CHAPEL HILL LUMO UPDATE

Feasibility of Density Bonuses to Support Community Benefits

October 27, 2023

SBFRIEDMAN

VISION
ECONOMICS
STRATEGY
FINANCE
IMPLEMENTATION

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LUMO UPDATE

Assessing the feasibility of density bonuses to support community benefits

The Town of Chapel Hill (the "Town") is undertaking a multiyear process to update its Land Use Management Ordinance (LUMO). The LUMO update is intended to advance Chapel Hill's collective vision for future development, while streamlining the entitlement process, which is perceived to be difficult to navigate for homebuilders and developers.

The Town has engaged Skidmore, Owings and Merrill, Orion Planning + Design, Rundell Ernstberger Associates, and SB Friedman Development Advisors (SB Friedman) to assist with the LUMO update. SB Friedman's work is focused on evaluating the feasibility of incorporating a density bonus system into the LUMO update to support community benefits. Our work to-date has focused on the feasibility of a density bonus system to facilitate additional affordable housing development.

LUMO Update Process:

April 2023 – June 2023

PHASE 1

INITIATION OF DRAFTING

July 2023 – February 2024

PHASE 2

PREPARATION OF PRELIMINARY DRAFT OF THE RE-ENVISIONED LUMO

February 2024 – June 2024

PHASE 3

PRELIMINARY DRAFT REVISIONS & OUTREACH

June 2024 – September 2024

PHASE 4

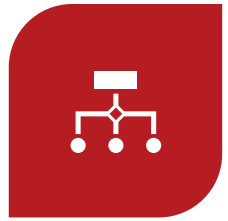
ADVISORY BOARD CONSIDERATION

September 2024 – November 2024

PHASE 5

FORMAL ADOPTION PROCESS

December 2024 – April 2025



PHASE 6

USER'S GUIDE AND STAFF & STAKEHOLDER TRAINING

HOUSING AFFORDABILITY IN CHAPEL HILL

Housing market pressures and limited protected affordable units are driving affordability challenges

Between 2015 and 2022, single family home prices in Chapel Hill increased by 33%, while average effective rents increased by 27%. Housing market pressures and a limited number of protected affordable units are driving affordability challenges. Nearly 6 out of 10 renter households are currently cost burdened, meaning that those households spend over 30% of their income on housing costs. In Chapel Hill, cost burdened households work in a variety of employment sectors, including education, and low-income and Black households have a higher likelihood of being cost burdened.

Per the Town's *Shaping Our Future: A Transportation and Land Use Initiative,* adopted in 2023, there is an unmet need for at least 1,970-2,300 housing units affordable to non-student households earning 60% AMI or less. The true housing need for lower- and moderate-income households is likely even higher, as many people who work in Chapel Hill cannot currently afford to live in the community.

The Town continues to take deliberate steps to deliver a diversity of homes at different price points to combat affordability challenges facing lower- to moderate-income households. The Town's many programs and policies are outlined on the following page.

HOUSING COST BURDEN IN CHAPEL HILL [1]

OWNER HOUSEHOLDS

19%
Households
Cost Burdened

RENTER HOUSEHOLDS

58%
Households
Cost Burdened

HOUSEHOLDS EARNING <$35K

89%
Households
Cost Burdened

[1] This analysis includes student households.
Source: ACS 2020 5-Year Estimates, Esri, SB Friedman

EXISTING AFFORDABLE HOUSING STRATEGIES

Chapel Hill takes deliberate steps to combat housing affordability challenges

HOUSING DEVELOPMENT	▪ Town manages 336 public housing apartments across Chapel Hill and Carrboro ▪ Town leverages publicly-owned land for new, affordable housing developments
HOUSING PROGRAMS	▪ Home Buyer Assistance and Rental Assistance Programs assist Town employees secure housing in and around Chapel Hill ▪ Transitional Housing Program assists low-income families transition from the Town's public housing to the private market
ZONING POLICIES	▪ Inclusionary Zoning Ordinance mandates larger for-sale developments in most districts to set aside 15% of units as affordable (10% in downtown) ▪ Town negotiates affordable units or in-lieu payment as part of conditional rezoning applications for rental housing developments ▪ Single-family units with accessory apartments allowed by right in most districts
PLANNING AND REGULATION	▪ Affordable Housing Development Fund uses in-lieu payments from developers towards affordable housing ▪ Manufactured Homes Action Plan addresses redevelopment threat facing manufactured home communities in Orange County ▪ Affordable Housing Preservation Strategy Framework sets forth approach for maintaining NOAH units
FUNDING MECHANISMS	▪ Chapel Hill voters approved a $10M affordable housing bond in 2018 ▪ Affordable Housing Development Reserve provides annual funding from the Town's general fund ▪ Chapel Hill receives CDBG and HOME funds from the federal government
PARTNERSHIPS AND COALITIONS	▪ Orange County Affordable Housing Coalition strives to foster collaboration among providers, local governments and advocates ▪ Northside Neighborhood Initiative acquires and sells properties for affordable housing as part of community land bank strategy ▪ Town provides operational support to Community Home Trust which has developed an inventory of permanently affordable for-sale homes

Source: Town of Chapel Hill

POTENTIAL ADDITIONAL AFFORDABLE HOUSING STRATEGIES

Recent planning processes outlined additional strategies

Shaping Our Future: A Transportation and Land Use Initiative recommended several policies to build on the Town's ongoing efforts to protect and expand the supply of affordable housing, including zoning code-based approaches, such as a density bonus system.

