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MILLENNIAL HOUSING COMMISSION
PRESERVATION TASK FORCE
BACKGROUND PAPER: BARRIERS TO ACQUISITION OF AT-RISK PROPERTIES BY PRESERVING ENTITIES

OVERVIEW

The Commission is considering advocating various reforms aimed at facilitating the long-term preservation of at-risk subsidized multifamily housing (HUD-assisted, RHS-assisted, and LIHTC) by capable and mission-sensitive owners ("preserving entities"), whether not-for-profit, public sector, or for-profit. See in particular the background papers on Sustainability and Preservation Tax Incentive.

First, the paper defines the at-risk universe and the concept of "preserving entities." The next section of the paper discusses each of the barriers identified by affordable housing professionals, providing an assessment of each barrier. The paper concludes with a summation of potential interventions that could reduce or eliminate particular barriers.

THE AT-RISK UNIVERSE

Assisted properties can be at-risk through a variety of causes, including: expiration of affordability restrictions, location in a market with rapidly rising real estate values, physical distress, financial distress, poor management, and poor ownership. The primary components of the potentially-at-risk universe are:

- **HUD "Older Assisted" Portfolio.** Developed 1966-1978, generally with below market interest rate mortgage loans under §236 and §221d3, and generally with twenty-year affordability restrictions that have expired. Estimated at 4,200 properties and 450,000 units.

- **HUD "Newer Assisted Insured" Portfolio.** Developed 1976-1984, with market interest rate FHA-insured mortgage loans, and with affordability provided through twenty-year project-based §8 contracts, most of which have expired[1]. Estimated at 3,500 properties and 320,000 units.

- **HUD "Newer Assisted Non-Insured" Portfolio.** Developed 1976-1984, with tax-exempt bond financing and without FHA mortgage insurance. Generally, affordability was provided through project-based §8 contracts coterminous with the bonds (usually 30 or 40 years). Estimated to be similar in size to the newer assisted insured portfolio.

- **RHS Portfolio.** 98% of the RHS portfolio was financed under §515. §515 was enacted in 1962, began producing housing in volume beginning in 1970, and is still active today. These properties are financed with direct loans from the Department of Agriculture's

[1] Most owners have accepted renewal contracts for one to five year terms.

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Rural Housing Service, generally with 1% interest rates. Properties generally had a twenty-year use agreement, which has expired for a large percentage of the portfolio. The remaining 2% of the portfolio consists of farm labor housing under §514. The RHS portfolio includes 17,700 properties and 460,000 units.

- **LIHTC Portfolio.** Most LIHTC properties developed prior to 1993 had a fifteen-year affordability period (properties developed since that time have a minimum affordability period of thirty years). The program was created in 1986, was later made permanent, was increased in scope in 2000, and develops or preserves roughly 70,000 units per year[2], implying a total portfolio of roughly one million units.

Estimates for the HUD portfolio are by the Compass Group[3]. Portfolio data for the RHS portfolio are from the Rural Housing Service. The LIHTC portfolio estimate is based on information from the National Council of State Housing Agencies.

"PRESERVING ENTITIES"

The following is an excerpt from the background paper on the Preservation Tax Incentive:

> **What is a "Preserving Entity"?** Some argue that only nonprofits (or only certain sub-categories of nonprofits) should qualify. Others argue that business capability, commitment to the affordable housing mission, and financial capability are the most relevant criteria. Moreover, in many areas of the country, there is an inadequate supply of highly capable nonprofits. *It seems clear that both nonprofit and for-profit entities should be able to qualify. Extension of 'preserving entity' status to for-profit entities places additional emphasis on the long-term use agreement. Governmental agencies (e.g., public housing authorities, redevelopment authorities) should also be able to qualify.*

BARRIERS TO ACQUISITION

This section discusses each of the barriers to acquisition that have been suggested by affordable housing professionals. A brief assessment of each barrier is provided in italics. Most of these barriers are also discussed in an excellent Policy Analysis Exercise by Kennedy School student Shereen Aboul-Saad[4].

