Affordable multifamily housing

An attractive institutional investment class

by Stuart Boesky and Olamide Fadairo

Virtually all of its population recognizes the United States suffers from a lack of affordable housing. Despite this trend, most institutional investors have not thought about affordable housing as an investible, non-concessionary ("concessionary" as used herein refers to below-market rates of return) asset class that offers attractive risk-adjusted market rates of return. Moreover, as we may be reaching the end of an economic cycle, most institutional investors are unaware of the strong recession-resistant characteristic of the asset class.

Most discussion about affordable housing includes public housing owned and managed by governmental entities, and for-sale housing. For the purposes of this article, both are excluded. This discussion will focus exclusively on affordable rental housing owned and operated by the private sector, or highly experienced not-for-profit entities dedicated to the development, ownership and preservation of the asset class.

The history of government subsidy

To understand affordable rental housing, one needs a rudimentary understanding of the federal government's role. The federal government began its involvement with the sector in 1937 as a result of the Great Depression.

Initially, governmental entities developed, owned and managed housing for the very poor. After World War II, the government promulgated programs to provide both rental and for-sale housing for returning veterans. With the establishment of the Department of Housing and Urban Development during the 1960s, housing policy changed to emphasize fair housing, desegregation and, most important, public/private partnerships. The U.S. government began to offer

private-sector sponsors direct subsidies, including but not limited to: (i) rental subsidies, (ii) below-market loans, and (iii) grants, all of which were intended to make development and ownership of affordable rental housing economic for the private sector. Finally, the U.S. Treasury entered the business in a substantial way with the Tax Reform Act of 1986, which included Internal Revenue Code Section 42, establishing the low-income housing tax credit (LIHTC). The LIHTC is designed to encourage the flow of institutional capital to develop and rehabilitate affordable multifamily rental housing in exchange for federal tax credits. Today the LIHTC generates approximately $15 billion a year of institutional investments in the form of equity dollars to develop and rehabilitate affordable rental housing, according to a report from CohnReznick. Private trade associations and state housing and finance agencies have collaborated to establish and monitor a set of best practices for these investments, which has helped the success of this program. Today these tax credits are the primary driver of new development and rehabilitation of affordable rental housing that targets low-income households.

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Together the U.S. Treasury, HUD, Fannie Mae, Freddie Mac, the Federal Housing Administration, and state and local housing agencies administer a host of programs with a common theme. All are designed to support and encourage private-sector development, rehabilitation, ownership and management of affordable rental housing targeted to tenants with household incomes less than or equal to 80 percent of area median income (AMI), and up to 120 percent of AMI in high-cost areas.

They have identified these income levels because the supply of quality housing that targets these households is severely constrained and demand cannot be satisfied on an economic basis without subsidies.

We have identified affordable rental housing as an investible asset class because: (i) it is privately owned and operated or, to a lesser extent, owned and operated by sophisticated not-for-profit entities; (ii) the amount of such housing is sufficiently large to be an institutionally investible asset class; (iii) the supply and demand characteristics are favorable; and (iv) the credit characteristics are compelling.

The industry divides the sector into three categories, distinguished primarily by the household income levels they serve:

- **Deeply subsidized rental housing (DSRH):** This category targets households at 60 percent or less of AMI. Since 1987, much of this housing has been developed and operated under the LIHTC program. Prior to 1987, this housing was primarily developed with the assistance of direct rental subsidies, known as Section 8 contracts, and below-market-debt programs and grants. Today an affordable rental housing property will generally benefit from more than one type of subsidy. These programs may include but are not limited to: (i) direct rental subsidy; (ii) tax-exempt bond financing; (iii) federal, state and local grants; (iv) LIHTC and historic tax credits; (v) brownfield tax credits; (vi) below-market first-mortgage financing; (vii) soft second-mortgage financing; or (viii) favorable zoning.
- **Naturally occurring affordable housing (NOAH):** This category of ARH targets households with incomes that are at 80 percent or less of AMI. This variety of housing will not benefit from LIHTC, which is restricted to households at 60 percent or less of AMI. It may, however, benefit from one or more of the other subsidies set forth above. In the alternative, NOAH may be unsubsidized traditional class B or C multifamily housing located in secondary or tertiary markets.
- **Workforce housing (WFH):** This category is simply NOAH housing that is located in urban areas with high development costs, as generally identified by HUD, and targets household incomes of 120 percent or less of AMI. It is less likely to benefit from one or more of the subsidies that are available to NOAH.