HOUSING DEVELOPMENT	Expand Affordable Housing Supply	**Developer Outreach** **Strategic Disposition** **Strategic Acquisition**
HOUSING PROGRAMS	Maintain or Expand Access to Affordable Housing	**Revolving Loan Fund**
ZONING POLICIES	Increase Supply of Affordable Units and Protect Existing Units	**Procedural Changes** **Code-Based Incentives** **By-Right Gentle Density in Neighborhoods**
PLANNING AND REGULATION	Protect Affordability	**Comprehensive Affordable Housing Plan** **Expanded Community Land Bank** **Tenant Right Of First Refusal**
FUNDING MECHANISMS	Establish or Expand Funding Sources for Affordable Housing	**Affordable Housing Bonds** **Tax Increment Financing** **Direct Impact Investments** **Increased Affordable Housing Development Reserve**

POTENTIAL ADDITIONAL AFFORDABLE HOUSING STRATEGIES

Recent planning processes outlined additional strategies

The Town of Chapel Hill *Affordable Housing Plan & Investment Strategy* recommended that the Town deploy funds and create policies to continue addressing local housing challenges and increase racial equity over the next five years. Recommendations were guided by four goals:

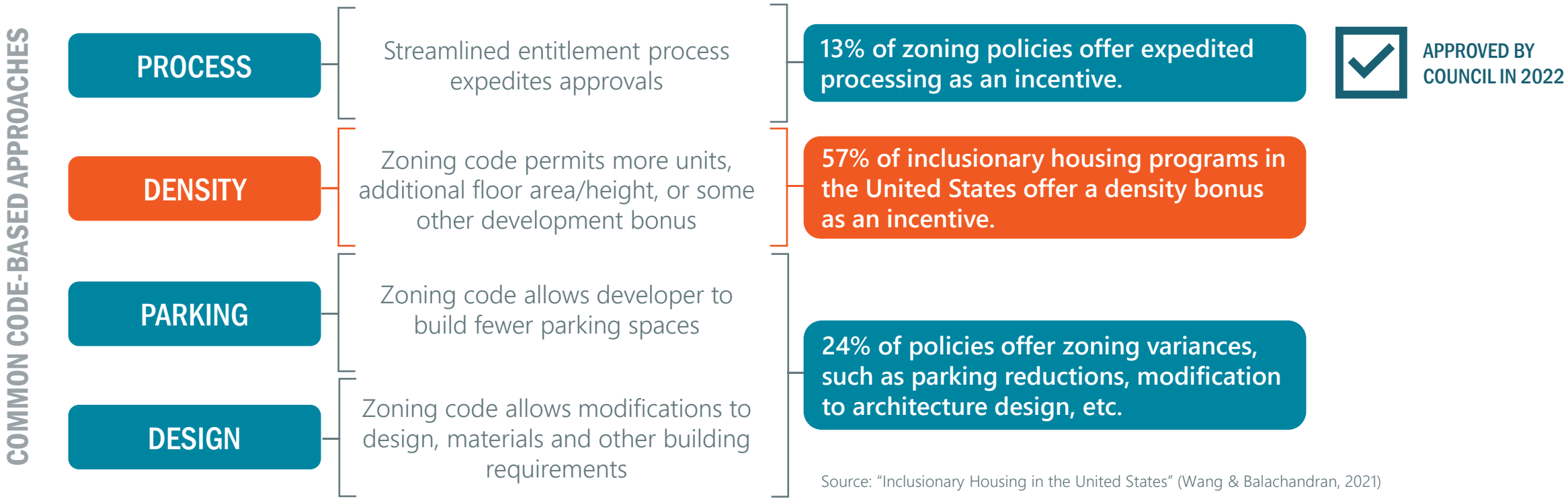
REDUCE BARRIERS TO BUILDING HOMES	▪ **Continue to pursue zoning and regulatory changes to streamline entitlements processes and evaluate the impact of development requirements on affordability.** ▪ Launch a formal education and outreach campaign in order to bolster community support for the Town's affordable housing priorities, including housing development. ▪ **Refine the Town's inclusionary housing policy to better incentivize the development of affordable rental homes.**
EXPAND AND PRESERVE AFFORDABLE HOMEOWNERSHIP	▪ Modify the Town's Employee Housing Program to provide down payment assistance for moderate-income homebuyers. ▪ Expand the Town's Transitional Housing Program and explore additional asset-building programs to serve more households interested in working towards homeownership. ▪ Dedicate consistent funding to provide low-income households with property tax assistance.
EXPAND AND PRESERVE AFFORDABLE RENTAL HOUSING	▪ Expand the Master Leasing program. ▪ Create relocation assistance packages for renters at risk of displacement or eviction. ▪ Continue to provide gap financing to preserve and create homes for low-income renters.
INCREASE STAFF AND FUNDING CAPACITY	▪ Dedicate new, consistent sources of funding. ▪ Realign the Town's governance and funding processes for its local funding sources. ▪ Establish a revolving loan fund. ▪ Enhance partnerships with regional collaborators. ▪ Align staffing capacity with existing and projected programming.

Source: HR&A Advisors, Town of Chapel Hill

ZONING CODE-BASED APPROACHES

Code-based approaches offer regulatory relief to developers in exchange for community benefits

Zoning code-based approaches include modifications to requirements related to design, height and density, and process which are granted to developers usually in exchange for onsite affordable housing units or other community benefits. Incentives which are clearly articulated in the LUMO, rather than negotiated individually for each development, would provide certainty for the developers on tradeoffs, while also streamlining the entitlement process. Key characteristics of code-based approaches are outlined below.



Source: "Inclusionary Housing in the United States" (Wang & Balachandran, 2021)

ZONING CODE-BASED APPROACHES

Density bonuses are the most common code-based approach to incentivize affordable housing

Some communities and states have facilitated affordable housing production through **mandatory inclusionary housing** programs, while other communities have implemented **voluntary zoning code-based incentives.**

While mandatory inclusionary zoning programs are not specifically prohibited in the State of North Carolina, nor are they explicitly allowed. North Carolina municipalities do not have home rule, which means they are only entitled to the powers granted to them by the State. Municipalities are therefore weary of adopting mandatory inclusionary zoning policies due to the threat of legal recourse.

Municipalities in North Carolina and elsewhere in the United States have enacted voluntary code-based incentives and inclusionary zoning policies. Key characteristics of voluntary programs in Durham, Raleigh, Wilmington and Charlotte are outlined on the following page.

The most common voluntary code-based approach, both nationally and in North Carolina, is to offer a density bonus in exchange for affordable housing unit production. However, these voluntary programs have had varying levels of success.

SB Friedman was tasked with evaluating the feasibility of incorporating a density bonus into the LUMO update to facilitate additional affordable housing development in Chapel Hill.

