City of
Portland, Oregon
Bureau of Development Services
FROM CONCEPT TO CONSTRUCTION

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BDS Financial Advisory Committee

Meeting Notes
Tuesday, November 19, 2020

FAC Members Present:
Jeff Renfro, Multnomah County
Jerry Johnson, Johnson Economics
Josh Harwood, City of Portland Economist
Mike Paruszkiewicz, Northwest Natural
Mike Wilkerson, ECONorthwest
Paul Delsman, DRAC
Peter Hulseman, Northwest Economic Research Center
Sean Green, DRAC
Tom Potiowsky, Portland State University

City Staff Present:
Andy Peterson, Special Projects, BDS
Angela Butel, Financial Analyst, City Budget Office (CBO)
Beth Benton, Property Compliance Manager, BDS
Brenda Fahey, Technology & Continuous Improvement (TCI)/Recruitment & Training Manager, BDS
Chariti Montez, Commissioner Dan Ryan's Office
Hawthorne, Deonte, Financial Analyst, BES
Darryl Godsby, Commercial Inspections Services Manager, BDS
David Kuhnhausen, Permitting Services Manager, BDS
Dave Tebeau, Residential Inspections Services Manager, BDS
Doug Morgan, Plan Review Services Manager, BDS
Elshad Hajiyev, Deputy Director, BDS
Erin Mick, Engineering-Residential Development Manager, Water
Jess Eden, Analyst, CBO
Kathy Lyndon, Financial Analyst, BDS
Kellie Torres, Commissioner Dan Ryan's Office
Ken Ray, Public Information Officer, BDS
Kim Tallant, Land Use Services Manager, BDS
Kyle O'Brien, Budget & Finance Manager, BDS
Nathan Walloch, Financial Analyst, PBOT
Nate Takara, Deputy Fire Chief
Mike Johnson, Manager, PHB
Ray Galinat, Financial Analyst, BDS
Rebecca Esau, Bureau Director, BDS
Sarah Huggins, Analyst, Parks & Recreation
Sarah Wood, Planning, BPS
Tammy Croll, BDS Training & Workforce Development (Meeting Host)
Tom Armstrong, Planning, BPS

Handouts
- Financial Summary
- Business Continuity Plan Summary
- Non-Cumulative Cost Recovery Report
- Workload Measures Report
- Large Projects – Valuation $15 Million or More
- Large Projects – 6-Month Comparison
- Line Item Budget
- Explanation of Line Items

1. Welcome
BDS Director Rebecca Esau welcomed Financial Advisory Committee (FAC) members and City staff and convened the meeting by expressing appreciation to the committee members for their participation and input. Director Esau explained the COVID-19 public health crisis has resulted in revenue stream reductions for BDS and has also emphasized the need for adaptability. In response, BDS is in the process of moving work processes to a teleworking format.

2. Self-Introductions
Attendees made self-introductions.

3. BDS Finances & Financial Planning Update

<u>Bureau's Current Financial State</u>
BDS Budget & Finance Manager Kyle O'Brien began by setting a framework for FAC meetings. This first meeting serves to provide an overview of the bureau's current financial state while looking to the Committee for insight on the economy as well as BDS's econometric modeling. Much has changed since the FAC met in August 2020 and the input received in this meeting will be crucial as BDS projects revenues for the next year to five years.

BDS is established as an operating fund, meaning it is primarily funded by fees and charges for services with very little support from the General Fund. This ties BDS revenues closely to the construction industry and associated business cycles. As such BDS has its own reserves and reserve goals are set to ensure continuity of operations. The overall bureau reserve goal is 50% of annual expenditures with the Building/Mechanical Program, Environmental Soils Program, Signs Program, and Land Use Services reserve goals set at 75%. The Building/Mechanical program performs structural and mechanical inspections that are usually the last stage in the bureau's work on development projects. The higher reserve goal ensures the bureau has enough resources to provide inspections services that were prepaid by developers and homeowners. Services provided by Land Use Services take place at the leading edge of the development cycle, with program revenues and workload highly susceptible to any fluctuations in the construction development cycle; therefore, a program reserve goal of 75% is prudent and provides BDS with the necessary time to react should reserves drop below this goal. The current programmatic reserve goals and bureau total minimum reserve level allow the bureau to better manage unpredictable fluctuations in economic conditions.

The majority of BDS fee revenues are associated with State-mandated building code programs, including Building, Mechanical, Plumbing, and Electrical. State statutes regulate these programs and prohibit revenue collected by them to be used for local code enforcement programs. BDS's local code programs include Land Use Services, Property Compliance Inspections, Environmental Soils, Signs, Zoning

Compliance, and Site Development. Revenues from these programs are to be used on the programs generating the revenues, according to City Code. Approximately $1 million, nearly 2% of all BDS revenues, come from the City's General Fund to support the Neighborhood Inspections Program. Historically Land Use Services received General Fund monies, however that support ended in FY 2017-18.

