Date:	July 11, 2024
To:	Brian Boudet and Alyssa Torrez; City of Tacoma
From:	Tyler Bump and Michelle Anderson; ECOnorthwest
Subject:	FINAL Development Feasibility Results of Home in Tacoma Phase II

Introduction and Background

This memo was created to support the City of Tacoma staff, the Tacoma Planning Commission, and the Tacoma City Council in understanding the development outcomes and tradeoffs associated with development standards and zoning decisions as part of the Home in Tacoma Phase II public review draft. The analysis in this memo relied on development prototypes that were created by Mithun and served as the basis for understanding the physical implications of development standards for desired housing types in the Low-scale and Mid-scale Residential designations (and corresponding Urban Residential — UR—zones). The analysis was structured to inform two distinct but related policy objectives. The first objective was to inform the City's development of middle housing zoning and standards that, to the extent the City can control, would achieve the City's objectives of allowing middle housing that is reasonably compatible with existing neighborhood patterns, and would still be feasible from a market perspective. The second objective was to establish development incentives to promote the incorporation of more deeply affordable housing that, again, would be market feasible and thus likely to be utilized.

Key findings

- Under the Home in Tacoma Proposal, middle housing development types are both feasible across Tacoma and more feasible than detached single-family development across Tacoma.
- The proposed zoning and allowed development types in the Home in Tacoma proposals will increase affordability compared to what is allowed today.
- The UR-1/UR-2 and UR-3 zones are likely to produce a diverse range of housing units in new development, including a range of unit sizes and bedrooms counts.
- Ownership housing is more likely to get built than rental housing, leading to more diverse unit size, types, and price points for new ownership housing than exists in Tacoma today.
- Of the housing types evaluated in the UR-1 and UR-2 zones, townhomes are generally the most feasible development types.
- Development outcomes vary across Tacoma depending on market conditions. As market conditions shift overtime, the affordable housing program should be evaluated every 3 to 5 years and updated accordingly.
- The affordability program recommendations, including the proposed requirements and incentives, are likely to be feasible under current market conditions.
- The affordability program recommendations, balance the City's desired policy outcomes, the administrative capacity of the City Tacoma, and maximizes public benefit for Tacomans.

- The fee-in-lieu option, where available, was calibrated to encourage contributions to the Tacoma Housing Trust Fund in UR-1/UR-2 zones and encourage on-site compliance in the UR-3 zone.

Why is development feasibility and pro forma analysis important?

Constructing housing can be costly and risky and the costs associated with constructing affordable housing can be even more challenging. Getting funding to build new housing requires lenders and investors to be reasonably confident they will earn enough financial return to justify the risks.

Economic or market feasibility is generally assessed by comparing the expected revenues (home sales or net income from rents) against the costs of development. If a development is not feasible, it will not be built. While some of the factors that determine market feasibility are outside a jurisdiction's direct control (e.g., labor and materials costs, interest rates, market rents), local jurisdictions can provide incentives (such as tax exemptions); or adjust fees, zoning, programs, and other regulations that can have a substantial impact on development feasibility.

