City of Lynn Inclusionary Zoning Analysis
Phase One Summary
March 12, 2021

Introduction

As part of Housing Lynn, a community-driven planning process that established goals and strategies to addresses Lynn's housing needs and challenges, the Metropolitan Area Planning Council (MAPC) conducted a preliminary analysis to ascertain whether inclusionary zoning might be possible in the city and under what circumstances. Using a financial pro forma, MAPC tested the impact of various inclusionary zoning scenarios on development feasibility, including what depth of affordability can be required, what amount of housing can be set aside as affordable, what incentives should be offered to offset costs, and other features. The assumptions underlying this analysis are based on discussion with several real estate professionals active in Lynn and familiar with local development conditions, as well as market data.

This analysis determined that there is a range of possible inclusionary policy approaches that could work in Lynn. Some would be less likely to impact a development project's bottom line, but would likely result in Affordable Housing that is less sensitive to local need. Other approaches would net greater community benefits, but would require additional tools beyond inclusionary zoning to maintain development feasibility.

The analysis findings in this document are intended to provide a high-level understanding of what inclusionary components are broadly feasible and should be considered further; they should not be interpreted as specific recommendations for a future inclusionary policy. The components that ultimately are included in a future inclusionary policy should be informed by substantive community input to define policy goals and prioritize tradeoffs, as well as additional technical analysis.

Inclusionary Zoning Overview

An Inclusionary Development Policy (IDP) or inclusionary zoning requires or encourages a certain portion of units within new housing developments of a certain scale to be deed-restricted Affordable Housing for low- or moderate-income households. It relies on the private market to generate Affordable Housing by tying its production to that of market-rate housing. Because of this, inclusionary zoning requirements are often paired with bonus measures, such as increased density or reduced parking, to offset the cost of the Affordable Housing units and minimize the risk of deterring housing development. Inclusionary zoning policies are found in cities across the United States and have been common in the Greater Boston region for decades.

Inclusionary zoning has many features, including affordability requirements and incentives for compliance. The former will include a certain rate of Affordable Housing within a development and a particular depth of affordability, among other elements, each of which comes with a cost for developers. To offset these costs, municipalities typically offer some combination of bonus measures, such as increased density or reduced parking.

In any inclusionary policy, there is only so much public benefit that a project can support before it becomes financially infeasible. This is particularly true in Lynn, where the housing market—while much stronger than in the past—is to a certain extent still considered a higher-risk market by some lenders and investors, especially those operating at a national level that typically fund large projects. For a policy to be effective, Lynn and all municipalities must balance policy components to achieve Affordable Housing priorities without dampening development.

Inclusionary zoning is not a replacement for nonprofit, subsidized Affordable Housing development, which can typically reach a deeper level of affordability and net greater units in a single project, but it is a good way to ensure new market-rate development benefits residents with lower incomes. It also creates mixed-income housing that integrates residents of different backgrounds within the building and common areas. Inclusionary zoning expands the overall supply of deed-restricted Affordable Housing without relying on limited government subsidy, facilitating the creation of more Affordable Housing overall.

Policy Components

Inclusionary zoning policies consist of a number of interconnected components that must work together to achieve community goals and ensure development is financially feasible. Although the details vary widely in response to local housing priorities and market constraints, most inclusionary zoning policies provide direction in the following:

- Percentage of units that must be affordable
- Income level(s) targeted (for example, 60% of Area Median Income)
- Cost offsets available
- Whether the program is voluntary or mandatory
- Size of development that triggers the inclusionary policy
- Whether the units may be provided on-site, off-site, or in the form of an in-lieu payment
- Length of affordability requirement
- Whether the affordable units must be comparable to the market-rate units
- Whether policy requirements apply citywide or differ by neighborhood

While each of these elements must be considered when drafting an inclusionary policy, this analysis focuses on the first three (percentage requirement, income level, and cost offsets) because they typically have the most significant impact on project feasibility. Additionally, the percentage requirement and target income level, which determine how many Affordable units are built and who can afford to live in those units, are key pieces in defining what the community benefit will be.