Kyle O'Brien then provided an update on BDS's finances over the last several months. So far in FY20-21 BDS has been drawing on reserves heavily except for the October 2020 accounting period where BDS operated at 98% cost recovery due primarily to revenue from a couple large projects. Fiscal year-to-date BDS is operating at 70% cost recovery as of October 31, 2020. Currently reserves sit at approximately $70 million, compared to the high of nearly $92 million seen in June of 2018.

FY 2019-20 Performance

Overall BDS underperformed in FY19-20 ending the year with an 89% cost recovery rate opposed to the 92% cost recovery rate projected in the Financial Plan. While total expenses posted 2% below estimate, total revenues came in 6% under projection. Year-end bureau reserves decreased from $86.2 million in FY18-19 to $77.8 million in FY19-20.

Overview of BDS's Forecasting Model

A brief overview of the bureau's Five-Year Financial Plan modeling was provided to the Committee. Over 80% of revenues are forecasted by econometric modeling, using data from Moody's, Northwest Economic Research Center (NERC), and State of Oregon Office of Economic Analysis (OEA) in addition to bureau data for land use case reviews, permit numbers, valuations, and revenues. Specifically, the Building, Mechanical, Plumbing, Electrical, and Land Use Services fee revenues are econometrically forecasted. The Facility Permit Program (FPP) rates are a weighted average of the Building, Mechanical, Plumbing, and Electrical growth rates. Site Development and Zoning Enforcement growth rates are based on the Building Program rates. Environmental Soils, Signs, and Enforcement are projected using averages of forecasted economic data such as population, housing price index and employment.

Expenditure projections are based on current expenditures with consideration for inflation, labor, and special projects.

Overview of BDS Expenditures

The handout **Line Item Budget** provided a bureau wide view of expenditures for the previous four years as well as the current year budget. Personnel expenses are by far the largest cost, accounting for nearly 70% of overall BDS expenditures.

Large Projects

Kyle O'Brien reviewed the handout **Large Projects - 6-month Comparison.** At first glance, the year-over-year comparison of May through October appears to show an increase in workload. However, much of the application valuation in the current year is tied up in 2 projects: 1. Benson High School ($212 million), and 2. Allamo Manhattan-Block 41 ($80 million). While the previous year had much of its application valuation tied to 2 projects as well: 1. Lincoln High School ($186 million), and 2. 11W ($82 million), overall the average application valuation decreased by nearly 37% year-over-year.

4. Current Economic Trends Discussion

Economic Outlook Discussion

When the FAC met in August 2020, the impression was the downturn would last two to three years. Kyle O'Brien asked the Committee if there were any changes to that sentiment. Jerry Johnson indicated the current situation looks worse for the City of Portland then surrounding areas with decreased office demand and an over-built urban apartment market with decreasing rents over the last 3 years. Jerry also mentioned that the COVID-19 pandemic has accelerated underlying trends already existing in some sectors. Kyle O'Brien agreed, specifically calling out the bureau had already expected a decrease in demand for hotel development.

Mike Wilkerson further explained that the last multi-family development cycle was jump started by people losing their homes during the last recession in parallel with in-migration. The current unknown, partly related to the COVID-19 pandemic, is the outlook of in-migration to the Portland Metro area, and the capture rate of in-migration by the City of Portland versus surrounding areas. Additionally, decreases in large multi-family development will most likely be seen due to decreased rents and increased construction costs. Multi-family development will most likely be seen in small scale wood-framed projects as rental rates and construction costs will not support tower or podium projects.

Kyle O'Brien asked about timelines and how long decreases will last before BDS will start to see revenue increases. Jerry Johnson noted that when rents increase in comparison to construction costs, development will pick up again. However, current variables result in low capitalization rates and high investment risk which do not attract investors. Paul Delsman indicated that construction costs are driven by subcontractors not wanting to lower costs, employees resisting pay cuts, and manufacturers not having high enough margins to reduce costs. Sean Green agreed that costs of doing business is very competitive in the current environment and contractors are faced with a tight labor market. Contractors and developers are not seeing direct costs lowering any time soon, except for lumber prices. Sean also noted high demand for residential renovation during the COVID-19 pandemic. Kyle O'Brien explained that residential renovation projects are low cost recovery and do not provide a major source of revenue for BDS. Jerry Johnson mentioned that expenses in the construction industry do not tend to decline, but rather plateau for periods of time. FAC members indicated these factors are likely to result in decreased development over a longer period.

Mike Wilkerson suggested that the residential single-family market is much brighter than multi-family or commercial development, noting the high percentage of people under 30 living with parents will eventually enter the market. When this occurs the strength of the single-family market will help the multi-family market.

Kyle O'Brien inquired if federal stimulus in response to COVID-19 will further strengthen the residential market. Jerry Johnson responded that this help will not affect the pace of new construction. Employees most impacted by the pandemic, and government financial help, are disproportionately renters. Additionally, it is difficult in the current environment to deliver houses at a price to attract first time homeowners.