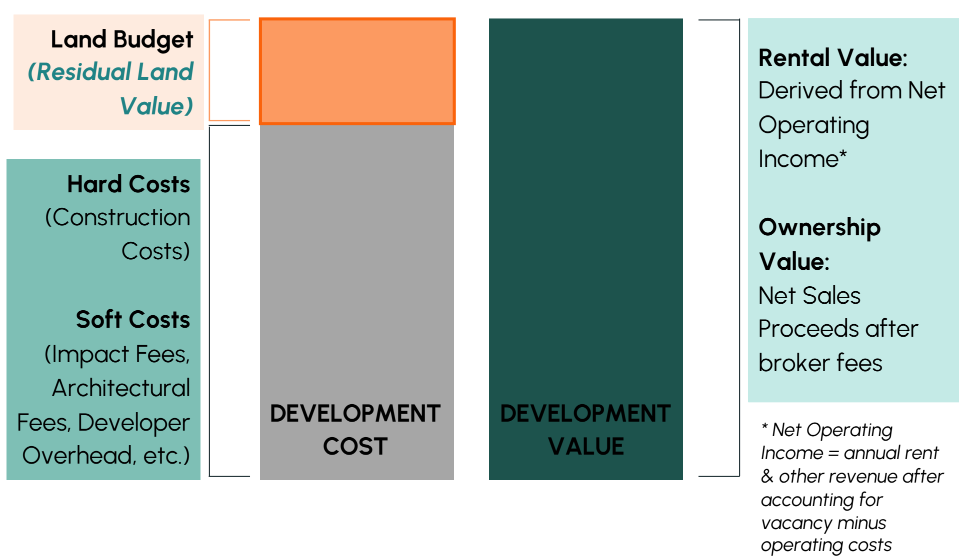
Development Feasibility Method

The ECOnorthwest team used a pro forma analysis to help answer the questions. This economic analysis models a developer's decision-making process and cash flow equation, for multiple prototypical residential developments (*prototypes*). The findings from this analysis can help guide the City of Tacoma on whether a developer will take advantage of the proposed zoning allowances. It helps the City and stakeholders understand the likelihood of developers producing desired housing types and affordable housing under different zoning and incentive scenarios.

The pro forma model considers the prototypes, entitlement limits, and the various financial market conditions of the target areas (e.g., rents, operating and construction costs, and investment return requirements). This model allows for the analysis to test the value of different regulatory options to inform the zoning recommendations.

To model development feasibility, we employed a pro forma model and used a residual land value (RLV) metric, which measures the land budget a developer would be left with after accounting for potential development costs and revenues.

Exhibit 1: Example of Feasible Development using Residual Land Value (RLV) Model



Source: ECOnorthwest.

If the RLV is equal to or above land prices in the potential development area, the development is considered feasible at market rate. If the RLV is zero dollars, the development could be feasible if the land were donated for free. However, if the RLV is less than zero, the development is likely infeasible unless a developer receives additional subsidies or incentives. Please note that results from this method describe a general analysis of prototypes and do not consider the many potential unique conditions that could be a factor in development feasibility (e.g., increased predevelopment costs, low land basis from longtime land ownership). For these reasons, a residual land value analyses should be thought of as a strong indicator of the relative likelihood of development, rather than an absolute measure of return to the investor or developer.

Evaluating Development Outcomes in Urban Residential Zones

The analysis of potential development types allowed in the proposed UR zones indicates that increased density allowances, and standards that support realizing density allowances, create feasible development for more diverse housing types. These findings show that across Tacoma, more dense housing types are more financially feasible than detached single family development.[1] However, overall development feasibility and feasibility by individual development types vary significantly by the market strength across Tacoma. High and medium market areas (areas with above average or high rent and sales prices for Tacoma) are more likely to see both greater housing production and more diversity in the housing types built. Low market areas (areas of Tacoma that have below average rent prices and sales prices for Tacoma) are more likely to see less overall development activity with less diversity in the housing types built.