"Exit Tax". Owners who acquired their properties prior to 1986 typically face large income tax liability upon sale, often exceeding the net cash proceeds consistent with the property's fair market value. See the Commission's background paper "Preservation Tax Incentive" for a full discussion of this issue. Oversimplifying somewhat, the existence of this tax barrier leaves purchasers and sellers with three bad choices: sell at market value and create a large tax problem

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[2] Program volume is expected to rise starting in 2001 as a result of increased Congressional funding.
[3] See the Commission's background paper "Historical Context" for additional information on the HUD- and RHS-assisted portfolios.
[4] "Overcoming Barriers: How and When Non-Profits Can Acquire At-Risk Affordable Housing", available at www.compassgroup.net/mhc

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for the seller, sell above market value and create a large financing problem for the purchaser, and fail to preserve the property. *By all accounts, this is the most significant barrier to the long-term preservation of pre-1986 properties.*

Lack of Support for "Sustainable" Principles. See the Commission's background paper on Long-Term Sustainability and Affordability for a complete treatment of this topic. By way of summary, traditional underwriting and financing approaches are not consistent with the long-term viability of affordable housing, as these approaches are generally founded on the presumption that additional governmental subsidies will be needed every fifteen to twenty-five years. As a result, in a sense, the owner has to obtain the government's permission (and money) every so often in order to continue to own. *Under the status quo, long-term preservation is largely a fiction, regardless of the length of the affordability agreements.*

Seller desire to retain property management. Oversimplifying somewhat, whereas the most significant barrier to preservation transactions from the limited partners' standpoint usually is the exit tax, often the most significant barrier from the general partner's standpoint is the loss of the property management contract. If the property management contract is as profitable for the purchaser as for the seller, there is an economic basis for a successful transaction. However, often the preserving entity will have fewer economies of scale than the seller, will intend to provide more intensive management, and/or is less purely economically motivated and may choose – for example – to pay higher than market wages to staff. Each of these factors would indicate lower property management profitability for the purchaser than for the seller, thereby creating an economic barrier to the transaction[5]. Sometimes, of course, the seller simply overstates (or has an unrealistic estimate of) the profitability of the management contract. *This barrier is here to stay. Some preserving entities conclude that they simply must achieve competitive levels of efficiency and profitability in order to be successful. Others conclude that those levels of efficiency are inconsistent with mission and thus must continually fund-raise so as to be able to acquire properties at competitive prices. Others choose not to enter the property management business, avoiding this problem but foregoing a potentially large source of ongoing and steady profitability*[6].

Seller Complexity. Most properties are held in limited partnership form, generally requiring a large percentage of the ownership interests to concur in a decision to sell. Some of these limited partnership structures can be quite complex, especially for publicly syndicated properties in which the syndication owns interests in several different properties. Typically, the various partners each have different economic and tax situations and thus may not be able to agree on sales that seem to be economically rational from the standpoint of the ownership entity as a whole. In particular, it is difficult to obtain partner consensus in favor of complex transactions that are not easily explained to busy investors who are not real estate experts. *This barrier will continue to frustrate preservation transactions. Its practical significance is to drive up the price, and extend the time, necessary to accomplish any given transaction.*

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[5] The barrier occurs because the purchaser cannot afford to pay a price that fully compensates the seller for loss of the property management contract. Approaches for overcoming the barrier include: overpaying, and retaining the seller as property management agent for some period of time. Both have disadvantages – not necessarily fatal -- for the purchaser.

[6] That said, not entering the property management business, and contracting with top quality third parties, is a much better strategy than entering the property management business but failing to achieve competitive quality, costs and profitability.

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Existing Primary Financing. Some properties have existing first mortgage loans that are inappropriate for the property's long-term preservation but cannot readily be prepaid. Examples include loans whose unpaid principal balance exceeds the economic value of the property, loans at high interest rates but with prepayment lockouts (or prohibitively expensive prepayment penalties), and "FAF Refunder" loans[7]. *Under-collateralized loans can be restructured, assuming that a "Mark to Market"-like program is available. It could be good policy to require that newly originated loans for affordable housing permit prepayment after, say, fifteen years without penalty[8].*

