THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Review of Proposed Affordable Housing Development Documents for 101 Ash Street

OVERVIEW

On July 29, 2025, the City Council will consider a proposal to enter into a Disposition and Development Agreement (DDA), 60-year Ground Lease Agreement (Lease), and a $45.6 million City Promissory Note (Note) with 101 Ash Venture LP to adaptively reuse the vacant, City-owned property at 101 Ash St. San Diego, CA 92101 into 247 units of deed-restricted affordable housing plus three unrestricted managers units, an on-site child-care facility, and retail space.

If approved, this action would enable the City to open escrow with 101 Ash Venture LP and provide them with the opportunity to finance and develop the proposed project, should they meet the requirements outlined in the Performance Schedule during the pre-development financing period and construction development period.

This report discusses the financial feasibility of the project as well as the fiscal impacts to the City. It also provides additional considerations and context for key elements of the project including: the City Promissory Note, total costs of the project, risk mitigation, the developer fee, and use of two different appraisals.

The actual development being proposed is typical of affordable housing development projects, though the history of the 101 Ash property over the past decade merits both public scrutiny and increased transparency. We therefore conclude with a recommendation that Council and the public be updated periodically regarding future material changes to the project and operation of the property.

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BACKGROUND

In IBA Report 20-18, our Office provided a high-level timeline of the City's relationship with the 101 Ash Street property between July 2016 and July 2020. Since that report, there have been additional major milestones related to the City's acquisition and planned development of the property.

In July 2022, the City purchased 101 Ash Street for $86 million and Civic Center Plaza for $46 million. In April 2023, five blocks in the Civic Core area, including 101 Ash Street, was declared surplus land under the Surplus Land Act (SLA) and was made available to interested developers in a Notice of Availability (NOA); the City received only one conforming response to that NOA, which specifically pertained to 101 Ash Street. However, after good-faith efforts, the City and the respondent were unable to reach an agreement.

In the summer of 2024, the City received three unsolicited bids for 101 Ash, each with different plans to redevelop the property. A proposal to purchase the building and convert it into short-term homeless housing was rejected, but the remaining two proposed plans to convert the building into permanent affordable housing were further negotiated. In January 2025, the development team of MRK Partners and Create Dev LLC, who later formed 101 Ash Venture LP, was selected to exclusively negotiate further details of the proposed development terms. The development proposal before City Council is the result of those negotiations.

FISCAL AND POLICY DISCUSSION

Together with our real estate consultant Kosmont Companies, our Office reviewed the financial and economic feasibility of the proposed 100% affordable housing project with the current financial models, development documents, and economic assumptions available as of this writing. As with any development project, but 100% affordable housing development projects in particular, it is expected that certain economic and fiscal assumptions will need to be updated in the future to maintain the feasibility and intent of the proposed project. Given this, **our analysis is a point-in-time review of the project**; further refinement of the proforma, unit mixes, and Area Median Income (AMI) mixes, and other elements should be anticipated in the normal course of underwriting and securing financing if the proposal is approved by City Council.

This section of our report focuses first on the economic feasibility of the project, then the fiscal impacts of the proposal on the City, and finally additional considerations and context associated with the proposed development.

<u>Economic Feasibility of the Proposed Project</u>

The economic feasibility of the proposed project, like all traditionally financed affordable housing projects, is determined by evaluating the development budget, including sources of funding, operating costs, and income. As part of the City finding that the proposed development fulfills economic objective consistent with California Government Code 52201, Keyser Marston Associates (KMA) was used by the City's Economic Development Department to publish an

Economic Opportunity Report. Tables 1 – 7 of the report make up a draft proforma, or hypothetical financial model, for the proposed project and are the basis for our review.

The proforma provides estimated costs and income for the total development and on a per unit basis. In general, our review found that the pro-forma makes reasonable and appropriately conservative assumptions. Regarding the per unit basis, while this is a helpful metric, we note it does not account for the nuance that over 50% of the units in the project are proposed to be two-bedroom and three-bedroom units. This blend of units – which is anticipated to provide housing that is appropriate for families - is more costly than projects that are exclusively studio and one-bedroom units. For this reason, our analysis primarily focuses on the total costs of individual line-items in the budget as a percentage of the Total Development Cost (TDC).