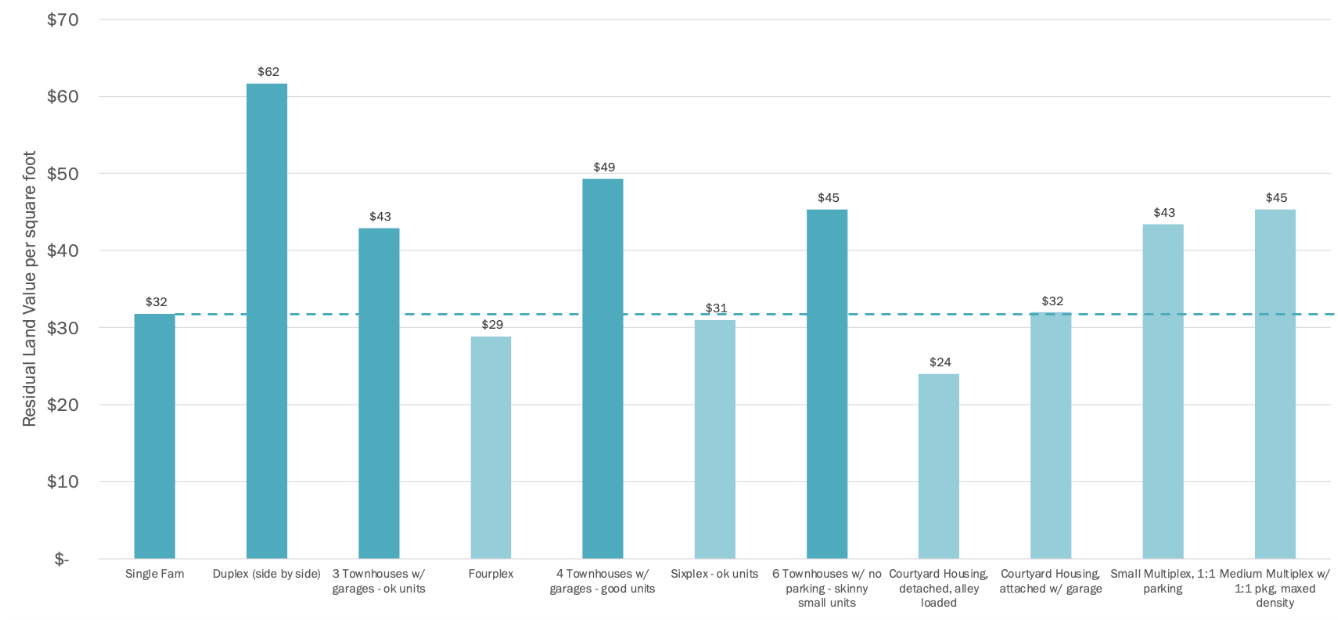
The analysis also indicates that across Tacoma, the UR zones are likely to produce a diverse range of housing units in new development types including a range of unit sizes and bedrooms counts. Also, across Tacoma, ownership housing is more likely to get built than rental housing, leading to more diverse unit size, types, and price points for new ownership housing than exist in Tacoma today. Of the housing types evaluated, townhomes are generally the most feasible development types followed by small and medium multiplex development.

Additionally, the analysis of the proposed zoning and allowed development prototypes indicates that these new housing allowances will increase affordability compared to what is allowed today (single-family houses). Generally, the housing types proposed could be affordable to households earning between 80% and 120% Area Median Income (AMI) compared to current new construction of detached single-family houses, which would typically be affordable to households above 190% AMI.

The following charts show development feasibility of the housing types evaluated in the UR zones across high, medium, and low market areas and achievable sales and rent prices for the units within development prototypes that were evaluated. In the following charts, the identified development prototype is considered feasible for the respective market area when the bar is at or above the dotted line.

[1] While other housing types outperformed singe family development across all market areas evaluated in this analysis, there will still be market demand for single family development and it will continue to be built, but along with a broader range of development types allowed in the UR zones.

