Attachment 1

Renewal Enterprise District

Options and Feasibility Assessment: Promoting Infill Development in Sonoma County

July 2020

Photo credit: Downtown Specific Plan Update 2020

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as part of the firm's engagement with the Renewal Enterprise District.

I. Introduction

For its assignment with the Renewal Enterprise District (the "RED"), Forsyth Street Advisors ("Forsyth Street") is exploring the feasibility of creating a new housing fund (the "Fund") for infill housing development in Sonoma County. Initially focused on urban Santa Rosa, the Fund will look to catalyze the emergence of more dense, vibrant infill communities by providing powerful new investment tools to deliver capital for affordable and market rate housing.

This Options and Feasibility Assessment (the "Report") presents an overview of the Fund's mission and goals; the existing development landscape within Sonoma County, the current challenges developers face in completing their projects, and why a new Fund is suited to deliver these missing capacities; and the types of products and mechanisms for delivery that could meet developers' financing needs.

Process

The concept for a new Fund was researched and tested through extensive outreach to Santa Rosa and Sonoma County's housing development community. This outreach sought to identify ways in which additional affordable and market-rate housing could be generated, and to identify the funding gaps and challenges developers face when looking to create more dense infill housing in an emerging market.

The process for conceptualizing a new Fund and identifying products that would help to move projects forward was informed by interviews with over 25 local and regional stakeholders. These included representatives from the public sector, for-profit and nonprofit housing developers, and local capital providers from the private sector. With their input, our organizations were collectively able to assess the market need for a new fund and identify products that meet developers' needs.

The process to date has culminated in the completion of this Report. Next steps for a possible Phase II include continued refinement around the contemplated product set, as well as moving to "stand up" the Fund by developing its legal structure, governance, management, operations, and capitalization.

II. Our Mission & Landscape Review

A. Purpose and Background

Why Santa Rosa?

Santa Rosa is the largest city in Sonoma County and is home to more than one-third of the County's population. Located roughly 50 miles north of San Francisco, Santa Rosa has developed into a major hub for North Bay Area government, commerce, medical facilities and tourism, with major economic drivers for the region being the nearby wineries, vineyards, parks and recreational facilities. Historically the region has experienced year-over-year population growth, with unemployment rates lower than the California and national averages[1] (though between 2017-2019 the County's population declined by approximately 4,700 or almost 1% due in part to high housing costs and impacts of the fires[2]). This, combined with historically low vacancy rates in both rental and single-family homes, has created a shortage of housing units for individuals at all income levels. Rising rental rates and home prices have made it difficult for individuals and families with lower to moderate incomes to obtain housing, while various policy and economic components have continued to impede development.

Exacerbating these housing conditions was the 2017 Tubbs Fire, which greatly devastated the existing housing stock within Santa Rosa and Sonoma County. Already experiencing a housing shortage, the fire destroyed more than 5,300 homes in the region, including entire neighborhoods in Santa Rosa. The housing gains the County had made in the years prior were severely diminished, with the City's residential stock expanding by approximately 870 net new units over an eight-year period (2010-2017)[3]. When compared to the stated goal of adding 5,000 new units by 2023, conveyed in the City's 2016 Housing Action Plan, the City is faced with the major challenge of the dearth of housing being built in a high-cost environment.

As a response, the City of Santa Rosa has taken significant measures to increase housing production while changing the historical pattern of development. Priorities of Santa Rosa residents have shifted as a result of these fires – where single-family homes and properties were once idealized, some residents have now expressed desires to live in denser, more centrally-located neighborhoods that are closer to both workplaces and lifestyle amenities. Local employers have also expressed support for additional infill development that could attract a workforce that increasingly prefers to settle in denser, more urban and walkable communities. Recognizing these changing housing and lifestyle priorities, both the City and County have taken several steps to support the policies, efforts, and initiatives that support infill development downtown and near transit corridors.

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[1] BBG Appraisal Group, 2019.
[2] The Press Democrat: *Sonoma County Population Declines Sharply,* January 2020.
[3] City of Santa Rosa; *Downtown Specific Plan Market Demand Study;* 2019.

Steps Taken by the City and County to Promote Greater Development

In the face of these community challenges, the City of Santa Rosa and the County of Sonoma have taken aggressive actions to reform and align policy, infrastructure, civic leadership, and investment strategies to create a supportive environment for reinvesting and refocusing development in infill, urban areas. Some examples of this include:

Creation of the Renewal Enterprise District. As a response to the County's severe housing shortages, the City of Santa Rosa and the County of Sonoma authorized the creation of the Renewal Enterprise District ("RED"), a Joint Power Authority in which the two municipalities are the initial members. Public stakeholders acknowledged that their housing challenges represented a more regional crisis, rather than contained in one municipality. Intended to catalyze and facilitate housing development in targeted infill areas, the RED is able to leverage public and private financing to support housing development that conforms to a set of project criteria. Acting at the intersection of public stakeholders, developers, and capital providers, the RED is poised to aggregate capital and knowledge from these sources in order to promote the targeted types of infill development throughout the City and the County.

Increasing Development Feasibility. To incentivize infill development the City has taken a number of steps to reduce fees and implement policies that would improve a project's costs. This includes implementing the Downtown High-Density Residential Incentive Program, which reduces impact fees and defers water and wastewater fees; and introducing an aggressive density bonus of up to 100% in the in the Downtown Station Area Specific Plan area to allow for more units.

