AFFORDABLE HOUSING AND INCLUSIONARY ZONING IN PORTLAND

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Over the last 20 years the City of Portland has evolved from a trendy, quirky destination to a desirable place to live and work. Over the last few years Portland has been getting even more national attention and was ranked fifth on Forbes "Coolest Cities" in 2017.[1] Reasons for Portland's recent national attention include a lower cost of living than major West Coast cities, fulfilling and available jobs, easy access to the outdoors, a young educated workforce, public transportation and a thriving food and drink scene.

These claims have been backed up by net migration numbers, between 2012-2014 the net migration to the state was 66 people per day, increasing the population of the Portland MSA to approximately 2.39 million.[2-3] The increase in population has also magnified deeper issues in the Rose City such as an increase (and a much more apparent) homeless population, middle-income wage stagnation, and what we will focus on, housing affordability.

The city was referenced in the TV show "Portlandia" as the place "Where young people go to retire", but nowadays this romantic notion is just a catchy line that is said when people talk about how things used to be.

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This paper will concentration on the development regulation of inclusionary housing (IH). First, we will dive into how we got to the point where the city felt it was necessary to introduce an affordable housing requirement in multifamily projects. This section will include the mechanisms enacted to enforce the IH regulations that commenced in 2017. Second, we will look at the immediate impact the IH regulations had on development and permitting at the city and on construction. Lastly, we will detail a few of the unintended consequences the IH has brought, or could bring going forward, in this development cycle and beyond.

HOW DID WE GET HERE?

As was mentioned above, Portland's net migration has been about 66 people per day for a few years. Within the Portland city limits, the population of Portland has increased from 583,799 residents to 639,863, between 2010-2016, nearly a 10 percent increase over that span.[4] With Portland's local economy being fueled by manufacturing, tech, and food/drink industries, the days of reliance on the timber industry are over. Of those 639,863 residents, approximately 47 percent of the adults have a bachelor's degree. Of the new migrants, about 62 percent are young and college-educated[2]. The young, college-educated demographic that is showing up to Portland in bunches is used to, and desires, different living arrangements then the generations before them.

The unemployment rate in Portland has also been trending in the right direction with unemployment a little below 4 percent at the end of 2017, which is about 8 percent lower than 2010, as shown in Figure 1.[5] With these current numbers, the Portland MSA (which includes Vancouver to Hillsboro) is projecting approximately 260,000 new residents and 140,000 new jobs by 2035.

If we look at the living arrangements in the City of Portland, 53 percent of the housing is owner-occupied. That leaves a large percent of the population as renters. If we drill deeper into the factors for the lack of owner-occupied housing units, we do not need to go much farther than looking at home prices in the Portland metro area. By the end of 2017, the average year-over-year Portland home value has increased 5.6 percent, to $373,500.[6] This is $167,000 over the national average. The average income per household in the Portland MSA from 2016 was $68,676.[7] When you factor the average home prices with the average household income, and consider that two-thirds of the new migrants are young and college educated (who typically are tend toward with ownership later in life), all signs pointed towards more renters. With this new migration, the vacancy rate in Portland hit an all-time low in 2015 at below 4.5 percent, as shown in Figure 3. The corresponding rent in January of 2015 was around $1.28 per square foot.[8]