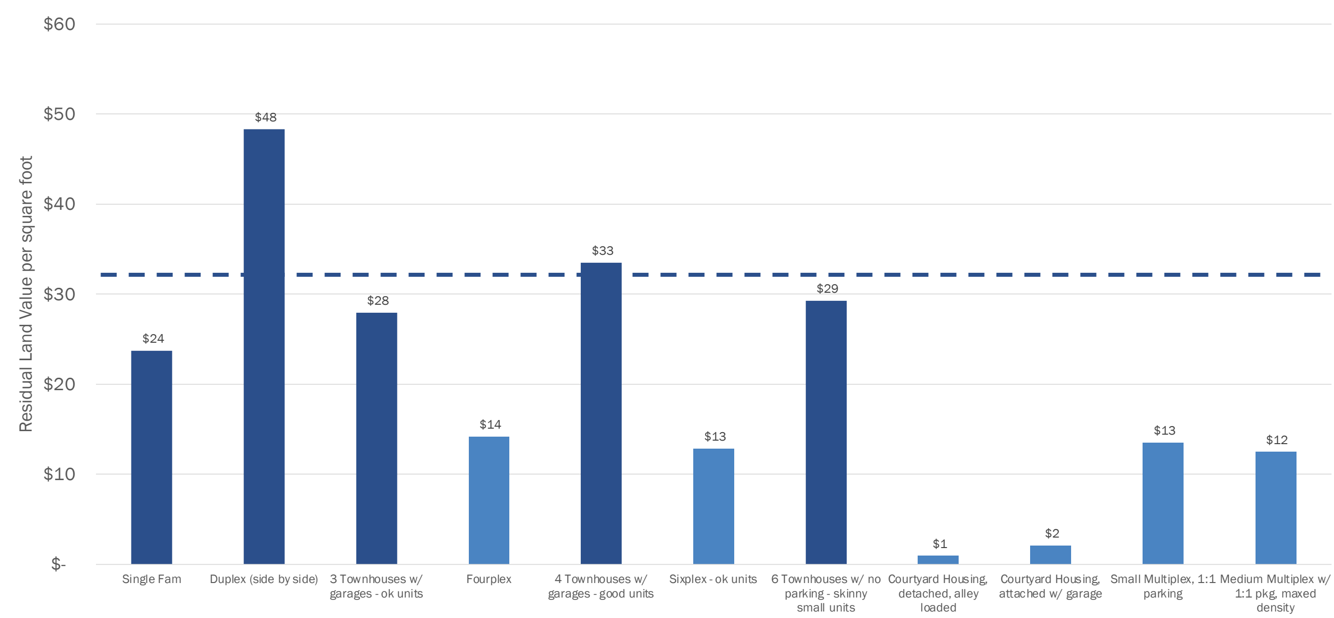
Exhibit 2. High Market Area Urban Residential Districts Development Feasibility



DU/A:	7.2	14.5	21.8	29.0	29.0	43.5	43.5	29.0	29.0	43.5	58.0
Tenure:	For-Sale	For-Sale	For-Sale	Rental	For-Sale	Rental	For-Sale	Rental	Rental	Rental	Rental

Source: ECOnorthwest. Note: DU/A is dwelling units per acre.

Exhibit 3. Medium Market Area Urban Residential Districts Development Feasibility



DU/A:	7.2	14.5	21.8	29.0	29.0	43.5	43.5	29.0	29.0	43.5	58.0
Tenure:	For-Sale	For-Sale	For-Sale	Rental	For-Sale	Rental	For-Sale	Rental	Rental	Rental	Rental

Source: ECOnorthwest. Note: DU/A is dwelling units per acre.

Exhibit 4. Low Market Area Urban Residential Districts Development Feasibility

Source: ECOnorthwest. Note: DU/A is dwelling units per acre.

Exhibit 5. High Market Area unit sizes, average rents, and average sales prices by development prototype

	Average Net Unit Size (sf)*	Average Rent	Average Sales Price	Percent of AMI
Single family	2,300	N/A**	$925,000	190%
Duplex (side by side)	1,900	N/A	$825,000	158%
3 Townhouses w/garages	1,400	N/A	$615,000	121%
4 Townhouses w/garages	1,113	N/A	$490,000	113%
6 Townhouses w/ no parking	1,000	N/A	$330,000	84%
Fourplex	1,099	$1,980	N/A	81%
Sixplex	898	$1,620	N/A	66%
Courtyard Housing, detached	1,050	$2,230	N/A	91%
Courtyard Housing, attached	1,361	$2,890	N/A	99%
Small Multiplex	904	$2,060	N/A	84%
Medium Multiplex	680	$1,500	N/A	78%

Source: ECOnorthwest.
**Though zoning does not regulate by tenure, the market tends to relate certain forms of housing with rental or ownership. We therefore selected either a rental or ownership assumption for each form.

