of development. When the cost of construction rises, it might hurt developer profits in the short term, but higher costs will then cause all developers to bid less for development sites. As land prices fall (or rise more slowly), developer profits tend to return to “normal” levels.

When a city requires developers to provide affordable housing, they are likely to earn less than they would have if they had been able to sell or rent the affected units at market value. This forgone revenue represents the “opportunity cost” of complying with the affordable housing requirements. It is fairly easy to calculate this “cost” for any given mix of affordable housing units and, if these requirements are predictable in advance, they should roughly translate into corresponding reductions in land value over the longer term.

Most inclusionary housing programs don't simply impose costs; rather, they also attempt to offset those costs (at least, in part) with various incentives for the developers. The most common incentive is the right to build increased density (e.g., building taller buildings, building more units in place of providing parking, etc.). When developers can build more units, the extra income can offset the costs of providing affordable units, and the result will be a smaller (if any) reduction in land value.

But incentives frequently don't fully offset the cost of providing affordable housing. In these cases, there is a real net cost which exerts downward pressure on land prices. If the net cost is small relative to land values, and if it is applied consistently and predictably, landowners will have little choice but to accept reduced prices. But, if the net cost is too great, landowners may choose not to sell their properties, and the result will be that the program prevents development that would otherwise have happened. Inclusionary housing programs have to work hard to understand land markets in order to avoid this situation.

Land values don't change overnight, and some communities have carefully phased in inclusionary requirements with the expectation that developers, when they can see changes coming, will be able to negotiate appropriate concessions from landowners before they commit to projects that will be impacted by the new requirements. Similarly, some program designs are likely to have a clearer and more predictable impact on land prices than others. More universal, widespread, and stable rules may translate into land price reductions more directly than complex and changing requirements with many alternatives.



Incentives

Both voluntary and mandatory programs tend to rely heavily on incentives to make affordable housing financial feasible. Incentives tend to take one of two forms: Planning incentives address feasibility by increasing project density or lowering other costs while financial incentives provide direct savings or public subsidies to offset all or a portion of the cost of providing affordable units.

Planning Incentives

Many communities offer planning incentives such as density bonuses or reduced parking requirements to projects that provide affordable housing. Depending on the constraints in the local planning code, these incentives can be very valuable to developers in some places. Where the code strictly limits density, a density bonus that effectively increases the number of housing units that can be built on a given site can increase project profitability by more than enough to fully offset the cost of providing 15% affordable housing. Even reduced parking requirements can be valuable enough to largely offset significant affordable housing requirements in some places. Planning incentives are often desirable from the city's perspective because they do not add significant costs, as compared to financial incentives which do have real municipal budget implications. Planning incentives work by creating new value and can feel like win-win proposals, if the economics work.

Our interviews with local developers and other stakeholders suggest, however, that these planning incentives will be of only modest value in Minneapolis. Because the city has already reduced parking requirements in most areas, developers report that further reductions would likely offer little or no value. However, it is important to remember that while some of the savings from building less parking may have been passed on to tenants in the form of lower rents much of the benefit likely resulted in increased developer profitability in the short term and increased land prices in the long term.

Similar to parking, the city has already zoned many areas for appropriate urban densities and the city currently offers three separate density bonus programs including one for voluntarily providing affordable housing. The developers we interviewed generally agreed that they were frequently able to build at the optimal density without accessing the affordable housing density bonus.

The City's existing density bonus program allows developers to increase density (or the maximum floor area in areas without density limits) on a project by 20% in exchange for providing 20% of units at a rent that is affordable to households earning 50% of median income. For our Downtown Midrise prototype, adding 20% density increases the value of the project by \$3.6 million. However providing 20% of the total units at 50% of median income reduces the value of the project by \$9.2 million. In other words, the affordable housing costs far more than the bonus density is worth.

However, examining recent developments, there is evidence to support the conclusion that bonus density is at least sometimes valuable. In recent years, a number of four or five story buildings have been built. A preliminary analysis by the City shows that at least some of these were limited by zoning. Generally, allowing buildings planned for 4 or 5 stories to go to six stories will increase the value for developers, providing an opportunity to add some level of affordable housing requirements. Developers generally discounted this opportunity because they believed neighborhood opposition would prevent them from building taller. If there were more certainty in the development process, additional height might be a valuable incentive for some projects, though not enough to support a voluntary program.

While the utilization of the current affordable housing density bonus program has apparently been low, it is likely that if the affordable housing requirement were mandatory, more projects would choose to take advantage of the bonus density (assuming it remained available). In these cases, the density bonus could offset some of the cost of providing even mandatory affordable units, helping to address concerns over feasibility in softer market locations.



However, even under a mandatory program, many projects would not realize any benefit from a density bonus program. An important limit to density bonus is the additional cost of construction associated with building higher. For example, a five story building might cost \$120 a square foot to build. A six story building would be very similar. Here, there is a good opportunity to provide a density bonus. However, a seven story building might cost \$160 a square foot because it can no longer be wood frame. A developer would likely not choose to build a seven story building, even if they were permitted to with no affordable housing requirements, because the change in construction type would add millions of dollars in cost compared to a six story building. Given the current Minneapolis market, the density bonus would not be useful in this case.

