THE CHALLENGES OF PROVIDING HOMEOWNERSHIP FOR WORKING FAMILIES: A CASE STUDY IN PINE KNOLLS DEVELOPMENT, CHAPEL HILL, NC

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Approved by:

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ABSTRACT

THE CHALLENGES OF PROVIDING HOMEOWNERSHIP FOR WORKING FAMILIES:
A Case Study in Pine Knolls Development, Chapel Hill, NC
(Under the direction of Roberto G. Quercia)

Working families increasingly find it difficult to become homeowners in the communities they serve. While federal housing policy promotes homeownership, most federal resources are targeted to assist low-income households. Without access to subsidies, developers of workforce housing cannot increase homeownership opportunities for moderate-income households. A case study of Pine Knolls Development in Chapel Hill, NC examines the challenges facing one affordable housing developer and demonstrates the importance of government-sponsored financial assistance. As communities create new policies and programs to increase homeownership options for working families, some emerging best practices are considered.
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CHAPTER 1
INTRODUCTION

What the world eminently requires is some wise adjustments, some remodeling of the Social machinery, diminishing its friction whereby every person willing to work shall assuredly have work to do, and the just reward of that work in the articles most essential to his sustenance and comfort.
— Horace Greeley, in “An Address to the Printers of New York,” January 17, 1850

Generations of working Americans have viewed homeownership as the fruit of their labor, if not the culmination of the American Dream. Supported by the federal government, the nation’s homeownership rate rose to a record 69 percent in 2004. At the same time, many local markets witnessed record-high property values, especially in rapidly growing areas like Southern California, Nevada and Florida. This rapid housing price appreciation far exceeded increases in household income and wealth (Wolff 2007). Consequently, access to reasonably priced housing, and especially the dream of homeownership, is well beyond the reach of many working and middle-class families. A Joint Center for Housing Studies report (2009) found nearly 18 million households paid more than half their incomes for housing in 2007. While low-income individuals and families can be most vulnerable to high housing costs, working households are not immune to the affordability crisis. A recent study suggests that between 47 and 50 percent of working households earning up to 120 percent of Area Median Income (AMI) experience moderate to severe housing cost burdens1 (Wardrip 2009). As employees, this category includes nurses, police officers, firefighters and service workers, often the core providers of “essential services” for a community. As renters and homeowners, these workers are caught in an income-trap: they make too much to qualify for government benefits and yet not enough to afford market-rate housing.

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1 Wardrip, Keith. (2009). Of the 23 million working households with moderate to severe housing cost burdens, the narrow majority (52 percent) are homeowners.
Many municipalities have begun to notice their “essential” workers, who earn service-economy wages, cannot afford to live in their communities’ average-priced homes. Emerging research acknowledges the need for both rental and for-sale workforce housing (Haughey et al., 2006). Given the cultural entrenchment of homeownership as the American Dream, this paper will focus on the particular challenges of providing for-sale workforce housing. Despite government policies supporting homeownership for low-and moderate-income families, public and private entities hoping to develop workforce housing often face tremendous barriers during the development process. Local government regulations, restricted access to public and private financing, and organizational inexperience can hinder workforce housing production, as evidenced by the proposed Pine Knolls Development in Chapel Hill, North Carolina. The success of Pine Knolls Development and other workforce housing projects depends on strong public/private partnerships and the availability of flexible subsidies.
CHAPTER 2
DEFINING AFFORDABILITY FOR WORKFORCE HOUSING

Researchers, policymakers and even the public often invoke the phrases “affordable housing” and “workforce housing” despite no universally accepted definitions. The phrases are used so often to describe housing units, it is easy to forget what Stone (1999) said, “Affordable is not a characteristic of housing. It is a *relationship* between housing and people” (p. 36). To define this relationship, Stone (2006) states three critical questions that must be answered:

- Affordable to whom?
- By what standard of affordability?
- For how long?

For this paper’s purpose, housing affordability is defined as the relationship between moderate-income, working households and the costs of homeownership under a commonly accepted indicator of affordability, the ratio of income to housing costs (Stone 2006). The standard ratio is no more than 30 percent of household income should be used to meet mortgage or rental payments plus utilities (Gunderson 2007). For the maximum housing cost calculations within Pine Knolls case study, a front-end ratio of 30 percent (including mortgage, principal, taxes, insurance, and homeowners’ association dues but excluding utilities) is used.

Who is “moderate-income,” however, when fully 80 percent of American self-identify as middle-, working-, and lower-income classes (Turnbull 2007, n.p.)? Because the federal government has long used income to determine eligibility for subsidized housing\(^2\), its definitions will be used to

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\(^2\) Under federal statutory authority (U.S. Housing Act of 1937, as amended), the U.S. Department of Housing and Urban Development (HUD) annually establishes income limits for its federally-assisted housing projects. HUD’s income limits pertain primarily to its multi-family rental housing programs, including public housing and voucher programs. The income limits also govern HUD programs that specifically target infrastructure redevelopment and affordable housing, including Community Development Block Grants (CDBG) and HOME Investment Partnerships (HOME) funds.
delineate “low-” from “moderate-” income households. The U.S. Department of Housing and Urban Development (HUD) calculates income limits using the U.S. Census data for median family income within metropolitan statistical areas and non-metropolitan housing markets. The geographically-based incomes are referred to as Area Median Income or AMI (Table 1). Limits may be adjusted for particularly low or high-cost areas as well as for family size.

