MEMORANDUM

To: City of Pittsburgh Affordable Housing Task Force

From: Paul Peninger

Re: Draft Financial Feasibility Findings re: Inclusionary Housing

Date: 31 May 2016

The City of Pittsburgh Affordable Housing Task Force retained Peninger Consulting (PC) to prepare a feasibility analysis to help inform ongoing policy discussions regarding the potential adoption of an inclusionary housing policy tailored to Pittsburgh's unique needs and market conditions. The overall purpose of this analysis is to determine the possible financial impacts of different types of inclusionary housing program requirements on prototypical residential projects. Based on a review of current market conditions and direct feedback from real estate industry stakeholders, the analysis tests varying levels of affordability requirements in combination with development incentives (e.g., density bonuses, tax abatements, etc.,) to establish the most advantageous program alternatives for generating new affordable housing while still allowing developers to earn an adequate return on investment.

Market and Economic Trends

As an initial step in the study process, PC conducted an analysis of market and economic trends in Pittsburgh in comparison to Allegheny County and the surrounding metropolitan region. This analysis was presented to the Mayor's Affordable Housing Task Force, Feasibility Committee on February 19, 2016. Major findings from the analysis included the following:

POPULATION AND HOUSEHOLD TRENDS

- After decades of population decline, current data from the US Census American Community Survey shows that Pittsburgh's population is now slowly increasing.
- The 25-34 age cohort is increasing the fastest, indicating an improvement in Pittsburgh's overall competitive position in terms of attracting and retaining households in this economically important age group.
- Household incomes are lower overall in the City compared to Allegheny County, but nonfamily households are relatively more affluent.

JOBS AND JOBS HOUSING BALANCE

- The regional economy is growing, although the growth is uneven and somewhat slower than the overall national economy.
- The City of Pittsburgh is relatively jobs rich compared to the surrounding region and is driving economic growth in key sectors like High Technology, Education and Medicine.

- Twenty-five percent of Allegheny County's population lives in Pittsburgh while over 44 percent of all County employment is in the City. This represents a potential opportunity for Pittsburgh to attract workers to new housing opportunities in the City.

DEVELOPMENT TRENDS

- The rental housing market is in a strong growth phase, but as pointed out by the recently commissioned Affordable Housing Needs Assessment prepared by Mullin and Lonergan, most lower-income families would find it difficult to afford rents in recently built market-rate rental projects.
- The for-sale market is also experiencing some growth, particularly for condominiums and townhomes in prime locations. Like new rental projects, the new for-sale housing units coming on-line are largely unaffordable to lower- and middle-income Pittsburgh households.
- According to data from the Urban Redevelopment Authority, approximately 8,000 units are currently in the City's development pipeline: either under construction or in in the predevelopment or proposal phases. These projects span the next 10-20 years. Approximately 95percent of all units in the pipeline are in rental housing developments, and the vast majority of these are in 4-5 story buildings.
- Although Pittsburgh is experiencing a strong period of residential growth, this development is highly concentrated primarily in just a few areas. Overall, 80percent of new development is concentrated in the following neighborhoods: Central CBD/Lower Hill; Strip District; Southside Flats; Oakland; East Liberty; South Oakland; Central Northside; Northshore; and Lawrenceville.

Development Prototypes

Building on the review of market and economic trends, PC developed seven development prototypes for subsequent financial feasibility testing. These prototypes were vetted with the Financial Feasibility Committee as well as with local development industry experts. Although not based on any one project, the prototypes reflect actual development projects built in Pittsburgh.

For rental housing, three major prototypes were identified: adaptive reuse/commercial building conversion projects; four to five story wood-frame buildings built at grade or over a concrete podium; and, high-rise, steel-frame buildings. Of these rental prototypes, wood-frame buildings are by far the most common project type currently being built in Pittsburgh, comprising the vast majority of new or planned units in the City's residential development pipeline.

For ownership housing, four major prototypes were identified: townhomes; midrise condominiums (wood frame); adaptive reuse/commercial buildings conversion to condominiums and townhomes; and high-rise condominiums.

Feasibility Analysis

Using the seven prototypes described above, PC prepared a series of development pro formas to test the feasibility of these projects under different development scenarios and with varying levels of inclusionary requirements and incentives. As an initial step, the prototypes were tested for feasibility in a base case with no affordable housing units and no incentives.

METHODOLOGY AND BASELINE FINDINGS

The pro formas created for this analysis are static pro formas looking at profitability at a future point in time at stabilized occupancy. Costs and revenues utilized in the pro f0rmas are based on background research conducted by Peninger Consulting, including direct feedback from local developers and other real industry stakeholders.

Although the two high-rise prototypes and the mid-rise condo prototype currently appear infeasible in the Pittsburgh marketplace based on the relationship between development costs and potential revenues for these product types, the remaining prototypes achieve a minimum return of 15 percent of development costs, the standard metric used in this analysis to define minimum required developer profit.