Existing Junior Financing. Assisted properties often will have subordinated debt that is held by an affiliate of the owner, or by an affiliate of a previous owner. Examples include notes to secure cash advances by the general partner, and notes representing a deferred portion of the purchase price from the current owner's acquisition of the property. Typically, but not always, these loans are worth something less than their face value. Generally, the subordinated debt cannot be assumed by the purchaser without the noteholder's consent. Often, the purchaser does not want to assume the subordinated debt. As there often is disagreement between the noteholder, borrower, and purchaser as to the fair value of the loan, the presence of such debt adds great complexity to what is likely already to be a complex transaction. *This will continue to be a fact of life for preserving entities.*

Extent of Affordability. To the extent that the preservation transaction intends to set rents below market, the preservation transaction needs government subsidies to pay for the portion of the property's fair market value represented by the rent reduction[9]. *If additional funds are not available, the property can be preserved at market rents but with a long-term affordability agreement.*

Competition with Market Conversion Transactions. The typical seller's alternative to a preservation transaction will be a market conversion, probably via discontinuing a project-based §8 contract, increasing rents to market, and converting to vouchers. Although these conversion transactions have their own complexities, their own uncertainties, and take time to consummate, sellers may feel that the contingencies are more under their own control than in a preservation sale, with its multiple stakeholders, political visibility, and more complex financing. *Preserving entities need to present proposals that are more attractive than the seller's alternatives. Under the status quo, that means a price premium vs. a market conversion transaction that the seller can undertake unilaterally.*

Transaction Complexity. Most preservation transactions involve HUD or RHS properties, but many preserving entities built their expertise on LIHTC properties and may be relatively unfamiliar with the HUD and RHS worlds. The frequent need for multiple subsidy sources means that would-be purchasers need to have considerable financial, legal, and real estate

[7] These are FHA-insured loans at above market interest rates, whose underlying tax-exempt bonds have been refinanced at a lower interest rate, generally without the consent of the property owner. As part of the refinancing transaction, FHA and the bond issuer agreed not to accept prepayment.
[8] Such a requirement would be unlikely to create capital markets problems. Such a requirement could not, however, be applied to loans already in place without the consent of the lender.
[9] For example, a $50 per unit per month rent reduction below market represents roughly $6000 per unit of value, using an income approach to value.

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expertise, plus intimate familiarity with a wide array of government programs and organizations. The ability to successfully lobby government for concessions is essential in all except the most straightforward transactions. This creates significant "barriers to entry" for would-be preserving entities[10]. It also creates considerable overhead costs for the various governmental agencies involved in affordable housing, causing them to spend considerable time considering program waivers and other concessions needed to facilitate particularly complicated transactions. *This indicates the need for statutory reforms to eliminate programmatic conflicts between the various governmental programs that support affordable housing, and for closer coordination between funding sources.*

Seller Reluctance to Pursue Preservation Transactions.

- **Complexity.** Preservation transactions typically involve multiple levels of government subsidy, each of which is allocated on a different cycle by allocators who do not necessarily talk to each other.
- **Mismatch Between Time to Close and Option Payment.** Many would-be purchasers are unable to commit "hard" option funds and instead request the seller to hold the property off the market for an extended period of time without significant compensation and without assurance of closing.
- **"Re-Trading The Deal".** Many preservation transactions experience last-minute crises, sometimes resulting in requests to the seller to reduce the price or accept less favorable terms[11].
- **Non-Profit Stereotypes.** Many preserving entities are nonprofits, and there is some evidence that many sellers incorrectly equate "nonprofit" with "not competent" and "not businesslike."
- **Politics Today.** Some sellers fear that they will not be able to back out gracefully if the transaction becomes non-viable.
- **Politics of the Past.** As discussed in the Historical Context background paper, starting in the early 1980s, some in government and some in the affordable housing community became convinced that owners as a group were part of the problem rather than part of the solution. The rhetoric often became heated and was frequently unfair. As a result, some sellers want nothing more to do with government or affordability, and intend to take their properties out of the regulated universe at the first viable opportunity.

In combination, these factors mean that – all else equal – many sellers will prefer a non-preservation sale to a preservation sale. A corollary is that preserving entities must be prepared to pay more than a non-preserving buyer who will put down hard option money and will close in 90 days. *For properties in distress, these factors are less important, because the seller may have no other options. However, for properties that are at-risk because of market improvement, these factors are material barriers to preservation.*

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[10] However, because affordable housing has been so complex for so long, there is a large community of technical assistance and consulting professionals. Most preserving entities are able to purchase the needed expertise from the m. Needless to say, they do not regard complexity as a problem but as an opportunity.