Streamlined Review and Permitting Processes. Lengthy, bureaucratic processes for project review and approvals have harmed projects – as developers wait for these processes to complete, associated project costs often rise, creating additional financing shortages for their respective projects. In order to prevent this from occurring, the City has curtailed discretionary action for design review and is creating clearer design guidelines for housing projects located downtown and in four other Priority Development Areas. The City has also created an "express permitting" process for downtown infill projects, aiming to reduce the typical 18-month process down to approximately six months. Separately, the County has also enacted some, and is in process of updating other, new zoning ordinances and simplified development standards to clear the way for higher density housing in other urban areas near jobs and transit.

With the local agencies maximizing and leveraging available tools and resources to move infill development forward, development seems poised to jumpstart in the downtown core. However, due to a number of challenges faced by developers, projects have failed to progress at the rate needed to counteract the County's housing shortage.

Why a New Fund?

Santa Rosa is Investment Ready. As noted above, the Santa Rosa community has invested heavily over the past few years in both policy and infrastructure changes to incentivize and streamline priority types of development in infill areas. The actions taken by public stakeholders and pro-housing advocacy groups have positioned Santa Rosa for new infill development, an initial step in creating a more vibrant, livable urban core.

The Fund Will Fill Existing Funding Gaps and Have the Ability to Leverage Additional Resources. Further articulated in the following sections of this Report, the Fund's primary purpose will be to deliver the types of investment products that are able to catalyze infill development in a way that has not been traditionally possible. Projects in Santa Rosa, especially those located downtown, have been challenging to finance with traditional debt and equity sources. With capital supplied by the Fund, these projects will create a more complete urban core, and will ideally prove that a market for this dense, infill residential housing typology exists. In addition, the Fund will seek to be structured in a way so that it is able to leverage capital from a variety of public, philanthropic, and private sources.

The Situation is Urgent. The ramifications from the Sonoma Complex Fires are still being felt within the Santa Rosa community and throughout the County. The income gap between wealthy and workforce residents continues to widen, and in a market where construction costs are high, in part due to disaster recovery and the mass rebuild underway, projects face increasing amounts of financial and political pressure to move forward, albeit with ever-constrained financial resources. The City and County desperately need new tools through which to increase the pace of development, and with financing provided by a new Fund, projects that have historically been stalled or abandoned due to increasing costs or the inability to locate sufficient funding may be able to progress.

B. Landscape Review

The Current Development Market

Historical Development Patterns. Single-family homes have long dominated development in Santa Rosa. However, recent studies have indicated that rental residences have been accepted and favored by a growing proportion of Santa Rosa residents[4]. In addition, many residents have expressed the desire for a more central, sustainable, transit-oriented community after experiencing the impact from the devastating Tubbs Fire. While there will always be a demand for single-family homes, the growing proportion of renter households within Santa Rosa suggests that there is also demand for a denser, infill product located within the City's urban areas.

Projects Under Consideration. As part of this landscape review, our analysis included conducting interviews with a number of affordable and market-rate developers based within and around Sonoma County. Some of these developers had active projects in various stages of predevelopment, with some specifically focused on densifying downtown Santa Rosa. The cost and market data provided by these developers influenced considerations on appropriate products for the Fund, how the Fund would be capitalized and how these products would interact with other sources of project financing. Characteristics from the set of reviewed projects included:

- <u>Affordable Projects:</u> Projects were at least 75 units, with the majority of units affordable to individuals at or below 80% of area median income (AMI). Projects discussed were in various stages of predevelopment, with most in the process of applying for Low Income Housing Tax Credits. Although projects use some conventional construction and permanent debt from both local and national banks, project financing is heavily reliant on "subsidized" sources including tax credit equity and subordinated debt from governmental agencies or foundations. Developers project public sources from the City, County and State.

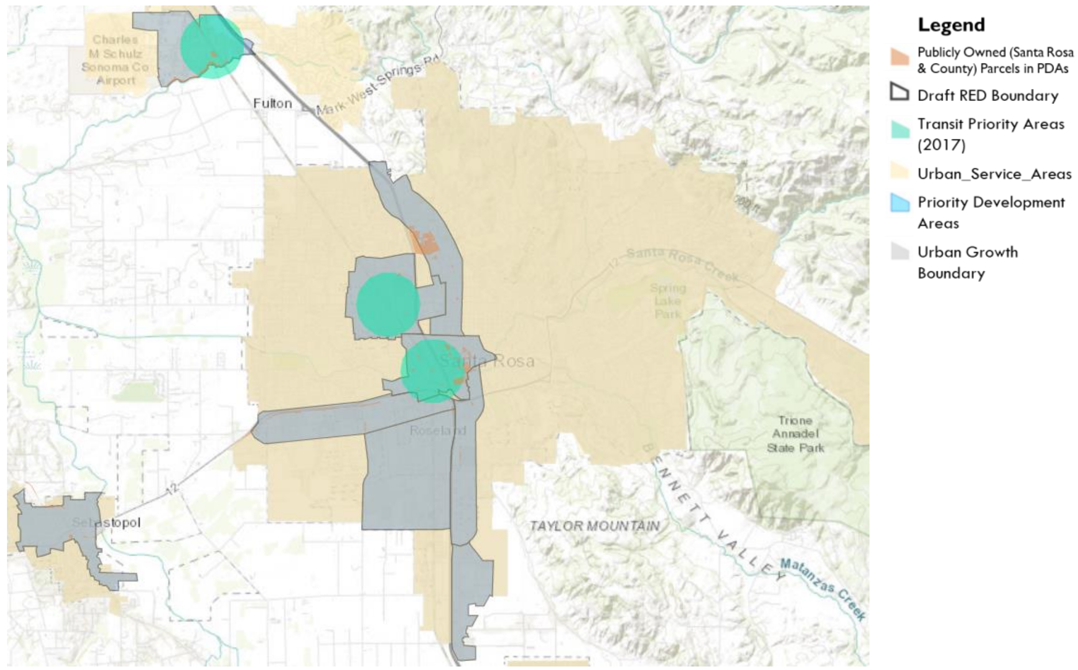
- <u>Market-Rate Projects:</u> Projects averaged approximately 100 units in size. Projects discussed were in various stages of predevelopment. Construction loans for these projects are typically supplied by local banks with some of these lenders also providing permanent loans. The