Table 1: Household income definitions

<table>
<thead>
<tr>
<th>Income Definition</th>
<th>Income No Greater Than</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extremely low income</td>
<td>30 percent of area median income</td>
</tr>
<tr>
<td>Very low income</td>
<td>50 percent of area median income</td>
</tr>
<tr>
<td>Low income</td>
<td>80 percent of area median income</td>
</tr>
<tr>
<td>Moderate income</td>
<td>100 percent of area median income</td>
</tr>
<tr>
<td>Moderate-high income</td>
<td>120 percent of area median income</td>
</tr>
</tbody>
</table>

Source: FY2009 Income Limits Briefing Materials, U.S. Department of Housing and Urban Development

HUD is mandated to calculate “low-,” “very low-,” and “extremely low-” income limits. “Low”-income refers to 80 percent of AMI and is the upper limit for nearly all federally subsidized rental and homeownership programs. Although HUD often scales AMI up to 140 percent to determine eligibility limits for some Federal Housing and Finance Agency mortgage programs, no hard statutory line defines “moderate”-income households. Thus, the use of “moderate” and “moderate-high” incomes to define workforce housing in this paper is based on other researchers’ definitions (Olson 2005; Booza, Cutsinger, & Galster 2006) and will include households with incomes between 80 and 120 of AMI.
CHAPTER 3
THE CASE FOR WORKING FAMILIES

While the national homeownership rate hit a record high 69 percent in 2004, homeownership was not achieved equally among households by income. Just half of households in the lowest income quintile are homeowners, and homeownership rates for Hispanics and African-Americans are below 50 percent (Carasso, Bell, Olsen, & Steuerle 2005). This discrepancy in homeownership opportunity is not surprising given the history of federal housing subsidies. The federal government spent nearly $41 billion in 2005 on direct capital outlays for housing assistance, most of it on HUD rental programs like Section 8 and public housing serving very-low income households (Carasso et al., 2005). Homeowners, by contrast, received about $147 billion in tax subsidies, including mortgage interest and property tax deduction. Yet these tax benefits accrued overwhelmingly to high-income households because of their higher incomes and marginal tax rates. As an Urban Institute report noted:

Families in the second quarter of income distribution receive almost no subsidies – their income is too high for rent subsidies and too low to gain much from tax preferences….our patchwork of federal housing subsidy programs pays higher-income households to own their homes while paying some low-income households to rent (Carasso et al., 2005).

That many working families do not receive adequate subsidy to achieve homeownership troubles many government officials. As HUD Secretary Henry Cisneros said, “Expanding homeownership is vitally important to our country because homeownership is critical to both individual economic opportunity and also to the building of strong communities” (1995, p. 6). By understanding federal housing policy over the past 50 years and the rationale for pushing homeownership, one can see why moderate-income homeownership will be an important consideration for future administrations.
Federal Policy Overview

The federal government set a goal in the Housing Act of 1949 to support “a decent home and suitable living environment for every American family.” Much of the government’s early subsidies for housing were capital outlays to subsidize renters, builders or owners of rental housing (Carasso et al. 2005). Often government financed and owned, early public housing programs sheltered more than 1 million households nationally (Schwartz 2009). As favor for government-built public housing waned in the 1960s and 1970s, voucher and certificate programs grew. Under the most prominent program, the Housing Choice Voucher Program (also referred to as Section 8), nearly 2 million households pay 30 percent of their income towards rent or less commonly mortgages, for private-market housing units. The federal government pays the difference up to the fair market rate.3 In the 1980s, policy shifted once again to private production of rental units through the establishment of the Low Income Housing Tax Credit program (LIHTC), which provides incentives to builders through substantial tax credits and savings. As with earlier federal housing programs, Section 8 vouchers and LIHTC-subsidized units target low-income households, with income limits of 80 percent and 60 percent of AMI, respectively. Moderate and moderate-high income households earn too much to qualify for rental assistance under these programs.

Historically, the federal government’s programs for homeownership have received less direct outlay and have produced fewer units than its rental programs. The largest homeownership programs include Section 235, Section 502, and HOME Investment Partnerships. The Section 235 Homeownership Program for Low-Income Households, begun in 1969, provided incentives such as low or no down payments and subsidized interest payments to roughly 500,000 households (Carasso et al., 2005). After investing in areas with low property appreciation and households ill-equipped for homeownership, the program faltered and was eventually terminated. The more successful Section 502 Rural Home Ownership Direct Loan Program through the Department of Agriculture has lent

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3 “The FMR is the 40th percentile of gross rents for typical, non-substandard rental units occupied by recent movers in a local housing market” (24 CFR 888).
more than $51 billion to nearly 2 million households over the past 50 years (Carasso et al., 2005). The mortgage program targets low- and moderate-income households earning up to 115 percent of AMI.

HOME Investment Partnerships is one of the few HUD program designed to provide subsidies for developers to build affordable housing for low-income households. Similar to the popular Community Development Block Grants (CDBG), HOME funds are federal block grants allocated to local and state governments for administration. Unlike CDBG, which can be used for acquisition and rehabilitation of existing housing as well as homebuyer down payment assistance but not new construction, HOME funds can be spent on any type of housing assistance (with restrictions), including the new construction of for-sale units. While HOME allocates over $2 billion annually, the funds are targeted to households earning less than 80 percent AMI (60 percent of AMI for rental units). Thus, workforce housing developers targeting moderate-income homebuyers are not able to access HOME funds, one of few federal subsidy sources for new construction.