[11] Sellers deeply resent last-minute pressure to make concessions. Some sellers refuse to do future business with entities that they believe took undue advantage of the seller's desire to close the transaction. Nonetheless, some in the affordable housing community regard pressure for last-minute concessions as a legitimate aspect of doing transactions. It is possible that this is part of the general seller reluctance to pursue preservation transactions, discussed earlier.

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Below-Market Operating Costs. Particularly for small properties in rural areas, the seller may be managing the property personally, and may be charging the property considerably less than a professional manager would charge. Leaving aside whether the quality of management is acceptable, this creates a barrier to sale because the purchaser (who intends to bring in professional management) has to obtain a rent increase (or, at substantially greater effort and time and uncertainty, debt restructuring) in order to be achieve a viable property. *In theory, HUD and RHS should recognize this phenomenon and should routinely agree to adjust operating expenses to competitive levels in the context of preservation transactions.*

Inadequate Information.

- **Information on Buyers and Sellers.** Although the Internet has some promise in this regard, there is no central source of information on properties that may be available for sale, and purchasers that may be interested in acquiring properties. *Sellers are reluctant to advertise widely, do not want residents to know the property is for sale, do not want to spend time except with "serious" purchasers, and do not want to release information except to "serious" purchasers. Thus, there is more potential for a central clearinghouse of information on potential purchasers, than for a central clearinghouse of information on potential sellers.*
- **Information on Expenses.** There is a lack of information generally on the costs to own and operate affordable housing. *Existing data from entities such as IREM, NAA and ULI are somewhat helpful. The Public Housing Operating Cost Study, and HUD's Real Estate Assessment Center, may eventually lead to additional sources of information.*
- **Informal Marketing Approaches.** Most properties are marketed and sold through word of mouth channels. *For the reasons noted above, this reflects valid business concerns and is not likely to change.*

Difficulty of Acting Rapidly. If a property is in distress, or if it is located in a rapidly appreciating market, the purchaser needs to negotiate, finance and close the acquisition quickly. However, subsidy allocation cycles are geared to six-month and longer approval schedules. Many transactions need multiple subsidy approvals, extending the time further. Moreover, preservation transactions tend to be legally complex and therefore take longer to document and close than non-preservation transactions. *This evidences a potential need for national or regional intermediaries who can acquire particularly preservation-worthy properties, using revolving funds that are partially or fully subsidized by government or foundations, and later dispose of the properties once the eventual preserving-entity purchaser completes its financing*[12]*. Conversely, it is possible that this problem can be solved by simplifying the acquisition and funding processes so that they can occur more quickly.*

Lack of Financial Capacity. While preserving entities are not necessarily small, or relatively new to multifamily housing, or with limited capital, they often will be. This may be particularly true in weak rural markets and difficult, inner city locations. Many preserving entities are motivated by their missions to care about specific geographies. Properties that had provided good and affordably housing for many years may suddenly be at risk. This will often cause the preserving entity to mobilize a preservation effort where the purely financial incentives are too weak to attract a buyer without that mission-based drive. An assessment of the financial

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[12] The National Housing Development Corporation, www.nhdc.org, is currently testing this approach. One logical alternative approach (but admittedly with less political appeal) is for the intermediary to buy and hold.

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capacities of preserving entities is, accordingly, colored by the assumption that many of them are small community-based organizations, and that many of these may be relatively new to multifamily acquisition. In contrast, the entities competing with a preserving entity in a strong market transaction are almost certainly for profit groups that are generally well capitalized. The assessment then must also acknowledge the financial capacity of the preservers relative to their competition.

