



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Leslye Krutko
Director of Housing

SUBJECT: SEE BELOW

DATE: July 19, 2006

Approved

Date

7/24/06

COUNCIL DISTRICT: 5
SNI AREA: N/A

SUBJECT: APPROVAL OF ADDITIONAL FUNDING OF UP TO \$4,271,125 TO SUNSET SQUARE, L.P., FOR THE REHABILITATION AND FINANCIAL RESTRUCTURING OF SUNSET SQUARE APARTMENTS

RECOMMENDATION

It is recommended that the City Council:

1. Adopt a resolution approving additional funding of up to \$4,271,125 to Sunset Square, L.P. for the rehabilitation and financial restructuring of Sunset Square Apartments, a 96-unit apartment building located at 2080 Alum Rock Avenue in San José.

OUTCOME

Approval of the proposed additional funding and financial restructure will help to ensure Sunset Square's financial stability, thereby reducing long-term risks to the City and ensuring long-term affordability for the property. In addition, the planned physical rehabilitation will enable the project to once again provide 94 units of safe, affordable housing to residents of the City of San José.

BACKGROUND

Sunset Square Apartments is a 96-unit apartment building built in 1963 that is located at 2080 Alum Rock Avenue and that offers restricted affordable units to 94 Low-, Very Low-, and Extremely Low-Income families as well as two unrestricted units for a manager and maintenance professional. On January 15, 2002, the City Council adopted a resolution approving business terms for a loan of up to \$2,209,000 and a conditional grant of up to \$450,000 for the acquisition, rehabilitation and permanent financing of Sunset Square Apartments (the "Development").

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Further, an additional loan amount of \$220,900 was approved via Delegation of Authority on May 24, 2002. The scope of rehabilitation work completed in 2002-2003 included installation of new kitchen cabinets, new countertops, new vanity countertops and cabinets, and new dual-pane windows in each apartment. Windows were also replaced in common areas as needed. The carpet was replaced in living and dining areas in all apartments; bathroom fixtures were installed in each apartment; new stoves and new refrigerators were placed in some of the units; repairs were made to some plumbing, mechanical and electrical systems; a new security system was installed; and units benefited from interior and exterior painting. Fifty-five (55)-year affordability restrictions were recorded in 2002.

ANALYSIS

This funding and financial restructuring proposal is based on the necessity of making repairs to certain areas of the building which have been affected by a water intrusion problem, as well as the need to reduce the amount of fully-amortizing debt due to the project's inability to realize projected rent levels.

The need to make physical repairs to address water intrusion became apparent in 2004. Charities Housing ("Charities" or "Developer"), the project's developer, hired water intrusion consultants Simpson, Gumpertz & Heger to assess the current water intrusion problems and recommend a course of action. The consultants confirmed that the building shows significant signs of damage due to water intrusion through cracked exterior plaster into interior sheetrock and plywood, the building's paper underlayment, and sealant joints. Additional repairs to the building's structural floor will also be required. Long-term effects of water intrusion could result in severe damage to the structural integrity of the building as well as mold and mildew that may cause health problems to the tenants.

To remedy this situation, replacement of water-damaged elements, windows, stucco surrounding the windows, and flashing will be undertaken on all four exterior elevations. Alliant Capital, the project's tax credit investor, will fund \$200,000 into the project's replacement reserve to help pay for future repair work in response to the City's proposal that Alliant match \$200,000 of the total City loan amount that also will be designated for this purpose.

In addition to the property's physical problems, this property has been unable to realize projected rents due to its age and condition. The actual rental income generated from the project is less than that projected at the time that the property was acquired and refinanced in 2002, and is therefore insufficient to support the project's current amount of debt. Based on underwriting from Citibank, the project's senior lender, Charities plans to redeem \$1,828,000 of the project's City-issued tax-exempt bonds. The new bond amount, approximately \$4,666,000, will be supportable given current income and expense projections. Staff in the Housing and Finance Departments will work together on the bond redemption.

During the rehabilitation, only temporary relocation of residents will be necessary as those in affected units will move into vacant units while their units are being rehabilitated. A small amount of relocation costs are included in the project budget, which will be funded by the City's contribution.

In summary, the uses for the additional City funds of up to \$4,271,125 are as follows: \$2,108,125 is for rehabilitation and related project costs; approximately \$1,963,000 is for bond redemption and related fees; and, \$200,000 will be contributed to the replacement reserve account specifically to help fund future repair work. In addition to the City funds, the County has awarded \$118,839 for rehabilitation work, with the total to be spent on rehabilitation of \$2,226,513. The project's Loan-to-Value (LTV) calculation, including all senior debt and City debt, yields a ratio of 99%, which complies with the City Council's policy on Loan-to-Value. Specific City loan terms will be established through the Delegation of Authority to the Director of Housing.

