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Excellence in
Affordable Multifamily Housing Properties
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We have learned a lot over the years about what makes a property desirable for the residents, the neighborhood and the owner over the long term. So why aren't these properties the norm?

We've Come A Long Way, But …

In a moment, I'll suggest that we should be setting our sights much higher, and that what we are doing isn't nearly good enough. Before doing that, however, I'd like to take a moment to acknowledge some of the important ways in which affordable housing is more successful today than thirty years ago:

- *Professionalism* – today, we have a large and diverse group of affordable housing specialists: accountants, architects, attorneys, developers, property managers, regulators and syndicators, to name a few. Most of these professionals have 10+ years of experience in affordable housing. Education and training opportunities are diverse, readily available, and responsive to professionals' needs.

- *Allocation of Funds* – the tax credit, volume-cap tax exempt bond, HOME and CDBG programs feature localized allocation processes, with local ability to set priorities within broad federal guidelines. This in turn leads to useful experimentation and vigorous competition.

- *Reliable Funding* – tax credits, volume-cap bonds, HOME and CDBG provide a stable base of funding. In turn, this allows a larger number of organizations to specialize in affordable housing, thereby enhancing competition, improving quality and driving down costs.

- *Lessons Learned* – we now have structures in place to prevent the recurrence of some of the major problems of the past. It's unlikely we will ever again combine above market rents, project based assistance, and government guaranteed mortgage debt. We seem to have resolved not to concentrate the poorest of the poor in isolated communities.

- *Long Term Capital Needs* – we know how to determine the ongoing major repair and replacement needs of properties. In a few cutting edge programs, such as Mark to Market, we are actually using capital needs assessments to set adequate reserve deposits.

- *Non Housing Services* – although much remains to be learned and done, we are well on the way to understanding when non housing services should be offered at or through an affordable housing property, and how to do so.

- *Project Based vs. Tenant Based* is now regarded as a false choice. We now understand that we need both approaches. A few of us are even inventing hybrid approaches.

- *Curb Appeal* is now regarded as an important part of affordable housing. For the most part, we now recognize that it's a bad idea to develop affordable housing that looks 'cheap'.

However, our funding programs are flawed. Vigorous competition has sometimes allowed rose colored glasses to substitute for sound underwriting. Many lessons from the past are evident but are not yet incorporated into affordable housing practice. Some of our experimentation with non housing services and mixed income communities is fundamentally unsound. Our unavoidably schizophrenic identity – pursuing an anti-poverty mission through a businesslike real estate system – often means that we act like bankers when we should act like social workers, and vice versa.

Let's now take a look at the best affordable multifamily housing.

Sustainably Excellent Affordable Multifamily Housing …

Is owned and managed by professional affordable housing organizations that are competent, committed to affordable housing, and have access to adequate capital. These organizations have the ability to survive market fluctuations, to survive in the absence of development opportunities, and to survive the departure of key staff. They monitor their properties closely, heading off most problems before they occur. I believe that the for-profit or not-for-profit status of the owner is largely irrelevant, by comparison to the characteristics noted above.

> Amateur ownership and amateur management are bad ideas, no matter how virtuous the amateurs happen to be.

Is truly affordable for its actual residents. Excellent affordable housing is developed:

- For a particular target market, with a thorough understanding of customers' household sizes, incomes and housing needs. *Not "build it and they will come."*

- With rents that are affordable based on the actual incomes of the target households, taking into account other demands on their incomes, and when there are a sufficient number of target households. *Large numbers of tax credit properties failed because there were too few households with incomes low enough to be eligible but high enough to afford the rents.*

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- With rents that are materially below prevailing market rent levels in the neighborhood. *Otherwise, don't ask me to justify the governmental cost to develop the housing.*

> It is time for us to stop relying on arbitrary formulas based on area median income, or 'Fair Market Rents', because these formulas often produce the illusion of affordability without producing affordability for real residents in real neighborhoods. See the attachment for an illustration of what I call 'the illusion of affordability.'

Is efficient. High development costs, high operating costs, slowness, sloppiness, and lack of professionalism are our own worst enemies. If we don't defeat these enemies, the people who pay our bills will take their money somewhere else. Shame on us if that happens.

> Several years ago, a member of the "A Team" of American capitalism told me, "low cost <u>is</u> high quality." It shocked me at the time. Since then, I have seen low cost and high quality in each other's company so frequently that I've become a believer. It's time we learned this lesson in affordable housing.