Voluntary code-based incentives need to be carefully calibrated to be effective. Successful programs should:

- **Produce investor financial returns in excess of those achieved under baseline conditions;** and
- **Be paired with a menu of other incentives to enhance feasibility.**

Our evaluation included a detailed prototypical financial analysis, as well as outreach to development community through interviews and a small group discussion.

VOLUNTARY CODE-BASED INCENTIVES IN NORTH CAROLINA

Code-based incentives in North Carolina tend to focus on density bonuses

RALEIGH **ADOPTED IN 2021**	In order for developers to qualify for a density bonus, a Project must set aside 20% of the bonus units for households earning 60% AMI or less for 30 years Raleigh's affordable housing density bonuses are calculated depending on the zoning district, as follows: ▪ In **mixed-use districts**, where apartments are already allowed, developers are allowed a **50% increase in the number of stories** (rounded up). Projects need to be within a transit-oriented development (TOD) designated area or within ¼ mile of a bus rapid transit (BRT) route. ▪ In built-out **residential districts**, where housing development is limited by available land area, density bonuses are calculated on a large dwelling unit per acre (DUA) bonus. Projects must be within ½ mile of a high frequency bus route, and buildings are restricted to 3 stories maximum even with a DUA bonus applied.
DURHAM **ADOPTED IN 2019**	For developers to qualify for a density bonus, a Project must set aside 15% of total units as affordable. Bonuses remove any DUA limits and allow for a height increase from 45 to 145 feet in certain zones, and an increase from 35 to 60 feet in other zones with the inclusion of affordable units. These bonuses result in potential **height increases between 71% and over 200%,** depending on the zoning district.
WILMINGTON **ADOPTED IN 2002**	Projects in certain Mixed-Use districts that ensure 15% to 30% of rental units remain affordable (at 80% AMI) for at least 10 years are eligible for a density bonus of 0.125 floor-area ratio (FAR) or 4 DUA.
CHARLOTTE **ADOPTED IN 2013**	Charlotte's code-based incentive program includes a bonus menu which exchanges development incentives, such as height or open space, in exchange for the provision of affordable housing units. The density bonus allowed depends upon the zoning district as well as the level and number of affordable units provided by the developer. Developers have the ability to pay an in-lieu fee, which has been the common practice since the program's inception. To date, Charlotte's code-based incentive program has produced only eight units of affordable on-site housing through the density bonus.

Prototypical Financial Analysis

- Regional Development Typology Analysis
- Financial Sensitivity Analysis

VOLUNTARY DENSITY BONUS FINANCIAL ANALYSIS

SB Friedman tested the effectiveness of a density bonus on typologies common in Chapel Hill

SB Friedman conducted a prototypical financial feasibility analysis to evaluate the effectiveness of a potential density bonus in exchange for affordable housing production. This evaluation included:

- **Regional Development Typology Analysis:** SB Friedman reviewed development characteristics of recently delivered projects in Chapel Hill and the broader Triangle region. This review informed the characteristics of the prototypical development types used in the feasibility analysis, including density, construction type, height and unit mix.
- **Existing Projects Benchmarking and Industry Insights:** SB Friedman reviewed development pro formas of recently delivered projects in Chapel Hill, analyzed industry market data, and conducted interviews with developers to determine various inputs for the financial feasibility analysis, including construction costs, rents, and financial return metrics.
- **Baseline Prototypical Returns:** SB Friedman created a financial returns model for different prototypical development types and evaluated financial returns at different densities. These analyses were used to determine baseline financial returns for each development type.
- **Density Bonus Sensitivity Testing:** To test the feasibility of a density bonus, SB Friedman incorporated the Town of Chapel Hill's target affordability set-aside (7.5% of units at 65% AMI and 7.5% of units at 80% AMI) into each prototypical development model. The density of the prototypical projects were then increased until the financial returns met the baseline returns set without affordability, or until the density increased above the range observed within the typology.

These analyses and findings are further detailed in the following sections.

Regional Development Typology Analysis

REGIONAL MULTIFAMILY CONSTRUCTION

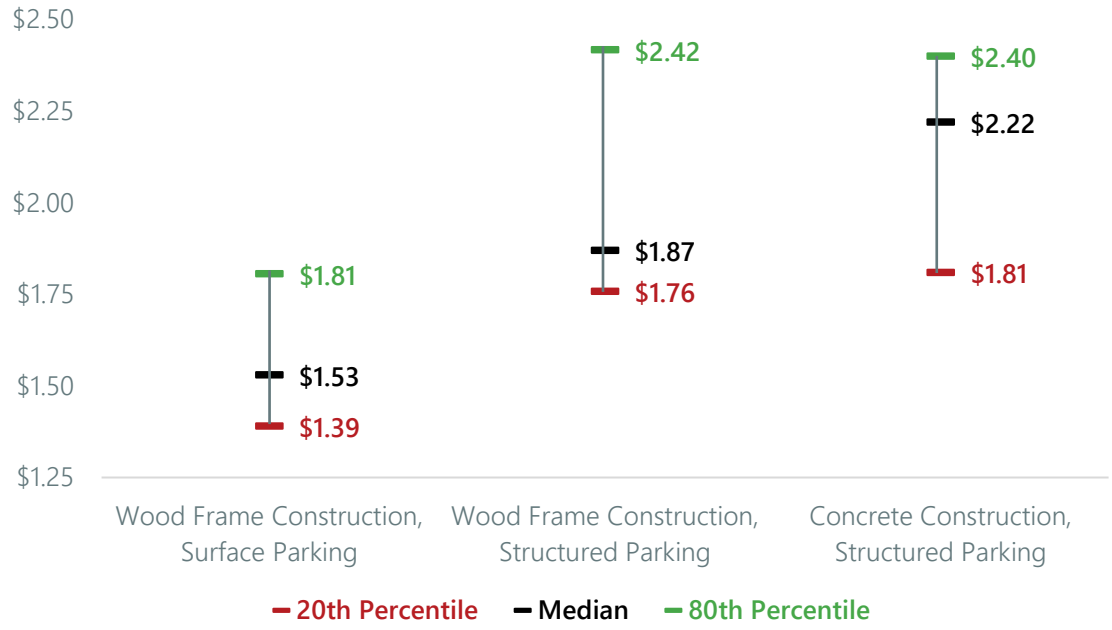
Various multifamily product types have been delivered throughout the region

SB Friedman reviewed the development characteristics of recently delivered multifamily projects in the broader Triangle region. New construction multifamily projects exhibit a range of densities. Generally, as height and density increase, so too do achievable market rents. Market-rate multifamily projects in downtown Raleigh and Durham, which have the greatest density in the region, also command the highest market rents (excluding specialized product like student or senior housing).