The new total City loan of \$4,271,125 will be equal to \$45,438 per affordable unit. As consideration for the City's additional loan, the City will receive longer affordability through amended restrictions: 51 units now targeted to 60% of AMI will be reduced to 50% AMI; 33 units now targeted to 50% AMI will be reduced to 45% AMI; and, all affordability restrictions will restart at the time of the new funding and last for 55 years, resulting in four additional years of affordability. The City will also receive an additional five percent (5%) of net cash flow (for a total of 75% of net cash flow) after the tax credit investor is expected to exit the partnership in 2018; however, if they exercise their option to remain as owner, the City's net cash flow split will remain at 70%.

POLICY ALTERNATIVES

To arrive at this proposal, which is discussed below the Alternatives, staff analyzed the following options:

Alternative #1: Deny the funding request, foreclose upon the property and take ownership.

Pros: Allows the City to take direct control in order to fix the property's problems.

Cons: Changing property owners does not change the rental market or the physical condition of the property, so the underlying problems would continue to exist. The costs of foreclosure would be significant, as the City (as new owner) would need to assume the existing senior lender debt and would potentially be required to make additional payments for the senior lender to allow the City to assume ownership. The City would be in the role of managing day-to-day operations of the project.

Reason for not recommending: There is no compelling financial advantage to foreclosure, and the City is not best-positioned to directly employ rehabilitation contractors or oversee ongoing property management.

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Alternative #2: Exercise the City's right to replace Charities Housing with another developer.

Pros: None.

Cons: Charities Housing has been operating the project in a responsible manner. A new developer would likely take the same actions as Charities is in ensuring a long-term solution to the property's physical and financial difficulties. Removal of Charities could discourage other property owners from forthrightly advising the City of problems.

Reason for not recommending: There is no performance-related reason to replace Charities Housing with another developer.

Alternative #3: Refuse to fund and force Charities Housing to get conventional financing.

Pros: The Housing Department has already funded the acquisition/rehabilitation of this project, and additional funds would be better spent producing new units.

Cons: The project cannot sustain additional conventional debt to fund rehabilitation, and in fact must reduce its senior debt in order to maintain financial feasibility. The tax credit investor is unwilling to put more than \$200,000 into the project for the matched window replacement reserve.

Reason for not recommending: This alternative is not financially feasible.

Alternative #4: Refuse to fund and allow the building to deteriorate.

Pros: The Housing Department has already funded the acquisition/rehabilitation of this project, and additional funds would be better spent producing new units.

Cons: Although the building is aging, it will still be a physically-viable residence if these repairs are made. Allowing the building to deteriorate would be a health and safety hazard for the tenants. Continued deterioration would also significantly reduce the value of this physical asset, upon which the City's existing financing is secured, thereby damaging the City's financial position.

Reason for not recommending: The City is responsible for ensuring the provision of safe, affordable housing for the residents of San José. Further deterioration of the property will undermine the City's loan security.

After considering these alternatives, Housing Department staff opted to seek the City Council's approval for this loan. Although the Department would prefer to spend City funds on creating new affordable housing units rather than rehabilitating older projects, funding this request will enable Sunset Square to remain a part of the City's safe, affordable housing stock. The additional funding will enable the project's health and safety hazards to be addressed. Additionally, the financial restructuring will allow the project to receive additional funds for its

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replacement reserve as well as the final contribution from the tax credit investor, and should restore the project's long-term financial health.

PUBLIC OUTREACH

- √ **Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This item meets Criteria 1: Requires Council action on the use of public funds equal to \$1 million or greater. This Council report will be posted to the City's website for the August 8, 2006, Council Agenda.

In addition, tenants will be notified of the impending rehabilitation. Because this project has already been built and the proposed rehabilitation will require only temporary relocation of selected tenants, no further specific public outreach to area residents is anticipated.

COORDINATION

Preparation of this memorandum was coordinated with the Office of the City Attorney and the Finance Department.

FISCAL/POLICY ALIGNMENT

This expenditure is consistent with the Housing Department's Five-Year Investment Plan, Fiscal Years 2002/03-2006/07, concerning the Council policy on Rehabilitation as adopted in 1995.

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COST SUMMARY/IMPLICATIONS

1. COST OF PROJECT:

Rehabilitation and related project costs:	\$2,226,513
Bond redemption and related fees:	\$1,963,000 (approximately)
<u>Replacement reserve account:</u>	<u>\$400,000</u>
TOTAL	\$4,589,513

2. COST ELEMENTS OF CITY LOAN AMOUNT:

Rehabilitation and related project costs:	\$2,108,125
Bond redemption and related fees:	\$1,963,000 (approximately)
<u>Replacement reserve account:</u>	<u>\$200,000</u>
TOTAL	\$4,271,125

3. SOURCE OF FUNDING: Fund 443—Low- and Moderate-Income Housing Fund

4. FISCAL IMPACT: No ongoing fiscal impact.

CEQA

CEQA: Exempt, File No. AD06-696.


LESLYE KRUTKO
Director of Housing

For questions, please contact Leslye Krutko, Director of Housing at 408-535-3851.