Affordable Housing

An Attractive Alternate for the Knowledgeable Investor

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Is investment in affordable housing merely a social objective or can it compete well against other, more traditional investment vehicles? Affordable housing offers stability, predictability, and a reasonable yield—insulated from many traditional real estate risks—for value-added debt and equity investment opportunities. Specifically, bond-financed rental affordable housing, the focus of this article, can minimize risk and create large, medium- to long-term quality income streams.

To evaluate this asset class for pension fund investment, the risk-return analysis must look first at the traditional real estate quantitative and qualitative indicators; however, yield optimization strategies and risk mitigation programs involve very different areas of focus from traditional, conventional apartment investment.

First: Risk by Traditional Standards

Any real estate investment analysis normally starts with an evaluation of the location, and affordable rental housing is no exception. Generally, the locations for affordable rental projects in states with advanced bond allocation[1] systems, such as California, would score very high on locational attributes—from amenities to public infrastructure (parks, schools) and mass transit opportunities—given the intense competition for tax-exempt bond and/or subsidy allocations. These bond allocation project rating systems assign substantial weight to "locational attributes."

Government allocation systems, however, frequently ignore or inadequately address the dependence in any submarket on vulnerable local industry employers. The economic analysis must address the employment diversification for the immediate submarket of the housing site. Depending on the percentage of project affordability, the apartments may be reasonably insulated from concentrated employment risk that would be inappropriate for conventional apartments. If the rental structure in the affordable apartments is sufficiently below market and initial debt service coverage is at a 1.20 debt service coverage or better, the market risk insulation should be effective, even in reasonably distressed employment markets.

1. Bond allocation refers to the federal allocation of tax-exempt bond cap, annually distributed on a per-capita basis between the states pursuant to Internal Revenue Service Code Section 146(d). Projects compete through submissions to state agencies for bond cap allocation. An award of bond cap allocation permits the project to sell tax-exempt bonds for construction and permanent mortgage financing, and the bonds entitle the project to 4 percent federal tax credits, which are sold to national investor groups in exchange for cash contributions to the equity requirements of the project.

Defining Affordable Housing

Affordability, for purposes of this article, is limited to the ranges prevalent in institutionally-sized, bond-financed projects subject to federal and California state bond allocations (see footnote 1). In that context, affordable means units with rents regulated at or below 60 percent of area median income, as defined by the U.S. Department of Housing and Urban Development (HUD) pursuant to Section 3 of the U.S. Housing Act of 1937, as amended.

Project Affordability Percentage Alternatives

In an affordable housing development, 40 percent to 50 percent of the units should be provided to tenants at or below 60 percent of median income[2] (mixed-income pool projects) or 100 percent of the units to tenants at or below 60 percent of median income (general pool projects). Although projects have been done with intermediate levels of affordability (between 50 percent and 100 percent of the units), once the 50 percent affordability boundary is passed, sustaining the market rate component of the project becomes difficult and the risk level of the project may increase significantly, unless the project sponsor is highly qualified in mixed-income affordable housing.

Projects with 20 percent of the units provided to the tenants at 50 percent of median income (offering a minimum level of affordability) represent higher risk models that are, generally, not well accepted in the tax credit investor community. Tax credit investors represent another key financial participant in most bond-financed affordable housing transactions, so this exclusion of 20 percent affordable projects from the normal tax credit market creates, at the very least, a substantial financial structuring constraint.

The Tax Credit Investor: A Source of Risk Mitigation

The tax-exempt bonds that finance affordable rental developments entitle the projects to 4 percent federal tax credits. The tax credit investors are, generally, nationally syndicated investment pools that provide tax-motivated equity investments to these projects. Because the tax credit investors are subject to severe recapture rules and tax penalties for the first 15 years of the tax-credit period, the initial period of any investment in mezzanine debt or an equity structure has the benefit of a "deep-pocket" capital partner. Historically, tax credit syndicators have protected their project investments; the foreclosure rate on bond-financed projects with tax credits is reported at .01 percent.[3] This rate is 1/44th of the .44 percent foreclosure rate for conventional apartments.

2. Affordability levels are defined, for most state regulatory purposes and for federal financial and subsidy purposes, at 50 percent of the Standard Metropolitan Statistical Area (SMSA) median income and at 60 percent of the SMSA median income, as set forth and adjusted annually by HUD procedures.

