DATE: FEBRUARY 26, 2001

TO: PASADENA COMMUNITY DEVELOPMENT COMMISSION

FROM: CYNTHIA J. KURTZ, CHIEF EXECUTIVE OFFICER

SUBJECT: AMENDMENT TO OWNER PARTICIPATION AND LOAN AGREEMENT; INCREASE OF $140,400 IN AMOUNT OF LOAN ASSISTANCE TO BUYERS OF 12 AFFORDABLE HOUSING UNITS IN THE HERITAGE WALK CONDOMINIUM PROJECT

RECOMMENDATION:

It is recommended that the Pasadena Community Development Commission ("Commission") approve the terms and conditions of the First Amendment to the Second Amended and Restated Owner Participation and Loan Agreement between Encanto Walk, LLC and the Commission (Exhibit "A"), and authorize the Chief Executive Officer to execute all documents and take all other actions as appropriate.

ADVISORY BODIES

The Community Development Committee considered the subject recommendation at its meeting on February 22, 2001. Staff will report to the Commission on the action taken by the Committee.

EXECUTIVE SUMMARY

The subject recommendation would increase by $140,400 the amount of Commission home buyer loan assistance to assist the sales of the remaining 12 moderate income units in the 38-unit Heritage Walk condominium project located at 620 E. Walnut Street ("Project"). Presently, $420,000 in home buyer loan assistance is available under the terms of the Second Amended and Restated Owner Participation and Loan Agreement ("OPLA") between Encanto Walk, LLC ("Developer") and the Commission. The recommended increase would result in a total of $560,400, or $46,700 per moderate income unit. The recommendation is in response to the Developer's request and disclosure, which were evaluated by financial consultant Keyser Marston Associates, that Project costs have increased substantially and that, despite diligent efforts, the Developer has found it difficult to identify moderate income buyers possessing the high degree of financial capability required to purchase the moderate income units.

BACKGROUND

On September 28, 1998 the Commission and the Olson Company entered into that certain Second Amended and Restated Owner Participation and Loan Agreement (the "OPLA") in connection with the development of the Project. The OPLA was assigned by The Olson Company to the Developer pursuant to that certain Assignment, Assumption and Release Agreement, and amended by that certain First Loan Modification Agreement, both dated November 4, 1998. The OPLA required the Developer to, among other things, sell 18 of the Project's dwelling units to moderate income home buyers at an affordable housing price; the other 20 units would be sold at market rate. Pursuant to the OPLA, the Developer owed the Commission $1,110,000. Of this amount, the Developer is required to repay the Commission $480,000 from dwelling unit sale proceeds. The balance, $630,000 would be recast as loans to assist the 18 moderate income buyers under the Commission's Homeownership Opportunities Program ("HOP"). The $480,000 has been repaid.

Two issues have lead to the Developer requesting revisions to the terms of the OPLA: 1) Project costs have increased substantially; and 2) the Developer has found it difficult to identify moderate income buyers possessing the high degree of financial capability required to purchase the designated 18 units.

The Developer has disclosed that the Project is in financial hardship due to substantial increases in project costs totaling approximately $1.91 million. Of this amount, approximately $1.0 million is due to the unforeseen escalation in construction industry costs for labor and material. The balance of $0.91 million is attributable to unanticipated increases in architectural and engineering fees as a result of required design changes and enhancements; on-site costs due to sidewalk closure permits and restricted access from adjacent properties for constructing staging; and financing costs associated with an extended construction schedule and dwelling unit absorption period.

Furthermore, the Developer has advised staff that they had found very few moderate income households which could afford to purchase the units under the current sale prices and Commission HOP loan assistance structure, and would not be able to meet the 18-unit requirement within their projected absorption period. In fact, despite diligent efforts by the Developer's marketing and mortgage financing team, only six moderate income units have been sold to date, all to buyers comprised of one- or two-person households at the top of the qualifying income range (120% of median) with excellent credit and who had the capacity to contribute, on average, a 20% down payment. In comparison, 13 of the 20 market rate units have been sold.

The City issued Certificates of Occupancy for the Project in the last week of December 2000. The Developer has requested that the Commission issue a Certificate of Completion for the Project, as provided under the OPLA. An inspection of the Project will be performed by Housing and Development staff, within the next two weeks, prior to release of the Certificate of Completion, to ensure that the Project complies with the OPLA's Scope of Development.