Assessing the size of the market

Approximately 19 million households, representing about 40 million people, rent apartments in properties that contain five or more units. Of this amount, more than half could qualify as affordable rental housing because the tenants have household incomes at 80 percent of AMI or less. We assume the units in which they live have an average value of $150,000, which equates to a total value of roughly $1.2 trillion. In addition, the LIHTC program is estimated by CohnReznick to produce or rehabilitate an additional 100,000 units each year, which we value at approximately $15 billion.

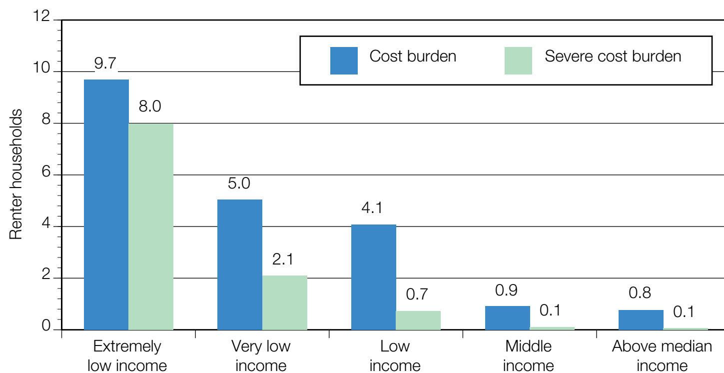
To further the case, the majority of class B and C units that can be considered affordable rental housing were built before 1980, and are generally in need of rehabilitation. It is clear the United States has more than enough apartments that could qualify as affordable rental housing for the sector to be considered an institutional investment class.

Tenant supply and demand

HUD defines a household as "rent burdened" if it pays more than 30 percent of its adjusted gross income for housing. This is why we have used 30 percent of AMI in defining affordable rental housing. Census data indicates 30 percent of renter households nationally are burdened, and that rises to 50 percent in urban locations. The graph below illustrates the number of renter households that are cost burdened and severely cost burdened by the following income classes: extremely low income (30 percent or less of AMI); very low income (50 percent to 31 percent of AMI); low income (51 percent to 80 percent of AMI); middle income (81 percent to 100 percent of AMI); and above median income (100 percent and above of AMI).

Presumably all of the households identified above would rent an affordable-housing unit if it were available. We identify the very-low- and low-income households as the most appropriate tenants for these properties for our purposes. Extremely low-income households are more appropriate public-housing tenants, and middle-class households are most likely only rent burdened in high-cost-to-develop locations. Therefore, for the purposes of this paper, approximately 11.9 million households that are cost burdened or severely cost burdened represent demand for affordable rental housing.

Renter households with cost burden, by income group, 2016



Source: National Low Income Housing Coalition tabulations of 2016 American Community Survey PUMS data

Given this tremendous excess demand, why aren't developers building more units? In fact, between 80 percent and 85 percent of all new apartments delivered each year are considered luxury or class A product. This is the case even though rents are increasing faster in class B and C properties and vacancy rates are lower. In Manhattan, for example, which is dominated by luxury apartment stock, the vacancy rate is approximately 5 percent, while in the Bronx, which is dominated by affordable rental housing, vacancy is approximately 3 percent, according to the "Selected Initial Findings of the 2017 New York City Housing and Vacancy Survey."

Unfortunately, wage growth has not kept pace with the increased costs of land, construction labor and materials. For a developer to earn a 6 percent to 7 percent return on cost — the return that is generally assumed to be the minimum acceptable — rents must be set at rates that are affordable to households with incomes above 120 percent of AMI. As a result, new affordable rental housing only makes sense if it benefits from scarce amounts of federal, state and local subsidies.

Over the past 40 years, only 5 million rent-restricted units have been built in the United States, or less than half of the 11.9 million units of demand we have identified above. Moreover, it should be noted some of these units are occupied by the extremely low-income households that we have excluded from our demand-side number.

Notwithstanding the limited pace of rent-restricted property construction, Freddie Mac estimated 1.62 million additional affordable-rental-housing units will be required over the next few years to satisfy additional demand. On an annual basis, only about 100,000 units are being built. "For every new affordable unit added, two are lost" each year due to conversion to market-rate housing, or becoming functionally obsolete through deterioration or abandonment, noted Jeffery Hayward, executive vice president and head of multifamily business at Fannie Mae, in *HousingWire* in 2017.

All of the above data clearly illustrates the overwhelming long-term demand for affordable rental housing can never be satisfied by the limited new supply. Unless something changes, the demand can only get stronger as the number of very-low- and low-income households grows.

