City and County of San Francisco

Office of the Controller – Office of Economic Analysis

Transfer Fee and Fee Deferral Options for Developers: Economic Impact Report

Items #091251 and #091252

Office of Economic Analysis

March 22, 2010

Main Conclusions

Two pieces of legislation have been proposed that are intended to stimulate the local economy by encouraging private construction in San Francisco. Both pieces of legislation offer developers new options for how and when they pay fees to the City. Changes in the way fees are paid can lower the cost of development, accelerating the financial feasibility and construction of new projects that are currently not moving forward because of the depressed state of the residential and commercial real estate markets.

The Office of Economic Analysis projects that, if developers elected to use these options, the combined effect of the two pieces of legislation could stimulate the construction of as many as 75-80 housing units per year, over the next twenty years. This development will expand the City's economy by an average of $250 million per year, and create an average of 330 jobs, across all industries.

Both pieces of legislation intend to reduce development cost by deferring when fee payments are due. The City requires developers to pay a fee for affordable housing, or build affordable housing themselves, in proportion to the size of their project. One proposed ordinance gives developers the option to reduce their affordable housing requirement by 33%, in exchange for accepting a transfer fee on their property. The transfer fee would require all future sellers of the property to pay an additional 1% of the sales value to fund the City's affordable housing efforts. In effect, the Transfer Fee Option attempts to stimulate development by reducing the upfront cost of funding affordable housing, and pushing this cost on to future occupants. If property buyers accept this fee, the Transfer Fee Option stimulate development. The OEA projects that, in time, the City will generate more affordable housing funding under the Transfer Fee Option that it would under the current system, although funding will decline in the short term.

The City also requires other fee payments, which fund the new infrastructure needed to serve new development. The second proposed ordinance allows developers to defer these payments until just before the new buildings are occupied. This will reduce developers' financing costs during the development process. The amount developers are required to pay will not change, and the City will not lose any fee revenue with this option. It will create a short-term reduction in fee revenue for the City, for approximately two years, before the deferred fees on the first affected projects are paid. However, the City has sufficient cash balances in its neighborhood infrastructure funds to continue two years of work at an average rate of expenditure.

The Two Ordinances

1. 090252, Transfer fee: gives developers the option to reduce fee payments by 33%, in exchange for accepting a 1% fee on all future transfers. This includes the initial transfer from developer to first resident.

2. 090251, Fee deferral: giving developers the option to defer fee payments, at a low interest rate that reflects the City's rate of return and cost of capital.

Transfer Fee: Economic Impact Principles

- In a competitive housing market, higher taxes, fees, or other encumbrances on a property lower its sales price, since they increase costs to all future buyers, who will bid less for the property.
- Developers will choose the transfer fee option if their fee savings are greater than any sales price reduction they face.
- The City can minimize its risk by reducing a relatively small portion of fees in exchange for the new transfer fee, but in doing so it also limits the stimulus effect of the incentive.
- The proposed percentage reduction: 33% - is a very conservative policy that will generate more fee revenue for the City over the long term—assuming that it will be attractive to developers.

How Much Will the Transfer Fee Generate?

- The OEA conservatively estimates that the net present value of a 1% transfer fee represents:
  - Between 54% and 80% of the fees required for a condominium development.
  - 47% of the fees required for an apartment development.
  - 34% of the fees required for an office development.
- These estimates are based on a conservative model of what a 1% transfer fee might generate in the future, for different types of construction.

How Does the Value Model Work?

- The model compares what the City gives up in initial fee payments, with what the City can expect to gain, on average, from a 1% fee on future transfers of new properties.

- The present value of that future revenue stream depends on four things:
  1. The initial sales price of the new unit.
  2. How frequently the unit will transfer ownership in the future.
  3. How much it will appreciate in value between transfers
  4. How much future revenue should be discounted against fee revenue today.

- The model uses reasonable and conservative estimates from third-party data sources to estimate the present value of the fee.

Details of the Transfer Fee Value Model

Development Type	Assumed Inclusionary Requirement	Minimum Feasible Price (per Unit or Sq.Ft.)	Projected Annual Appreciation	Average Turnover	Discount Rate	Net Present Value of Transfer Fee	33% of Fees per Unit/SF	**City Gain per Unit / SF**	Current Fee Payment per Unit/SF	Initial Payment per Unit Under Policy
Midrise Condominium	20%	$742,506	varies	10	7.0%	$37,428	$19,229	**$18,199**	$57,686	$45,882
Low-rise Condominium	20%	$624,111	varies	10	7.0%	$31,460	$19,229	**$12,231**	$57,686	$44,699
High-rise Condominium	20%	$926,917	varies	10	7.0%	$46,724	$19,229	**$27,495**	$57,686	$47,727
Apartment	20%	$498,391	4.9%	10	7.0%	$26,244	$18,494	**$7,750**	$55,481	$36,987
Office	N/A	$431	0.9%	16	8.5%	$5.10	$4.94	**$0.16**	$15	$10

The analysis above applies to residential projects with a 20% inclusionary requirement, and office developments subject to the jobs-housing linkage fee.