Besides direct capital outlays, the federal government has supported homeownership through fiscal policy. Since the early 1990s, efforts to promote low-income homeownership through lower borrowing costs have been politically and publicly popular (Belsky, Restinas, & Duda 2005). Currently, the Federal Housing Finance Agency, which oversees the Federal Home Loan Banks and now Fannie Mae and Freddie Mac, targets affordable mortgage products to households earning up to 140 percent of AMI. It has established affordable lending goals for its mortgage products, backed by an implicit federal guarantee that reduce interest rates for low-income households. Besides lower borrowing costs, moderate-income homebuyers often may finance most if not all of their down payments through a second mortgage. With FHA loans, for example, purchasers may borrow up to 96.5 percent of the costs of buying a home.

During this time, lenders also relaxed underwriting standards, providing more credit to a greater number of households. Lower credit standards certainly contributed to the record US. homeownership rate in 2004, but the easy credit coupled with a burgeoning secondary market for
high-interest loans targeted at riskier borrowers led to rapid growth in subprime lending to low-income households (Belsky et al., 2005). The 2007-2010 housing crisis that stemmed from defaults on these risky loans, among other factors, may significantly impact the availability of low-cost financing for future low- and moderate-income buyers. Whether favorable financing terms from FHFA will continue once the housing market stabilizes—and if expectations for rising interest rates come true—remains to be seen. Many policymakers even question whether homeownership should continue to be federal, state and local governments’ predominant housing policy for low-income households below 80 percent of AMI. That debate aside, one can reasonably expect the continued federal promotion of affordable for-sale housing to moderate-income, working families. After all, historically the middle-class has been the principal beneficiaries of homeownership (Shlay 2006).

**Moderate-Income Homeownership: Evaluating the Goal**

The original federal policy recommendations for increasing homeownership for low- and moderate-income homeowners were founded in the hope of reaping social, political and/or economic benefits. In her critical analysis of recent housing policy, Anne B. Shlay (2006) surveys the academic literature to document low-income homeownership goals and the rationale behind them. As Shlay highlights, the assumed social benefits of homeownership include greater family stability and civic participation as well as a perceived increase in control over one’s housing, which may increase self-esteem (Deitz & Haurin 2003; Rohe & Stegman 1994). Living in owner-occupied households is also expected to improve physical and mental health of children, exemplified by positive behavioral outcomes such as decreased juvenile delinquency (Haurin, D., Dietz, & Haurin, J., 2002). Because buying a home reflects a greater economic investment than renting, policymakers expect homeownership to produce positive effects including well-maintained neighborhoods, stabilized property values and fewer incidents of vandalism, blight, and abandonment (Haurin, Dietz, & Weinberg, 2003). While research on the *actual* effects of homeownership show only weak evidence of different attitudes towards civic engagement between renters and owners (Rossi & Weber 1996),
other studies find significant neighborhood stability and property value appreciation from homeownership (Rohe & Stewart 1996).

Granted, investing in homeownership may also come at a cost. At the macro-level, homeownership may decrease residential mobility or lead to exclusionary behavior (Rohe, Van Zandt, & McCarthy 2000). Another risk is depreciating property values, especially during a recession when a homeowner may owe more on his mortgage than the value of the underlying property. A homeowner also risks missing loan payments as a result of what Restinas & Belsky (2005) terms income shock (lost wages or job) or budget shock (unanticipated home repair or replacement or large medical or transportation bills). Such payment delinquencies may lead to default, which can reduce one’s credit score and increase future borrowing costs. Furthermore, an unsophisticated homeowner may lose money by not holding the asset long enough to recoup transaction costs, such as attorney’s fees, from buying and selling too soon.

Speaking generally however, homeownership provides a financial benefit to low- and moderate-income buyers. Benefits flow to homeowners primarily through a favorable tax system. First, a homeowner builds equity as he make principal payments towards his mortgages. Second, homeowners receive government supported tax breaks through interest payment and property tax deductions that essentially reduce their effective tax rate. Third, most homeowners do not pay tax on the capital gains from the resale of their home. These tax savings for all households total about $147 billion annually and more than 3.5 times the federal government’s direct subsidy outlays for low-income housing (Carasso et al., 2005). Evidence also suggests property appreciation rates for lower-valued housing – typically occupied by low- and moderate-income households – generally equals appreciation for higher-valued housing (Pollakowski, Stegman, & Rohe 1991). This price appreciation across property values suggests positive investment returns for moderate-income homeowners. Belsky et al. (2005) evaluated the effects of mortgage interest rates, refinance behavior and tax policies on low-income homeowners. The study found that low-income homeowners are more likely to take out higher interest rate loans and less likely to refinance. Educating homeowners,
however, about avoiding subprime loans and refinancing mortgages when it is beneficial to do so can improve their returns significantly.

Thus, homeownership can be an effective asset-building strategy, particularly for low-income households who tend to use home equity as their principal source of saving (Restinas & Belsky 2002). In fact, even most middle-income households’ home equity exceeds assets held in retirement plans such as 401Ks and other investments like stocks and bonds (Carasso et al., 2005). Granted, the current economic crisis characterized by a national decline in property values (Case 2010) may have had disparate impacts on property owned by lower and higher-income households, attenuating homeownership’s merits for asset-building. As more property sales data becomes available, research into recent rates of return among property values of all levels will emerge.