Inclusionary Requirements

When first adopting an inclusionary policy, many communities require affordability at 80% of Area Median Income (AMI), the upper bound of what is typically considered low income. However, the goal of Housing Lynn and many community members is to achieve affordability for a typical Lynn household with an income well below the conventional 80% of AMI. Providing Affordable Housing units at the lowest income levels (30% of AMI or less) is simply not feasible through any inclusionary policy, and instead should be pursued through other means described in Housing Lynn. But there is a potential opportunity for inclusionary zoning to require units at deeper levels of affordability than the standard 80% of AMI requirement, depending on the amount of affordable units required and other factors. MAPC considered the following scenarios in this analysis:

1. 10% of units at 50% of AMI
2. 15% of units at 60% of AMI
3. 10% of units at 60% of AMI
4. 15% of units at 80% of AMI

The first two scenarios above are uncommon due to their higher cost to developers; the fourth requirement is more typical. Of course, there are many possible scenarios beyond the four considered here, including tiers of affordability at differing AMIs, which could be considered in a next phase of analysis.

Some municipalities choose to adopt a base level of inclusionary zoning with public benefits that are more modest, and therefore less costly, than any considered here (such as 10% of units at 80% AMI). This approach has a much lower impact on project feasibility and requires few, if any, cost offsets. However, such a scenario is not reflective of the community goals identified in Housing Lynn and was not considered here.

This analysis also considered the option of an in-lieu fee. An in-lieu allows a development project to pay a fee rather than construct affordable units within the project itself. The municipality uses this fee to support Affordable Housing production or programs. There is a wide variety of methods that can be used to determine an in-lieu fee, each resulting in a different fee requirement that impacts development feasibility in different ways. Some municipalities do not permit in-lieu fees at all or permit them only under exceptional circumstances. Other municipalities offer the option of an in-lieu fee but set the fee at a level high enough to strongly discourage its use. Still others set a lower fee that more closely approximates the cost to the developer of an on-site unit but is typically not sufficient to build an affordable unit elsewhere. Each method has benefits and drawbacks that a community should consider in light of its housing priorities.

Typically, MAPC recommends that inclusionary units be provided on-site. Although an in-lieu fee allows increased flexibility for the developer, it can result in geographic inequities, with affordable units concentrated in neighborhoods with fewer resources and reduced access to amenities. Depending on method of calculation, an in-lieu fee can be far less than the cost of developing a new Affordable Housing unit, resulting in fewer Affordable Housing units built overall. Finally, if the municipality lacks the capacity to direct the funds to Affordable Housing production, the in-lieu payments may lie unused for years. However, in-lieu fees can provide a funding stream dedicated to the creation of Affordable Housing and are preferable to no inclusionary policy at all, particularly if the municipality has the capacity to effectively administer the funds generated through the fee.

Instead of or in addition to an in-lieu fee, a municipality may also consider a provision for off-site units. In Lynn, this approach may be appropriate for waterfront projects with high per-unit development costs. Like an in-lieu fee, at least some of the benefit of this approach to developers is in the flexibility it provides them, which is difficult to represent in a financial model. Accordingly, an off-site provision was not explored in this analysis, but should be considered in future discussion.

For the purposes of this analysis, MAPC considered two different methodologies for determining an in-lieu fee. The first is the "affordability gap" method, which is based on the difference in value between a market-rate unit and an affordable unit. The second is based on per-unit development costs, or the cost to construct a new affordable unit from scratch in another location. Any future study should consider a range of fee calculation methods, including their impact on development feasibility and their alignment with City priorities.

<u>Cost Offsets</u>

Because the inclusion of affordable units negatively impacts a development project's bottom line, many municipalities offer bonuses to offset the cost of the affordable units, particularly if seeking a deeper level of affordability. Because the City's goals include addressing the need for deep affordability while at the same time encouraging development, cost offsets will be a critical piece of Lynn's inclusionary policy.

In Lynn, traditional cost offsets will not serve as considerable incentives in major areas of the city where development interest is strong. In the Downtown and Waterfront, by-right zoning for mixed-use and multifamily development is so permissive that a density bonus, reduced parking, or other incentives are already allowed without requiring community benefits like Affordable Housing in exchange. There are three ways to implement effective inclusionary zoning in these areas: offer cost offsets beyond the current zoning, such as a further increase in building height; rezone these areas to allow for the negotiation of community benefits; or consider alternative cost offsets. This analysis explores a combination of these approaches, including property tax relief though the Housing Development Incentive Program (HDIP), an increase in allowable height, and a 50% reduction in permitting fees.