Credit quality

Affordable rental housing historically has exhibited excellent credit characteristics. The reason should be self-evident to anyone who understands the supply/demand imbalance

set forth previously. The most unpredictable commercial real estate risk, and the one that is most difficult to underwrite, has always been the long-term demand for any given space and the price a tenant will be willing to pay for such space — market risk. As defined, the sector has rents that are restricted to rates that are below market. As a result, as illustrated above, the demand is overwhelming. We also have illustrated that new supply cannot satisfy new demand, primarily because new supply generally requires scarce subsidies to be developed. Therefore, we believe it is not hyperbolic to say, in most markets, affordable rental housing carries little, if any, market risk.

Conventional multifamily delinquency rates fluctuated between approximately .060 percent and .075 percent before and after the Great Recession, but increased to a high of 4.25 percent during it. In contrast, the foreclosure rate for LIHTC properties was less than .01 percent before and after the Great Recession and increased to only .02 percent during it. It should be emphasized how strong the performance was even during the Great Recession. This should be comforting if one believes we are headed into a downturn at the end of a very long economic cycle.

Accessing investments

LIHTC: The largest amount of institutional equity capital flowing to affordable rental housing is through syndicated and direct investment into LIHTC funds and properties. As discussed above, the LIHTC program is responsible for funding equity of about $15 billion per year, and produces approximately 100,000 new or rehabilitated units per year. The credit history of these properties is extremely compelling, with a cumulative foreclosure rate since 1987 of only 0.71 percent, according to CohnReznick.

Notwithstanding the preceding, these investments are only suitable for taxable C Corporations because 100 percent of an investor's return of capital and return on capital is derived from federal tax credits that offset federal income tax liability. Individuals and pass-through entities can use only a small amount of LIHTC per year. The economics associated with these properties are retained by the developer, who generally has little, if any, cash equity requirement. These investments are considered public welfare investments under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Community Reinvestment Act (CRA). For this reason, U.S. banks represent the lion's share of the investment activity each year.

Private equity funds: Several for-profit and not-for-profit private equity sponsors offer funds to acquire and rehabilitate existing and naturally occurring affordable housing. These funds generally target a cash-on-cash return of between 5 percent and 7 percent, based on a recent Pembrook Capital survey. They are often referred to as preservation funds because they seek to maintain the properties as affordable housing for households at 80 percent or less of AMI, and restrict rents to no more than 30 percent of 80 percent of AMI.

Given the overwhelming demand for affordable rental housing, the cash flows from these properties are predictable and stable, and often benefit from favorable financing from government-sponsored enterprises (GSEs). Overall returns for these properties have been attractive during the falling interest-rate and cap-rate environment we have experienced since the 1980s. A rising interest-rate and cap-rate environment may be particularly problematic for these investments, however, because rent increases for these assets generally are limited to increases in AMI. If inflation increases faster than wages (which has been the recent experience), rent increases at these properties may not keep pace with expense increases, and net operating income may not grow sufficiently to offset rising terminal cap rates and interest rates as the properties are sold or refinanced. As a result, the lower terminal value may offset the stable current cash flows they generate, making the stable and predictable current cash-on-cash return less compelling.

In addition, recently these types of funds have had to compete for acquisitions with value-add buyers that are hoping to remove these properties from their various subsidy programs so they can convert them to market-rate housing. This has driven up the price of affordable-rental-housing assets to the point that they need new subsidies to remain economic.

Concessionary debt: Debt comes in many varieties and is provided by GSEs, banks, bank consortiums, not-for-profit entities and private equity funds. Often this debt is offered to developers and owners on a concessionary basis, either for regulatory purposes, as is the case for the GSEs and banks, or as part of their mission, in the case of not-for-profit entities. The banks generally focus on construction financing for LIHTC properties. They also acquire tax-exempt multifamily housing bonds that finance construction, rehabilitation and permanent ownership of LIHTC properties.

The GSEs and their correspondents — Delegated Underwriting and Servicing (DUS) lenders

in the case of Fannie Mae, and Program Plus lenders in the case of Freddie Mac — generally offer long-term fixed-rate financing to fully stabilized properties. Nonprofits generally focus on small loans, less than $5 million in size. A common theme for all of these sources is they are either willing to offer below-market concessionary terms because of the strong credit history of the sector and to earn valuable regulatory consideration, or to fulfill their charitable or impact mission. One should consider potential terminal value issues and mortgage refinancing risk associated with long-term debt in the sector.