Meanwhile, the national decline in median home sales from $221,900 in 2006 to $165,100 in February 2010 (National Association of Realtors) has prompted critics to assume the foreclosure crisis has lessened the nation’s affordable housing crisis. A recent study by the Center for Housing Policy noted that while the ratio of home prices to income has fallen, housing costs have not declined for homeowners or renters (Wardrip 2009). In fact, housing costs have risen largely because of growing utility costs and demand for multifamily housing as homeowners displaced by foreclosure enter the rental market. Thus, acute demand for workforce housing continues. How the government chooses to allocate scarce resources between low and moderate-income households and between affordable rental and homeownership opportunities is of critical importance.
CHAPTER 4
BARRIERS IN AFFORDABLE HOUSING DEVELOPMENT

No one knows for certain how many renters would prefer to own their own home but cannot buy a home because of serious barriers (Carasso et al., 2005, p. 6). High housing costs for many working families suggests demand for affordable homeownership opportunities. A shortage of affordable housing stock creates supply-side constraints that filtering—the process of aging and deteriorating housing stock moving from higher to lower-income households—cannot fully solve (Collins, Crowe, & Carliner 2002). Because existing housing stock ages and needs to be replaced and the nation’s population continues to grow, the supply of housing units affordable to moderate-income homebuyers must also increase. Yet private and non-profit organizations seizing the opportunity to develop safe, decent, low-cost workforce housing to meet market demand find themselves facing multiple challenges from pre-development planning issues to land and construction costs to financing to securing qualified buyers.

The development process may take years to complete, each stage containing risks that can derail the entire project. Development is capital intensive; one pays for land, hard construction costs, and soft costs like permits, architects, engineers, appraisers, and financing. Because most non-profit organizations do not have sufficient cash to finance housing projects internally, they must secure capital from external sources. Many banks and even private foundations will not lend to non-profit organizations, however, because non-profit organizations often lack strong balance sheets and enough capital reserves to secure or guarantee the lender’s investment (Enterprise 2007). By contrast, many private developers have sufficient capital and access to collateral and other guarantees. Yet affordable housing tends to offer low profit margins, creating a disincentive for private developers to provide below-market rate units in the absence of public incentives. Even if developers were
attracted to a project, workforce housing projects often require equity investments of less than $10 million, which excludes them from institutional capital markets funded by pension funds, insurance companies and other large investors typically looking to invest $15 million or more (Rosenthal & Stark 2005). Smaller community banks may be able to handle smaller construction loans but are unwilling to invest due to a perceived higher risk in lending to workforce housing projects. Risk includes the financial risk of lending to an unproven or undercapitalized developer; construction risk due to not finishing a project on-time or on-budget; and market risk resulting from a lack of qualified buyers, whose sale proceeds play a vital role in paying off the lender’s construction loan.

Also, both private and non-profit organizations face high barriers to entry, especially in local markets with rapidly appreciating property values. In the development budget, land is typically the second biggest line item after hard construction costs (Foong 2008). As a California Roundtable Report (2002) said:

The truth is the single most significant factor affecting property values is the pre-existing value of the land in a given community or area. This in turn is based on supply and demand, proximity to major urban centers, nearby attractions (beachfront property, panoramic views), and negative factors such as environmental contaminants, and availability of adequate infrastructure and services (p. 5).

Without public support to facilitate the acquisition and disposal of vacant, blighted or government-owned land to affordable housing developers at below-market rates, developers often cannot make the project financially feasible. Federally funded Community Development Block Grants may be used for land acquisition and infrastructure improvements. The similarly structured HOME program may be used for new construction costs as well as down payment assistance. These federal funds are restricted, however, to serving households with incomes below 80 percent of AMI. The lack of funding available to workforce housing projects serving households between 80 and 120 percent of AMI presents a serious obstacle for developers.

Barriers to workforce housing production also occur when developers seek assistance from local governments. Many communities have strict zoning and subdivision ordinances that may discourage the development of multifamily housing or make approval a lengthy process that few organizations
have enough resources to sustain. Another obstacle may rise because of institutional divisions within local government between traditional planning and community development departments. For example, one study found that “few local governments correlate policy initiatives in their comprehensive plans with housing and development policies with their respective HUD Consolidated Plans,” creating fragmented programs with conflicting policies (Hosford 2009). Even when governments promote workforce housing, Lake (1993) demonstrated that negative externalities from development make local residents protective of their property. The negative externalities—including pollution, noise and traffic—foster not-in-my-backyard (NIMBY) opposition to proposed projects.

Developers may also have trouble finding qualified buyers who can secure sufficient financing. Low-and moderate-income home buyers tend to have lower credit scores, which can elevate a household’s financing costs and lower the total monthly payment it can financially support. The inability of local government and community groups to provide down-payment assistance, low-cost mortgages, and homebuyer education to a broad group of potential homebuyers creates market risk and is an obstacle for developers (Enterprise 2007; Belsky et al., 2005). Neither the developer nor the community wins if homeowners receive financial products at greater than justified cost, increasing their risk of default and losing their home.
CHAPTER 5

CASE STUDY: PROPOSED PINE KNOLLS DEVELOPMENT

In practice, how difficult is it for private developers and non-profit organizations to provide affordable homeownership opportunities for moderate-income households? To answer this question, presented below is a case study, including financial analysis of a moderate-income housing project.

Pines Community Center, Inc. (PCC) is one non-profit organization planning to develop a workforce housing project in Chapel Hill, North Carolina. Currently celebrating its forty-second year of operations, PCC’s mission is “to promote and protect a positive quality of life in Pine Knolls Development,” a historically African-American neighborhood (Pines Community Center, ¶ 3). During its history, PCC has managed an affordable housing program for renters and buyers, provided summer and after-school programs for youth, and organized support for neighborhood preservation. Led by PCC President Ted Parrish, the nonprofit has initiated planning and predevelopment work for a proposed 31-unit subdivision within the Pine Knolls neighborhood. PCC’s development will target moderate-income homebuyers with incomes between 80 percent and 120 percent of AMI. The nonprofit also is exploring an option to retain up to 25 percent of the units as rental housing targeted at families earning less than 60 percent of AMI.