Evaluating Opportunities for Affordable Housing Through Incentives

This analysis evaluated both regulatory (density bonuses, FAR bonuses, and parking reductions) and financial incentives (multifamily tax exemption) for both proposed UR-1/UR-2 and UR-3 zone development prototypes to understand how developers might consider participating in an affordable housing program that mixes regulated affordable units in market rate development projects. The City's intent in developing these bonuses is to promote the development of more affordable housing, and the analysis sought to inform program decisions like the depth of affordability (AMI level), the number of units, and the duration of affordability that could be integrated into a development while still being market feasible given the value of the development incentives offered.

Proposal included in the Planning Commission public review draft:

- Affordability requirement and use of bonuses: Voluntary
- UR-1 and UR-2 (Tier 1 bonuses): Based on local housing need, targets 80% to 100% AMI (moderate rather than deeply affordable), fee in lieu $62,000 per affordable unit
- UR-3 (Tier 2 bonuses): 70% AMI rental, 100% AMI ownership, fee in lieu $72,000 per affordable unit
- Number of units: 2 units or 20% of the total project units (whichever is greater)
- 50-year duration of affordability
- Fee in lieu option
- Can be layered with MFTE in UR-3

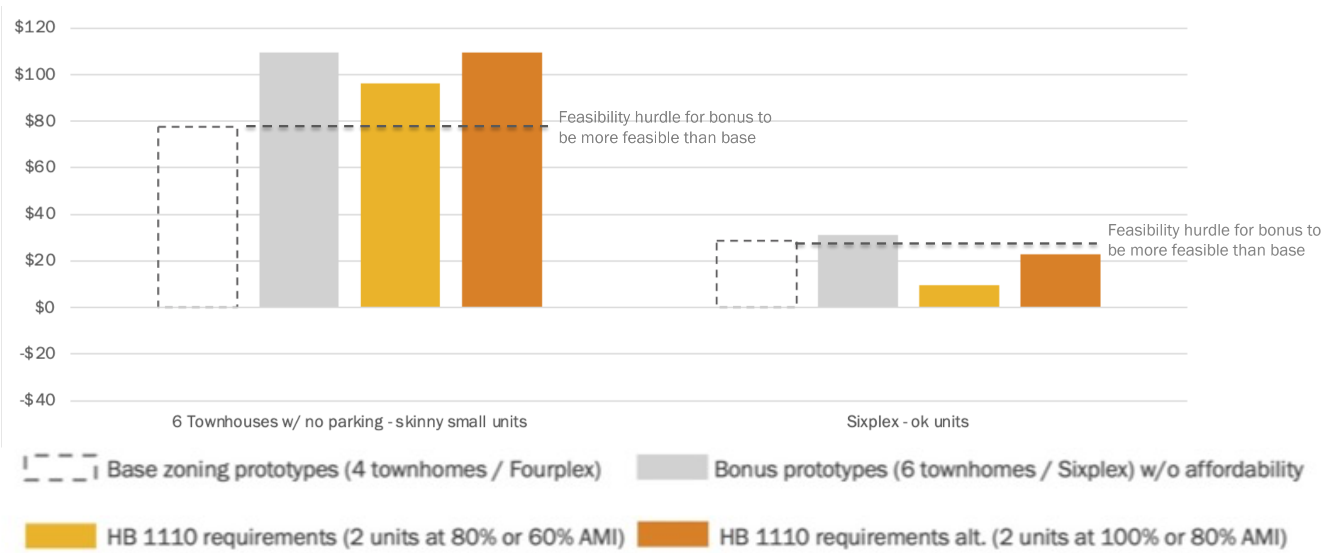
Tier 2 bonuses were not studied in this analysis for market feasibility since it is assumed that these would likely not be feasible for market-rate housing developers. However, they could be feasible for non-profits, other providers of dedicated affordable housing, or socially oriented market-rate developers who might have social impact funding.

For the UR-1 and 2 zones, this analysis found that a combination of a density bonus, FAR bonus, and parking reductions could create enough of an incentive for a market rate developer to opt-in to building a mixed-income development. However, this financial incentive is most likely to be utilized for ownership housing developments, going from a four-unit townhouse development to a six-unit townhouse development, when two of the six units are affordable between 80% and 100% AMI. These incentives are less valuable for new rental housing at this scale predominantly due to the rental market not being as strong as the ownership market in most areas of Tacoma.