NEW, REGIONAL MULTIFAMILY PROJECTS – TYPICAL CHARACTERISTICS

	Stories	DUA	FAR	Example Regional Submarkets
Wood Frame Surface Parking	3-4	10-30	0.2-0.6	Durham RTP, Farrington, North Cary, North Raleigh
Wood Frame Structured Parking	4-5	40-100	1.2-2.2	Durham City Center, North Cary, Raleigh Glenwood
Concrete Frame Structured Parking	6-7	85-185	2.0-4.0	Raleigh Cameron Village, Raleigh Capital District

REGIONAL MARKET PER SQUARE FOOT RENTS



REGIONAL DEVELOPMENT TYPOLOGIES

Multifamily rental housing in the region typically falls within one of four typologies

SB Friedman conducted financial feasibility sensitivities for prototypical developments which closely align with the existing building typologies found in Chapel Hill and the broader Triangle market area. The following typologies are common in the broader market area and represent the prototypical typologies in SB Friedman's analysis.

4-STORY | SURFACE PARKING

~25 Average DUA
~0.5 Average FAR

Apartments with Surface Parking

Wood Frame Construction

5-STORY | WRAP PARKING

~75 Average DUA
~2.0 Average FAR

Apartment Units Wrapping Structured Garage

Wood Frame Construction

5-STORY | PODIUM PARKING

~100 Average DUA
~2.25 Average FAR

Apartment Units Over Structured Base Parking

Wood Frame Construction

7-STORY | PODIUM PARKING

~135 Average DUA
~3.0 Average FAR

Apartment Units Over Structured Base Parking

Concrete Construction

Source: CoStar, SB Friedman

TYPICAL TYPOLOGY DENSITIES

There are a range of densities within each typology due to specific project and site characteristics

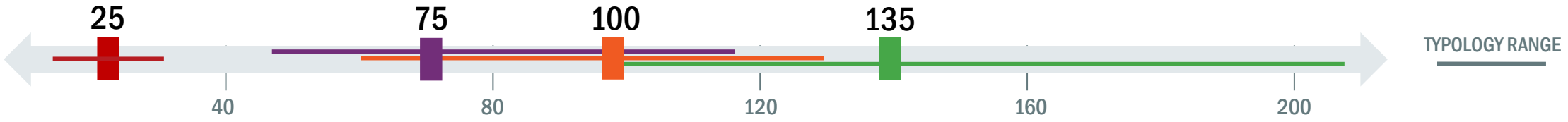
Recent projects in the Chapel Hill and Triangle market have been delivered at a range of densities within each typology. These ranges are driven by site characteristics, development program, as well as developer preference for certain unit counts and mixes.

4-STORY | SURFACE PARKING

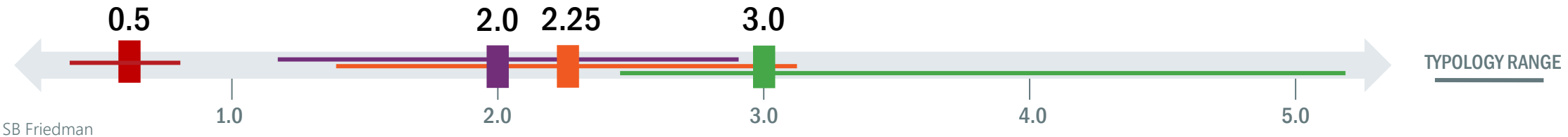
5-STORY | WRAP PARKING

5-STORY | PODIUM PARKING

7-STORY | PODIUM PARKING



DWELLING UNITS / ACRE FOR RECENTLY DELIVERED PROJECTS



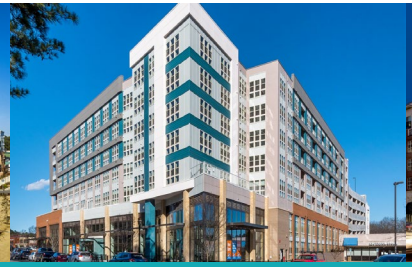
FLOOR AREA RATIO FOR RECENTLY DELIVERED PROJECTS

Source: CoStar, SB Friedman

RECENT CHAPEL HILL PROJECTS

Recent projects have been wood frame construction, rather than concrete, which is more expensive




	Carraway Village	Link Apartments Linden	Bell Chapel Hill	Berkshire Chapel Hill	Carolina Square
Dwelling Units per Acre	47	50	84	90	-- [1]
Floor-Area Ratio	0.88	1.28	2.19	2.45	-- [1]
Stories	4	4	6	6	5
Total Units	610	215	272	265	246
Studios	342 (56%)	--	71 (26%)	--	48 (20%)
One Bedrooms	109 (18%)	135 (37%)	118 (43%)	177 (67%)	29 (12%)
Two Bedrooms	136 (22%)	80 (63%)	83 (31%)	88 (33%)	59 (24%)
Three Bedrooms +	23 (4%)	--	--	--	110 (44%)
Average Unit SF	952	778	817	907	1,099
Average Rent Per SF [2]	$1.99	$2.41	$2.43	$2.31	$3.02

[1] Carolina Square parcel contains several office and retail condos and Granville Towers project – density measures not comparable to other projects
[2] Average rent per SF is impacted by typology, unit mix and unit size
Source: CoStar, Orange County Assessor, SB Friedman

Financial Sensitivity Testing

PROTOTYPICAL DEVELOPMENT PRO FORMAS

SB Friedman's analysis is intended to test the feasibility of a density bonus in Chapel Hill

The prototypical pro formas developed by SB Friedman are intended to reflect the calculations, assumptions and decisions facing private developers in the Chapel Hill market.

Development cost inputs for the prototypical model were informed by pro forma development costs of recent projects in Chapel Hill, interviews with local developers, recent land sale transactions and market data related to soft and financing costs.