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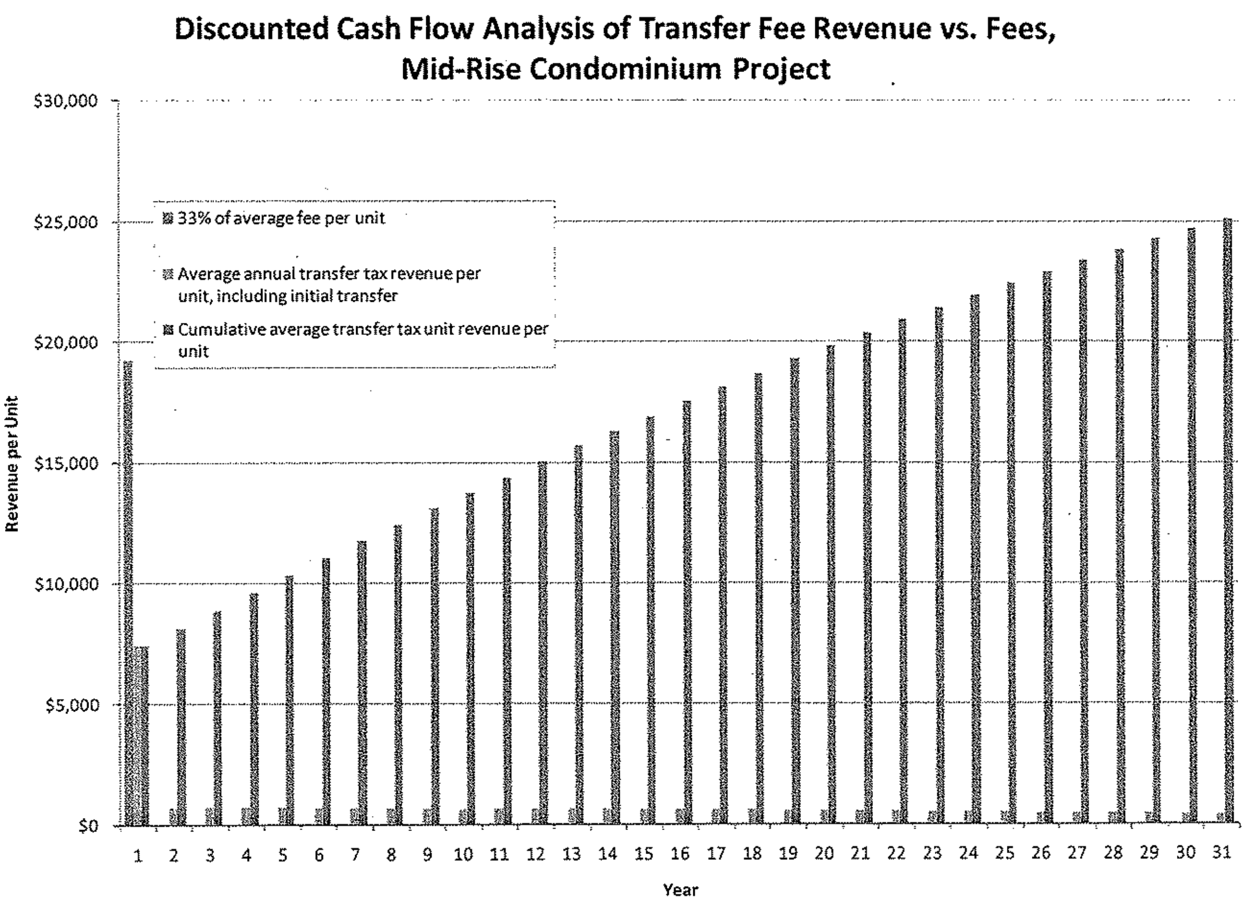
How Does Cash Flow Compare?



Looking at the cash flow from an upfront fee payment in today's dollars, vs. a stream of discounted future payments under the transfer fee option (mid-range condo), the transfer fee "pays off" to the City by year 18. After that, the City is earning more revenue—in today's dollars—than it would with the upfront fee payment.