- **Operating Support.** Preserving entities need sufficient ongoing revenues to support their staff and other operating costs. Most owner / manager organizations derive these revenues from net property management fees, and from cash flow. However, many affordable housing properties are small, and others require especially intensive management, thereby eroding or eliminating property management profitability. Moreover, many affordable housing programs prohibit cash flow distributions and asset management fees. *This indicates the need for higher property management fees for small properties, and for "high difficulty factor" properties*[13]*. It also indicates the need to allow preserving entities to earn and receive asset management fees and cash flow distributions.*
- **Working Capital.** Preserving entities need sufficient working capital to support due diligence and other acquisition-related activities, recognizing that more than one property will be pursued for each property that is actually acquired or developed. Most owner / manager organizations derive this working capital from retained profits from successful properties, and/or from borrowing based on their property management profitability, and/or from borrowing based on their equity in successful properties. Owner / manager entities with particularly strong track records are often able to obtain due diligence support from their architects, attorneys, engineers and general contractors "on the come", without the need to pay up front. Each of these sources is of limited availability to preserving entities, under current programs and practices. *This indicates the need to reform affordable housing programs to allow reasonable levels of economic profitability to preserving entities.*
- **Acquisition Bridge Financing.** Preserving entities need access to the capital needed to bridge-finance the acquisition of at-risk properties until the eventual financing is funded. Examples include the necessity to borrow against investor installment payments for LIHTC equity, the necessity to bridge-finance subsidy funds that will not actually be received until construction completion or substantial occupancy, and construction financing in general. *There is generally good capability to access bridge financing once the take-out financing is in place and assured. More difficult to obtain is bridge financing when there is less than complete assurance of take-out financing.*
- **Acquisition Equity Capital.** Some transactions require the purchaser to come up with genuine real estate equity (whose return is paid through distributed cash flow). This is a foreign concept to many in the affordable housing community, despite being a universal feature of the market-rate apartment markets. *As affordable housing shifts closer to the*

[13] Rules of thumb for property management fees are usually stated in terms of dollars per unit per month, or percentages of collected income. These rules of thumb fail to recognize that the fee for the entire property must be adequate to meet the property management company's costs of providing the appropriate management services, plus a reasonable margin for profit. One fundamental problem is that regulators focus on fees per unit, whereas almost all of the management agent's costs are driven by the property and not by the number of units. A second fundamental problem is that the very existence of rules of thumb works to the disadvantage of properties with above-average complexity and difficulty. Accordingly, formulaic application of rules of thumb sets fees far too high for large properties that are easy to manage and far too low for small properties that are difficult to manage.

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sustainable approach, true equity capital will become a central facet of every property. Similarly, properties that need true equity capital should adopt sustainable financing approaches in order to have any reasonable prospect of attracting such capital.

Varying local and State support. The primary subsidy vehicles (LIHTC, HOME, and CDBG) can be used for a variety of housing and community development purposes, only one of which is the preservation of at-risk assisted housing. In particular, States and localities have established widely differing priorities as between production and preservation activities. *This local and State variation is appropriate*[14]*. Nonetheless, this can present problems for preservation transactions in areas with significant production priorities.*

Physical and/or Financial Distress. Some properties are at-risk by virtue of having significant unmet needs for renovation, and/or excessive debt. Generally, these properties will have negative equity value (that is, taking into account the renovation needs, the property in 'as is' condition is worth less than the amount of its mortgage debt). These properties are perhaps the most difficult to preserve. Not only does the seller have to virtually donate the property (incurring 'exit tax' in the process), but the purchaser also has to complete workout negotiations with the lender(s), and obtain financing for renovations, in order to complete an acquisition. *This underscores the need for the ability to restructure debt as in HUD's Mark to Market program.*

Accelerating Capital Needs of Older Properties. Typically, properties are 20-30 years old when the preservation transaction is being pursued. This is a time in the property's life during which a number of major and expensive building systems are requiring their first cycle of replacement (examples include kitchen cabinets, ranges, HVAC systems, siding, parking lots, and perhaps windows). Typically, the property's existing reserves are not adequate to fund those replacements. *The fact that properties cannot address these needs today is testament to the "planned obsolescence" that is built into traditional affordable housing financing approaches. This is one of the key problems that the sustainable approach is designed to solve.*

Purchaser Desire to Accelerate Normal Replacements. Some purchasers desire to have a "virtually new property" after acquisition, replacing as many original components as possible, without regard to remaining useful life, on the theory that this will enhance marketing (which is true) and make fewer demands on downstream cash flow (which may or may not be true, depending on how the replacements are financed)[15]. *This is an understandable motivation but, at its foundation, a largely wasteful approach in that it discards a considerable amount of remaining useful life in the name of a temporary "newness" benefit. The property's systems and components will not be new for long and will need replacement again soon enough.*

Need for Major Renovation. Some properties will need dramatic reconfiguration. Some buildings may need to be demolished (with or without reconstruction). Non-marketable efficiency units may need to be combined into marketable 1BR or 2BR units. Community facilities and recreational facilities may need to be added. HVAC systems may need to be

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[14] This assumes that each jurisdiction's priorities are aligned with housing needs. The federal requirements for local and State implementation of LIHTC, HOME and CDBG provide reasonable assurance that this is the case.