Actual performance of recently delivered projects in Chapel Hill were benchmarked to inform rent assumptions of the prototypical pro formas for each typology. Industry market data informed operating cost assumptions of the prototypical model and local property tax research informed property tax assumptions.

Sources for our prototypical pro forma assumptions are outlined on page 21.

While prototypical analyses can be used to demonstrate the feasibility of a development typology, actual feasibility of a proposed development can vary. Development program, site-specific regulations, site conditions, and current market dynamics impact feasibility. While specific projects must be considered on a project-by-project basis, the point-in-time prototypical feasibility analysis can be used to inform policy and general feasibility of a development typology.

DEVELOPMENT PRO FORMA CONSIDERATIONS

TOTAL DEVELOPMENT COSTS

Land Costs
+ Site Prep & Hard Costs
+ Soft & Financing Costs
+ Developer Fees
- Grants, Tax Credits, and/or Public Subsidy

= Total Development Costs (TDC)

NET OPERATING INCOME

Rents/Revenues
- Operating Costs
- Property Taxes
- Vacancy Loss

= Net Operating Income (NOI)

PROTOTYPICAL DEVELOPMENT PRO FORMAS

Prototypical project models replicate the decisions facing private developers in Chapel Hill

To test the financial feasibility of the prototypical projects, SB Friedman used unleveraged internal rate of return (IRR). Unleveraged returns generally evaluate overall project feasibility and ability to secure financing rather than returns to specific investors. SB Friedman reviewed financial pro formas of projects in Chapel Hill and elsewhere, as well as industry survey data from RERC and PricewaterhouseCoopers, to determine typical target rates of return. These return hurdles vary depending on the market area and land use.

For these analyses, developers are assumed to maximize profit when contemplating whether to build a certain project. Based on industry sources, a minimum unleveraged IRR of 7.0% is needed for a multifamily project to be considered "financially feasible" in Chapel Hill. If unleveraged IRR is below this benchmark, it is likely that a developer would not pursue the Project unless certain incentives or policy levers were in place to improve the financial feasibility of the project.

Return metrics used in the prototypical analysis reflect a point-in-time and are based on current market condition. However, these metrics may not be appropriate to apply to specific projects in the future.

YIELD ON COST

Net Operating Income

÷ Total Development Costs

= Yield on Cost

UNLEVERAGED INTERNAL RATE OF RETURN (IRR) The rate of return for a project, accounting for initial expenditures to construct the project (total development costs) and ongoing cash inflows (annual net operating income [NOI] before debt service), as well as a hypothetical sale of the project at the end of the analysis period.

	Year					
	0	1	2	3	4	5
Total Development Costs	-$$$					
Net Operating Income		+$	+$	+$	+$	+$
Sale of Property						+$$$

CHAPEL HILL THRESHOLD RETURN BENCHMARKS

Metric	Benchmark
Yield on Cost	5.9%
Unleveraged IRR	7.0%

PROTOTYPICAL DEVELOPMENT PRO FORMA ASSUMPTIONS

Financial feasibility model inputs were informed by several data sources

Metric	Sources
Acquisition Costs	CoStar, Comparable land sale transactions in Chapel Hill. Appraisal Data, provided by the Town of Chapel Hill.
Site Prep Costs	Comparable Projects Reviewed by SB Friedman, Developer Interviews, Development budgets from the Town of Chapel Hill.
Hard Construction Costs	Developer Interviews, CoreLogic Marshall and Swift Cost Estimator, RS Means, Regional Building Permit Data (Durham County), Turner Construction Cost Index, Comparable project development budgets provided by the Town of Chapel Hill.
Hard Costs per Parking Space	Comparable Projects Reviewed by SB Friedman, Developer Interviews, Development budgets from the Town of Chapel Hill.
Soft Costs	Comparable Projects Reviewed by SB Friedman, Developer Interviews, Development budgets from the Town of Chapel Hill.
Financing Costs	Comparable Projects Reviewed by SB Friedman, Developer Interviews, Development budgets from the Town of Chapel Hill.
Developer Fees	Developer Interviews, SB Friedman.
Market Rents	CoStar, Comparable Market-Rate Projects Delivered in Chapel Hill.
Affordable Rents	U.S. Department of Housing and Urban Development, Town of Chapel Hill.
Parking Revenues	Apartments.com, Town of Chapel Hill, Zillow.
Operating Expenses [1]	Institute of Real Estate Management (IREM), National Apartment Association (NAA).
Property Taxes	Orange County Assessor, Property Taxes for Comparable Projects in Chapel Hill.
IRR Benchmark	Real Estate Research Corporation, PricewaterhouseCoopers.

[1] Operating expenses do not include property taxes. Chapel Hill specific property tax rates were used for accuracy.

PROTOTYPICAL DEVELOPMENT PRO FORMAS

Sample project pro forma and key assumptions by development typology are outlined below

	4 STORY | SURFACE PARKING	5 STORY | WRAP PARKING	5 STORY | PODIUM PARKING	7 STORY | PODIUM PARKING
Dwelling Units per Acre	25	75	100	150
Floor Area Ratio	0.6	1.85	2.45	3.45
TOTAL DEVELOPMENT COSTS				
Land Costs	$1.74 M ($20/Land SF)	$1.74 M ($20/Land SF)	$1.74 M ($20/Land SF)	$1.74 M ($20/Land SF)
+ Site Prep & Hard Costs	$9.1 M ($171/SF)	$30 M ($187/SF)	$39.6 M ($185/SF)	$64.1 M ($213/SF)
+ Parking Costs	$0.25 ($5,000/Stall)	$3.7 M ($24,800/Stall)	$5.0 M ($24,800/Stall)	$7.4 M ($24,800/Stall)
+ Soft & Financing Costs	$1.59 M	$5.73 M	$7.59 M	$12.16 M
+ Developer Fees	$0.55 M	$1.97 M	$2.61 M	$4.18 M
= Total Development Costs	$13.23 M	$43.12 M	$56.56 M	$89.60 M
NET OPERATING INCOME				
Rents/Revenues [1]	$1.08 M ($1.94/SF)	$3.55 M ($2.15/SF)	$4.74 M ($2.15/SF)	$7.15 M ($2.32/SF)
- Operating Costs	$0.20 M	$0.69 M	$0.92 M	$1.38 M
- Property Taxes	$0.13 M	$0.38 M	$0.51 M	$0.72 M
- Vacancy Loss	$0.05 M	$0.19 M	$0.25 M	$0.38 M
= Net Operating Income	$0.70 M	$2.48 M	$3.31 M	$5.05 M
YIELD ON COST				
Net Operating Income	$0.70 M	$2.48 M	$3.31 M	$5.05 M
÷ Total Development Costs	$13.23 M	$43.12 M	$56.56 M	$89.60 M
= Yield on Cost	5.73%	6.19%	6.30%	6.08%
Unleveraged IRR	6.88%	7.85%	8.08%	7.62%