HDIP is a state program for Gateway Cities aimed at encouraging market-rate development, though projects with up to 20% affordable units are eligible. The program enables a 5- to 20-year local tax exemption on all or part of the increased property value resulting from improvements. Lynn has utilized HDIP to support several development projects in recent years. Prior to the adoption of HDIP, the City used local tax increment financing to provide property tax relief to desirable development. This analysis considered two HDIP variations: a 10-year and 20-year HDIP term, each with a steady annual increase in taxes owed over the course of the agreement. Both the term and the rate of incremental increase can vary, and additional variations should be studied if the City pursues HDIP as a cost offset tool. HDIP also includes provision for a state tax credit, though that has not previously been utilized in Lynn and is not considered as part of this analysis.

One of the most common cost offsets offered through inclusionary zoning is relief from specified dimensional requirements such as height, density, or parking requirements. This analysis considered a 3-story height increase, which was approximated as a 30% increase in the number of units (from 10 stories, the current height limit in the Downtown, to 13 stories). While this is a simplified interpretation of how a height bonus might be utilized, it provides a rough indication of how such a bonus would impact a project's bottom line. Furthermore, it assumes that height is currently a limiting factor for development projects, which is not necessarily the case. Indeed, several developers interviewed as part of this process indicated that, because Lynn's zoning code is already relatively permissive, they were unlikely to maximize allowable height, in which case a height bonus would be ineffective. Likewise, other dimensional relief not considered here, such as reduced parking or setback requirements, is unlikely to make a difference because they rarely constrain development in areas of Lynn of greatest interest to developers.

To address the larger issue of Lynn's relatively permissible regulatory environment and subsequent inability to offer meaningful cost offsets through dimensional relief, the City might consider amending its underlying zoning ordinance. As highlighted in Housing Lynn, a less permissive zoning ordinance would create the opportunity to offer greater incentives, which would in turn enable the City to require more Affordable Housing units or deeper affordability. Amended zoning was not considered as part of this analysis; if the City wishes to pursue this approach, it will need to study the potential base rezoning alongside any potential inclusionary policy.

Each of the cost offsets described above were considered independently of one another, but future analysis should also explore how these offsets might work in concert. Likewise, offsets not considered here—including additional variations of HDIP terms, other options for dimensional relief, or direct subsidy through local sources such as Community Development Block Grants—should be explored in future analysis.

Methodology

To understand the impact of each of the inclusionary requirements and cost offsets described above, MAPC utilized a financial feasibility model. This model is based on a pro forma analysis that is typically used by a developer to understand whether a real estate project is financially feasible. A development pro forma takes into account dozens of project-specific real estate development variables to arrive at a projected level of profitability. As each of these variables change—for example, as construction costs decrease or interest rates increase—profitability goes up or down. If profitability falls below a certain level, the project is considered infeasible.

MAPC's financial model considers development costs (including land acquisition, construction, and soft costs like legal and permitting fees), financing costs, and operating costs for projects of varying sizes. An important part of financial modeling involves market research to ensure that the model's inputs reflect Lynn's local development conditions. This analysis relies on interviews with real estate professionals active in Lynn and familiar with local development conditions, along with information from industry real estate database CoStar. A full list of assumptions can be found in the appendix.

To understand how different inclusionary requirements might impact development feasibility, MAPC developed a baseline scenario for a rental development project with no inclusionary zoning and no cost offsets. For the purposes of this analysis, the baseline project is a theoretical mid-rise project that might be located in the Downtown. Of course, Lynn is home to a variety of neighborhoods, and additional baseline projects, such as low-rise wood frame construction and projects that involve waterfront mitigation costs, should be considered in future analysis.

From there, MAPC explored the ways that different iterations of an inclusionary policy (for example, number of affordable units required, level of affordability required, or cost offsets available) might impact the project's bottom line. To assess impact to the project's bottom line, this analysis utilizes Internal Rate of Return (IRR), one of many metrics that developers use to determine anticipated profitability of a potential development project.