[4] City of Santa Rosa; *Downtown Specific Plan Market Demand Study;* 2019.

remainder of the project's financing is comprised of equity from the developer/owner, "friends and family", and regional equity investors. National lenders and institutional investors are not particularly common in the market.

Promoting Infill Development

Defining Infill Development. Products offered by the Fund will seek to activate priority infill projects located in planning areas targeted by the RED. More concretely, the Fund will look to support projects located in dense, urban areas of Sonoma County, with a natural focus on Santa Rosa's urban core. Projects will be principally multifamily residential, possibly with a mixed-use component (e.g., ground floor commercial space), and will be targeted to a range of income levels, including affordable, middle-income/workforce, and market-rate.



RED-Adopted Project Criteria. Shortly after its formation, the RED adopted project criteria to help determine the types of projects the RED would support (and eventually, help to determine the types of projects a new Fund would finance). Intentionally broad, these criteria are flexible so as not to exclude any projects that are aligned with the following core principles:

- <u>Located on an Infill Site:</u> Projects must on urban sites within Santa Rosa or unincorporated Sonoma County that have either been previously developed or are currently vacant but are adjacent to sites with qualified urban uses.
- <u>Provides Mid- to High-Density:</u> Project density is at least at the middle of a jurisdiction's qualified zoning for a site.
- <u>Located in a Transit-Rich/Planned Area:</u> Projects must be located entirely within Transit Priority Areas, Priority Development Areas, Rural Community Investment Areas, Specific Plan Areas, High-Quality Transit Corridors and/or Qualified Opportunity Zones.
- <u>Are Either Residential or Mixed-Use Residential:</u> At least 75% of the total building square footage for the project consists of residential uses.

In addition, projects must incorporate one or more of the following criteria: include affordable units (determined by the income limits published for Sonoma County by the State Department of Housing and Community Development), include on-site workforce housing, include on-site "affordable by design" units (e.g., units are smaller than typical market-rate units, are more efficient and have fewer amenities), be closely located to transit, are energy efficient, are water efficient, and include an innovate design component, among others.

III. Challenges Facing Development

Over the course of our interviews with developers, many were in the predevelopment phases of their projects, with these projects stalled before moving towards construction. Developers face a variety of factors that impact a project's construction costs and rental revenue, two critical factors in determining a project's financial feasibility and ability to move forward.

A. Cost and Revenue Assumptions

High Construction Costs

A number of factors impact a developer's construction costs. Within Santa Rosa, our interviews with developers spoke to the following construction cost barriers:

Contractor Costs. The largest cost of a project is the contractor's construction budget. California especially has seen rapidly rising costs over the last decade – a recent study found that hard costs per square foot, which includes labor and materials, increased 25% between 2008-2018[5]. Inflated construction costs are exacerbated by the high demand for labor and materials as the County rebuilds homes and businesses lost during the 2017 and 2019 wildfires in addition to the 2018 floods. Furthermore, infill development is inherently more expensive to build due to the typology: multiple stories require higher-cost materials such as concrete and steel, parking garages, elevators, higher fire-rated materials, etc. Affordable housing can have even higher construction costs due to prevailing wage and other labor requirements that are driven by government funding. While these changes alone will not solve the high cost of construction, developers are exploring, and in some cases moving forward on methods that may reduce construction costs slightly, including using in-house general contractor capabilities to cut fees, hiring out-of-area labor, and using modular construction.

Offsite Costs. In some projects, developers are required to pay for adjacent infrastructure or streetscape costs, which further increase a project's hard costs. Where public funding can cover these costs, this will help a project's feasibility.

Land Costs. As the California real estate market has become more competitive, landowners demand high prices for infill parcels. In some cases, developers may have acquired parcels years ago at a lower cost, though there are ongoing holding costs such as property taxes and interest. If public agencies that own land are able to offer their parcels to developers at low-cost, this ultimately can support a project's feasibility.

Local Policies. Local policies, including permitting, zoning requirements, and approval processes, can further add to a project's costs. Although there are still costs such as permitting and impact fees that some developers hope could be reduced even further for project feasibility, local agencies have taken meaningful steps to reform processes and curtail costs. Steps already taken include:

- *Reform Design Review and Streamline Permitting*: The City has reduced discretionary reviews and shortened the design review and permitting timeline. These clear design guidelines and shorter timeframes can reduce cost escalation risk.
- *Modify Zoning Requirements*: Updated requirements allow for reduced parking and more density.

[5] Terner Center, US Berkeley: *Hard Construction Costs, March 2020.*

Limited Revenue Assumptions

When a developer assembles projections for the project, they are generally limited with respect to the range of revenues and rent levels they expect their project to command.

Unproven Market/Lack of Comparable Projects (Market-Rate). Beyond high costs, a big challenge for market-rate projects is that Santa Rosa represents a new market for a denser, urban, infill product. The existing housing stock in Santa Rosa is primarily single-family homes and low-rise garden-style apartments. There are currently no comparable projects in the local market to verify the rents required to cover the higher cost of development inherent in a denser infill project.

