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October 5, 2023

Carrie Tai
Director
Community Development
City of Hermosa Beach
1315 Valley Drive
Hermosa Beach, CA 90254

Re: City of Hermosa Beach Land Value Recapture – Summary of Methodology

Dear Ms. Tai,

The City of Hermosa Beach ("City") retained Kosmont Companies ("Kosmont") to evaluate potential provisions of the City's proposed Land Value Recapture ("LVR") program. The LVR program is intended to "capture" added land value on properties within certain commercial corridors on which the City is allowing residential development through rezoning actions. The LVR program is intended to incentivize the development of affordable housing within the City. To ensure that new developments result in production of affordable housing units in the City, the City proposes to levy this fee. Developments may be exempted from the fee if they include affordable housing. Fees paid would support the development of affordable housing units elsewhere in the City. The summary of methodology herein ("Summary") highlights pertinent assumptions utilized in evaluating the potential number of affordable units to be required within a residential development in order to be exempt from the fee, as well as the potential amount of the fee that the City may desire to initially levy under the LVR program.

As summarized herein, Kosmont's analysis ("Analysis") generally indicates that requiring residential projects to include a set aside of 10% very low-income, 15% low-income, 20% moderate-income units, or alternatively, pay a fee of approximately $60 per net residential square foot may be justifiable for the initial implementation of the LVR program. It is expected that the City will need to regularly revisit the amount of the fee, and potentially the exemption set-aside requirements, as fundamental inputs to the Analysis highlighted in this Summary will change over time.

The figures presented in this Summary are based on an evaluation of the potential impact to value of requiring the various percentages of affordable housing in a given multifamily (rental) development versus an exclusively market rate development. The impact of requiring affordable housing as part of a *for sale* development is generally considered to be greater than the figures presented herein. Given current real estate market conditions, it is expected that the developer of a for sale project would likely opt to pay the fee rather than include affordable housing in such development. However, each development has unique economics.

The assumptions presented in this Summary represent one of many potential development scenarios evaluated as part of the Analysis completed, though could generally be considered a baseline set of assumptions. Finally, the assumptions herein are based on a review and modeling of inputs including real estate market conditions specific to the City, current affordable housing guidelines in the State of California ("State"), Los Angeles County Development Authority ("LACDA") guidance on monthly housing expenditures for utilities, and the potential relationship between the LVR program and State Density Bonus Law (Government Code § 65915 – 65918).

<u>Summary of Baseline Assumptions & Methodology</u>

1. Maximum Housing Expenditures (Multifamily / For Rent)

Maximum monthly affordable housing expenditures were calculated based on Health & Safety Code § 50053 which provides that very low-, low-, and moderate-income households shall not expend more than 30% of 50%, 60%, and 110% of the area median income ("AMI") on housing, respectively. The AMI for Los Angeles County as published by the California Department of Housing and Community Development ("HCD") is $98,200 for 2023. The calculated amounts were adjusted for unit sizes (bedrooms) and household size (persons) based on HCD guidance. To determine the maximum amount of monthly rent as a share of total housing expenditures, allowances for utilities as published by LACDA for the 2023 all electric schedule were deducted from the calculated amounts. The household size assumptions and utility allowances follow below.

	Bedrooms			
	Studio	1	2	3
Household Size (Persons)	1	2	3	4
Household Size Adjustment	70%	80%	90%	100%
Monthly Utility Allowance	$ 193	$ 227	$ 262	$ 309

Based on these factors, the maximum monthly rent for very low-, low-, and moderate-income households was calculated to be the amounts below.

Maximum	Bedrooms			
Monthly Rent	Studio	1	2	3
Very Low	$ 666	$ 755	$ 843	$ 919
Low	838	951	1,064	1,164
Moderate	1,697	1,933	2,168	2,392

2. Market Unit Size, Distribution, & Rent

Based on a review of data from sources including CoStar, Zillow, and the Los Angeles County Office of the Assessor, assumptions on the square footage of units of different sizes (bedrooms), the ratio of unit sizes, and market rents were developed. A summary of these assumptions follows below. For reference, monthly market rents are based on rates of $4.75 / $4.50 / $4.00 / $3.75 per square foot for studio / one-bedroom / two-bedroom / three-bedroom units, respectively, and are considered moderately conservative relative to general market comparables in the City.

	Bedrooms			
	Studio	**1**	**2**	**3**
Ratio	15%	45%	35%	5%
Square Feet	475	700	950	1,150
Market Rent	$2,256	$3,150	$3,800	$4,313

3. State Density Bonus Provisions

Density Bonus Law allows residential developments that include income restricted units to develop more units than may otherwise be provided under City code. The increase in total units allowed is based on the percentage and depth of affordability provided. The contemplated LVR program requirement of 10% very low-, 15% low-, or 20% moderate-income units would entitle a developer to increase the total number of units in a development by 32.5%, 27.5%, and 15.0%, respectively. Density Bonus Law applies to developments with five or more units, includes a *roundup* provision on calculations, and provides for other concessions by right including increases in height, and reductions in setback requirements.