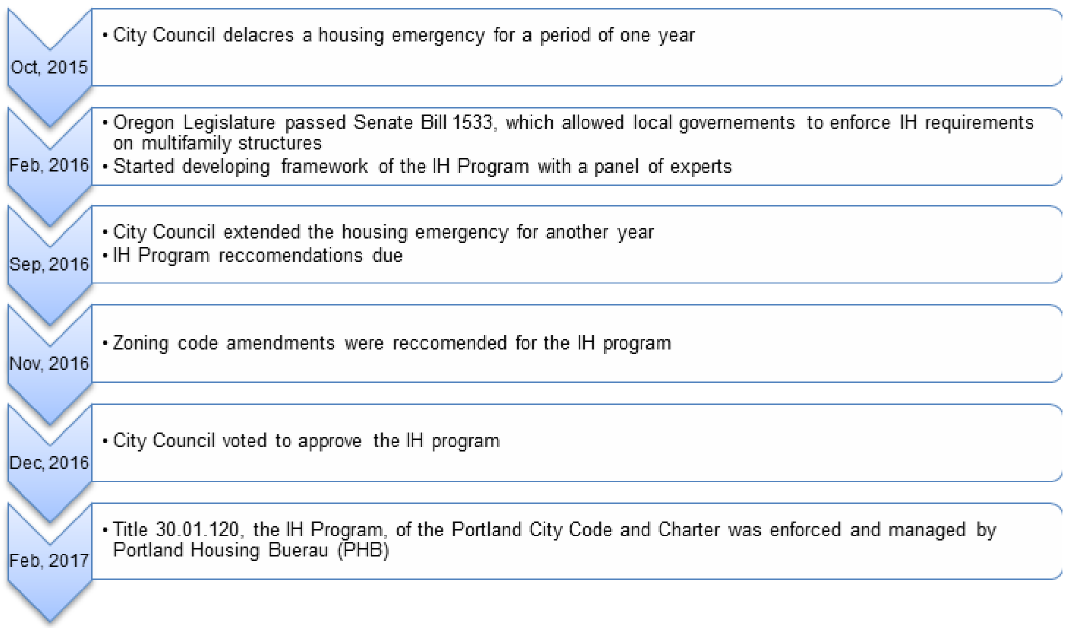
If we recap, the Portland market in 2015 has constant increase of population (especially the young, college-educated demographic), relatively high housing prices, vacancies at an all-time low and a very low unemployment rate. Multifamily developers and investors recognized the solid fundamentals of the Portland market and started getting their projects teed up.

Fast forward two years later to 2017 and rents peaked at $1.51 a square foot, or almost an 18 percent increase in two years. Approximately 10,500 units were put online in 2016 and 2017 combined.[9] With the median income of Portland households growing but being relatively stagnant compared to rent and housing prices, the issues of housing affordability was magnified and worsened. At this point the City of Portland decided to step in.

CITY'S RESPONSE

The City of Portland set out to make a program that could increase the supply of affordable housing by utilizing the private developer's appetite for adding housing supply to the Portland market.

Below shows a few key steps the city took to achieve the IH legislation that is in effect today.



On February 1, 2017, title 30.01.120, or the Inclusionary Housing program, was put into effect. Any projects submitted to the city for permitting before this date were vested, and not subject to the new inclusionary housing regulations. The main details of the program are as follows for projects that include 20 or more units.[10]

Option 1:
20 percent of the units must be at or below 80 percent of the AMI (Area Median Income produced by HUD). Projects outside of the Central City District only need to achieve 15 percent. The financial incentives for the developers include a 10-year property tax exemption on all units if the FAR (floor-area-ratio) is greater than 5:1 and only on the affordable units if less, waived Construction Excise Tax, exempt from parking requirements and FAR Bonuses.

Option 2:
10 percent of the units must be at or below 60 percent of the AMI. Projects outside of the Central City District only need to achieve 8 percent. The financial incentives for the developers are the same as Option 1 and include SDC (System Development Charges) exemptions of the affordable units. The SDC savings are waived during the permitting process.

Option 3:
The affordable units can be transferred from the original site (sending site) to another new development (receiving site). The number of units are based off the sending sites total number of units and there are two options. The first is 20 percent of the sending sites total number of units can be transferred to the receiving site, but they must be at 60 percent AMI. The second is, 10 percent of the sending sites total number of units can be transferred to the receiving site, but they must be at 30 percent AMI. The financial

CITY'S RESPONSE

incentives are similar to option 2. Other key requirements include; must be within one-half mile of the sending site or have a higher Combined Opportunity Map score and receiving site must receive Certificate of Occupancy within three years of sending site's building permit issuance.

Option 4:
Units in an existing building (receiving site) can be designated to be affordable to exempt the proposed project (sending site) from the requirements. 25 percent of the sending site's total number of units would need to be affordable in the receiving site at 60 percent AMI, or 15 percent at 30 percent AMI. The financial incentives are FAR bonuses and exemption from the parking requirements.

Option 5:
The distribution mix of affordable units can be based of bedrooms rather than units to provide less number of affordable units, but the same number of bedrooms and larger affordable units.

Option 6:
A fee-in-lieu of affordable units can be paid based off Figure 5.[11]

All projects, not exclusive to any of the options, must maintain the affordable units as affordable for a period of 99 years and the owner must provide annual documentation regarding tenant income and rents for the affordable units.