Kyle O'Brien then asked if a flattening of revenues is likely or if further decreases are more likely until construction picks up. Jerry Johnson explained that uncertainty is leading to an overall halt in development. However, BDS should look at individual market segments separately as some revenue sources are tied to variables outside of the overall market, for example School projects which are related to bonds.

BDS Director Rebecca Esau asked the FAC members if they see existing apartment buildings converting to condos on the horizon. Jerry Johnson explained that condo markets are typically in high demand in alternating cycles and currently it's a low demand cycle. The condo market is typically for starter homes, but current economic conditions are causing hesitance in people making this conversion. Sean Green added that it is slow to move condos and the legal costs of smaller condo developments do not pencil out. Mike Wilkerson noted that the cost of retrofitting to condos is not feasible as condo prices have been dropping due to decreased demand despite an overall rise in prices.

Modeling & Forecasting Discussion

Kyle O'Brien described how BDS adjusted revenue projections in response the COVID-19 pandemic; due to the expectation of substantial decreases in large projects BDS estimated the percentage of revenue from those projects and removed that revenue from projections. Large project information was then gathered from Process Management and associated revenues were added back in. Kyle noted this method seemed to work well and asked if the Committee agreed with this approach for the remainder of this fiscal year and into next fiscal year.

There was consensus that econometric modeling may be more feasible in the long term and that using information from subject matter experts will increase short-term accuracy. Mike Paruszkiewicz explained that he uses subject matter expert information to create forecasts for the first 3 years and then appends econometric modeling for longer-term projections. Jerry Johnson mentioned that using panels such as the Finance Advisory Committee can be a good source of information to building out expectation for the first 3 years of a forecast period.

The Committee also discussed variables used in BDS's econometric modeling. There was consensus that variables may not be accurate in the current environment and potentially for future forecasts as well. Peter Hulseman mentioned that many econometric model variables do not make sense in the current environment and are especially challenging for forecasting multi-family projects. Mike Paruszkiewicz and Mike Wilkerson expressed uncertainty as to the underlying historical relationship of model variables. Jerry Johnson and Mike Wilkerson also noted that data used for model inputs is based on a Metro region as a whole and may not indicate reality for a specific City within the region. While reiterating that some variables may not currently be relevant, Jeff Renfro explained there is still value is running econometric models as a baseline as the laws of economics still hold.

Kyle O'Brien then asked the Committee for their opinion on the best leading indicators. Mike Wilkerson recommended looking at household growth instead of overall population growth. Kyle O'Brien mentioned that BDS does use the number of households in several of its models. Josh Harwood suggested caution with this variable as the migration pattern is expected to deviate from historical norms with a higher percentage of in-migration moving to suburbs or Vancouver. Mike Wilkerson agreed that Portland's capture of in-migration will be lower than in the past, noting that Vancouver is still seeing high levels of construction activity and in-migration.

Mike Paruszkiewicz asked if BDS incorporates delinquency rates in its econometric modeling, and recommended using sources such as Black Knight, Inc. for real-time data. Kyle O'Brien confirmed that BDS has incorporated delinquency rates or similar type date in the past. Jeff Renfro added that Amy Vander Vliet at the State of Oregon Unemployment Department might have related data sets BDS could use to better understand the current economic environment.

Kyle O'Brien shifted the conversation from modeling back to construction activity bringing up the point that recent large project submittals were far enough into the permitting processes prior to the pandemic that they progressed despite the economic downturn. Kyle inquired as to the Committee's thoughts on how large projects will be affected going forward. Josh Harwood explained that it will depend on how long the public health crisis lasts. Jerry Johnson mentioned that equity markets are averse to uncertainty reiterating that we are currently in a highly uncertain environment. Mike Paruszkiewicz added that in the current low capitalization rate market there is hesitation to be the first investor; however, the longer this environment continues, transactions will eventually occur.

Andy Peterson explained that there is a pool of projects with Land Use Services approval that are not currently moving forward. These projects might get missed when using Land Use Services as a leading indicator as they have been in the process for too long. Jerry Johnson mentioned that many developers are "slow walking" these projects as it takes a long time to get entitlements from the City, hoping that something changes to move the projects forward. Mike Wilkerson added that some of the "slow-walked" projects that already have entitlements were expected to be picked up by other developers, however that has not materialized.

Kyle O'Brien asked if Committee members were willing to provide their best estimate of how long the construction downturn will last. Mike Wilkerson voiced uncertainty as to whether the current environment is a plateau or still on a downward trajectory and, based on Land Use Services data, recommend adjusting down for one more year and then modeling a plateau. Jerry Johnson added that the current environment is more accurately described as a construction cost plateau more than an activity plateau. Rebecca Esau asked the Committee when the bottom will hit. Mike Wilkerson suggested that, from a fee generation standpoint, it looks like at least another year, and is dependent on how fast current projects are absorbed.

5. <u>Next Meeting Details</u>

The next FAC meeting is scheduled for Tuesday, January 5, 2021.

Meeting notes prepared by Kathy Lyndon, and Ray Galinat, BDS