[15] A common practice is to combine accelerated replacement with a small ongoing Reserve deposit. This practice is contrary to sustainability principles, as it more or less guarantees a downstream preservation crisis when the newly replaced systems reach their next replacement cycle.

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reconfigured (for example, changing from electric baseboard heat and no air conditioning to central forced air "split systems"). Elevators may need to be completely reconditioned. *Such properties are perhaps best regarded as development opportunities rather than preservation opportunities. It is not unusual for gut-rehab approaches to cost as much or more than new construction.*

Relative Lack of Interest in Difficult Properties. Some at-risk properties are located in declining markets or sub-markets. Some are plagued with drug-related crime. Some are located in rural areas with which few purchasers are familiar (and few property management firms are available). Some involve resident populations requiring intensive management, significant non-housing services, or both. Some of these property categories are also difficult to finance through the mainstream mortgage markets. *Rather than a barrier, this is to some extent a competitive advantage for preserving entities. From a purely business viewpoint, the fewer competing purchasers, the better.*

The Rest of the Story

Preserving entities also have offsetting advantages. As one seller said, "You're the only organization besides mine that can manage this place. And, HUD will never give me the money to do it right!" Similarly, the ability and willingness to pursue and complete complex transactions knitting together disparate resource streams, and the ability and willingness to work with community stakeholders, confer distinct advantages on preserving entities.

Summary of Potential Commission Recommendations

1. **Preservation Tax Incentive.** The Commission could recommend full or partial relief from sellers' tax on "minimum gain", when at-risk assisted housing is sold to a preserving entity under a long-term use agreement.

2. **Adopt Sustainability Principles.** The Commission could recommend that future affordable housing transactions, including preservation transactions, proceed under sustainability principles.

3. **Prohibit Certain Prepayment Limitations.** The Commission could recommend that affordable housing loans originated in the future be required to permit prepayment, without penalty, after fifteen years.

4. **Reduce Complexity.** The Commission could recommend statutory reforms to eliminate programmatic conflicts between the various governmental programs that support affordable housing, and for closer coordination between funding sources.

5. **Clearinghouse.** The Commission could recommend the creation of a clearinghouse of information on preserving entities, the portfolios at risk[16], and owners who have expressed an interest in selling to a preserving entity.

[16] Proprietary or confidential information could be included only with the owner's permission.

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6. **Industry Data Warehouse.** The Commission could recommend the creation of an industry data warehouse that would collect information on properties and their income and expenses, and that would make available accurate and helpful information from which practitioners could benchmark their properties, perform accurate underwriting of proposed developments, and perform accurate underwriting of proposed acquisitions.

7. **Intermediaries.** The Commission could recommend additional funding for revolving funds accessible to regional or national intermediaries who could then quickly purchase at-risk properties or portfolios, for later re-sale. This would help to preserve properties that, if not purchased quickly, will be lost as affordable housing.

8. **Property Management Fees.** The Commission could recommend that regulators adopt considerably more sophisticated approaches for regulating property management fees. In particular, current regulatory approaches result in inadequate fees for small properties and for "high difficulty factor" properties.

9. **Economics of Ownership I.** The Commission could recommend that regulators allow preserving entities to earn and receive asset management fees and cash flow distributions.

10. **Economics of Ownership II.** The Commission could recommend reforms to allow reasonable levels of economic profitability to preserving entities.

CONCLUSION

A number of significant barriers exist to the long-term preservation of at-risk assisted housing. The Commission is considering suggestions to reduce or eliminate some of these barriers. Others appear to be unavoidable and must simply be regarded as background conditions of the affordable housing world.

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This paper was prepared by Charles S. Wilkins, Jr., principal of The Compass Group, LLC, under contract to The Millennial Housing Commission.