At the same time the IH program was being crafted, the City Council passed a renter protection policy that required landlords to pay a relocation fee between $2,900 and $4,500 for tenants they evict without cause or vacate because of a rent hike more than 10 percent.[12]

THE MARKET'S RESPONSE

The following permitting analysis is mainly based off of the Bureau of Planning and Sustainability's "Six Month Review of Inclusionary Housing Zoning Code Program" and the update, the "One Year Review of Inclusionary Housing Zoning Code Program" by Senior Economic Planner, Tyler Bump.

There was to be expected a rush of applications to the city because any developer, even considering a multifamily project with over 20 units, would benefit financially from being exempt from the new IH program. What everyone, including the city, wanted to see is how the market would respond after the predictable lull of permit activity directly after the implementation of the IH program.

Prior to the IH program going to effect in February 2017, it is estimated that 19,000 units were submitted to the City of Portland, which vests the applicant's rights for a period of 3 years.[13] After one year, of these 19,000 units, there are approximately 10,000 units still in the development pipeline. Around 5,000 units of the original 19,000 have moved along the permit process and are in review or approved to issue.[14] This means that about 4,000 units represent projects submitted that were not complete or withdrawn. These are mainly made up of the projects that developers submitted as placeholders—in case they decided to move forward with a project, they would be vested a pre-IH. There are close to 10,000 units currently under construction in the Portland metro area.[15] The number of units that are currently vested or under construction represent about two years of development activity, which is down about two years of activity from the initial 19,000 units, but is still under the forecasted amount of housing that will be needed as Portland continues to grow.

THE MARKET'S RESPONSE

In the year since the IH program had been enforced, 17 projects included the IH requirements. Five were with public financing. The other twelve were privately financed and represented 565 market rate units and 89 affordable units. Of the 89 affordable units, 69 chose Option 1, while 20 chose Option 2. The publicly financed projects represent 353 units at varying income levels at or below 80 percent. It is worth noting that all of the projects were outside of the Central City.

To forecast farther out than one year, one can look at the Early Assistance Review activity—52 appointments have been completed that incorporate affordable housing into their projects. This shows that developers and investors still feel confident about the Portland's market fundamentals and are willing to work within the IH program.

One important factors to note is that rents in Portland have softened due to the sudden increase of new housing supply. Landlords are offering more concessions and new marketing strategies to fill their vacancies. Also, labor and material escalation for construction have been trending in an upward direction, which is another reason development activity can slow.

THE UNINTENDED CONSEQUENCES

The program is only one year in, and because of the amount of pre-vested multifamily projects, we still do not know the ultimate effect the IH program will have on the City of Portland. The following section is dedicated to the unintended consequences and the effects they could have on the market in Portland.

The 19-Unit Building Boom

The IH program doesn't mandate developments that are under 20 units. Because of this, it was thought that there would be a steep increase in multifamily projects permitted between 15-19 units. One year in, and the data does not show that this has been the case, as shown in Figure 6. There have only been 5 permits issued between 15-19 units, totaling 83 units in the year since the IH program was enforced. The previous year saw 8 permits and 145 units issued. The fact of the matter is that these developments are more of a product of their land size and zoning. Unless you are in a high density residentially zoned area, you would not be able to put over 20 units on a site because that determination is made by the size of the lot.

New Project Style

An effect of the IH program, that has already been seen, is the creativity of developers to avoid the IH mandate. There have already been a few permits at the city that have multiple buildings in a development, instead of one larger building, to stay under the 20-unit threshold. Although building two separate building does add costs to a project, those costs may still be less than any of the IH options.

Shift to the Suburbs

The latest multifamily boom has been centered around the Central City, and justified by the premium in rents. Multifamily development in the suburbs only boom when the rents can support the construction costs and returns needed for investments. Up to this point the increase in construction costs have been too great and not been able to support suburban multifamily development. The IH program has certainly slowed the number of projects being submitted for permit in the City of Portland, which will only increase the rents in Portland once the new deliveries have been absorbed and landlords gain leverage. Looking ahead to 2018 and beyond, if the IH program remains in its current form, the increase in Central City rents will start its creep into the suburbs. As the Central City prices residents out, the residents could shift to the suburbs. Just as what happened in the Central City, more incoming migrants to the suburbs increases the demand on the

THE UNINTENDED CONSEQUENCES

existing housing supply. In turn the rents will start to increase, which would then justify investments for new multifamily projects in the suburbs.