FINANCIAL ANALYSIS

When the OPLA was negotiated in October 1998, the Commission and Developer estimated that $630,000 in HOP loan assistance would be sufficient to bridge the gap between the sale prices for the 18 moderate income units and what a moderate income buyer could afford. State law allows affordable housing prices to be based on the home buyer's actual down payment contribution, other available financial assistance (e.g., the Commission's HOP loan and income tax credits through the Los Angeles County Mortgage Credit Certificate program) and, most critically, the household's actual income. Determination of qualifying moderate income limits is based on the buyer's household size; the larger the household the higher the income limit. Accordingly, the Developer based its marketing and pricing on households consisting of three or more persons at the top of the moderate income range (120% of median) with a 10% down payment, and established sale prices of $227,00 for the two-bedroom units and $250,000 for the three-bedroom units. However, in order to recover costs and in response to the upturn in the real estate market within the last two years, the Developer has increased its moderate income unit sale prices to $253,000 and $300,000, respectively (the sale prices of the market rate units were also increased). While the moderate income unit prices, with Commission HOP assistance, meet the affordable cost definition under state law, in actuality their affordability applies to a narrow band of moderate income households who possess the financial profile necessary to purchase the designated units (i.e., top of moderate income range, 20% down payment, excellent credit).

Keyser Marston Associates ("KMA") reviewed the Developer's request and project pro formas, and noted the following:

1. The Project will experience an unfunded affordability gap unless all 18 moderate income units are sold to households at the top of the qualifying income range (120% of median) that can also contribute a minimum 20% down payment. This gap implicitly represents a cost that would have to be borne by the Developer.

2. The Project development costs are approximately equal to the sales revenue assuming that all 38 units could be sold on an unrestricted basis at market prices. Under this hypothetical scenario the Developer would break even. However, in actuality, the revenue received by the Developer from the sale of moderate income units would be net of the Commission HOP financing amount. For example, on the sale of a $300,000 moderate income unit with a $35,000 Commission HOP loan, the Developer would receive $265,000 in proceeds.

Based on these factors, KMA concluded that there is no scenario under which the Project could generate any profit to the Developer. Moreover, if the existing transaction structure remains in place, KMA estimated that the Developer could incur a net loss of up to $1.12 million. This clearly indicates that the Project is in financial jeopardy, and the Developer may ultimately deem it financially prudent to allow the construction lender, Wells Fargo, to take the Project back. This would result in a loss of the affordable covenants. The staff proposal amending the OPLA permits the sharing of the cost increases and allows the Developer to recover a portion of its losses.

PROPOSED AMENDMENT TO OPLA

Upon reviewing KMA's financial analysis and after further consultation with KMA, staff determined that the most acceptable restructuring alternative is to increase the amount of Commission HOP loan assistance for home buyers of the remaining 12 moderate income units. Presently, $420,000 in Commission HOP financing are available to assist moderate income buyers in the Project. Assuming that an average HOP loan of $46,700 is needed to meaningfully increase the affordability of the remaining 12 moderate income units, the Commission would need to provide additional funding in the amount of $140,400, for a total of $560,400.

In consideration of the increase in the average amount of Commission HOP loan assistance to moderate income home buyers, staff and KMA concurred that the amount of contingent interest to which the Commission is entitled to receive in the event of resale should be increased, particularly during the first 5 years of the HOP loan term. This would be achieved by increasing the Applicable Percentage, a factor used to calculate the Commission's contingent interest amount (see attached Applicable Percentage schedule, Exhibit "B").

As an alternative to increasing the amount of HOP loan assistance to the moderate income home buyers in the Project, the Commission may wish to consider reducing the moderate income units required in the OPLA from 18 to 15, while maintaining the HOP loan assistance at $630,000. The 15 moderate income units represent 39% of the Project's total dwelling units. The 15 units would consist of 11 two-bedroom units and 4 three-bedroom units (the OPLA currently requires 12 two-bedroom units and 6 three-bedroom units). The Developer has sold 6 two-bedroom units to moderate income buyers with HOP loan assistance totaling $210,000 ($35,000 per unit). Therefore, HOP assistance in the amount of $420,000 would be available for the remaining 9 moderate income units, for an average HOP loan of approximately $46,700 (compared to the current $35,000 average).

Both options -- either providing additional Commission home buyer assistance or reducing the number of assisted units -- result in an average HOP loan of approximately $46,700, compared to $35,000 under the existing OPLA. This per-unit subsidy for affordable ownership housing is less than the $50,000 limit approved by the Commission in 1996 for another Downtown project (80 N. Raymond Avenue). Under both options, a potential buyer would not necessarily have to be at the top of the qualifying moderate income band or need to make a down payment as high as 20%, thereby broadening the pool of potential moderate income buyers in the Project.

HOUSING IMPACT

Approval of the subject recommendation will increase the per-unit amount of Commission loan assistance available to moderate income home buyers in the Project, thereby expanding the pool of potential qualified buyers and facilitating the marketing and sale of the remaining 12 moderate income units.

FISCAL IMPACT

Approval of the subject recommendation will increase by $140,400 the total amount of Commission HOP loan assistance available to qualified buyers of the remaining 12 moderate income units in the Heritage Walk project, from $420,000 to $560,400. The additional loan funds shall be drawn from the Commission's Low and Moderate Income Housing Trust Fund. For the sale of those moderate income dwelling units assisted with a Commission HOP loan exceeding $35,000, the Commission shall be entitled to recapture a greater amount of contingent interest upon resale. In the example described in Exhibit "B", the increase in the Commission's contingent interest would be approximately 88%.

Respectfully submitted,

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