Private debt funds: Although many private equity sponsors offer commercial real estate debt funds, very few include affordable rental housing as part of their target asset classes because this lending requires a special knowledge of the vast number and types of subsidy programs.

Certain DUS lenders, Program Plus lenders and FHA seller servicers have raised funds to warehouse multifamily loan product that will ultimately be refinanced as part of their core agency business. Their primary reason for fundraising is to build a forward pipeline of loans for their agency businesses. The loans are usually short-term floating-rate bridge loans. Once the loans mature, they are refinanced with agency loans so they can retain valuable servicing rights associated with long-term fixed-rate GSE financing. Most of these loans, which carry market-rate risk, are made on market-rate housing and are also actively seeking affordable-rental-housing loans. The funds essentially serve as balance sheets for firms that otherwise do not have the capital to warehouse loans for their GSE pipelines.

Hybrid debt/equity funds: We are aware of two sponsors that have established what we believe to be hybrid affordable-rental-housing debt/equity funds. In addition, at least one has established separate institutional accounts to buy bespoke agency mezzanine interests in securities or loans collateralized by affordable rental housing. We are told the GSEs' long-term plans are to market these mezzanine interests on a concessionary basis to impact and CRA investors. Because the loans are generally long-term and fixed-rate, they too are exposed to terminal value risk and refinancing risk.

Private equity bridge lending: Some debt funds are solely focused on affordable rental housing and make short-term floating-rate loans. This is a transitional property niche. The loans generally are used by the sponsors for acquisition and rehabilitation of assets. The borrower's business plan may be to preserve the housing as affordable by positioning the properties to receive new subsidies, such as new LIHTCs by virtue of tax-exempt bond financing, or by applying to increase rent subsidies under the Section 8

Non-concessionary funds strategies for ARH debt or equity

Debt funds				
Asset class	**Strengths**	**Weaknesses**	**Property type**	**Target returns**
Bridge loans	No interest rate risk; alpha opportunity	Reinvestment risk	DSRH	8% current
Existing properties acquisition/rehab			NOAH	
Short-term floating			WFH	10%-12% total return
Bespoke agency	Stabilized properties	Interest rate risk; refinance risk	DSRH	8%-9% current
Mezzanine			NOAH	
Long-term fixed			WFH	
Bridge loans	No interest rate risk; large asset class	Market-rate risk; high program leverage	Affordable and market rate	10%-12% current
Existing properties acquisition/rehab				
Short-term floating				
Equity funds				
Asset class	**Strengths**	**Weaknesses**	**Property type**	**Target returns**
Multifamily equity	Cash flows stabilized and predictable	Cap rate expansion risk; equity risk; price competition from market-rate value-add developers	Year 15 LIHTC	5%-7% cash-on-cash, plus possible appreciation
			B and C properties in secondary and tertiary markets	

Source: Pembrook Capital

program, or a combination of these and a whole host of other subsidies. Alternatively, the properties may be rent restricted under local rent control, rent stabilization or extended LIHTC compliance, and the plan may be to continue to improve the properties, control expenses and operate the properties with restricted rents. The properties may be in secondary or tertiary markets, and as NOAH, the rents are at or below 30 percent of AMI; the sponsor will improve the property, control costs, and move rents up but still maintain them at or below 30 percent of AMI.

These bridge loans are opportunistic in the sense the sponsor generally needs to close quickly, and they require certainty of execution to satisfy terms of a purchase and sale agreement. For this reason, these lenders are able to generate true alpha by moving quickly because of their knowledge and focus on affordable rental housing. These loans are generally short-term, floating-interest-rate loans, so they do not carry rate risk, and do not carry the special cap-rate and interest-rate risk associated with being a long-term affordable-rental-housing investor or lender that we discussed. In a private equity format, however, these funds must reinvest proceeds from the repayments on short-term loans, so there is reinvestment risk.

The table on page 52 sets forth a small sample of nonconcessionary fund strategies for debt or equity in the sector, and it highlights some of their strengths and weaknesses.

Conclusion

An old investment idiom posits where there is a crisis, there is an opportunity. We believe that idiom is appropriately applied to affordable rental housing. It is one segment of the commercial real estate market that is sufficiently large, will always have a favorable supply/demand imbalance, and has proven to have a remarkable credit history. Moreover, the special skills and knowledge necessary to access and underwrite transitional affordable rental housing suppresses traditional demand, so attractive risk-adjusted returns should be sustainable. Considering its lack of commercial exposure, its stress-tested results and its current demand, the case for the sector's profitability can be made. The financing structure is already in place, so its growth is more a matter of education than market creation. ❖

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