The minimum IRR required to advance a project varies depending on the developer's requirements, those of their lenders and equity investors, and project-specific conditions. For the purposes of this analysis, MAPC considered the comparative feasibility between no inclusionary zoning and different inclusionary zoning scenarios rather than absolute feasibility. In other words, the analysis is focused on the extent to which various policy elements increase or decrease the baseline project's IRR, making it more or less feasible, rather than whether the IRR is above a certain threshold. This approach was used because it is more broadly applicable to projects that may have differing IRR targets. Consideration for the degree of change, rather than whether a project is above of below a certain threshold, also offers a more nuanced understanding of policy impacts.

For the purposes of this analysis, any scenario with a positive change in IRR or with a negative change of less than a half percent is considered to have a minimal impact on the project's bottom line. A negative change in the IRR of up to 1% would make the project less profitable, but could likely be absorbed. Of course, these numbers are guidelines only; projects on the cusp of feasibility will be highly sensitive to even small changes in profitability, whereas projects with greater margins may have more leeway.

Analysis

The impacts of the affordability requirements and cost offsets considered in this analysis are shown in Table 1 below. In all cases, the change in IRR is in relation to the baseline project (no affordability and no cost offsets).

Table 1: Affordability requirements and cost offsets

		Affordability Requirement Scenarios				
		No affordability	(1) 10% units at 50% AMI	(2) 15% units at 60% AMI	(3) 10% units at 60% AMI	(4)15% units at 80% AMI
Cost Offsets	No offsets	**16.0%**	13.0%	12.7%	13.7%	14.3%
		Baseline	-3.0%	-3.3%	-2.3%	-1.7%
	50% permitting fee reduction	16.3%	13.3%	13.0%	14.0%	14.6%
		0.3%	-2.7%	-3.0%	-2.0%	-1.4%
	10-year HDIP	17.7%	14.6%	14.3%	15.3%	15.9%
		1.7%	-1.4%	-1.7%	-0.7%	-0.1%
	20-year HDIP	19.1%	16.0%	15.7%	16.8%	17.4%
		3.1%	0.0%	-0.3%	0.8%	1.4%
	In lieu fee: Aff. gap ($100-225k/unit[1])	16.0%	13.0%	12.7%	13.7%	14.3%
		0.0%	-3.0%	-3.3%	-2.3%	-1.7%

[1] When using the affordability gap method, the large difference in per-unit fees is due to the differing values of a unit depending on the income level at which it is deed restricted.

	In lieu fee: Dev. costs[2]	16.0%	12.0%	10.4%	12.0%	10.4%
	($300-350k/unit)	0.0%	-4.0%	-5.6%	-4.0%	-5.6%
	3-story height increase	16.8%	13.7%	13.3%	14.5%	15.0%
	(30% density bonus)	0.8%	-2.3%	-2.7%	-1.5%	-1.0%

Percentages in grey text indicate a given scenario's IRR.

Percentages in a colored gradient indicate that scenario's change from the baseline IRR: -5.0% 0.0% 3.0%

The first row in Table 1 demonstrates the impact that varying affordability requirements would have on the baseline project if no cost offsets were offered. Unsurprisingly, as the percentage of affordable units increases and the required affordability levels become deeper, the impact on the project's IRR becomes more deleterious. Any of the scenarios that address the community's desire for deeper affordability—in the 50-60% of AMI range—would substantively reduce development feasibility. This does not mean this shouldn't be pursued, only that cost offsets will be needed to meet these deeper affordability goals without deterring development.

Conversely, the second column demonstrates the extent to which various cost offsets positively impact IRR in the absence of inclusionary requirements. While MAPC does not recommend utilizing any of these tools for projects that do not include an affordable component, this column is instructive in that it clearly indicates the degree to which some cost offsets are more effective than others.

The remainder of the columns and rows demonstrate the degree to which each cost offset mitigates each affordability requirement:

Permitting fee. While a 50% reduction in the City's permitting fees results in a small increase in IRR in all scenarios, it is not sufficient to substantively recoup the costs of providing Affordable Housing units. This is likely to be true even if the permitting fee was waived entirely. However, a permitting fee reduction could be a useful tool when used in combination with other cost offsets.