This analysis found that an affordability level of 80% AMI for rental housing could be utilized in some cases where a developer could see value in the regulatory incentives in exchange for affordability restrictions, However, utilization of the incentive structure for rental housing in the UR-1 and UR-2 zones will likely be low.

This analysis also tested a depth of affordability at 60% for rental housing and found that the density bonus, FAR bonus, and parking incentives were not enough to create a feasible development scenario that would outperform a four-unit rental development with no affordable restrictions. While there is some statewide limitation on the flexibility of setting affordability targets through HB110, if the City of Tacoma wanted to make the affordable rental housing prototype feasible in the UR-1 and UR-2 zones, they would need to target a depth of affordability at 80% AMI for the affordable units or add additional subsidy to create more of an incentive for this mixed-income rental development type.

Exhibit 6. UR-1 and 2 Zone Affordability Density Bonus Results, High Market Area



Source: ECOnorthwest.

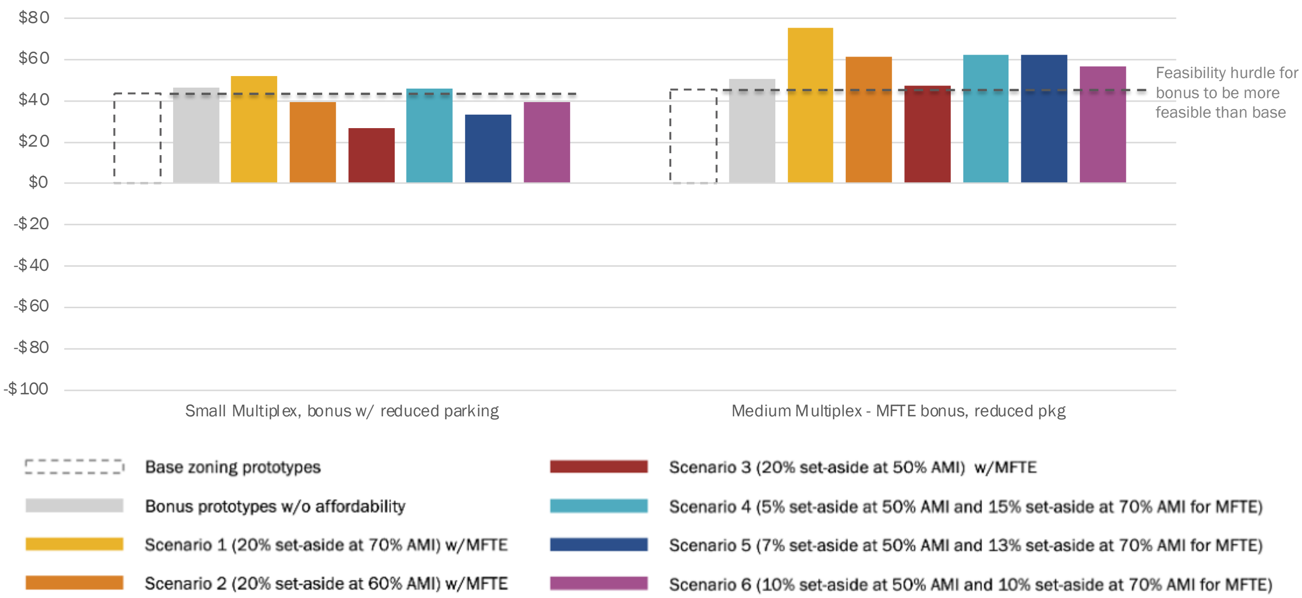
For the UR-3 zones, this analysis found that a combination of regulatory incentives (density bonuses, FAR bonuses, and parking reductions) and financial incentives (expansion of the MFTE program to residential target areas that are aligned with the UR-3 zoning districts) create enough of an incentive for a market rate developer to opt-in to building a mixed-income development at different depths of affordability and set-asides. Given that there are a variety of scales of development that could be built within the entitlements of the proposed UR-3 zone, it is important that any affordability requirements (both set-aside and depth of affordability) could be financially feasible across a diversity of development types. This would help mitigate for avoidance behavior that could contribute to underbuilding in important multi-dwelling residential zone capacity and create a true incentive that works across these different development types.