Capped Rents (Affordable Housing). Alternatively, the demand for affordable housing is almost limitless. In order to qualify for tax credits and public agency funds, affordable housing projects offer below-market rents that are affordable to lower-income households. Because of these low rent levels, the public subsidy provided is essential to the project's financial feasibility.

B. Financing Implications

Financing for Market-Rate and Affordable Projects

Market-Rate Financing. While developers are optimistic that changing demographics and attitudes will attract sufficient demand and higher rents for an infill project, lenders and investors view this unproven market with uncertainty. For example, a construction lender may lend at the lesser of 70% of cost ("Loan to Cost" or "LTC") or 80% of projected value when leased ("Loan to Value" or "LTV"). In order to determine Loan to Value the lender must project future rents. Because there are no precedent projects to prove the market, the lender takes a conservative approach and uses rents lower than the developer's assumptions. The result is that the lender's projected value can be lower than the project cost, which limits the construction loan to an even lower amount (to the equivalent of 60% LTC for example).

- In this example, the remaining 40% of the project's construction costs must then be financed with equity. Equity is more expensive than debt because a construction lender may charge 4% interest, while an equity investor may require a 12-15% rate of return ("IRR"). The combination of high construction costs and unproven rent assumptions makes it infeasible to meet the equity IRR requirements as it becomes a larger percentage of the capital stack. The developer is unable to meet the required rate of return for the equity within their current model of construction costs and projected rent levels.
- As a result, there is a need for a lower cost mezzanine (second-position) debt product that can work alongside traditional loan products to bridge the gap between developer and lender expectations and achieve a higher total combined loan amount. Ideally this would jumpstart "pioneer projects" that could be catalytic in proving the market and ultimately stimulate more infill development under traditional financing mechanisms.

Affordable Housing Financing. High development costs and low rents make it impossible for an affordable housing development to be financially feasible without permanent "subsidized" financing. Besides federal and state tax credits (which are allocated by the federal and state governments and purchased by banks), most developments rely on subordinated debt from governmental agencies or foundations. Typically, repayment amounts are flexible as they are repaid based on a specified percentage of "residual receipts" or cash flow after expenses and must-pay bank debt. Interest rates are low (0-4% simple) with a very long loan term (e.g. 55 years). In a few cases, particularly where a project offers units to tenants at higher AMIs while still qualifying as affordable or middle income, the associated higher revenue may allow for a small tranche of subordinate debt to be repaid as a fixed monthly amount.

- Developers apply for these loans through City, County, and State programs. Funds are extremely limited at the City and County level, but projects that apply for competitive State programs benefit when they have local commitments first (projects receive "leveraging" points for bringing other public funds to the table). The more funds that can be made available to developers in Sonoma County, the more affordable housing can be built.
- As a result, there is a need for additional sources of both mezzanine and residual receipt debt that can fill in gaps at any point in the development process beginning with predevelopment and can stay in the project long-term.

IV. Potential Fund Products

Through a mix of initial products targeted to both affordable and market-rate developments, the Fund will seek to activate projects in urban Santa Rosa initially before expanding to other RED designated planning areas within Sonoma County. As the market within Santa Rosa for multifamily residential buildings matures, the Fund may look to change its product offerings to be more responsive to future market needs and/or additional interventions and gaps in the market.

The products described below have been identified and structured as a result of the conversations and interviews conducted to inform this Report. In addition, these products have been vetted with various Santa Rosa stakeholders, developers, and other capital providers and lending intermediaries within the community.

Prioritization of Projects. All projects financed by the Fund will be aligned with RED criteria. Designed to be flexible, these criteria are supportive of a range of different project types, but all enforce the goal to create a more dense, livable and vibrant urban Santa Rosa. However, because these criteria are broad, and the Fund will likely have a limited amount of capital to support projects, the Fund may need to further identify criteria beyond the RED's to help prioritize certain projects. For example, the Fund may look to prioritize projects that are led by experienced local developers, are in need of immediate financing, or are, with additional financing from the Fund, financially ready to begin construction and have assembled all remaining construction and/or permanent financial sources. At a later date, a governing body for the Fund may need to determine how to prioritize projects further.

A. Products for Affordable Developments

Affordable project developers require capital that is able to be patient and stay in a project for as long as needed to make the project fully feasible. This could mean capital provided only at the predevelopment stage (and repaid by the project's construction financing) or capital that is able to stay in the project after construction completion and support the project permanently. The Fund will seek to offer highly flexible financing to affordable projects that meets the developers' specific financing needs.

Affordable Product Term Sheet:

Description:	Financing able to fill gaps in a project's capital stack at all phases of the development process.
Market Need:	High project costs and below-market rents result in projects requiring a source of highly flexible, long-term, subordinated debt.
Project Analysis:	Initial underwriting at origination to determine appropriate size/term
Eligibility:	Affordable (typically up to 80% AMI, 80-140% AMI negotiable) multifamily rental projects that align with RED Criteria
Illustrative Terms:	• Term: To be determined; depends on project specifics • Amount: To be determined • Rate: Target [1.0-4.0% simple]

	• Lien: First position on predevelopment/acquisition; second position on construction or permanent; limited recourse. • Eligible Uses: Flexible; predevelopment, acquisition, construction and permanent financing
REPAYMENT TERMS:	Flexible; determined by project specifics. Predevelopment/construction interest may be paid current by borrower or capitalized to the loan amount.