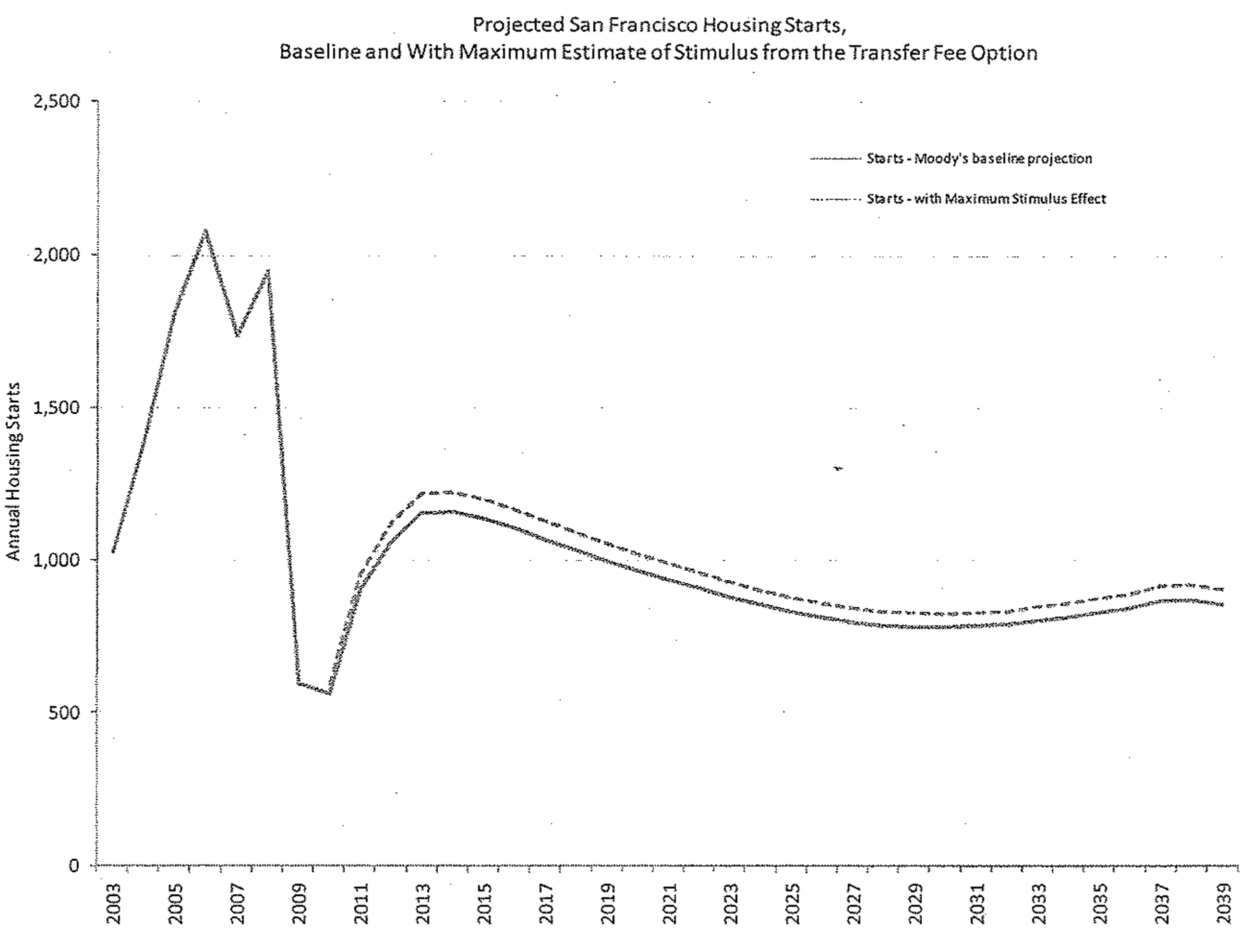
Effects of the Transfer Fee Option on the Timing of Development

- The analysis on the preceding slide shows that the City would earn more revenue over the long term if a typical condo developer took the proposed transfer fee option.
- However, this does not mean every developer would take the option. If developers cannot pass the transfer fee's value on to customers, which seems likely, the transfer fee will reduce the sales price by more than what is saved in fee payments.
- For a mid-rise condo, the transfer fee is valued at $37,000, and in a competitive market would reduce sales prices that amount. But the fee savings is only $19,000.
- The fee revenue generated by individual projects will vary around these average appreciation, sales price, and turnover rates, in ways that no one, including developers, can predict.
- But there appears to be no segment of the industry where the City would lose revenue from developers taking the Transfer Fee option.