Market Overview

Besides being home to the University of North Carolina’s flagship campus, Chapel Hill has one of the most expensive housing markets in the Triangle, a combined statistical area including nearby cities Raleigh, Durham, and Cary. Attracted to the Triangle area for its strong employment outlook and moderate climate, new residents are expected to increase the area’s population by 5 percent within the next five years, according to US Census Bureau projections. The strong demand for housing has
pushed the price of the average home sold in the Durham metropolitan statistical area (MSA), which includes Chapel Hill, well above essential and service employees’ incomes. According to the Center for Housing Policy, a household needs to earn nearly $55,000 annually to afford the MSA’s median home price, $168,000. Typical professions eligible for workforce housing, including teachers and janitors, all earn less than the minimum income required for owning a home at the median price (Figure 1).

Figure 1: Need for workforce housing in Durham MSA*

Potential moderate-income homebuyers in Chapel Hill face even higher housing costs than in the overall Durham MSA. By 2006, the average home in Chapel Hill—including single family, townhomes, and condominium units—sold for $387,452, up 48 percent since 2000 [Town of Chapel Hill 2007]. Concerned about the lack of housing supply for working individuals and families, the Town of Chapel Hill (TOCH) amended its comprehensive plan ten years ago to encourage developers building five or more new units to set aside at least 15 percent of them as affordable to households earning below 80 percent of AMI or make a payment-in-lieu to a housing trust fund. TOCH concluded only a quarter of housing units sold within the Town’s zip codes were affordable to
households earning less than the area median income or $65,500 in 2009. While the affordable housing policy adopted a decade ago encouraged new developments to include moderately-priced units, the subsequent mix of housing offered by developers – mostly 1 or 2 bedroom condos – did little to help working families achieve homeownership.

Consequently, TOCH currently is reviewing a draft inclusionary zoning ordinance to require all developers to provide expanded affordable housing options for residents in exchange for density bonuses. Unfortunately, the proposed ordinance requires the units to be set-aside as affordable housing to target only low-income households below 80 percent of AMI. TOCH still faces a critical shortage of homeownership opportunities for working families with moderate to moderate-high incomes.

**Site Overview**

The proposed affordable housing site is located at the intersection of South Merritt Mill Road and Park Road in Chapel Hill. The parcels are zoned medium density residential – up to 7 units per acre – and are part of a neighborhood conservation overlay district. Not far from the site’s northern boundary lies neighboring Carrboro’s town limit. Less than a mile northeast sits downtown Chapel Hill, including restaurants and retail shops. The University of North Carolina at Chapel Hill and UNC-affiliated hospitals, both major area employers, are also nearby. North Carolina State Highway 54 is within a half-mile of the site and gives residents access to I-40 and beyond, including Durham, Raleigh, and Research Triangle Park (Figure 2).
The Pine Knolls neighborhood differs demographically from the Town of Chapel Hill (Table 2). Pine Knolls’ non-white, non-Hispanic population is nearly 67 percent, while just 32 percent of TOCH is non-white. This difference reflects Pine Knolls’ history as a neighborhood for African-American and black families. While Pine Knolls’ median household income trails the Town’s by approximately $5,000, the percentage of owner-occupied housing units in Pine Knolls nearly reaches the TOCH’s homeownership rate. Still, at 45 and 47 percent respectively, both the neighborhood and the Town’s homeownership rates trail the national average. This disproportionately high number of renters in Chapel Hill may be attributed to its status as a college town with a large resident student population. Still, the remarkably low homeownership rate suggests latent demand for below-market rate for-sale housing units.

Table 2: Town of Chapel Hill and Pine Knolls neighborhood demographics

<table>
<thead>
<tr>
<th></th>
<th>Pine Knolls*</th>
<th>Chapel Hill</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>1,097</td>
<td>49,629</td>
<td>305,548,770</td>
</tr>
<tr>
<td>Households</td>
<td>500</td>
<td>23,827</td>
<td>118,000,003</td>
</tr>
<tr>
<td>% Owner-Occupied Housing Units</td>
<td>44.6%</td>
<td>46.5%</td>
<td>67.7%</td>
</tr>
<tr>
<td>% Non-white Residents</td>
<td>66.8%</td>
<td>32.3%</td>
<td>27.5%</td>
</tr>
<tr>
<td>Median HH Income</td>
<td>$45,714</td>
<td>$51,690</td>
<td>$54,180</td>
</tr>
</tbody>
</table>

Source: US Census Bureau 2009 Estimates  *Based on Block Group 0107022, Orange County, NC.
Site History

According to Orange County Land Records, PCC originally acquired four parcels totaling 9.20 acres of land in 1995 for $368,500, financed by Central Carolina Bank and the Town of Chapel Hill. The Town loaned PCC $115,000 from the Town’s Housing Loan Trust Fund, which was due and payable to the Town in 1997, according to a memorandum to the Mayor and Town Council from W. Calvin Horton, then Town Manager (September 11, 2000). After acquisition, PCC developed a couple of lots as affordable for-sale housing, using sweat-equity from the homebuyer – essentially his or her time and labor – to reduce costs. Most of the site remained vacant, however.

By 2000, PCC still owed the Housing Loan Trust Fund $109,250—nearly its original balance—and the Council was considering initiating foreclosure proceedings. First Baptist Church approached the Town Council and proposed purchasing 6 acres of the site to build Manley Estates, a HUD Section 202 elderly housing project with 40 one-bedroom rental housing units. The land sold that year for $336,000, which repaid the loan from Central Carolina Bank and reduced the Town’s lien against the property to $54,000. According to Chapel Hill News, Ted Parrish and PCC cured the Town’s lien in October 2007, giving the nonprofit organization unencumbered ownership of the land (Decanto 2007, p. A1).