To identify potential affordability requirements that are most likely to generate both affordable units and market rate units, this analysis evaluated different program requirements for the following two different scales of development allowed in the UR-3 zone: a small multiplex rental development and a medium multiplex rental development. This analysis found that a set-aside of 20% of units at 70% AMI is the combination of affordable housing program options that are most feasible across these different scales of development and would be most likely to advance housing goals identified in the Affordable Housing Action Strategy and in the Home in Tacoma Phase I project. Affordability requirements of 20% of units at 70% AMI creates enough of an incentive where a developer is more likely to purse a more dense residential development project while also providing affordable units in the development.

Of the regulatory and financial incentives evaluated, the MFTE program provides the most benefit to making this incentive structure attractive to developers. As the City updates the Affordable Housing Incentives and Bonuses Administrative Code to implement these new zoning districts through Home in

Tacoma Phase II, it is critical that the MFTE program requirements are clear and streamlined to limit barriers to participation in the program. It is also important to use all the regulatory, process, and financial incentives available to the City to minimize development and program application complexity which in turn, helps optimize program participation and create the highest yield of affordable units.

Exhibit 7. UR-3 Zone Affordability Density Bonus Results, High Market Area



Source: ECOnorthwest.

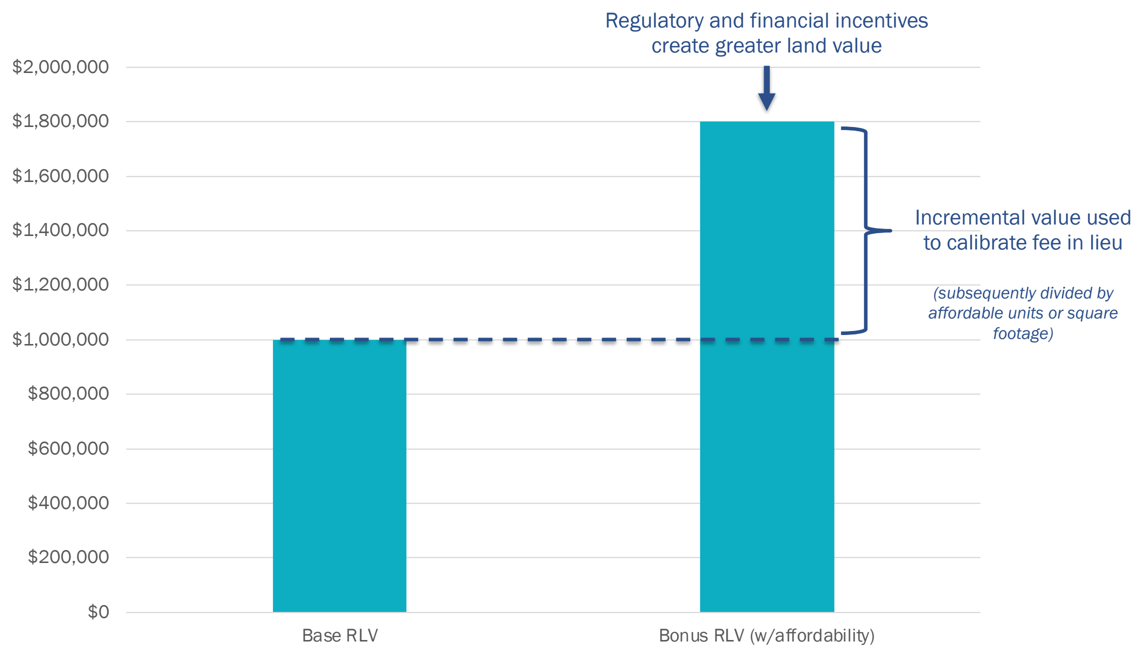
Consideration for Calibrating a Fee-in-lieu of On-site Affordable Housing Program Compliance

