

Policy on the Development and Funding of Commercial Space in Housing Developments Funded by the Mayor's Office of Housing (MOH)

A. Background

In San Francisco developers of affordable housing are often presented with the opportunity or requirement to create or acquire non-residential commercial space simultaneously with the housing development. The inclusion of commercial space in appropriately zoned residential developments is consistent with the City's commitment to support mixed-use development with adequate social infrastructure near transit lines. Among the challenges faced by housing developers in the City is how to finance the cost of developing such commercial space.

MOH encourages the development of commercial space in MOH-funded affordable housing where permitted as long as it does not significantly reduce the number of affordable housing units that can be built or otherwise materially increase the cost of developing the housing.

B. Definitions

"Commercial Space" is defined as all non-residential space within the envelope of a Housing Development that is a structurally integral part of the building and is or can be leased or sold to a third-party except that non-residential space used by the developer primarily for the benefit of the building's tenants shall not be considered Commercial Space.

"Commercial Shell" is defined as all components of an unfinished Commercial Space. Sheetrocked and fire-taped walls and ceiling, rough electrical and plumbing systems and stub-outs, doors and windows, unfinished flooring, and other items that may be required in order to obtain a temporary certificate of occupancy for the Housing Development shall be considered part of the Commercial Shell rather than Tenant Improvements. The Commercial Shell may include utility light fixtures, fire-sprinkler system, smoke detectors, operable water, gas and sewer lines, standard bathroom plumbing fixtures, and other items associated with a ready-to-lease but unfinished commercial space that are an integral part of the Housing Development. The Commercial Shell may only include elements that might otherwise be considered Tenant Improvements as defined herein if those elements must be constructed while the housing portion of the development is built (e.g. commercial kitchen flues that must be built into chases that pass through residential spaces above).

"Housing Development" is defined as the new construction or acquisition/rehabilitation of affordable housing that is or has been financed by MOH housing capital subsidies.

"Public Benefit Purposes" are activities or programs that primarily benefit low-income persons, are implemented by one or more non-profit 501(c)3 public benefit organizations, and have been identified by a City agency or a community planning process as a priority need in the neighborhood of the proposed Housing Development. Examples include childcare centers, adult day health centers, low-income-serving nonprofit office spaces,

public libraries and supportive services or rent subsidies for residents of the Housing Development.

“Surplus Cash” is the excess of commercial income over the sum of the commercial debt service, operating expenses, management fees and reserve deposits as approved by MOH.

“Tenant Improvements” are improvements intended to make the Commercial Shell ready for occupancy by a tenant, including any customized fixtures or any other improvements needed to adapt the space for a specific tenant’s use.

NOTE: Tenant Improvements are generally not an eligible use of MOH housing funds. However, other project financing sources, such as tax-exempt bond financing and private mortgages, may be used to pay for tenant improvements so long as the following conditions are met:

- Such use conforms to all applicable regulatory restrictions of the proposed financing source;
- All costs associated with the Commercial Space and Tenant Improvements, including prorated architectural and engineering services, permits and fees, and project and construction management costs are segregated from the housing budget;
- Commercial income fully services that portion of the non-MOH debt attributable to the TIs as well as all commercial operating expenses, including brokers’ fees, insurance, taxes, replacement reserves, and property management expenses.

TIs may also be financed indirectly through reasonable rent concessions given to commercial tenants. Such rent concessions are subject to approval by MOH.

C. Eligibility Criteria for Including Commercial Space in MOH-funded Housing Developments

Whether or not the Commercial Shell is financed with MOH funds all of the following criteria must be met if commercial space is to be included in a Housing Development:

1. The development of the Commercial Space must not materially increase the cost of the Housing Development. Any significant additional costs associated with modifying the housing design or building systems, including underground parking, in order to accommodate the commercial space must be financed by non-housing sources except to the extent that the development complies with the Conditions Associated with MOH Investment in the Commercial Shell described below.
2. The use of the Commercial Space must be consistent with all applicable redevelopment plans and local planning and building codes. The uses must also be reasonably compatible with the design and purpose of the Housing

Development. Incompatible uses shall include bars, liquor stores, or other businesses that cater exclusively to adults and that may lead to problems of public safety and welfare.

3. The Housing Development regulatory agreement must give MOH the right to approve all commercial tenant leases and the right of first refusal regarding sale of the Commercial Space for the length of the agreement, which approval shall not be unreasonably denied.
4. If there is an underlying City or Redevelopment Agency lease of the land to the developer, the lease must require that the Commercial Space be used for Public Benefit Purposes commensurate with the value of any discounted lease payment.

D. Conditions Associated with MOH Investment in the Commercial Shell

As permitted by the source of funds, MOH housing funds may be used to pay for the reasonable costs of acquiring, designing and rehabilitating or constructing a Commercial Shell if the following conditions are met:

1. Gap Financing: MOH funds must be used as gap funds after all other financing sources prove to be unavailable including debt from conventional lending institutions, financing from other government agencies, and private foundation grants.
2. Determining Whether MOH Funds have been Invested in Commercial Space: For purposes of this policy, the use of MOH funds for any portion of the development of the Commercial Space including hard construction costs, applicable soft costs and site acquisition costs shall be considered invested in the Commercial Space.
3. Public Benefit Purpose: For the length of the Housing Development regulatory agreement, the Commercial Space must be used for a Public Benefit Purpose or all Surplus Cash generated by use of the Commercial Space must be directed toward a Public Benefit Purpose or toward repayment of MOH's investment in the development of the Housing Development and Commercial Space.
4. Applicability of Residual Receipts Policy: Until such time as MOH's investment in the Housing Development and the Commercial Space has been repaid, all Surplus Cash generated by the Housing Development and the Commercial Space shall be subject to the City's Policy on the Use of Residual Receipts (effective 2/28/00).
5. Restrictions Following Full Repayment: Once MOH's investment in the development of both the Housing Development and Commercial Space is repaid and for the length of the Housing Development regulatory agreement, all Surplus Cash shall continue to be subject to the restrictions on distributions and the use of program income contained in that agreement.

6. Funding Source Restrictions: The use of MOH funds shall be consistent with all applicable requirements associated with the source of those funds, including MOH reporting and federal program income reporting.

E. Commercial Space Financed Separately Without MOH Financing:

As long as the entire Commercial Space is financed wholly and separately without the use of MOH housing funds at any stage, complies with the eligibility criteria described in Section C. above, and pays its share of operating expenses, MOH will not restrict the rent levels or make any claim on the cash flow generated by the use of such Commercial Space. Non-MOH financing must pay for all costs associated with the development of the Commercial Space, including costs directly attributable to the Commercial Shell such as drywall, fixtures or doors and windows, costs shared with the Housing Development and pro-rated on the basis of the total square feet of the Commercial Space as a part of the Housing Development, such as acquisition costs, foundation costs and shared architectural services, and any significant additional costs associated with modifying the housing design or building systems in order to accommodate the commercial space, such as the marginal cost of creating underground parking which would otherwise be provided above ground.

F. Applicability and Effective Date:

This policy will become effective on _____, and will apply to all developments that have not yet received an approval recommendation from the Citywide Affordable Housing Loan Committee for their final project development financing.