While it may be difficult for non-profit organizations like PCC to obtain land free and clear, owning property outright can be a key determinant of project feasibility. Generally, land costs ranks second only to hard construction costs in budgets for affordable housing developments. As developer Bruce Dorfman said, “By eliminating the land cost, you are eliminating as much as 25 to 35 percent of the total [development] budget” (Foong 2008). That savings acts as a subsidy to reduce the homes’ selling price, an important factor to be discussed further.
To efficiently develop the 3.32 acres of land currently owned by PCC, the nonprofit organization will need to add a second parcel totaling .17 acres, which forms a “keyhole” into the main parcel off of Park Road (see Figure 3). PCC previously owned this parcel and its improvements, including a 3-bedroom, 2-bath single-family house, before selling it to a low-income homebuyer. PCC plans to relocate the house within the site with the cooperation of its owners.

**Zoning Regulations**

According to the Town of Chapel Hill’s Land Use Management Ordinance, the site is currently zoned R-3, a medium density residential designation permitting up to 7 units per acre. R-3 zoning continues North and Northeast along Merritt Mill Road, while the site is surrounded by more intensive residential zoning (R-4) on adjacent properties to the South and Southeast. Further away are lower-density residential neighborhoods comprised of single-family houses and duplexes. Currently, R-3 zoning does not permit multi-family attached townhomes, PCC’s proposed building type. In addition to rezoning the site, the developer will need to obtain a special use permit, which TOCH requires for
all projects disturbing more than 20,000 square feet of land. The entitlement process may take between 18-36 months, depending upon the timing of required applications and public hearings.

Figure 4: Pine Knolls Neighborhood Conservation District

In 2005, Pine Knolls Neighborhood residents approached the Town of Chapel Hill concerned about recent development activity that converted the neighborhood’s characteristically modest homes into duplexes, an effort to attract university students as renters. In response, the Town approved an overlay zoning district for the Pine Knolls Neighborhood. The overlay district, formally known as the Pine Knolls Conservation District, establishes “special regulations especially designed for and intended to help preserve the character of a particular, older residential neighborhood” (Town of Chapel Hill 2006), (Figure 4). While the Pine Knolls Conservation District’s specific regulations on building height, floor-area regulations, etc. apply only to single-family development, the accompanying design guidelines detail the Town of Chapel Hill’s preferences for parking, fencing.
and landscaping. Given the proposed Pine Knolls Townhomes’ location within this neighborhood conservation district, PCC should be mindful of these recommendations when initiating its design drawings. By gaining community support for design schematics early, PCC can reduce carrying costs resulting from a lengthy entitlement process.

Financial Analysis

An analysis of Pine Knolls Townhomes’ development budget demonstrates the importance of subsidies to the financial feasibility of workforce housing projects. PCC owns the proposed site for the 31-townhome project and consequently does not need to pay land acquisition costs. Even with this substantial saving, the project is expected to cost approximately $5.5 million or $178,000 per unit (Appendix I). This sum incorporates hard construction costs of approximately $100 per SF for a mix of 2, 3, and 4 bedroom units that are 1,300 square feet on average. Total development costs also include general requirements, builder’s profit and overhead, and a 5 percent contingency reserve to mitigate risk of cost overruns. Remaining use of funds fall into three categories: predevelopment work (architecture, engineering fees); financing costs (construction loan interest); and other soft costs (legal fees, permits, marketing).

The project will rely on home sales to generate revenue to pay down the construction loan. The 2009 median household income for a family of four in the Durham MSA is $65,500. Assuming a 5 percent down payment on a 30-year fixed rate mortgage at 7.25 percent interest, property taxes, insurance and a $100 monthly homeowners’ association fee to cover ongoing maintenance for common areas, a homebuyer earning the median area income may afford a maximum housing price of approximately $160,000 (Appendix III). PCC would like to target homebuyers earning 80 to 120 of AMI. Therefore, homes will have a range of price points above and below $160,000 depending upon the mix of bedroom-sizes built and targeted income and household size. As the townhomes’ sale prices approach the maximum affordable to moderate-income households, the market of potential
homebuyers narrows. To more steeply discount offering prices, the project will require additional subsidies.

If the proposed townhomes sell for $160,000 on average, the sales will generate approximately $4.7 million in revenues to offset development costs. This revenue is insufficient, however, to cover all development costs, including interim financing. The project’s budget deficit totals approximately $800,000 (Appendix II). This deficit means each unit needs an additional $26,000 for the project to break even. Without additional public or private subsidies, the Pine Knolls Development is financially infeasible, and the community loses an opportunity to provide affordable homeownership for working families.
CHAPTER 6  
RECOMMENDATIONS FOR SUCCESS

Affordable housing developers like Pine Knolls Community Center can achieve homeownership opportunities for workforce housing. Success will depend, however, on the organizations’ willingness and ability to forge new public and private partnerships and explore alternative financing models.

The creation of public/private partnerships can foster affordable housing development by effectively allowing each partner to provide complementary skills (Haughey et al., 2006). The public sector can remove barriers to the development process and facilitate low-cost financing and direct subsidies for affordable housing developers. For example, governments can implement inclusionary zoning regulations to require all developers to set aside a certain percentage of new construction for moderate-income households in exchange for more lenient zoning laws for density and building height. Under this approach, increased density generates additional revenue from more market-rate units to offset development costs incurred building below-market rate units. The success of higher density, mixed-income developments has already been demonstrated (Haughey et al., 2006; ULI 2009). Studies of thriving mixed-income developments suggest key determinants of success include superior location, comparable quality between subsidized and market rate units, and attractive design to attract renters and homebuyers with many housing choices (Brophy & Smith 1997). Analysis of data from HUD’s HOPE VI program, which aimed to end the concentration of low-income housing in aging public housing stock by providing new housing options targeted at renters and homebuyers of varying income levels, has shown the importance of creating a critical mass of market units – at least 30 percent – in workforce housing developments to foster economically integrated neighborhoods.
Public/private partnerships can support the development of workforce housing units by bringing additional resources and political support to the entitlement process.