Total Development Cost (TDC)
The draft estimated TDC for the proposed project is $267.6 million. We consider this to be a conservative to realistic estimate. It is important to note, however, that the estimated TDC will be different from the final TDC after the project is completed.

TDC can be broken down into the following cost types:

1. *Direct Costs:* At $157.4 million, or 58.8% of the TCD, direct costs are the largest cost category, and include site preparation, conversion from office to residential and commercial, labor costs, and contingency.

   The largest direct construction cost is anticipated to be $67.0 million in materials and equipment to convert the existing office space into residential units. The second largest direct cost is $40.7 million to remove or encapsulate asbestos in the building. These estimates have been informed by multiple site visits by the developer, general contractor, and subcontractors. The third largest direct cost is a $20.5 million contingency budget (equal to 17.4% of direct costs). A contingency to cover unexpected costs is a standard requirement; a 17.4% contingency is higher than typically associated with new construction, but is a reasonable amount for an adaptive reuse project with higher levels of uncertainty involved.

   Lastly, State prevailing wages make up $18.5 million in costs, which is in line with a 2024 analysis by the Terner Center on the cost to construct Low-Income Housing Tax Credit (LIHTC) projects with prevailing wage requirements in California.[1]

   Direct costs are often most adversely impacted by changes to interest rates, material costs, and labor costs.

2. *Indirect Costs:* Indirect costs are budgeted at $42.3 million, which is 26.8% of the direct costs and 15.8% of the TDC.

[1] Terner Center. "Low-Income Housing Tax Credit Construction Costs: An Analysis of Prevailing Wages." August 2, 2024. ternercenter.berkeley.edu/research-and-policy/lihtc-construction-costs-prevailing-wages.

The largest indirect cost is $32.7 million, 12.2% of the TDC, for the developer fee. As will be discussed in more detail later, the developer fee is based on a prescriptive formula prescribed by California Tax Credit Allocation Committee (CTCAC) regulations that apply to all Low-Income Housing Tax Credit (LIHTC) affordable housing projects and contribute to the project's ability to apply for more tax credits to fund the project.[2] Of the total developer fee, about $3.8 million will be paid up-front at construction finance closing, and the remaining $28.9 million will be deferred and paid from the project's cash flow during operation.

3. *Financing Costs:* The financing costs for the proposal are $22.3 million in interest, fees, and reserves. The largest financing cost is $16.3 million, 10.4% of TDC, for interest on the construction loan before the project is completed, occupied, and converted to a lower interest, long-term permanent loan. At 10.4% of TDC, the construction interest budget is higher than typical for new construction, but this reflects a conservative assumption to protect against interest rate increases in the near term and construction timeline uncertainty associated with adaptive reuse of an existing building.

4. *Acquisition Costs:* The City is ***not*** proposing to sell the property to 101 Ash Venture LP, but is instead proposing to enter into a long-term, 60-year ground lease where the City would maintain ownership of the property.

   The $45.6 million "acquisition cost" is based on a developer-commissioned appraisal of the property using a cost approach methodology.[3] This methodology values the property as the replacement cost for a new building minus physical depreciation of the existing building, and does not include the land value. CTCAC regulations require this methodology to determine tax credit amounts. As will be discussed in more detail in the City Promissory Note section of the proposed project's funding sources, the developer will not be paying the City $45.6 million up front, but is budgeting the acquisition cost of the property to increase the amount of LIHTC credits the project will be able to apply for. This is a common, and advantageous structure permitted by CTCAC to encourage municipalities to long-term lease developable properties for affordable housing.

   Notably, an appraisal using the required cost-basis methodology here results in a significantly higher appraised value than a sales or income-capitalization methodology. The cost-basis appraisal is helpful both in the developer's ability to acquire LIHTC credits *and* in the developer's obligation to later remit residual receipts payments back to the City; in another scenario where the City would simply sell the property outright, the appraised value of the property – and any payments the City would receive for that sale – would be *significantly* less than $45.6 million.