Housing Development Incentive Program. Of all the tools considered in this analysis, HDIP has the greatest potential to offset the costs of deeper affordability. The 10-year HDIP agreement, the lesser of the two HDIP options considered, reduced the impact of 15% of units at 80% of AMI to almost nothing; the 20-year HDIP did the same for even the more deeply affordable scenarios (10% of units at 50% of AMI and 15% of units at 60% of AMI). Of course, HDIP is a complex tool and additional study is needed before incorporating it into an inclusionary policy (specific next steps are described later in this document).

In-lieu fees. The first method used to calculate an in-lieu fee, the affordability gap method, is intended to result in a fee that is roughly equivalent to the difference in value between an affordable unit and a market-rate unit. Accordingly, such a fee does not change the project's IRR.

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[2] When basing fees on development costs, the IRR is responsive only to the percentage unit requirement, not to target AMI, because the cost of physically building a unit is the same regardless of target affordability.

However, from a developer's perspective, there are many advantages to an in-lieu fee—such as increased flexibility and decreased management responsibilities—that are not quantified in this analysis. An affordability gap-based fee would likely be an appropriate offset for a minimal inclusionary requirement, or used in combination with another cost offset, but would not be sufficient on its own to achieve deeper affordability.

An in-lieu fee based on development costs, the second method used here, increases project costs rather than offsetting them, decreasing the projected IRR even further. An in-lieu fee using this metric would serve as strong encouragement for developers to build affordable units on-site and would likely be rarely utilized. While there are concrete policy benefits to this approach, as described above, it is not effective as a cost offset.

Height increase. An increase in height, calculated here as a 30% increase in units, results in a moderate cost offset but is not sufficient to neutralize the cost of including affordable units (though it comes close when the requirement is 15% of units at 80% of AMI). This is in part because the analysis assumes that any bonus units would also be subject to a 10-15% affordability requirement. There are several modifications to this approach that may increase its benefit, potentially to the extent that a lighter affordability requirement (such as those contemplated in scenarios three or four) becomes feasible. However, if a project is not seeking to maximize allowable height, as discussed above, this approach will be minimally useful regardless of potential modifications.

Conclusions

This analysis demonstrates that there are multiple ways to structure an inclusionary policy depending on the City's priorities. Of the scenarios considered above, the fourth is the least effective in terms of meeting the deeper affordability goals defined in Housing Lynn. Although it requires fewer cost offsets to achieve fiscal neutrality, affordability at 80% AMI simply does not align with local need.

The feasibility of the remaining three scenarios—those targeting 50% or 60% AMI—ultimately depends on the City's ability to offer substantive cost offsets. If the City's highest priority is to minimize its financial outlay for an inclusionary ordinance, it should consider dimensional relief. Depending on the policy details, a height increase of 2-3 stories above the current 10-story downtown height limit could enable a moderate affordability requirement. Combined with a permitting fee reduction, the policy may be able to achieve a requirement akin to the third scenario without long-term subsidy and with only minimal impact to project feasibility. However, because many developers may not be interested in the complexities that come with constructing taller buildings, this option may be limited in its use. Reconsidering the underlying zoning could also enable cost offsets that do not require local subsidy, though this option requires further analysis.

If the City wishes to achieve the depth and breadth of affordability that will begin to address local need, such as those in the first and second scenarios, its most powerful tool is the provision of financial offsets through HDIP or another tax increment financing mechanism. The extent of the public benefit enabled by HDIP varies broadly depending specific details such as term length, and the City will need to determine its own goals and limitations with regards to the HDIP program in order to more fully understand the level of public benefit that HDIP could leverage.

Finally, this analysis focused on mechanisms that would result in net neutral policies, meaning that in general they would not reduce a developer's profit margin. However, many municipalities adopt policies that may incrementally reduce development profitability but that would not be prohibitively burdensome and would not be expected to deter development; the City should consider this approach as well.

In short, the specific components of an inclusionary policy in Lynn will depend on how the City ultimately prioritizes creation of Affordable Housing relative to market-rate housing and income from new development. No matter the City's priorities, this analysis demonstrates that there is a set of inclusionary requirements that can be crafted to better meet housing need in Lynn.