Industry Effects

As the IH program starts to shape the development scene in Portland, many industries that have been booming over the last four years could see dramatic effects. First, is the construction labor market. By all accounts, there is a labor shortage in Portland for many trades.[16] Many contractors are having to turn down work, as they cannot perform the projects because of their current pipeline. The rippling effects the IH program could have on the development pipeline could cause a potential labor surplus with many of the same companies turning down work now, having to let go many of their workers due to too little or no projects in the pipeline. Of course, there will still be projects outside of multifamily to be built, but the sheer amount of multifamily projects during the current cycle have forced contractors to increase their number of employees and emptied out union halls. Unless there is an uptick in new projects into the development pipeline, the future could be bleak for some contractors.

Second, is the design industry. There have already been significant layoffs at local architecture firms due to the decrease in developers bringing new multifamily projects to their doors. Many firms had to increase their staff to support the influx of developers looking to have their projects vested pre-IH regulations. Since that day has come and passed, many of the local firms realized that they could no longer support all that staff that was brought on to help facilitate the multifamily boom. We could see reorganizations at more firms if the IH program remains as it is now.

Decreasing Land Value

One stakeholder that has not yet been mentioned is the land owners. To determine the feasibility of a project, the land value of a project can be determined by working backwards from the feasibility analysis of the developer. The developer estimates all costs to build a project, including financing and returns needed to get that financing from investors and debtors, and the residual value is how much a developer can pay for land. This cycle has seen record high land prices because the increases in rents have been able to support it. The IH program, and the set aside affordable units, reduces the net operating income of a project, which effectively reduces the amount the developer can pay for the land. Many projects that were feasible at these record high land values are no longer feasible, unless the market rate units can subsidize the gap of missing income. With rents already softening and more concessions being provided, the burden of the affordable units will be too great for most developments to be feasible. A land owner who is not following the cities policies would likely not realize that the land they own just decreased in value overnight. The recent sales comparisons are no longer valid due to the change of development policies by the city.

CAPITALISM AND CREATIVITY

Even with the IH program, the fundamentals of Portland are still attractive to local and out-of-market investors. Now we will get to see the creativity of the market in terms of living with the IH policies. We touched on one, which is building separate buildings to stay under the 20-unit threshold, but the city has seen an increase in Early Assistance meetings to discuss working within the IH policy. Though not backed up by statistics yet, you could see a decrease in apartment size, to increase the number of units to subsidize the affordable units. Co-housing has become one of the buzz words in the real estate industry, and there is potential to get creative with how rooms and units are classified. Although it does come down to the City's determination if your project is exempt from the IH policies.

CAPITALISM AND CREATIVITY

The IH program can be amended, and likely will to some degree, if the goals of the program are not achieved. According to a study by the Urban Land Institute, "Economics of Inclusionary Zoning", the key takeaway from the study was that to have an IH program that is effective, there must be a sustained level of market-rate development in the local market.[17] Another key point was that the development incentives must align with market conditions to be effective. One year in, it appears that the incentives are not aligned with the market conditions, and the City of Portland development pipeline beyond 2019 will not be enough to reach the stated goals of the IH program.

Even though the immediate situation does look grim, the developers in the city should look at it as an opportunity. An opportunity to collaborate with the city to work within the program, and an opportunity to improve on the program. An opportunity to inject new life into the multifamily sector that has become mundane and sterile. An opportunity to, once again, be a city that does things a little "weird" and to bring the charm back to Portland.

The fact is, Portland is going to continue to increase its population and housing will be built. In the United States, there are 886 jurisdictions in 25 states, with an inclusionary housing program.[18] The ultimate success or failure of the IH program in Portland will be the balance of incentives to mandatory requirements to keep the development pipeline full. This will be the job of the City of Portland to listen, learn and implement concepts and practices from the business community, and other jurisdictions, to really make any meaningfully changes to the current housing situation. On that note, Mayor Ted Wheeler has said that in March, City Council will be looking at revamping or adding to the incentives structure to promote more development and bring more affordable units online. The City of Portland's slogan is "The City That Works", and now that inclusionary housing in Portland is here to stay, the City has an opportunity to really show that the catchy slogan is more than just a soliloquy.