Potential Projects. Developers and stakeholders indicated that this type of product could also be useful for "adaptive re-use" projects, in which a developer would use the Fund's financing to acquire and repurpose distressed assets. The COVID-19 pandemic has severely crippled tourism and hospitality industries across the nation. Sonoma County, like elsewhere, may encounter distressed hotels or other assets that could become potential acquisition targets for affordable housing. Depending on the quality of the asset and potential purchase prices, the Fund's affordable product may be also used to support the acquisition and rehabilitation of these assets.

B. Products for Market-Rate Developments

As expressed in earlier sections of this Report there are a number of infill market-rate developments in the predevelopment phase that are in need of cost-effective financing to start construction and ideally spur infill development. After discussing and reviewing projects with market-rate developers, Forsyth Street identified two products working in conjunction with each other, that could support market-rate projects.

Subordinate Construction Loan Product:

DESCRIPTION:	Subordinate construction financing with the ability to convert to permanent mezzanine debt or equity (see following product).
MARKET NEED:	The market uncertainty faced by both developers and traditional market-rate capital providers in downtown Santa Rosa, for example, has resulted in developers being unable to secure sufficient construction financing. Construction lenders often size their project loans according to two metrics; lenders will offer financing at the lower of (for example) 80% of the project's value, or 70% of the project's total cost. Since there are no precedent projects to prove the market, the lender's appraiser undervalues the project (e.g., the project is not as valuable as the developer expects it to be), and in a market environment of extremely high construction costs, this almost always results in a smaller construction loan than what the developer needs to fund the project's construction. As a result, the developer is either forced to raise an additional loan or higher cost equity to fully fund

	the project. The developer may be unable to raise enough capital in this situation, or additional capital may only be available at terms that make the project infeasible. The Fund's loan is able to fund the lending gap at a lower cost than equity.
PROJECT ANALYSIS:	Upfront underwriting of the construction financing and variability of permanent loan sizing. The Fund will analyze how different rental rates at lease-up would affect the sizing of the first position permanent loan and the ability of the Fund's construction loan to be repaid, or the need to be converted to permanent mezzanine debt or equity.
ELIGIBILITY:	Market-rate and workforce multifamily rental projects that align with RED criteria.
ILLUSTRATIVE TERMS:	• Term: Up to [5] years • Amount: Up to total of [70%] loan-to-cost (LTC) when combined with the first lien construction loan • Rate: Target [4.0%] fixed • Lien: Second position, guarantees follow first position loan • Eligible Use: Site acquisition, hard construction costs and/or rehabilitation
REPAYMENT TERMS:	Flexible; to be determined based on project specifics. • If sufficient permanent financing is available upon project completion, then the Fund's loan will be fully repaid from permanent financing sources • If the borrower is unable to raise a sufficient amount of permanent financing to fully repay the Fund's loan, then a portion of the loan is repaid while the remaining balance converts to a permanent mezzanine loan or equity (see following product). Interest to be paid current by borrower.

Mezzanine Permanent Loan:

DESCRIPTION:	Gap-filling, permanent loan sized to the project's available cash flow after payment of required debt service on the project's first position permanent loan. Convertible to equity in limited circumstances.
MARKET NEED:	Developers have indicated that they may require a source of financing that is able to stay in the project long-term and is lower cost than the project's equity. Permanent lenders will size their permanent loans based on a debt coverage ratio ("DCR", or how much debt the project can support), for example, at 1.15. This means that the loan will be sized so that the income after operating expenses is at least 115% of the project's annual debt service payments.

	Depending on the resulting rents at lease-up, the first position permanent loan may be as projected (if rents hit the developer's target), or the loan may be resized downward (if rents achieved are lower). If the latter, this results in a funding gap between the first position permanent loan and the raised equity. In this scenario the Fund's mezzanine permanent loan, which has a lower DCR requirement than the first position loan, would be available to fund the gap.
ELIGIBILITY:	Market-rate and workforce multifamily rental projects that align with RED criteria.
ILLUSTRATIVE TERMS:	• Term: Up to [15] years • Amount: Sized to available cash flow after payment of required debt service, down to a minimum debt service coverage ratio of [1.05] • Rate: Target [4.0%] fixed • Lien: Second position; guarantees follow first position loan • Eligible Uses: Refinance construction financing • If rents at lease up are significantly less than projected and the project is unable to meet the Fund's permanent loan DCR sizing, the Fund may convert all or a portion of its outstanding construction loan to equity.
REPAYMENT TERMS:	Fully self-amortizing over the loan term. Partial amortization with a balloon payment possible subject to Fund underwriting and approval. If converted to equity, Fund receives a portion of cash flow and sale proceeds.

A Coordinated Product Offering

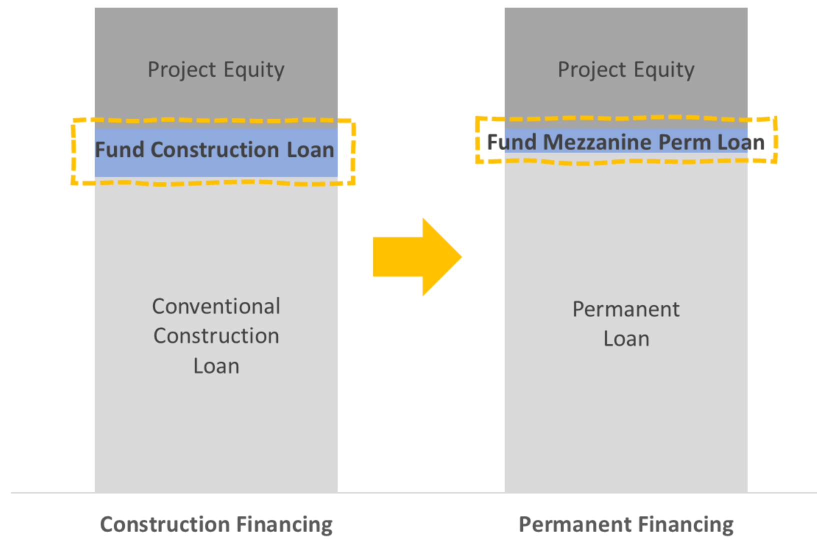
A Coordinated Approach. It is anticipated that certain market-rate projects will require both products to be financially feasible. At the time of underwriting the Fund's construction loan, the Fund will analyze the potential need for a portion of its subordinate construction loan to stay in the project on a permanent basis based on several scenarios:

- *The building is fully leased at rents at or higher than what the developer expected.* In this situation, the developer may not require that a portion of the Fund's construction loan stay in the project as permanent capital. The developer is able to fully repay the Fund's construction loan from the permanent loan and/or equity contributions, and the Fund is able to recycle its funds for additional projects.

- *The building is leased at rents slightly below what the developer expected.* Lower-than-expected rents will require the developer raise additional permanent capital to fill the gap between the actual rent levels and the permanent debt/equity on the building. With the first position permanent loan sized downward, a portion of the Fund's mezzanine construction loan is repaid with permanent proceeds, while the remainder converts to the Fund's permanent mezzanine loan. The project's cash flow will be required to pay debt service on the first position permanent loan first, and then the Fund's loan before payment of equity.

- *The building is leased at rents significantly below what the developer expected.* In this scenario, a greater portion of the Fund's construction loan is required to stay in the project as permanent capital. If the project is unable to meet the Fund's DCR sizing and required fixed loan payments, the Fund may look to convert its permanent financing to equity, in which the Fund would have an ownership interest in the project and receive cash flow and sale proceeds along other equity investors.

Prudent Underwriting. While a forward commitment on the Fund's permanent loan will be made at the time of the construction loan closing based on underwriting, the Fund will need to be flexible enough in case the permanent loan needs to be resized or restructured as equity once the project is fully leased and stabilized. Due to the limited resources available to capitalize the Fund, project underwriting will seek to be highly critical in finding the "right" types of projects to support. These projects will likely be close to being fully financially feasible on their own, with the Fund providing the last remaining portion of critical financing to move it forward.



If after the first few market-rate projects financed by the Fund are able to help build and prove a market for this infill product, this type of market-rate financing product may no longer be needed for projects in downtown Santa Rosa. As the number of completed projects in downtown Santa Rosa rises, developers, appraisers and capital providers will have a better sense of what actual lease-up rates and rent levels are for multifamily units. With this knowledge, capital providers may be able to better assess what a multifamily rental project located downtown requires financially, and could offer terms on their loans and/or investments that more accurately reflect the market in downtown Santa Rosa once several projects have been completed. At this point, the Fund may retire these products and allocate its capital to fund a different type of product that accurately responds to the current market's needs.

V. Fund Formation

To deliver the above financial products to the market, a new Fund will need to be created. Creation of the new Fund would be the focus of the Phase 2 workplan. The new Fund will seek to deliver the financial products as efficiently as possible. To do so, the following will need to be accomplished:

- Confirmation of availability of sufficient capital that is low-cost, flexible, and long-term enough to be used by the Fund to make available the financial products;
- Identification of an appropriate legal structure for the Fund; and
- Development of a suitable governance, management, and operating structure for the Fund.

This section of the report is intended to highlight key considerations and criteria for the formation of the Fund, which would be further explored in Phase 2.

A. Capitalization

Types of Capital

The Fund will require several different types of capital:

Investment Capital. The Fund will need to raise flexible, low-cost, long-term capital that it can use to provide its products to infill development projects. The products intended to be provided by the Fund are flexible, low-cost, and long-term in nature, and will only be possible for the Fund to provide if it can raise capital that also has these characteristics.

Operating Capital. On an ongoing basis, the Fund will need to be able to cover the costs of its operations. Revenue generated from the Fund's investment activities may cover much of these costs; to the extent there is a shortfall in available revenue, public or private grant funding will be needed.

Start-Up Capital. Launching the Fund will incur legal, accounting, and other start-up costs that will need to be paid for from public or private grant funding.

Sources of Capital

The Fund will seek to raise its capital from a mix of the following sources:

Public Sector. Frequently, financing entities similar to the proposed Fund are seeded with public capital. A role of the public sector in similar funds is to lead the way for other investors to participate. In general, the public sector is more able than either the philanthropic or private sector to invest in programs that seek to achieve a policy goal, rather than generate a financial return. Typically, public capital is subordinate to other sources of capital on a fund's balance sheet, providing credit enhancement to other participating investors.

Philanthropic Sector and Other Local Stakeholders. Local philanthropies and employers that also share the policy goals of the Fund are another possible source of investment capital for the Fund. These entities may also be able to provide grant funding to support the start-up and operations of the Fund.

Other Private Investors. Due to the nature of the financial products intended to be provided by the Fund, which are significantly more flexible than lenders are currently able to provide, the Fund is unlikely to raise significant investment capital from national financial institutions or other private investors that require a market rate of return. However, some of these entities may be interested in supporting the start-up or operation of the Fund with grants.