BASELINE ASSUMPTIONS AND RETURN ON INVESTMENT BY PRODUCT TYPE

	Rental			For-Sale			
	4/5 Story Wood Frame	High-Rise Steel Frame	Conversion/ Reuse	Townhomes	4/5 Story Wood Frame	High-Rise Steel Frame	Conversion/ Reuse
# Units	140	350	80	20	38	120	30
Baseline Density (DU/Acre)	62	175	80	13	22	120	30
Parking Type	Podium	Structured	Offsite Garage	Covered	Podium	Structured	Covered
Avg. Unit Size	760	846	850	2,000	1,042	950	1,038
Average Rent/Sale Price	$1,768	$2,100	$1,750	$400,000	$347,368	$425,000	$412,500
Average Rent/Sale Price/Sq. Ft.	$2.33	$2.48	$2.06	$200	$333	$447	$398
Hard Costs/Sq. Ft.	$160	$200	$125	$110	$175	$225	$175
Total Development Costs/Unit	$202,046	$273,134	$209,319	$322,020	$312,176	$374,905	$325,247
Exit Capitalization Rate	5.8%	5.8%	5.8%	-	-	-	-
Profit (% of Total Dev. Costs)	20.4%	5.8%	15.0%	18.0%	5.7%	7.7%	20.5%

Source: Peninger Consulting, 2016.

SENSITIVITY TESTING

For the four project types that are feasible in the base case and that represent the vast majority of long-term residential development activity in the City of Pittsburgh, hypothetical affordability requirements were added and sensitivity testing was conducted to measure financial feasibility under a range of affordability scenarios and with the addition of development incentives.

Affordability Standards. For rental properties, a housing unit is deemed affordable if an individual or family earning 60percent or less of the Area Median Income (AMI) pays no more than 30percent of household income towards housing costs. It is important to note, however, that this average AMI target could potentially be reduced to reach lower-income households if inclusionary housing units were made eligible for housing choice vouchers from the Housing Authority. For ownership households, affordable units are defined as being affordable to households earning 80percent of AMI.

Incentives. Nationally, the density bonus is by far the most common incentive used in inclusionary housing programs and is often accompanied by some form of reduction in required parking standards. For some types of housing projects, however, an increase in allowed market-rate units to offset affordability requirements is not a valuable incentive, either because the site density has already been maximized, or because there is no way to add density to an existing building. Accordingly, this analysis included streamlined processing and tax abatements as potential incentives in addition to the density bonus and parking ratio reduction.

As each prototype tested for this analysis is based on a different set of cost and revenue assumptions, varying requirements and incentives can have very different impacts in each case. Moreover, not all incentives tested in this analysis are applicable to each prototype.

Key Findings and Recommendations

Results from the sensitivity analysis are presented in the summary table below. As expected, the bottom line feasibility findings vary significantly by prototype.

Wood-frame Rental Prototype. In general, the product type with the strongest potential for accommodating affordable housing requirements in combination with incentives is the wood-frame rental prototype. This prototype could potentially support an inclusionary requirement of 5percent and still remain profitable. With the addition of one or more incentives, a 10percent affordability requirement would also be potentially feasible.

Conversion/Reuse Rental Prototype. The rental conversion/reuse prototype would be less feasible with the addition of affordable units, and would likely only be able to offset the costs of inclusionary housing requirements with the provision of an annual tax abatement that would accrue to the owner/operator of the building.

Townhomes. The addition of either a 5 or 10percent requirement would result in an infeasible project in the absence of some form of regulatory incentive that could potentially reduce the development timeline and associated market and financial risk. Assuming that a townhome project could benefit from a streamlined approvals process that allowed the developer to deliver the project to the market with lower overall holding costs, a 5percent requirement could potentially prove feasible.

Conversion/Reuse For-Sale Prototype. In the case of this prototype, the marginal cost of adding each new affordable unit tends to outweigh the benefit of the streamlined processing incentive. It is unlikely in this case that added density or a parking reduction could be of value. At most, a 5percent requirement could potentially be supported in combination with a streamlined processing incentive of 6 months.

RETURN ON INVESTMENT WITH AFFORDABILITY REQUIREMENTS AND INCENTIVES

	Rental				For-Sale			
	4/5 Story Wood Frame		Conversion/ Reuse		Townhome		Conversion/ Reuse	
% of Units Affordable	5%	10%	5%	10%	5%	10%	5%	10%
Incentives								
Density Bonus (%)	0%	10%	NA	NA	NA	NA	NA	NA
Parking Reduction (%)	0%	10%	NA	NA	NA	NA	NA	NA
Streamlined Processing (Months)	-	6	-	-	6	12	6	12
Tax Abatement ($/Unit/Yr.)	$0	$0	$500	$1,000	NA	NA	NA	NA
Profit (% of Total Dev. Costs)	16.0%	15.2%	15.1%	15.2%	15.1%	12.2%	15.0%	11.0%

Source: Peninger Consulting, 2016.

Note: Green shaded cells represent feasible combinations of requirements + incentives.

This analysis shows that an inclusionary housing requirement of five percent would not undermine the bottom line feasibility of most projects currently being built in Pittsburgh's strongest market neighborhoods. For requirements above five percent, one or more development incentives in combination would be needed for most prototypical development projects to achieve the minimum return on investment needed for developers to enter the marketplace. In the strongest market neighborhoods where increased density, parking ratio reductions, tax abatements and other incentives are particularly attractive to developers, these types of incentives could also potentially be used to encourage higher percentages of affordable housing units than could typically be feasibly incorporated under normal development conditions.

As market conditions change over time and Pittsburgh continues to revitalize, it is likely that a broader range of neighborhoods will support new market-rate development and achieve the types of returns that can accommodate inclusionary housing and other value capture/community benefit strategies. In the short-term, the City should continue to strategically deploy development incentives both to support new investment in weaker market neighborhoods and encourage the inclusion of higher levels of affordability in new projects in stronger market neighborhoods.