Figure 1 - Unemployment in Portland

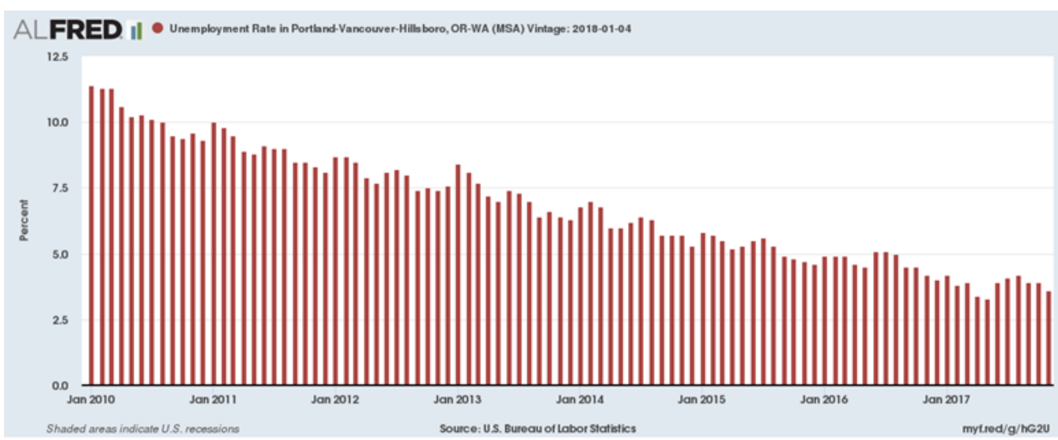


Figure 2 - Average Income in Portland

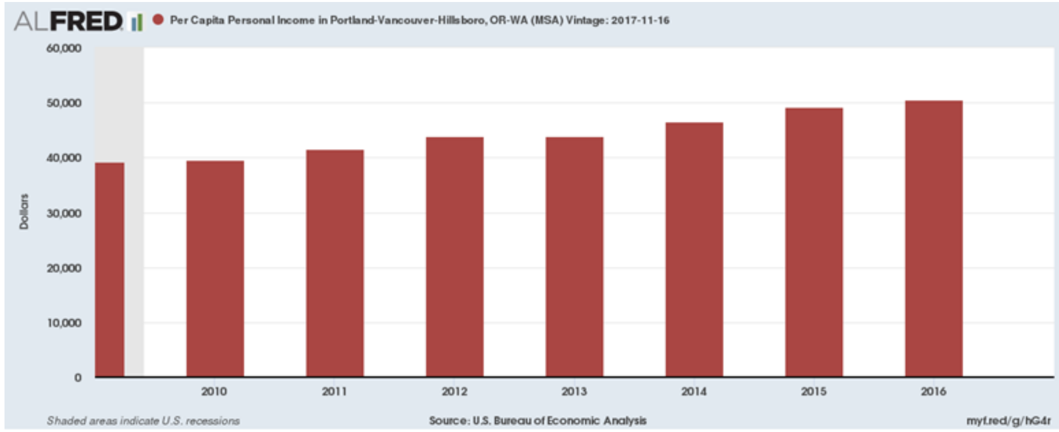


Figure 3 - Vacancy Rates in Portland - Costar

VACANCY RATE

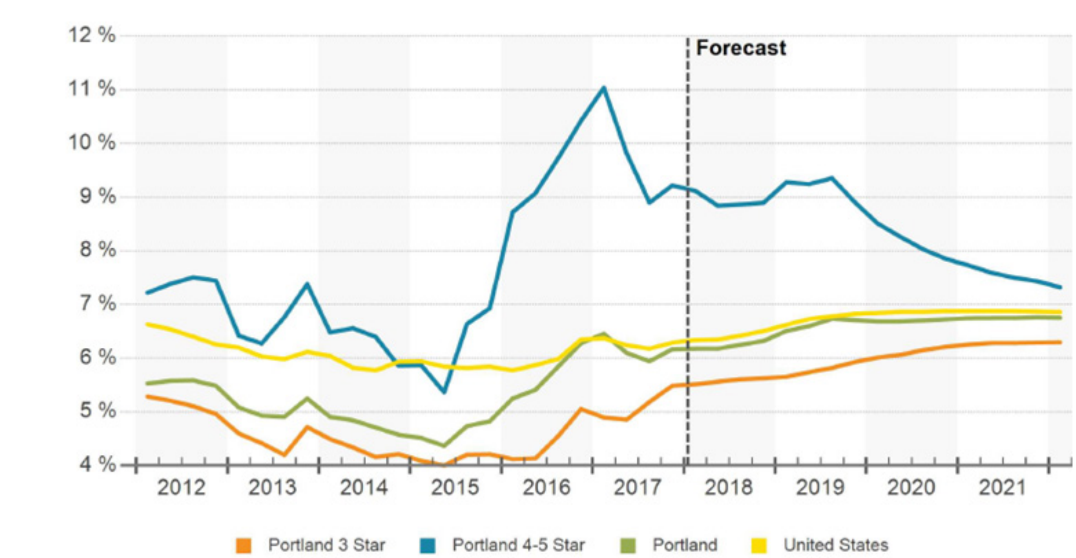


Figure 4 - Rents in Portland - Costar

DAILY ASKING RENT PER SF

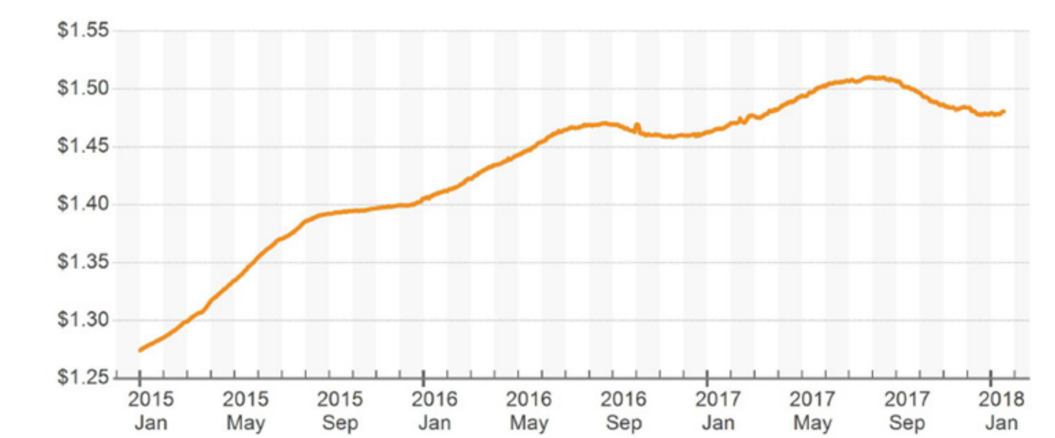


Figure 5 - Fee-in-lieu Schedule

Within Central City Plan District

Zone/FAR		Fee per GSF
3.0/4.0	*Base FAR*	**$27.39**
3.0/4.0	*Base with Bonus FAR*	**$28.57**
5.0/6.0	*Base FAR*	**$28.57**
5.0/6.0	*Base with Bonus FAR*	**$28.99**
8.0	*Base FAR*	**$28.99**
8.0	*Base with Bonus FAR*	**$29.81**
9.0	*Base FAR*	**$29.81**
9.0	*Base with Bonus FAR*	**$29.42**
12.0	*Base FAR*	**$29.42**
12.0	*Base with Bonus FAR*	**$29.85**
15.0	*Base FAR*	**$27.39**
15.0	*Base with Bonus FAR*	**$28.57**

Outside Central City Plan District *(before December 31, 2018)*

Zone/FAR	Fee per GSF
CN1, CO1, CO2, CM, CS, CG, CX plus EG1, EG2, EX and R3, R2, R1, RH and RX zones	**$19.50**

Outside Central City Plan District *(after December 31, 2018)*

Zone/FAR		Fee per GSF
CM1	*Base FAR*	**$23.83**
CM1	*Base with Bonus FAR*	**$25.79**
CM2	*Base FAR*	**$25.79**
CM2	*Base with Bonus FAR*	**$26.50**
CM3	*Base FAR*	**$26.03**
CM3	*Base with Bonus FAR*	**$28.58**

GSF= Gross Square Feet

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