3. Study by Ernst & Young's Affordable Housing Services and Quantitative Economic Statistics Group for the period ending December 2000.

More Traditional Risk-Balancing Factors

With a reasonable percentage of affordable units, affordable apartment developments are effectively insulated from rental-demand shocks driven by cycles in the domestic economy, local economic events, and global geopolitical influences. Fundamentally, the quality of this market insulation is controlled by two factors:

- Debt Service Coverage Minimums: Affordable project mortgage financing that permits a 1.10 debt service coverage—even though sanctioned by government-sponsored enterprises (GSEs) such as the Federal National Mortgage Association—does not provide adequate market risk insulation, unless the rent spread from market is extremely deep (greater than 20 percent) and operating expenses have intentionally been underwritten at inflated levels to cushion future expense exposure. Effective market insulation should be supported by a real 1.20 debt service coverage using actual, expected operating expenses, even if the rental spread from market is wide on a 100 percent affordable development. For product types with a reduced risk profile, like a fully occupied apartment development that is a candidate for an acquisition or rehabilitation program,[4] a 1.15 debt service coverage may be appropriate.
- A "Deep" Rental Spread in the Primary Submarket: Affordable housing rents spread from market is often quoted in terms of the Standard Metropolitan Statistical Area (SMSA), but the project will compete against direct conventional comparables in its submarket or the nearest competitive submarket, if there are no equal or better quality comparables in the immediate submarket. If the project represents the highest quality in its submarket, it must present a positive rent spread from market in its submarket, despite higher amenities and higher quality. Generally, it is not sufficient for the project to be "affordable" when the designated low and very low income units have rents equal to or higher than competitive projects in its submarket, regardless of positive quality differentials. Valid exceptions to this guideline do, however, arise in redevelopment or revitalization areas with substantial public subsidies.

4. This assumes a minimal tenant displacement construction program.

Advantages of Affordable Housing Investments

If affordable housing has been held to a thorough, traditional risk evaluation that concludes market insulation is strong, investments in affordable housing can represent a superior investment option when judged by the following criteria:

- predictability of success;
- cash flow sustainability;
- insulation from local and national economic cycles;
- benefits from equity leverage at low risk;
- financial restructuring flexibility;
- insulation from interest rate risk;
- a reasonable ability to raise rents in a market with increasing vacancy,[5] offsetting the normal inflation in operating expenses over time;
- a very low vulnerability to future events;
- insulation from vacancy increases due to tenants converting to entry-level ownership during periods of low interest rates; and
- reasonable protection from local government rent control and/or discriminatory tax, impact fees, and special assessments otherwise levied against commercial properties.

Given the enumerated advantages, an investment return for affordable rental housing that approaches or equals the average investment yield on conventional apartments represents an attractive incentive to participate in this socially productive sector. These yield outcomes represent a positive yield result on a risk-adjusted basis. These yields are, however, based upon higher financial leverage, although a portion of the financial leverage is commonly derived from public entities—cities, counties, redevelopment agencies—with debt structures that pay only from available cash flow and, therefore, do not create a default risk for the pension fund mezzanine debt or equity investment. This public debt leverage along with the tax-exempt bonds and the tax credit funding permit the yield objectives to be achieved on the pension fund component of funding.

Avoidable Special Risks of Affordable Housing Investments

Entrants into the affordable rental housing investment field must recognize a specialized set of risks. These risks are avoidable with the correct investment structure and investment team but can be substantial if the technical layers of overlapping regulations, rules, and legislation impacting this field are not thoroughly understood and in practice. Risks can include the following:

Project Structuring on Future Financial Models

The investment team must look forward and design financial structures that will work a year to two years later, when construction begins. Industry or Financial Accounting Standards Board (FASB)–driven financial and accounting changes in syndicators, tax credit public offering structures, credit enhancers, and/or company structures, for example, must be forecast to create a conservative, predictable future funding model. In addition, participants/advisors without substantial track records and volume in the field will not receive 12 months' advanced informal briefings by the major tax credit syndicators, construction lender policy leaders, and GSE credit enhancement intermediators.[6]

For example, a number of highly successful and knowledgeable conventional developers have recently made the mistake of structuring 20 percent affordable, bond-financed projects (based solely on historical practices) with the expectation of selling tax credits on the affordable portion of the project. At least 18 months ago, affordable housing experts knew that this would be extraordinarily difficult unless substantial discounts or disadvantaged structuring terms were delivered. Effectively, a number of project investments were made in affordable housing with an upside that depended, in part, upon selling the tax credits on 20 percent of the units, when this was not a reasonable expectation.