If the Transfer Fee Does Not Affect Prices

- While an efficient market will price a transfer fee into the unit's initial sales price, a developer might not believe the market is efficient. While they could be wrong, their decisions affect the economic impact.
- Such a developer would take the transfer fee option because they are more concerned about immediate fee payments.
- If that were the case, the developer would save 33% of fee payments, and only pay the initial 1% transfer fee. We estimate this would reduce total development costs by between 1.4% and 2.6%, for condo developers.
- This would accelerate the development of all affected projects, stimulating construction. The long-term stimulus impact of this reduction in development costs depends on the elasticity of supply for housing.
- By statistically comparing the impact of housing prices on housing permits in San Francisco, the OEA estimates the elasticity of supply at 2.2, indicating a 1% increase in price (or a reduction in fees equivalent to a 1% of price) generates a 2.2% increase in construction.
- The reduction in fees could generate a 3.1% - 5.6% increase in housing construction.

Stimulus Impact of the Transfer Fee



This chart shows Moody's projection of housing starts in San Francisco as a baseline. Note the large drop-off in 2009 and the weak long-term recovery.

The dashed line shows the maximum projected 5.6% increase in housing starts that could occur, if the transfer fee did not lower sales prices. This stimulus effect translates into about 50 units per year.

Fee Deferral: Economic Impact Principals

- While early fee payments may be seen as an impediment to development, developers do have the option to seek commercial lending to finance these fees.
- If the interest rate paid to the City through fee deferral is below the commercial lending rate, development costs will decline in two ways:
  - Lower interest payments on the loan portion directly applicable to fees.
  - Lower loan-to-value ratio on the entire loan, which may result in a lower overall rate.
- Either way, lower development costs will stimulate development to some extent.

Fee Deferral: Magnitude of Impact

- At present, commercial lending rates for credit-worthy borrowers are set at about 300 bps above prime, or about 6.25%.
- If the City set its fee deferral rate at 1.61%, a mid-rise condo developer financing $70k per unit in fees for two years would save about $6,500 per unit, or about 1.2% of development costs.
- The combined 1.2% reduction in development costs could increase development by about 2.5%, or 20-25 housing units per year.
- This stimulus affect would likely decline as the City's rate of return on funds increased, but it would fairly significant during the current recession.

Cash Flow Impacts of Fee Deferral on Neighborhood Development Funds

Fund	Average expenditure per year ($M)	Cash Balance ($M)	Years of average expenditures at current cash balance
Child Care Capital Fund	$0.44	$1.28	2.9
Downtown Park Fund	$0.64	$4.42	6.9
Eastern Neighborhood Public Benefit Fund	$0.00	$0.07	N/A
Market & Octavia Community Benefit	$0.00	$0.10	N/A
Neighborhood Other Loans, Non-Grant	$0.01	$0.46	51.2
Rincon Hill Area Plan Impact Dev Fd	$0.14	$4.81	34.9
Visitation Valley Infrastructure Fund	$0.00	$0.92	N/A

Fee deferral could delay the City's ability to fund the new infrastructure that is funded by impact fees. Fee revenue could decline for the next two years, but beyond that, revenue will stabilize as the first round of deferred projects pays its deferred fees.

An examination of the annual expenditure rates, and fund balances, in neighborhood development funds indicates that all have sufficient funds for average expenditures for at least the next two years.

Maximum Combined Economic and Fiscal Impact of the Two Proposals

- The maximum economic impact of the two proposals combined would be to generate an average of 78 housing units per year over the next twenty years.
- This is equivalent to a $101 million average annual increase in construction spending in San Francisco.
- With multiplier effects, the total economic impact will be an expansion of an average of $250 million per year, and 330 jobs in all industries.
- Accelerating the development of these housing units by an average of 2 years each would generate a total discounted Property Tax revenue benefit of approximately $19 million by 2030.

Conclusions

- The vast majority of new development in the last ten years has been condominiums. This analysis suggests that the City is unlikely to lose money on condo projects that elect to accept a 1% transfer fee payment in lieu of paying 33% of fees.
- On the other hand, for the same reason, the transfer fee will be relatively weak as an economic stimulus policy.
- If developers can get customers to assume the cost of the transfer fee, which is unlikely, it could increase construction by approximately 5% per year.
- The fee deferral option will probably prove more attractive, depending on the rate each year, but the small size of the savings involved would stimulate development by perhaps 2.5% per year during the current recession.

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