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[2] California Tax Credit Allocation Committee. "Regulations (Qualified Allocation Plan)." Section 10327(c)(2)(B), December 11, 2024. treasurer.ca.gov/ctcac/programreg/regulations.asp

[3] The three primary appraisal methods are the Sales Comparison Approach (which estimates value based on comparable property sales), the Income Capitalization Approach (which values property based on its income-generating potential), and the Cost Approach (which estimates value based on the cost to replace or reproduce the improvements, less depreciation, plus land value).

Sources of Funding

The sources of funding for the proposed project should be equal to the TDC of the project to ensure there are not any gaps or overfunding. As of this report, the developer has identified seven funding sources, of which we analyzed the five largest. Similar to how estimated project costs can increase or decrease with changes in economic conditions, the amount of funding available and sources of funding to a project will change with economic conditions.

1. *Supportable Permanent Loan:* The developer uses a Debt-Service Coverage Ratio (DSCR) approach to determine a supportable permanent loan amount, which relies on an annual Net Operating Income (NOI) of $5.2 million in year 1 of operation, a 6.50% interest rate, an amortization term of 40 years, and a debt coverage ratio of 1.17.[4] This would allow the developer to support a permanent loan of $63.4 million. Our Office and our real estate consultant believe these economic assumptions are reasonable.

2. *Low Income Housing Tax Credit (LIHTC):* LIHTC is a federal program that awards tax credits to private developers in exchange for creating affordable rental housing. Developers can then sell these tax credits to other investors, who buy these credits to reduce their own tax obligations. This sale of tax credits provides upfront equity to help finance projects.

   There are both 9% and 4% tax credits available, though 9% tax credits are highly competitive. The 4% credits are less competitive and more widely available but only cover around 30% of TDC. The developer plans to apply for 4% credits in September 2025 which is the final round of calendar year 2025. If they are unable to make that deadline or their application is unsuccessful, they will need to wait until calendar year 2026, when there will be additional 4% tax credit application rounds.

   The project assumes $87.8 million in funding from 4% credits. This amount is based on a CTCAC formula that considers the eligible costs (basis) of the project, the fact that the project gets a basis boost by being in a Federally designated Difficult to Develop Area (DDA), the 4% tax credit rate, and an assumption that tax credits are expected to be sold to investors at 86¢ on the dollar. We believe the estimated LIHTC funding amount to be a conservative to realistic estimate, and note that every additional cent on the dollar that the credits are sold at will generate an additional $1.0 million in funding for the project.

3. *Historic Tax Credit (HTC):* The proposed project anticipates applying for Federal Historic Tax Credits, which is an incentive program to rehabilitate and reuse historic properties. Funding from the sale of the HTCs is estimated to generate $36.1 million for the project. We note the property is not currently registered as a historic resource, but the developer intends to apply for historic designation from the National Parks Service in the U.S. Department of the Interior, and is confident in the receipt of this designation because the building was designed by a master architect and constructed by a master builder. Of the three-part application, parts 1 and 2 will need to be completed before escrow and

[4] A debt coverage ratio of 1.17 means that the project generates 17% more income than is needed to pay the loan. Therefore, the loan is sufficiently supported by the project's projected NOI.

construction closing, but are generally reviewed at the State and Federal levels within 60 days of a completed application.[5]

4. *Deferred Developer Fee:* As noted previously, the entire developer fee for the proposed project is $32.7 million, or 12.2% of the TDC. However, per CTCAC regulations, any fee above $6.0 million will need to be deferred from the up-front cash fee at closing, and will be repaid from the project's operating income.[6] Not only is the deferral of excess developer fee required under regulations, but it also helps the project fill financing gaps without increasing the project's debt.