[1] Based on SB Friedman's analysis of typical rent premiums in the region after controlling for location, it is assumed that projects with structured parking have an 11% rent premium over surface parked projects, while concrete frame projects have an 8% rent premium over wood frame projects built in the same area.

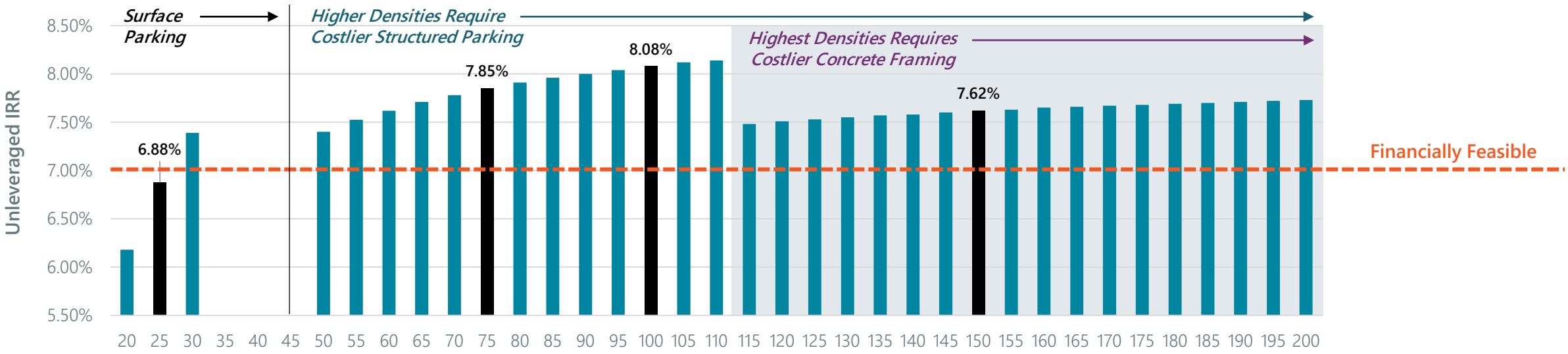
DENSITY ANALYSIS

Costlier construction methods are required to achieve greater density

SB Friedman tested the impact of increased density on returns for prototypical multifamily developments without any affordability set aside. For these analyses, SB Friedman assumed a two-acre site with land costs reflective of more outlying areas of Chapel Hill ($20/SF). Returns generally improve as density increases.

However, construction cost increases associated with structured parking and concrete framing appear to outpace the rent premium that appears achievable by higher density projects in Chapel Hill, thereby reducing returns when higher density construction modalities are required. In Chapel Hill, many of the higher-density projects have been catered to students and are not included in our analysis of market-rate multifamily housing.

PROJECT RETURNS BY DENSITY – NO AFFORDABILITY SET-ASIDE



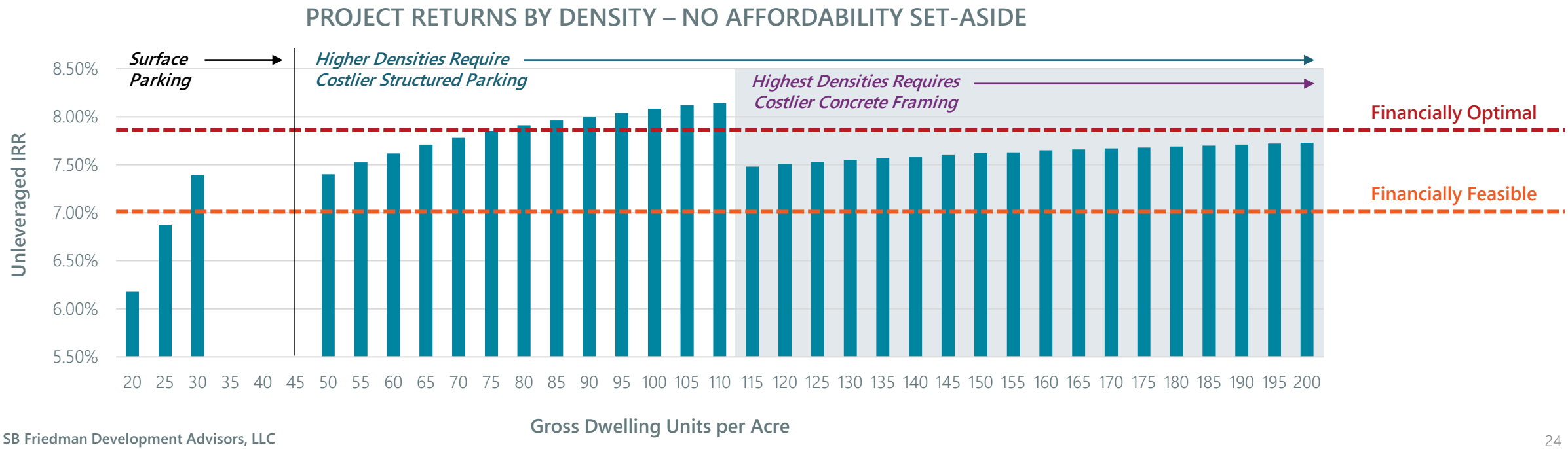
[1] Black bars indicate sample prototypes from previous page

DENSITY ANALYSIS

Developers will calibrate their projects to optimize the project and/or maximize return on investment

Developers are assumed to maximize profit when considering whether to advance a project. In the Triangle region, wood frame construction at a density of ±75 DUA is a common typology. The development of this typology across the region indicates that this density is producing attractive financial returns to developers and is likely within the range of being "financially optimal." Assuming a base density of 75 DUA, the estimated "financially optimal" return on investment is an IRR of 7.85%.