The forward-planning model also mandates embedded structural provisions in the legal documents to provide the framework for flexible, "back-door" restructuring options in the event of unforeseen changes.

Multiple Exit Strategies

The financial plan exit options must anticipate the interplay of various technical provisions to properly forecast realistic investment exit implementation. The primary investment exit plan should be built around a multiple payout option strategy. The effective investment returns described earlier cannot be achieved, generally, in a 15-year time frame, so the structure must provide

5. Statistically, in areas with increasing unemployment, the median income of the employed workforce will often rise, as the workforce members with lower experience and lesser seniority leave the area through workforce reductions.

6. GSE credit enhancement is generally advanced through delegated, private-sector underwriter/risk-sharing groups called DUS lenders.

for multiple, predictable exit options in the four-year to eight-year range.

The exit plan must also be structured to avoid creating project stress resulting in negative publicity. Because public entities have financially underwritten and subsidized these projects, which creates major insulation from political and financial risk during the development stage, the exit plan cannot stress the operational performance of the project and run the risk of negative publicity from putting the political entities' investment in affordable housing at risk.

The primary investment exit plan must recognize downstream constraints on exit options created in the underlying regulations of the credit enhancers providing support for the tax-exempt debt. Similarly, the tax credit equity providers create complex document structures that frequently limit certain exit options that would stress the project financially.

Expert Competence

Expert competence with a substantial development history in this specialized affordable housing rental product is a critical threshold experience requirement for any development/advisor team. Many novice affordable housing developers, who may be experts in conventional apartments, have developed affordable rental housing projects that are literally 20 percent affordable. An expert affordable housing team, however, would rarely, if ever, develop a project with exactly 20 percent affordability; the transactional risks of compliance dictate actually delivering a project that is 21 percent to 22 percent affordable. The IRS implications of failing the 20 percent test, including failures occurring during lease-up, are extreme (including a potential taxability of the interest on the bonds financing the project); and therefore, experienced developers without the specialized background in affordable rental housing may unwittingly be vulnerable to risk levels that expert investment teams operating in the affordable housing area would avoid.

Although the risk of developing at the "compliance margin" historically has been subject to tax credit penalty adjustors, tax credit recapture, and other major economic disincentives, IRS compliance audits on the tax-exempt bonds have not been a significant risk. Recently, however, this has changed, and the IRS has issued new bond-audit regulations concurrent with instituting a program of audit samplings. Whereas historically developers/advisors might have operated with less knowledge and/or a lower concentration on compliance risk, they should make this a high priority in the design of the financial structure for the construction and long-term operating phases of any project.

The level of compliance buffer required will vary based upon the number of "firewalls" in the compliance design and the expertise of the development/manager/advisor team. A structure similar to the following four-level firewall structure would normally be important::

- The property manager must have a "seasoned" compliance officer who ideally should complete a compliance update course taught by the independent CPA compliance auditor staff.
- An independent certified public accounting firm completes a pre-year-end first-year audit of all lease-up files, with a case method review for the onsite staff and the owner of any compliance corrections.
- The tax credit investor's compliance field staff conducts a pre-year-end first-year audit of all lease-up files and provides feedback to the independent CPA, the property management compliance officer, the onsite property management staff, and the owner. At this point, all file documentation should be signed off as final and the compliance cushion should be completely validated.
- Depending upon the expertise of the onsite property management staff, other interim stage audit compliance steps are interposed in the project development process.

A Great Investment Option—With the Right Team

Clearly, affordable housing has numerous investment risk benefits that are particularly relevant during a period when the domestic economy is highly vulnerable to international geopolitical events. In addition, the risk characteristics of the affordable housing field provide excellent stability and yield benefits even in "distressed" local residential apartment markets. To optimize this opportunity, however, one must create highly expert teams of developers and investment advisors that understand the specialized regulatory risks on a technical-legal basis and on an operational basis. In addition, it is critical that this team always look forward in the market, with the objective of gaining insight into the economic and risk perspectives of the major national capital and credit providers to this market segment. This information permits investors to anticipate, one to two years in advance, the changes in the specialized capital and credit providers' participation preferences and exclusions from the market. Affordable housing is a field that relies heavily on expertise and experience. ■