A fee-in-lieu provides developers with the ability to opt out of an on-site affordability commitment by making a payment to the jurisdiction in lieu of meeting requirements to provide below-market units on site. In-lieu fee payments are typically used by cities to directly support the development of affordable housing units elsewhere and in the case of Tacoma, can help create an additional funding stream for the Tacoma Housing Trust Fund. Providing the option of a fee-in-lieu payment creates additional flexibility for developers to contribute to affordable housing while at the same time maximizing the potential for capturing value from these zoning changes to support affordable housing.

This affordable housing incentive structure is a voluntary program, so there needs to be enough value for someone to participate in the program. For a developer to opt-in to either on-site compliance or pay a fee-in-lieu, the value of the benefit to the developer needs to be aligned with the requirements. As such, it is important to calibrate a potential fee-in-lieu that is aligned with the financial realities of development in the UR-1, UR-2 and UR-3 zones as well as balanced against policy goals to create mixed-income developments and mixed-income neighborhoods. In conversation with City staff, community stakeholders, and decision makers there was a clear preference for prioritizing on-site compliance where the City already has administrative capacity to manage these programs. The City has existing staff and processes to manage affordable housing monitoring and compliance for rental housing but creating a tracking and monitoring system for affordable housing will be challenging from both an administrative and financial resource perspective. As such, there is a policy priority to support on-site compliance for rental housing while creating an opportunity for contribution to the Tacoma Housing Trust as fee-in-lieu for ownership housing.

The analysis method for identifying potential options for a fee-in-lieu in the UR-1/UR-2 and UR-3 zones uses an approach that looks at the delta between the residual land value (RLV) in the base allowances and the RLV for a feasible development with regulatory and financial incentives. Like calibrating the affordability program options for an effective on-site program discussed above, this approach to a fee-in-lieu calculates the fee based on the value that is created through the incentives with the goal of having contributions to the Tacoma Housing Trust Fund aligned with the realities of development economics. The example below is a theoretical graphic illustration of this approach where the incremental value of the regulatory and financial incentives above base allowances is used to calibrate the options for a fee-in-lieu.

Exhibit 8. Example of Incremental Value of Incentives and Fee-in-lieu Approach



Source: ECOnorthwest.

One additional consideration for setting a fee-in-lieu is the spatial variation in market conditions across the City of Tacoma. Because a fee should be set at a citywide level to minimize complexity and confusion which would limit interest and participation from the private sector, it is important that a fee be set at a rate that is feasible across as many market areas as possible. If a fee is calibrated to the highest performing real estate markets in Tacoma, it would not be feasible in other locations throughout the City, limiting the efficacy of the program. If the fee is set too low, then developers might be realizing financial incentives without proportionally contributing to a public benefit—in this case affordable housing or payments in the Tacoma Housing Trust Fund. ECOnorthwest conducted a feasibility analysis and identified the following ranges of potential fees for the medium market area in the UR-1/UR-2 zones and the UR-3 zone that balance the City's desired policy outcomes, the administrative capacity of the City Tacoma, and maximizes the public benefit for Tacomans. These ranges are also aligned with the development prototypes and affordable program recommendations on depth of affordability and set-aside from the previous section. The lower end of the UR-1/UR-2 zone range was selected to provide a slight advantage to a fee option for ownership units while the upper end of the range was selected for the UR-3 zone to prioritize on-site production in higher density rental developments.

Exhibit 9. Fee-in-lieu Range by Zone and On-Site Affordability Level

	UR-1 and UR-2
60% AMI rental / 80% AMI ownership	\$47,000 - \$68,000
80% AMI rental / 100% AMI ownership	\$62,000 - \$89,000
	UR-3
20% set-aside at 70% AMI	\$50,000 - \$72,000

Source: ECOnorthwest.