   In this case, the developer will take out an upfront fee of $3.8 million at the close of escrow and construction finance from its financing proceeds, and the remaining $28.9 million will be deferred with 2.0% simple interest that will come from the project's cash flows after operating expense, debt service, reserve deposits, and fees, but before the City's 50% of residual receipts[7], as further discussed in the next section.

5. *City Promissory Note:* The $45.6 million promissory note from the City, also known as carryback financing or a deferred payment note, is *not* a cash loan from the City, but is instead a promise from the developer to repay the cost-approach appraised value of the property. Instead of the City receiving an up-front cash payment from the developer for the value of the property's ground lease, the developer will pay back the City the value of the note plus 4.0% simple interest from 50% of the property's residual receipts during operation.

Fiscal Impact on the City

Similar to any other disposition of City-owned real estate, the financial benefit the City will receive from this transaction is confined by the State Surplus Land Act (SLA) and the City's obligation to maximize public benefit - not profit - while balancing fiscal responsibility. While the total revenue the City can expect to receive from this transaction over the 60-year period is relatively small, since this is a 100% affordable housing deal, levers to maximize the City's financial benefit need to be balanced against their potential negative impact on the proposed project's construction financing and long-term operating success. Additionally, as will be discussed later under 'Different Appraisals' in this report's Additional Considerations section, the financial value the City could receive through the sale of this property to another entity for another purpose is also limited.

Financial benefits to the City associated with this proposal are largely related to the potential to offload current ongoing maintenance and security costs, future proceeds related to developer refinancings and the eventual payment of residual receipts to the City, and base rent amounts. It is also notable that at the conclusion of the lease term the improved building would revert to the

[5] If the developer applies for 4% Low Income Housing Tax Credits at the September 9, 2025 CTCAC deadline and is awarded them on the November 19, 2025 award date, they will have 180 days to close escrow and construction financing, which would give them until approximately the end of May 2026.
[6] California Tax Credit Allocation Committee. Section 10327(c)(2)(B)(iii)
[7] Residual receipts are the surplus cash remaining from a property's operations after paying all operating expenses, required reserves, and debt service, which is then typically used to repay subordinate loans or deferred developer fees.

City's control, though this reversion assumes no lease extension or renegotiation. These are each discussed below.

Maintenance, Operation, and Security

From FY 2023 through FY 2025, the City spent approximately $7.2 million, $2.4 million annually, on the maintenance and operation contract for 101 Ash Street. In FY 2026, an additional $2.6 million is budgeted for the same purpose. If the City approves the proposed project, the City will still be responsible for the operation and maintenance costs of the property until the close of escrow when the developer takes full responsibility for the maintenance, operation, and security of the site. As noted in footnote 3, the soonest the developer would be responsible for the property would be the end of May 2026. This standard structure limits liability, minimizes pre-development carrying costs for the developer, and transfers the ongoing costs to the developer only when they have full site control at the close of escrow.

Capital Event Fee

When the property's debt is refinanced or the leasehold estate is sold, 2.0% of the net proceeds of the capital event are proposed to go to the City. For example, in year 15 when the project has higher and more stable NOI, with the City's permission the developer may refinance its initial $64 million permanent supportable loan with a larger $78 million refinanced permanent supportable loan. Of the $14 million in net proceeds, the City would receive $280,000. Year 15 is often when LIHTC projects refinance, resyndicate (i.e. securing new tax credits), or sell because it is the end of the Internal Revenue Service's (IRS) 15-year monitoring period to ensure the project complies with the tax credit award obligations.

City Note Residual Receipts

The proposed City Promissory Note is for $45.6 million with 4% simple interest over a 55-year period and will be repaid from 50% of residual receipts. Residual receipt loans are a way for government agencies like the City to provide below-market financing with flexible terms (i.e., soft debt) to affordable housing projects to help them leverage more financing. Repayment of the note will be subordinate to any other private debt, which is a standard underwriting requirement from lenders.