Proceeding to Phase 2. As next steps in Phase 2, the Forsyth Street team will:

- Build out a capitalization model for the Fund, showing anticipated sources of capital and how they support the Fund's investment program;
- Develop a start-up budget;
- Seek to identify lead investors in the Fund. The team anticipates that the Fund will require about $[20] million in flexible, long-term, low-cost investment capital to be able to provide its intended products to an initial set of projects. The team will reach out to the public and philanthropic sectors, and to other local stakeholders, to identify possible sources of funding.
- Raise grant funding. The Fund will require grant funding for start-up and operating costs. The team will seek to raise this funding from philanthropic and private sources supportive of the mission of the Fund.

B. Legal Structure

Structural Options. Options for the legal structure of the Fund that will need to be evaluated include:

- Establishing the Fund as a new subsidiary, affiliate, or program of the RED.
- Establishing the Fund as a new subsidiary or program of another existing organization. Aside from the RED, other existing organizations that could be evaluated as possible sponsor organizations to the Fund include community development financial institutions (CDFIs) and local philanthropies.
- Establishing the Fund as a new, stand-alone nonprofit.

Evaluation Criteria. Criteria for evaluating each alternative include:

- *Compatibility of the Fund's legal structure with the Fund's purpose.* A subsidiary or program of an existing entity would need to be compatible with its sponsor organization's mission and other requirements. To the extent additional requirements would attach to the Fund if it were established as a subsidiary or program, those requirements would need to be evaluated for their effect on the utility of the financial products provided by the Fund. For example, if the Fund were established as a program or subsidiary of a public entity, public funding requirements may attach to loans provided by the Fund, which could increase project costs; or if established as a program or subsidiary of a CDFI, aspects of the CDFI's governance, accounting, lending, and underwriting policies may attach to the Fund. A stand-alone entity would have more flexibility to be customized for maximum compatibility with the Fund's purpose.

- *Existing capacities that can be brought to the Fund.* Existing entities may have organizational and operational systems with which the Fund could coordinate.
- *Fund stakeholder requirements.* Stakeholders providing capital to the Fund may have requirements for the Fund's legal structure. They may, for example, require or prefer that the Fund's capital be kept apart and not commingled with another organization's balance sheet, or may only be able to provide funds to a nonprofit.
- *Complexity and timeline for standing up the Fund.* Establishing a new, standalone nonprofit, for example, would require significant lead-time, possibly exceeding a year, to be incorporated and receive nonprofit designation. Alternatively, establishing the Fund as a program within an existing entity, or as a subsidiary of an existing entity, may be more time efficient. If established as a subsidiary to a nonprofit organization, the Fund may also be able to benefit from its parent organization's nonprofit status.

Proceeding to Phase 2. As next steps in Phase 2, the team will need to explore and compare:

- Whether the Fund could feasibly be established as a program or subsidiary of the RED, and what the process for doing so would be;
- Possible partnerships with existing CDFIs, local philanthropies, or other organizations; and
- Process and timeline for establishing the Fund as a standalone entity.

C. Governance, Management, and Operations

Supporting the Fund's Mission. The Fund's governance, management, and operations will also need to be built out in a way that supports the Fund's mission, allows stakeholder input and oversight over Fund activities, and supports efficient delivery of the Fund's financing to infill development projects. Operationally, the Fund will need to have the capacity to source, underwrite, originate, service, and report on its investments; to raise and manage investment capital; and to provide periodic programmatic and financial reports to its stakeholders.

- If the Fund is established as a subsidiary or program of an existing entity, the Fund will inherit some of its sponsor organization's governance, management, and operations; and to the extent it needs to build out additional governance, management, and operating capacity, it will need to do so in a way that conforms with its sponsor organization's requirements while also supporting the Fund's mission.
- If the Fund is established as a stand-alone entity, it will need to build its governance, management, and operations from scratch.

Evaluation Criteria. Criteria for evaluating alternatives will include:

- *Compatibility*. The desired model for Fund governance, management and operations will need to be compatible with and support the Fund's mission.
- *Stakeholder requirements*. Fund governance, management, and operations will need to balance the interests of all stakeholders participating in the Fund, which may span the public, private, and philanthropic sectors. Stakeholders will need to feel confident that they can continue to exercise oversight over the activities of the Fund, that the Fund will be a careful steward of all capital invested in it, and that the Fund will have strong capacity to underwrite and evaluate all investment opportunities. Stakeholders may require representation in the Fund's governance structure, for example, with a seat on the Fund's Board of Directors or through some other means.
- *Cost*. To the extent possible, the Fund will seek to support its operations with revenue generated from the Fund's investment activities. Any gap between the costs of operating the Fund and available revenues will need to be covered with grant funding.
- *Complexity and timeline*. The Fund's governance, management, and operations will need to be streamlined to be as responsive as possible to both its stakeholders and its borrowers. As for any financing entity providing loans and investments to real estate projects, the Fund will need to be able to move at the pace of the market and in sync with other financing sources supporting a project.

Proceeding to Phase 2. As next steps in Phase 2, the team will need to:

- Evaluate which governance, management, and operational capacities will be available to the Fund from its sponsor organizations;
- Which capacities can be provided by "in-house" staff either already on-staff at the sponsor organization, or newly hired to support the Fund;
- Identify which additional capacities will need to be provided by third parties/consultants; and
- Build out a financial model for the Fund, showing how the Fund's operations are paid for from revenues from projected investment activity, grant funding, and any other available sources.