A developer would only choose to build at a higher density and/or voluntarily include affordable units in a scenario where they would be no worse off financially than in the base scenario.

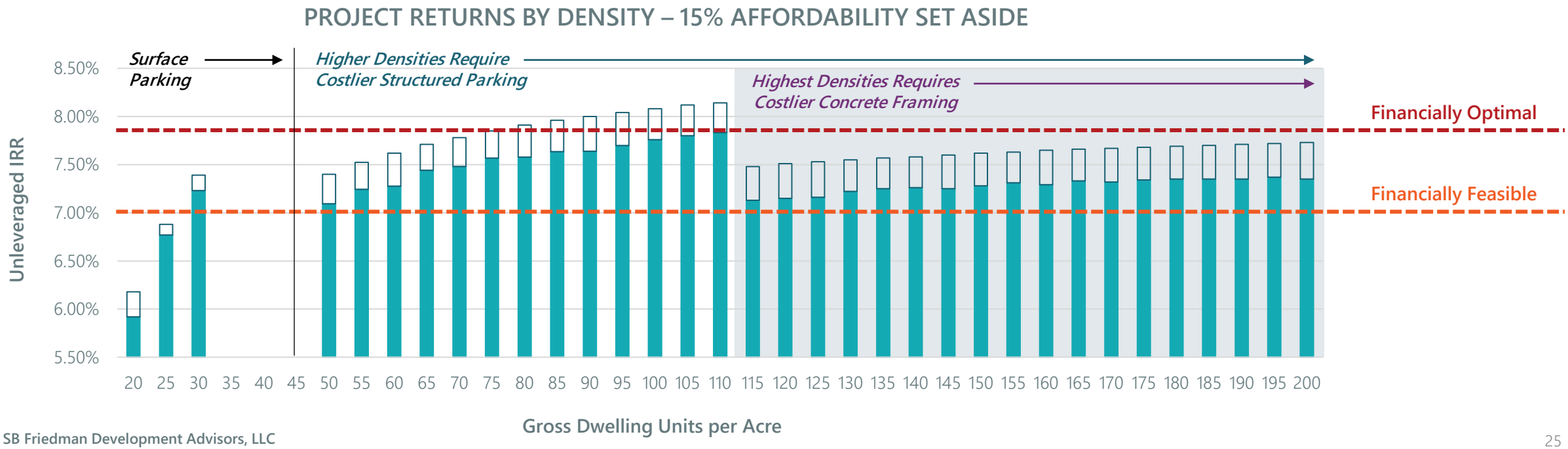


DENSITY ANALYSIS

A minimum 50% density bonus is needed to return to financially optimal returns

SB Friedman tested the impact of increased density on returns for a prototypical multifamily development with a 15% affordability set aside (7.5% of units at 65% AMI and 7.5% of units at 80% AMI). For these analyses, SB Friedman assumed the same site area and land costs as in prior analyses.

A minimum 50% density bonus is needed to achieve returns comparable to the base scenario. However, to be truly attractive to developers, a voluntary density bonus would need to provide significantly higher returns than the base scenario. Therefore, a density bonus with this 15% set aside is unlikely to produce many affordable units, as developers would prefer to build at a lower density without any set aside. Additionally, a density bonus beyond 50% would likely require more expensive construction modalities, which diminish financial returns.



PROTOTYPICAL PROJECT ILLUSTRATION

The density analysis applied to a single illustrative project is outlined below

ILLUSTRATIVE PROJECT

5-STORY | WRAP PARKING

75 DUA
~2.0 FAR

Apartment Units Wrapping Structured Garage

Wood Frame Construction

Target Affordability Set Aside: 15% of units
7.5% of units at 65% AMI
7.5% of units at 80% AMI

With an illustrative 75 DUA project, **market value decreases by 2.2% and baseline financial returns decrease by 3.7%** with the target affordability set aside

To return to baseline returns, a **50% density bonus is required** (110 DUA)

To be attractive to developers, a voluntary **density bonus would need to provide significantly higher returns than the baseline**

Regionally, multifamily projects at 115 DUA or above typically require concrete construction

Concrete construction costs are approximately 15% higher than wood frame costs on a per-square-foot basis

Achievable rent premiums (on a per-square-foot basis) associated with higher density projects appear to be below 10%

In Chapel Hill, the relationship between concrete construction costs and achievable rents will likely limit the appeal of a voluntary density bonus without additional incentives

Developer Outreach

DEVELOPER OUTREACH

Developers provided feedback regarding the entitlement process in Chapel Hill

SB Friedman engaged the development community through interviews and a small group discussion to discuss development economics in Chapel Hill and the feasibility of a density bonus system. Outlined below is a summary of anonymized developer feedback.

Entitlements

Comments collected from developers regarding the entitlement process are summarized below:

- Uncertainty in the entitlement process and the high cost of development in Chapel Hill are driving higher rents/price points.
- Only large developers/projects can carry the additional costs or are willing to be at-risk of not recovering predevelopment costs.
- Architects, landscape architects, and civil engineers all charge higher fees to account for the longer design/development period and multiple iterations of work products.
- Stormwater and sustainability requirements increase the hard construction costs, while traffic impact, tree survey, and geotechnical studies increase soft costs.
- Impact fees, tap fees, and Town submittal fees are perceived to be higher than in peer communities.
- Some building code requirements are perceived to exceed requirements in peer communities, thereby increasing development costs.
- Resource Conversation District buffers and setback requirements are perceived as challenging and higher than in peer communities. Relaxing these requirements would make sites more efficient and could result in more units being developed.
- Façade articulation and step-back requirements result in the production of fewer housing units.