The project's NOI will first go to paying down debt from permanent loans, fees paid to the Limited Partner and General Partner, asset management fees, and deferred developer fees. After this, 50% of the remaining cash flow can be used to begin paying down the City Note. Based on the KMA proforma, the more senior debts deplete the NOI in the first 15 years of operation, not leaving any residual cash flow to be distributed to the City until after a capital event potentially occurs in year 15. While there are many variables that could significantly change the City's revenue from residual receipts, the KMA proforma models a total of $86.4 million in revenue to the City over the 60-year ground lease term, though given inflation and the time-value of money, the net present value of this amount is lower.[8]

[8] Net Present Value (NPV) accounts for inflation and the time-value of money by discounting the value of future dollars. KMA calculated that the NPV of the City's residual receipt revenue would be $2.9 million by assuming an annual discount rate of 10%. A 10% discount rate is particularly high; a discount rate more reflective of actual inflation or the City's cost to borrow money would typically be closer to 5%. At a 5% discount rate, the NPV of this amount would be $11.0 million.

Base Rent

The base rent of the lease will be $15,000 and will increase annually by the greater of 3.0% or the Consumer Price Index (CPI). In the grand scheme of the project's total net operating income (NOI), the base rent only accounts for about 0.3% – 0.6% of the total NOI. While more profitable base rent structures could be negotiated, the increased base rent would likely be on such a small scale that it would not have a meaningful positive impact on the City's General Fund but could reduce the amount of permanent supportable loan proceeds the project would be able to take on.

Reversion of Improved Building

At the end of the 60-year lease term, the improved building and its cash flows would revert back to the City. However, this would require the City to be the owner and operator of a multi-family building and take responsibility for its maintenance. In practice, at year 15 when the developer seeks approval from the City to refinance or resyndicate, the City will renegotiate the terms of the affordability covenants and ground lease to maximize the long-term affordability of the property.

Additional Considerations

In addition to the fiscal and economic review of the proposed project, our Office notes five additional considerations for the City Council and the public.

Promissory Note

As previously stated, the $45.6 million City Promissory Note is *not* a cash loan from the City, but seller financing where the developer agrees to pay the City the principal amount plus 4% simple interest from residual receipts. The current KMA proforma does not model a scenario where the full principal and interest of the note is paid back by year 55, though this is common for affordable housing projects with tight cash-flows. The City would need to forgive or write off the remaining balance if it is not repaid.

Project Cost

The current estimated TDC of $267.6 million and per unit cost of $1.1 million is higher than average, but also not unprecedented or without justification. As previously noted, looking at a project's costs solely on a per unit basis may mask relevant nuances, including a unit-mix that includes higher proportions of two- and three-bedroom units. Looking at 314 projects across California that were awarded 4% LIHTC credits between 2023 – 2025, 22 of them (7.0%) had a per unit cost above $1.0 million.

In the specific case of the proposed development project for 101 Ash Street, the higher costs can be reasonably attributed to the larger number of two- and three-bedroom units, as well as asbestos remediation, higher contingency costs associated with adaptive reuse projects, large developer fee, and the cost approach appraised value of the building included in the TDC despite the fact there will not be an upfront cash payment for the value of the ground lease.

Risk Mitigation

Our Office believes the economic and financial assumptions made in the project's proforma are reasonable to conservative estimates likely to protect against unforeseen complications during construction. Additionally, the City and developer have various "off ramps" from the deal during pre-development before escrow closing should there be insufficient performance or financing, including, but not limited to:

1. Termination of the agreement if there is an inability to secure entitlements or financing during the escrow period.
2. The developer must provide payment and performance bonds not less than 100% of the construction costs.
3. The developer will indemnify the City from liability during the project's construction and operation.
4. The City has approval rights over the design and construction drawings.
5. The developer cannot assign the DDA or Lease without prior approval from the City.

The proposed project faces typical development risks, primarily unforeseen construction costs. While asbestos abatement is already accounted for, a conservative contingency budget is in place to absorb potential cost overruns and reduce the likelihood of the developer needing to seek City, County, or State bridge financing during construction.