D. Estimated Cost and Timing of Phase II

Forsyth Street anticipates that the Phase II workplan would take approximately one year to complete, up to and including creation of the Fund. However, there are significant uncertainties with respect to this timeline. Availability of capital for the Fund, in particular, will inform whether and how the Fund could be established. The novel coronavirus may also have significant and unforeseen effects on the availability of resources for the Fund and the pace of the workplan. Given these uncertainties, Forsyth Street would propose a flexible and responsive workplan, with periodic reevaluation of progress with the RED to confirm that creation of the Fund continues to be achievable and realistic.

Cost for Forsyth Street's Phase II workplan, up to and including creation of the Fund, is estimated at $150,000. If at any point the workplan needs to be paused, or if at any point creation of the Fund is determined to be infeasible due to lack of availability of capital or other reasons and the workplan needs to be set aside, only a portion of the fee would be payable. Legal, accounting, and other specialized services would need to be obtained at additional cost, as needed. Legal costs in particular can be a significant and highly variable additional expense for Fund formation, affected by factors such as the preferred legal structure for the Fund, the complexity of the Fund's capital structure, and the willingness of capital providers to cover their own legal costs.

VI. Recommended Next Steps

Over the estimated one-year timeline to establish the Fund, numerous tasks will need to be completed. These include immediate next steps, with respect to evaluating alternatives for, and determining, the capitalization, legal, governance, management, and operations structures of the Fund; as well as subsequent activities to document, close on, and operationalize the Fund.

A. Immediate Next Steps

Immediate next steps for Fund formation, summarized from the preceding section, include:

Capitalization. With respect to capitalization:

- Build out a capitalization model for the Fund, showing anticipated sources of capital and how they support the Fund's investment program;
- Develop a start-up budget;
- Seek to identify lead investors in the Fund. The team anticipates that the Fund will require about $[20] million in flexible, long-term, low-cost investment capital to be able to provide its intended products to an initial set of projects. The team will reach out to the public and philanthropic sectors, and to other local stakeholders, to identify possible sources of funding.
- Raise grant funding. The Fund will require grant funding for start-up and operating costs. The team will seek to raise this funding from philanthropic and private sources supportive of the mission of the Fund.

Legal Structure. For the Fund's legal structure, explore and compare:

- Whether the Fund could feasibly be established as a program or subsidiary of the RED, and what the process for doing so would be;
- Possible partnerships with existing CDFIs, local philanthropies, or other organizations; and
- Process and timeline for establishing the Fund as a standalone entity.

Governance, Management and Operations. With respect to governance, management, and operations:

- Evaluate which governance, management, and operational capacities will be available to the Fund from its sponsor organizations;
- Which capacities can be provided by "in-house" staff either already on-staff at the sponsor organization, or newly hired to support the Fund;
- Identify which additional capacities will need to be provided by third parties/consultants; and
- Build out a financial model for the Fund, showing how the Fund's operations are paid for from revenues from projected investment activity, grant funding, and any other available sources.

B. Additional Anticipated Tasks

As Phase II proceeds, **additional anticipated tasks** to create the Fund would be anticipated to include:

- Development of the Fund's underwriting manual, underwriting guidelines, and other investing and operating policies and procedures.
- Drafting and review of legal documentation, including:
  - Organizational legal documents, such as Articles of Incorporation, Bylaws, Operating Agreement, or others, as applicable;
  - Agreements with all capital providers to the Fund;
  - Agreements with all service providers to the Fund; and
  - Set of model loan and investment documents for financing the Fund provides to specific projects.
- Identification of representatives who could participate in the Fund's governance structure, for example, as board members if the Fund is established as a nonprofit.
- Creation of a programmatic and financial reporting framework acceptable to all Fund stakeholders.
- Identification of third-party service providers who can provide ongoing legal, accounting, underwriting, and other support to the Fund, as needed.
- Fundraising for costs of Fund start-up and operations.

VII. Appendix 1: Feasibility Study Interview Participants

In order to produce this report, Forsyth Street conducted interviews with various City and regional stakeholders, developers and capital providers. A full roster of interviewees is listed below:

1. Michelle Whitman – Renewal Enterprise District
2. Vice Mayor Victoria Fleming - City of Santa Rosa and RED Chairperson
3. Supervisor David Rabbitt - County of Sonoma and RED Boardmember
4. Councilmember Jack Tibbetts –City of Santa Rosa and RED Boardmember
5. Supervisor Shirlee Zane – County of Sonoma and RED Vice Chairperson
6. Karin Demarest – Community Foundation of Sonoma County
7. Andrea Garfia – Sutter Health
8. David Guhin – City of Santa Rosa
9. Jesús Guzmán – Generation Housing
10. Jen Klose – Generation Housing
11. Alena Ritch-Wall – Kaiser Permanente
12. Peter Rumble – Santa Rosa Metro Chamber
13. Dan Schurman – Providence/St. Joseph Health
14. Robin Stephani – 8th Wave
15. Ben Wickham – Burbank Housing
16. Tony Ghisla – Poppy Bank
17. Jeff Owen – Exchange Bank
18. Eric Anderson – Urban Green Builders
19. Zack Berkowitz & Ed Khakbaz – Developers
20. Loren Brueggemann – Phoenix Development Co
21. Chris Dart – Danco Communities
22. Larry Florin, Efren Carrillo & Rich Wallach – Burbank Housing
23. Hugh Futrell – Hugh Futrell Corporation
24. Ali Gaylord – MidPen Housing
25. Keith McCoy & Scott Ward – Urban Mix Development
26. Tom Robertson & Rob Robinson – IGH Partners
27. Peter Stanley – Cornerstone Development/ArchiLOGIX
28. John Stewart, Jack Gardner & Don Lusty – John Stewart Company
29. Robin Zimbler – Freebird Development