The public must also advocate for private and additional public resources to increase access to housing targeted at moderate-income households earning between 80 and 120 percent of AMI. The precedent has already been set: nearly all low-income housing developments require creative financing through multi-layered subsidies. This creative financing may include tax credits, permanent loans, deferred payment and/or interest loans, grants, voucher subsidies, and deferred developers’ fees. But because the federal government caps CDBG and HOME block grants as well as Section 8 vouchers to households at 80 percent of AMI or below, local and state governments will need to set up and fund housing programs and trusts with higher income restrictions than the typical 80 percent of AMI. In the Pine Knolls Development case, the Town of Chapel Hill has already established a housing loan trust fund to supplement federal resources. The fund is restricted, however, to projects serving households with incomes below 80 percent of AMI. To fund workforce housing projects like Pine Knolls Development, the program’s income restrictions will need to be raised. Alternatively, state governments can create programs to fill this financing need. Community Workforce Housing Innovation Pilot Program initiated in Florida in 2006, for example, funded $112.5 million in low-interest and forgivable loans to affordable housing developers producing units targeted at households earning up to 140 percent of AMI. Participating developers could receive up to $5 million per project if they pledged to leverage additional public and private resources (ULI July 2009). Due to its flexible income limits, the funding provided essential subsidy to make homeownership viable for working families. The state estimates that the two-year program will generate 1,589 homeownership units and 337 rental units for working, middle-income families. An alternative approach to filling the subsidy gap is to subsidize the homebuyers. For example, organizations and governments may provide moderate-income homebuyers with second and third deferred interest mortgages that allow them to pay a higher purchase price than they for which they
would typically qualify. These “soft” loans are either forgiven after homeowners meet minimum occupancy requirements, say 10 years, or are not repaid until the property is resold.

Local and state governments may also work with the private sector to leverage investment from unexpected sources. Phoenix Realty Group has created a model to bridge the subsidy gap and fund “middle-sized investments for middle-sized housing projects for middle-income people” by raising funds from the California Public Employees Retirement Fund (Rosenthal & Stark 2005). By finding investors willing to look at the “double bottom line” of social and financial returns, developers can attract additional resources, notably equity with a lower required rate of return.

Even if public funding for workforce housing is not available, local communities can help affordable housing developments through policy changes. For example, a local government can initiate an expedited review process for zoning approval to reduce developers’ carrying costs (insurance, taxes, bridge loan interest) during the predevelopment and planning phase. For non-profit developers in particular, local governments may help non-profit organizations’ financial position by delaying upfront hits to cash flow during the development timeline. A town may, for instance, defer permit and impact fees until a certificate of occupancy is issued (Gunderson 2007).

Partnering with a community land trust (CLT) is another way local governments can alternatively finance affordable housing by reusing vacant, abandoned or blighted property. A CLT is a non-profit organization that acquires and holds land as open space for future development, eventually leasing land to a third party who builds housing and then leases or sales the improvements to income qualified renters or home buyers (Enterprise 2007). Benefits include reduced development and carrying costs (property taxes, maintenance, etc.), as the CLT usually acquires and leases the land at little or no cost. As shown in Pine Knolls Development, saving on land costs can make a big difference in total development costs per unit.

Developers should also explore ways they can reduce development costs and subsequently, their need for subsidy. At the project level, a developer can mitigate interest-rate risk during construction and lease-up by underwriting project at 100 basis points higher than current market
interest rates (Rosenthal & Stark 2005). They can also reduce construction risk by using bonded contractors, funding sufficient contingency reserves and entering guaranteed maximum price contracts with builders. To ensure qualified homebuyers, developers can partner with government and community-based programs offering both pre- and post-purchase homebuyer education courses. If an area has a lack of qualified homebuyers due to poor credit and little or no savings, an organization may also explore alternative financing models. The recent foreclosure crisis has created renewed interest in lease-purchase programs in particular. Under lease-purchase, an organization develops and leases a home to a family for a set time period, usually 2-5 years. During this period, the family receives financial literacy and homebuyer education courses while working on improving its credit and saving a down payment, with the goal of purchasing the home from the sponsor. Benefits for the sponsoring organization include access to subsidy and equity sources set aside for rental housing. Organizations should be cautious, however, if they do not have extensive property management experience or access to capital reserves, as the model involves significant risk of default (Enterprise 2007). Still, the model may be appropriate in some situations.
CHAPTER 6

CONCLUSION

As the availability of housing affordable to essential service workers continues to decline in many local markets, more communities will realize a need to provide reasonably-priced homes to retain middle-class employees. Pine Knolls Development demonstrates that filling that gap with for-sale housing units targeted at working families is often not financially feasible without additional subsidy to the developer or homebuyer. Given that the subsidy gap is relatively small – just $26,000 per unit in Pine Knolls’ case – innovative organizations can find ways to lower costs or increase financial support through public/private partnerships and alternative financing mechanisms. Federal programs like HOME and local programs like the Town of Chapel Hill’s Housing Loan Trust Fund already exist to serve low-income households. Changing income restrictions for existing programs can provide the vital subsidy needed for moderate-income workforce housing projects.