One other planning incentive is to increase certainty in the development process. By adding zoning approval certainty for projects that have affordable housing, developments become less risky and developers often will accept a lower rate of return because of the lower risk. For example, if a city could eliminate the Conditional Use Permit for developments that met strict design and affordable housing guidelines. For example, a city could review projects administratively in circumstances where no variances are requested and where strict design and affordable housing requirements are met. The tradeoff for this incentive is that there is less opportunity for public input.

While we would recommend continuing to offer bonus density under a mandatory affordable housing requirement program, we would caution against assuming that a density bonus would, by itself, reliably offset the cost of providing affordable units for most projects.

Financial Incentives

A more promising approach for Minneapolis might be to offer financial incentives to help offset the cost of providing affordable units. A number of cities have developed programs which provide capital grants or annual tax benefits for projects that include affordable housing units. In many cases, these financial incentives are matched with planning incentives to make mandatory affordable housing requirements financially feasible. If financial incentives are either targeted to

specific geographic areas or limited to projects that can demonstrate economic need, they can be used to make affordable housing requirements feasible in marginal locations without subsidizing profitable projects in stronger locations.

For example, our high density woodframe rental project with no affordable housing requirements was marginally feasible in Stadium village with a yield on cost of 6.09%. This return is not strong enough to support a 15% affordable housing requirement. At that level the project's Yield on Cost falls to 5.83%. Without additional incentives this project may not be built. However a subsidy of \$50,000 per affordable unit created would return the project's yield on cost to 6.09%. It may not be necessary, however, to fully offset the entire cost of providing affordable units – even in the more marginal locations. For this prototype a subsidy of \$30,000 would bring the yield on cost above the 6% threshold. Alternatively an annual tax abatement of \$250 per unit (for all units) would have the same impact on feasibility.

It is important to evaluate this potential public investment in the context of other possible uses for the same limited funding. The Minneapolis Housing Trust Fund currently provides only \$25,000 per affordable unit to create units that are more deeply affordable than the mixed-income project units in our example. One reason for this is that the Housing Trust Fund is generally investing local money into projects that also benefit from state and federal affordable housing subsidies – in particular the Low Income Housing Tax Credit. The total subsidy from all sources necessary to create these affordable units is much greater than Minneapolis's share. In general, only very large mixed-income projects are able to access the federal tax credits – for most market rate projects, adding lower income units has to be accomplished without state or federal funding. It is clear that using existing Trust Fund resources to subsidize mixed-income units instead would result in far fewer affordable housing units being created. But because federal and state subsidies are strictly limited, it is not clear that the City could achieve the same leverage if it were to grow the trust fund.

It is possible to have the affordable housing funding come from other sources besides the general fund. Some cities like Denver, described below, allow developers to pay in lieu fees rather than build units, and use this money to subsidize developments that provide affordable units.



Examples

Denver's In Lieu Fees

Many cities with affordable housing requirements allow developers to meet their affordable housing obligation by paying a fee 'in lieu' of building affordable units onsite. While there are risks involved in allowing this option, these fees can provide an important source of flexibility for both projects and the City. Most cities invest these funds in 100% affordable housing projects in nearby areas but Denver has been using their in lieu fee revenue in a unique way. In response to the very different economics in different projects, Denver developed a policy that allowed the city to invest in lieu fee revenue in market rate projects that included affordable units. Developers who chose to build the required affordable units onsite were eligible to apply for cash assistance from a housing trust fund that held the fees paid by other developments that opted to pay the fee in lieu. Access to this fund relieved some of the financial burden on projects and made onsite development of affordable units economically feasible for a greater range of projects.

Seattle's Tax Abatement

Many cities offer partial property tax exemptions for projects that include affordable housing units. Seattle, for example, offers a Multi-Family Tax Exemption (MFTE) to projects located in targeted areas that include at least 20% affordable units. Developers receive a 12-year exemption from tax on the improvements that they make to a property. At the beginning of 2016, Seattle had roughly 4,000 units in the MFTE program and an additional 2,100 in approved projects expected to be completed soon. Projects that are required to build affordable housing units under Seattle's recently approved mandatory inclusionary housing policy or their prior density bonus program are also able to access the MFTE and the tax savings is key to the financial feasibility of including affordable units in market rate buildings.

St. Louis Park Tax Increment Financing

Minnesota law authorizes the creation of TIF districts specifically intended to support the creation of affordable housing. However the rules for 'Housing TIF' districts appear to be more appropriate for the creation of 100% affordable housing projects (or very large mixed-income projects) than ordinary mixed income projects with some affordable housing. While Housing TIF districts have been used successfully in Minneapolis, 'Redevelopment TIF' districts may offer a more flexible strategy for supporting a broadly applied policy that requires affordable units in all new market rate projects. Redevelopment TIF districts would, however, be limited to only areas where at least 50% of the buildings are deemed structurally substandard (ie. it would be costly to bring them up to current building codes).