Developer Fee
At the July 2, 2025, Land Use and Housing (LU&H) committee meeting, the draft KMA report estimated the total developer fee at $24.5 million based on the eligible basis from construction-related costs alone, and did not include the eligible basis from the acquisition-related costs. Including the acquisition basis costs added $6.8 million to the total developer fee. However, the additional developer fee is offset by 1) providing more LIHTC equity to the project since it increases the eligible basis upon which tax credits are calculated and 2) increasing the amount of the developer fee that is required to be deferred. As previously stated, the maximum total developer fee and maximum non-deferred developer fee are based on formulaic regulations from CTCAC.

Different Appraisals
A City appraisal report from Collier International and a developer appraisal report from BBG were both finalized in July 2025. These appraisals were commissioned for different purposes using different methodologies, and their valuation reflect different findings.

The City commissioned an appraisal to establish the fair market value of the property in its as-is condition using the income and sales comparison approach to comply with Council Policy 700-10 and State regulatory requirements. This valuation, which more closely reflects any payment the City could receive for an outright sale of the property came in at $3.9 million, and comes from finding that the highest and best use of the property in its as-is condition would require the current building to be demolished or asbestos abated, which would significantly negatively impact the fair market value of the property. Notably, the appraised amount may be overstated because it did not include the depreciation that would result from any disposition of City property under the Surplus Land Act requiring the inclusion of 15% affordable units in housing development projects.

The developer commissioned its appraisal to establish the cost approach appraised value of the property, not the fair market value of the property. As previously stated, the BBG cost approach valuation of $45.6 million is required by CTCAC for projects involving the adaptive reuse of office buildings to determine the appropriate acquisition basis for the project's LIHTC application.

CONCLUSION AND RECOMMENDATIONS

In many ways, the proposal to convert 101 Ash into 100% affordable housing is unique: the office-to-residential conversion, complex history and condition of the property, and history of the City's past real estate decisions leading to this point all bear into consideration as the City moves forward. In many other ways, however, the proposed project is a typical affordable housing development that relies on a traditional method for financing and with which the City has a strong track record. Regardless, we believe the magnitude of the proposal warrants increased scrutiny from the City Council and public.

Our Office's review of this proposal, after consultation with our independent real estate consultant Kosmont Companies, finds the proposal appears financially and economically feasible and that it provides a clear public benefit in providing needed affordable housing. Risks associated with the proposal are typical of affordable housing developments more generally, and various off-ramps help safeguard the City against potential impacts.

Notable takeaways for City Council to consider are:

1. The City is not providing a cash loan to the project, only a seller note based on the cost approach appraisal by the developer.
2. The financial assumptions in the proforma are reasonable to conservative and should give the project flexibility during construction and operation.
3. The building is not currently a Federally recognized historic resource, though it stands a good chance of becoming one before the project closes escrow.
4. The total development cost and per-unit costs are higher than Council has seen for many recent affordable housing deals, but these costs are not a direct measure construction costs, are not uncommon in the State, and are not costs that will be borne by the City.
5. The developer fee, based on a State formula, adds to the total amount of tax credits the project will be eligible for, and 88% of the fee is deferred.
6. The ongoing security, maintenance, and operation of the building would not be transferred to the developer until the close of escrow.

Since the City has a long-term interest in the property, we recommend that the Economic Development Department (EDD), the developer, and any future operator of the property make every effort to proactively publicize important information and material changes related to the development and operation of the property. Since EDD recently created a website for the proposed project, we recommend that EDD and/or the developer regularly update that website with architectural and engineering drawings, funding award updates, detailed construction timeline, large change orders, lease-up status, preliminary rent rolls, changes in property management company, and future capital improvement needs and costs. Additionally, we recommend that any significant concerns or complaints by tenants regarding the building condition be communicated to City Council.

We recognize that the regular disclosure of these documents may go beyond standard practice, but we also believe that increased transparency in the normal course of business, especially as it pertains to 101 Ash, will be important in rebuilding public trust in the City's real estate practices, which will be critical for the many large scale redevelopment projects the City hopes to pursue in the civic center over the coming decades.

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