As an example, assuming a 100-unit residential development, if 10 units were restricted to very low-income households, a total of 133 units could be developed; if 15 units were restricted to low-income households, a total of 128 units could be developed; and if 20 units were restricted to moderate-income households, a total of 115 units could be developed. The calculations in this Summary assume that a development including enough affordable units to be exempt from the LVR fee would utilize the benefits of Density Bonus Law.

4. Impact on Rental Revenue

Despite the accretive provisions of Density Bonus Law, the inclusion of affordable units within a residential development was generally found to have a negative impact on overall rental revenue. It is assumed that market and affordable units will have similar operating costs. The overall impact to blended gross rent is provided below. For reference, the figures are compared to assumed market rents illustrated above, and blended figures are weighted averages based on unit bedroom count distributions / ratios identified in Section 2 above. As an example, this calculation provides that a 115-unit residential development that included 20 units restricted to moderate income households with 15% studio / 45% one-bedroom / 35% two-bedroom / 5% three-bedroom units would realize an average reduction in gross revenue of $226 for each of the 115 units, each month.

	Bedrooms				
Average Rent	**Studio**	**1**	**2**	**3**	**Blended**
Very Low	$2,137	$2,970	$3,578	$4,057	$ 3,112
Low	2,090	2,892	3,479	3,944	3,030
Moderate	2,159	2,938	3,516	3,978	3,076

	Bedrooms				
Delta From Market	**Studio**	**1**	**2**	**3**	**Blended**
Very Low	$ 120	$ 180	$ 222	$ 255	$ 190
Low	166	258	321	369	272
Moderate	97	212	284	334	226

5. Capitalized Value

Multifamily real estate is generally valued based on capitalization ("cap") rates that convert net annual rental income to a present value. Cap rates represent the initial rate of return on the total cost of project investment. Cap rates in the City are generally lower than other regional markets, indicating that investors are willing to pay more for properties in the City than they would for another property with the same income stream in an *inferior* market with more perceived risk. In this step of the Analysis, the impact of the inclusion of affordable housing units within a given development was evaluated on a present value basis utilizing a hypothetical 4.5% cap rate. This rate is higher than recent multifamily property transactions in the City, however is thought to be reasonable on a forward-looking basis as cap rates are increasing due to increases in interest rates and required rates of return. For reference, a lower assumed cap rate would increase the value impact per square foot discussed in Section 6 below.

Capitalized	Bedrooms				
Impact to Value	**Studio**	**1**	**2**	**3**	**Blended**
Very Low	$ 4,200,000	$ 6,400,000	$ 7,900,000	$ 9,100,000	$ 6,700,000
Low	5,700,000	8,800,000	10,900,000	12,600,000	9,300,000
Moderate	3,000,000	6,500,000	8,700,000	10,200,000	6,900,000

Note: The value / cost impacts illustrated above are based on a 133-, 128-, and 115-unit development that included 10% very low-, 15% low-, or 20% moderate-income units, respectively.

6. Value Impact Per Square Foot

The final step of this method of evaluation is to consider the impact to value on a per square foot basis. The total leasable square footage, and impact to value on a per square foot basis are illustrated below. These figures reflect the unit square footages identified in Section 2 above, and the total unit counts identified in Section 3 above (e.g., a 133-, 128, and 115-unit development).

Gross Leasable SF	Studio	Bedrooms 1	2	3	Blended
Very Low	63,175	93,100	126,350	152,950	103,241
Low	60,800	89,600	121,600	147,200	99,360
Moderate	54,625	80,500	109,250	132,250	89,269

Value Impact / SF	Studio	Bedrooms 1	2	3	Blended
Very Low	$ 67	$ 69	$ 62	$ 59	$ 66
Low	93	98	90	86	94
Moderate	55	81	80	77	76

Based on the blended rates in the table above, and given the assumptions identified herein, levying a fee of $66 – 94 per net (leasable) square foot of residential development would conceptually be considered economically equivalent to a developer as delivering affordable housing as part of a given development.

Findings

Based on the information presented in this Summary, a LVR fee of approximately $66 – 94 per net square foot of residential development is appropriate given a requirement for the inclusion of 10% very low-, 15% low-, or 20% moderate-income units as part of a residential development on eligible commercial properties in the City. In light of current real estate market conditions, and the infancy of the LVR program, Kosmont finds a fee of approximately $60 per net square foot of residential development is justifiable as an initial rate. The City should plan on revisiting the fee based both on the market response relative to the intent of the LVR program, and as the inputs to the calculation illustrated herein change over time.

Kosmont is available to further discuss its findings as desired at your convenience.

Yours truly,

Wil Soholt
Senior Vice President