Next Steps

The findings of this analysis are intended to serve as a foundation for a more extensive, community-driven planning process. Specifically, future inclusionary work should include:

- Engagement. Though not described in detail here, an in-depth understanding of community priorities will be critical to developing a successful inclusionary policy that is responsive to local need. Engagement should include education of how inclusionary zoning works and the tradeoffs between requirements and cost offsets.
- Supplementary market research. This includes additional interviews with for-profit developers, non-profit developers, lenders, and equity partners. Depending on the timing of the next phase of work, post-pandemic real estate trends should be assessed.
- Geographic considerations. These may include lower affordability requirements where HDIP is not available, greater flexibility such as in-lieu or off-site units for projects that require waterfront mitigation, and different cost offsets appropriate for a variety of neighborhoods and development types. Additionally, opportunity zones were not considered in this analysis because initial feedback from local developers indicated that this tool is of limited use and would likely go unused in many circumstances; this assumption should be confirmed.
- Deeper exploration of in-lieu payments. This includes identifying policy goals for in-lieu fees, such as whether their use is encouraged, discouraged, or not permitted; assessing City capacity to utilize in-lieu payments; studying additional methodologies for payment calculation based on City priorities; and evaluating non-tangible benefits associated with an in-lieu option.
- Deeper exploration of HDIP options. This includes analyzing additional variations on term length and rate of incremental increase; confirming that utilizing the program as a cost offset for a local inclusionary policy is consistent with state regulations; identifying a mechanism for local tax increment financing in the event that the HDIP program is discontinued; researching the state tax credit component of HDIP and potential for use on a case-by-case basis; and refinement of analysis assumptions regarding associated soft costs and anticipated assessed value.
- Refinements to the financial feasibility analysis. This includes identifying and evaluating additional potential cost offsets, such as reduced parking, different finishes or units sizes for affordable units (within specified limits), or alternative methods of property value assessment; addressing fractional units; evaluating a greater range of development types, including small developments and low-rise development; performing a sensitivity analysis; determining whether the affordability requirement is based on the number of units or on floor area; and identifying market conditions under which additional community benefit might become possible.
- Plan for implementation within the framework of current city processes. Because most development projects in Lynn can be built by right, the City will need to identify a mechanism through which to administer a future inclusionary policy, confirm that any such mechanism is consistent with current City and State regulations, and define a new process so that program administration runs smoothly and efficiently.
- Potential zoning ordinance changes. One of the recommendations in Housing Lynn is to amend of the City’s zoning ordinance, particularly with an eye towards creating opportunities to offer greater cost offsets and leverage deeper affordability through inclusionary zoning. Any major dimensional or use changes would impact how inclusionary

scenarios effect development feasibility and should therefore be made in advance of or in concert with determining inclusionary requirements.

Ultimately, the City will need to draft an amendment to its zoning bylaw that is approved by a two-thirds majority of City Council.

Development Assumptions

This analysis is based on the following assumptions pertaining to future development:

Development program

- Project size: 75 units and 200 units (two project sizes were considered)
- Unit mix: 10% studio units, 60% 1-bdrm units, 25% 2-bdrm units, 5% 3-bdrm units
- Unit size: 450 sq.ft. studios, 650 sq.ft. 1-bdrms, 850 sq.ft. 2-bdrms, 1,200 sq.ft. 3-bdrms
- Common area: 20% of total building area
- Parking: 0.5 spaces per unit

Construction costs

- Construction costs (mid-rise construction): $300/sq.ft.
- Parking costs (structured parking): $20,000/parking space
- Acquisition costs: Varies; $25,000-$50,000/unit depending on project size
- Soft costs: 20% of construction costs

Operating

- Rents: $1,800/month studio, $2,200/month 1-bedroom, $2,500/month 2-bedroom, $3,000/month 3-bedroom, Affordable rents per HUD requirements
- Operating costs: $8,500 per unit annually
- Vacancy rate: 5%
- Parking fee: $125/month

Financing

- Debt/equity: 65% permanent debt, 35% equity
- Permanent debt interest rate: 5.0%
- Mortgage term: 30 years
- Sale at year 10
- Inflation: 3%
- IRR: 16%

Note: The current pandemic has impacted the regional real estate market, most notably through higher vacancies and decreasing rents in urban centers. This analysis assumes that current market conditions are unique and temporary, and uses assumptions based on a pre-pandemic housing market.