Of course, creating homeownership opportunities for working families engenders policy implications for how to allocate scarce resources. Should funding provide housing for the most needy or allow for flexibility? What should be done to help working families in high-cost areas, where a greater proportion of the population is at risk of finding no affordable housing? While no easy answer exists, it is clear the federal government has a legacy of providing direct outlays to help low-income families with rental assistance and tax subsidies to assist with middle-to-high income families with homeownership. If current housing production programs can be expanded and new funding opportunities can be formed, more working families will have an opportunity to own their own home.
### DEVELOPMENT BUDGET

#### ACQUISITION
- Building Acquisition:
  - $0
- Land Acquisition:
  - $0
- Transaction Costs:
  - $0

#### REHABILITATION
- Unit Construction ($100 per SF):
  - $4,085,800

#### OTHER CONSTRUCTION
- General Requirements, Builder's Profit & Overhead:
  - $408,580
- Landscaping:
  - $7,750
- Permits:
  - $48,041
- Utility Connections & Tap Fees:
  - $6,913
- Contingency:
  - $207,425

#### INFRASTRUCTURE
- Site Improvements:
  - $75,000
- Water and Sewer:
  - $3,906
- Impact Fees:
  - $65,100

#### SOFT COSTS
- Site Planning:
  - $68,150
- Approval Application Fees:
  - $43,782
- Architecture & Engineering:
  - $62,000
- Market Study and Appraisals:
  - $0
- Environmental Review:
  - $5,000
- Insurance (Builders Risk):
  - $0

#### FINANCE COSTS
- Acquisition/Construction Loan Interest:
  - $151,044
- Construction Origination:
  - $0

#### MARKETING AND OTHER COSTS
- Marketing:
  - $2,500
- Closing Docs and Deed Stamps:
  - $0
- Construction Period Insurance:
  - $0
- Property Taxes:
  - $0

#### DEVELOPER FEE
- 5%:
  - $275,842

#### TOTAL DEVELOPMENT COST
- $5,516,833

#### Per Unit
- $177,962
## Appendix II:
### Pine Knolls Development Sources and Uses

### SOURCES: REVENUE

<table>
<thead>
<tr>
<th>New Construction</th>
<th>Average SF</th>
<th># Units</th>
<th>Total Revenue</th>
<th>Revenue Per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-4 bdrm, 2-2.5 bath</td>
<td>1,300</td>
<td>31</td>
<td>$4,960,000</td>
<td>$160,000</td>
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<tr>
<td><strong>Less Selling Costs</strong></td>
<td><strong>5%</strong></td>
<td><strong>248,000</strong></td>
<td><strong>8,000</strong></td>
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</table>

**TOTAL SOURCES**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>$4,712,000</strong></td>
<td><strong>$152,000</strong></td>
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</tr>
</tbody>
</table>

### USES: COSTS

<table>
<thead>
<tr>
<th>Total</th>
<th>Per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Acquisition</td>
<td>$-</td>
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<tr>
<td>Unit Construction</td>
<td>$4,085,800</td>
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<tr>
<td>Other Construction (including contingency)</td>
<td>$678,709</td>
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<tr>
<td>Infrastructure</td>
<td>$144,006</td>
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<tr>
<td>Planning/Architecture/Engineering</td>
<td>$178,932</td>
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<tr>
<td>Construction Interest/Origination</td>
<td>$151,044</td>
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<tr>
<td>Other Soft Costs</td>
<td>$-</td>
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<tr>
<td>Marketing and Sales Costs</td>
<td>$2,500</td>
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<tr>
<td>Developer Fee</td>
<td>$275,842</td>
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</table>

**TOTAL USES**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Per Unit</th>
</tr>
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<tbody>
<tr>
<td><strong>$5,516,833</strong></td>
<td><strong>$177,962</strong></td>
<td></td>
</tr>
</tbody>
</table>

**REVENUE FROM SALE OF HOMES**

- **$4,712,000**
- **$152,000**

**TOTAL COSTS**

- **($5,516,833)**
- **($177,962)**

**NET REVENUE (LOSS)**

- **($804,833)**
- **($25,962)**

**DEVELOPMENT SUBSIDY NEEDED**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>$804,833</strong></td>
<td><strong>$25,962</strong></td>
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### Appendix III:
Pine Knolls Development Homebuyer Analysis

<table>
<thead>
<tr>
<th>Bank Requirements</th>
<th>Family Information</th>
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</thead>
<tbody>
<tr>
<td>Bank Ratio</td>
<td>Front End</td>
</tr>
<tr>
<td>Annual Interest Rate</td>
<td>7.25%</td>
</tr>
<tr>
<td>Loan Term (Years)</td>
<td>30</td>
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<tr>
<td>Loan to Value</td>
<td>95%</td>
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<tr>
<td>Closing Costs</td>
<td>$3,000</td>
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</table>

**Debt Capacity**

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<tr>
<th></th>
<th>$</th>
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</thead>
<tbody>
<tr>
<td>Monthly Income x Front Ratio</td>
<td>1,637.50</td>
</tr>
<tr>
<td>- Taxes</td>
<td>359.43</td>
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<tr>
<td>- Insurance</td>
<td>83.33</td>
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<tr>
<td>- Other Monthly Housing Cost (HOA fees)</td>
<td>100.00</td>
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<tr>
<td>Maximum Monthly Debt Service</td>
<td>1,094.74</td>
</tr>
</tbody>
</table>

**MAXIMUM LOAN USING FRONT END RATIO** $160,478
REFERENCES