Currently Minneapolis policy requires that any project receiving city financial assistance (including TIF) must include 20% of units affordable at 60% of AMI – very close to the housing TIF requirements. St. Louis Park, MN has adopted a more flexible approach which requires affordable units but fewer of them. Rather than utilizing the Housing TIF to create affordable units, St. Louis Park is using its TIF commitments to produce both redevelopment and affordable housing. This approach also gives them more flexibility in the affordability housing requirements. Where a housing TIF district would require that 20% of the units be targeted at 50% of AMI (or 40% at 60% of AMI), St. Louis Park requires 8% of units be affordable at 50% of AMI or 10% at 60% of AMI.

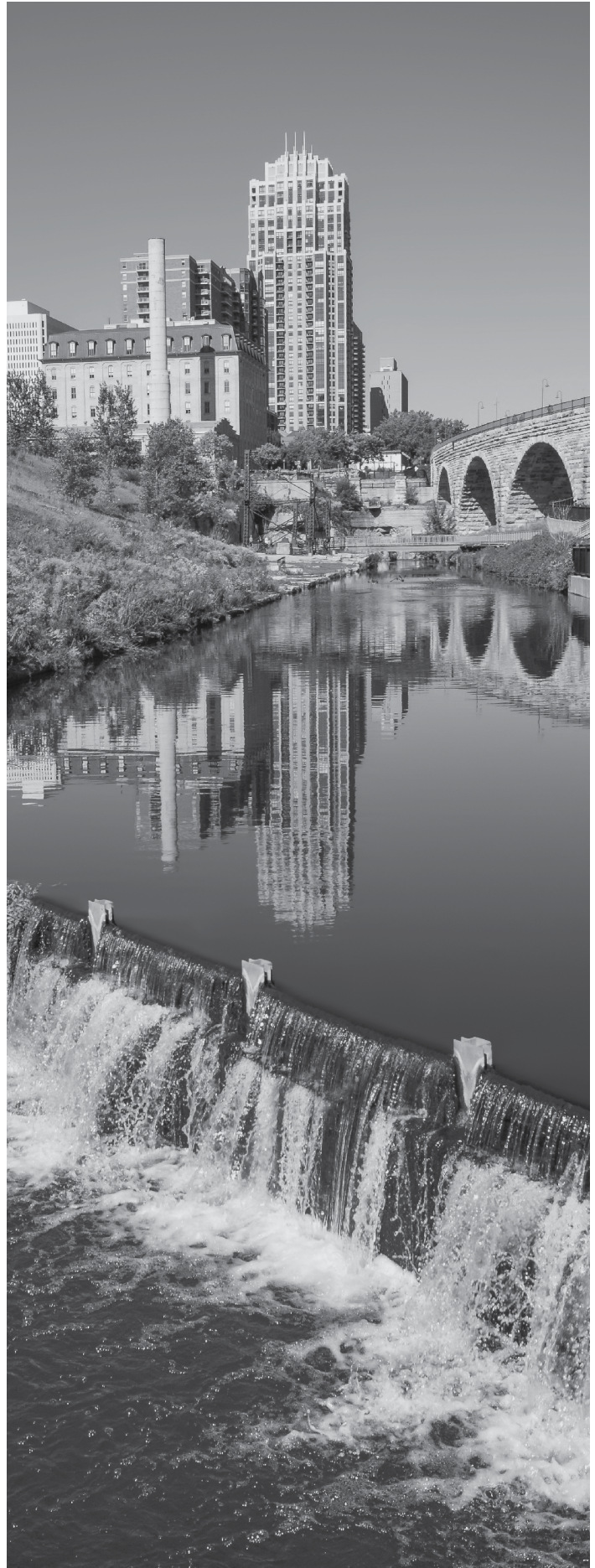


Targeting

While many communities offer financial incentives without respect to financial need (ie they allow projects to access the incentives even if they could feasibly provide the affordable housing without the incentive) some communities attempt to target incentives to projects that truly need them - either by limiting their application to specific neighborhoods or by underwriting individual projects. Using redevelopment TIF districts would require limiting the incentive to areas that meet the standard for blight. A tax abatement program could also be developed with geographic limits that ensured that it was only used in softer market areas where projects are challenged to meet affordable housing requirements. Either approach could also rely on project-by-project underwriting to determine financial need for public assistance.

Conclusion

Minneapolis has a robust housing market and a growing need for affordable housing. Our analysis of the economics of prototypical developments reveals that development is currently profitable in many parts of town but that there are several areas where development is currently happening but marginally profitable. Any affordable housing mandate would risk undermining the feasibility of projects in these areas if it were implemented at a citywide scale without any offsetting incentives. We have outlined several potential policy approaches that minimize the risk of reducing the overall pace of residential development either by targeting requirements only to strong market locations or by providing offsetting economic incentives that would make it financially feasible for projects in all locations to include meaningful levels of affordable housing. No mixed income housing policy will alone solve Minneapolis's dire need for affordable housing but our analysis of the economics suggests that it is possible for the City to supplement its other affordable housing investments by partnering with market rate developers to build more mixed income buildings.



Appendix

Inclusionary Housing Program References:

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Washington, DC- Inclusionary Zoning Implementation

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