DEVELOPER OUTREACH

Developers provided feedback regarding the inclusion of affordable units in market-rate projects

Affordable Housing Set-Aside

Comments collected from developers regarding the inclusion of affordable units in market-rate projects are summarized below:

- Due to the economics of projects in Chapel Hill, it is difficult to overcome the difference in development costs and the income-based valuation of the project when 15% of units are set aside as affordable at the Town's target affordability levels (7.5% of units at 65% AMI and 7.5% of units at 80% AMI). This makes it difficult to attract debt and equity investors.
- Affordable housing set-aside requirements become increasingly difficult when additional community benefits are also requested.
- Consistency is sought in negotiated community benefits to ensure that competing developers are providing similar benefits.
- Flexibility in the percentage of units set aside as affordable and/or target affordability levels (e.g., workforce housing at 100% AMI) could produce more affordable units. Higher affordable rents would reduce the gap between development costs and the income-based valuation of the project.
- Density bonus system may not produce many units given that residential development in Chapel Hill rarely exceeds six stories given the achievable market rents.
- Density bonuses could potentially be appealing in the downtown area where land costs and rents are generally higher.
- Developers indicated that direct subsidies would be more effective than a density bonus in facilitating affordable housing production.
  - Upfront assistance, or a reduction in fees, would improve developer returns by reducing their development costs
  - Incentives that would improve annual cash flow—such as economic incentive agreements—would increase the income-based valuation of the project.

Conclusions

CONCLUSIONS

Feasibility of density bonuses to support community benefits

- At minimum, a 50% density bonus is needed for a project with a 15% affordability set aside (7.5% of units at 65% AMI and 7.5% of units at 80% AMI) to achieve financial returns comparable to a lower density project without any set aside.
- However, to be attractive to developers, a voluntary density bonus would need to provide significantly higher returns than the base scenario.
- Based on common development typologies in Chapel Hill, a 50%+ density bonus would likely require that developers employ more expensive construction techniques (concrete framing).
- In the Chapel Hill market, the hard construction cost premium associated with concrete framing exceeds the rent premium for market rate units associated with taller, denser construction. Therefore, taller concrete frame projects are generally not financially optimal for developers.
- This appears to be a contributing factor as to why market-rate, non-student residential development in Chapel Hill rarely exceeds six stories.
- A density bonus with a 15% set aside is unlikely to produce many affordable units without additional development incentives, as developers would likely achieve similar financial returns by building at a lower density without any set aside.

CONCLUSIONS

Calibrating code-based and development incentives in exchange for community benefits

- Given that the current relationship between concrete framing construction costs and achievable rents limits the utility of a density bonus system, the Town could explore offering other code-based incentives in exchange for community benefits.
- Developers perceive setback and buffer requirements to be challenging and higher than in peer communities and indicated that façade articulation and step-back requirements result in the production of fewer housing units.
- Code-based incentives that improve site and building efficiency, specifically setback, buffer, and step back modifications, would likely be attractive to developers in Chapel Hill since additional units could be built within heights allowed with wood-frame construction.
- The Town could also explore offering modifications to building design requirements (e.g., materials) in exchange for community benefits.
- Developers indicated that uncertainty in the entitlement process and the high cost of development in Chapel Hill are driving higher rents/price points. The Town could also consider providing fee rebates or discounts on other municipal costs associated with new development in exchange for community benefits.

These considerations could be explored further as the LUMO update process continues.

CONCLUSIONS

Calibrating development incentives to facilitate affordable housing production

- Developers indicated that, due to the economics of projects in Chapel Hill, it is difficult to overcome the difference in development costs and the income-based valuation of the project, when 15% of units are set aside as affordable at the Town's target affordability levels (7.5% of units at 65% AMI and 7.5% of units at 80% AMI). This makes it difficult to attract debt and equity investors.
- In addition to the code-based and development incentives outlined on the prior page, the Town could consider the following approaches to incentivize affordable housing development:
    1. Continuing to provide upfront financial assistance for affordable units and explore additional funding sources such as TIF or synthetic TIF.
    2. Reducing the threshold for expedited review to 15% of total units to align with the voluntary inclusionary zoning minimum, reducing predevelopment costs for developers that include 15% affordable units in their projects.
    3. Providing flexibility in the percentage of units set aside as affordable and/or target affordability levels (e.g., workforce housing at 100% AMI) to reduce the gap between development costs and the income-based valuation of the project.
    4. Exploring the feasibility of a property tax abatement to partially offset the cash flow impacts associated with including affordable units.
- The Town could also explore combining multiple incentives to facilitate affordable housing development. A case study of a municipality that has paired a density bonus with other voluntary incentives is presented on the following page.

These considerations could be explored further as the LUMO update process continues.

CASE STUDY | BELLEVUE, WA

Combining multiple incentives to facilitate affordable housing development

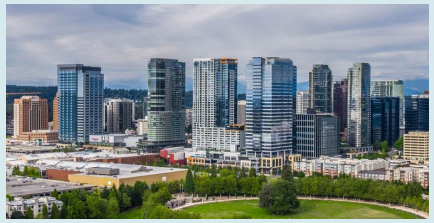
The City of Bellevue, Washington offers a menu of development incentives to facilitate affordable housing development. Citywide, developers may receive a density bonus equivalent to 15% of FAR or DUA by setting aside 15% of units or project square feet as affordable. In addition to the citywide policy, specific areas of Bellevue—including its Downtown and TOD districts—are eligible for increased density bonuses in exchange for a higher affordability set aside.

Developers who use the density bonus may also be eligible to modify certain dimensional standards such as lot minimums, setbacks and open space requirements to improve the project feasibility. Additionally, the City has reduced parking minimums for affordable housing, which may be paired with the density bonus.

In addition to allowing for additional density and flexible building design, Bellevue provides financial incentives to developers building affordable units. The City's Multifamily Tax Exemption (MFTE) is a 12-year property tax exemption on the residential portion of a development, which is earned if 20% of total units are kept affordable for households earning 80% of AMI for 12 years. The MFTE can be paired with the density bonus incentive, though projects using both must set aside units at a deeper affordability level than projects only taking one of the incentives.

While some communities have leveraged pay-in-lieu fees which allows developers to navigate around affordability requirements, Bellevue has removed these fees in priority areas.

CITY OF BELLEVUE WASHINGTON



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AFFORDABLE UNITS DELIVERED

Source: City of Bellevue, Grounded Solutions Network

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