Is located in a viable neighborhood. The neighborhood mix of homeownership to rental, and residential to nonresidential uses, is appropriate and reasonable. The neighborhood's housing, transportation, jobs, schools, public safety, shopping, recreation, and public spaces form a smoothly functioning network that supports residents and community.

> For the last fifty years, we've focused on developments. Now it's time to focus on how those developments relate to transportation, jobs, schools, shopping, recreation, and homeownership.

Fits into the neighborhood. Its architecture echoes that of nearby residential buildings. The number of dwelling units is neither too few nor too many, in comparison with other nearby rental properties.

> The best affordable housing properties are part of the neighborhood, not walled off from the neighborhood.

Has an attractive, low maintenance design. A 'zero maintenance' exterior adds a lot of value. Simple construction is better than complicated construction. Simple mechanical systems are better than complicated mechanical systems. Slab-on-grade construction is better than crawl space. Pitched roofs are better than flat roofs. Individual unit entries are better than common hallways.

> High maintenance designs look good at the ribbon cutting. Low maintenance designs look good year after year.

Is a community. Residents value the opportunity to live here. All members of the community expect to be treated fairly and courteously, and this mutual expectation creates an informal but powerful force for community cohesion.

> Communities don't just happen; they require good ownership, good management, and elbow grease – none of which is free.

Is subject to an appropriate, long term, use agreement. The availability of the property for long term affordable housing use is assured through a binding covenant running with the land. The long term affordability of the property is not dependent on the identity or motivations of the sponsor, and is assured even if the property fails financially and undergoes a workout or a foreclosure. The length of the use agreement term and the level of affordability it requires are appropriate for the property, its target resident population, and the subsidies with which it is financed.

> Good intentions and thoughtful mission statements are good things. But they're not enough.

Is physically sound over the long term. The operating budget contains sufficient funds to operate and maintain the property to high standards, not just in the early years but over time. From the beginning, the property makes reserve deposits that are sufficient to fully fund expected major repairs and replacements.

> And, periodically, the property's reserve deposit is adjusted, based on a property specific capital needs assessment.

Does not rely on appreciation in value. The mortgage financing is fixed rate and self amortizing, so that the property is not exposed to interest rate risk or refinancing risk. The property's debt burden (from all loans, not just the first mortgage) declines over time, at a rapid enough rate to avoid the risk of over-leverage. The property's long term physical and financial viability can be supported by the projected stabilized cash flow, even if this cash flow does not grow over time. This gives the property the potential to improve its affordability over time, but the flexibility to increase rents as needed to respond to unanticipated problems.

> … otherwise, the people who give us money will come to expect that each property will have to be bailed out after ten or twenty years. And, sooner or later, they'll stop giving us money.

Is financed appropriately. By comparison with market rate apartments, affordable housing requires lower rents and may require higher operating expenses. Moreover, affordable housing requires a reserve deposit that is adequate to fund 100% of

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reasonably expected major repairs and replacements. As a result, an affordable housing property generates a much smaller net operating income than an otherwise similar market rate apartment property, and can support only a very limited amount of mortgage debt. The remaining development costs must be financed with grants.

> … and while we're at it, let's stop calling these grants 'equity'.

Has an adequate operating margin. This is not merely a matter of debt service coverage in an underwriting spreadsheet. The projected rents must be achievable, with room to spare. The vacancy and collection loss allowances must be reasonable and must recognize that real estate markets fluctuate. Projected operating expenses must be at or above the level that good management will need in order to operate the property successfully, not just in the early years when nothing breaks, but over the long term. There must be adequate debt service coverage, without regard to the amount of cash flow the owner is allowed to distribute. Basically, the property must be able to withstand the sorts of income, expense, and capital needs shocks that frequently impact affordable apartment properties.

> I've seen too much affordable housing underwriting in which 1.20 DSCR in the projections translates into 0.85 DSCR in reality.

Is financed through grant programs that combine flexibility, adequate funding, accountability and competition. Each grant program recognizes the full array of development costs that are reasonably required to produce the desired affordable housing. Where appropriate, multiple grantors will collaborate to create 'one stop shopping' grants for the development of unusual properties (e.g., mixed income / mixed use / service enriched) that would otherwise have to assemble multiple funding sources. Each grant program is capable of funding the entire gap between supportable debt and total development cost. Failure to comply with program requirements produces adverse results that are predictable and that occur rapidly. A successful grant program attracts a reasonable (but not excessive) number of highly acceptable proposals.

> The reason so many affordable housing developments need multi-layered financing is that our grant programs are badly designed. Rather than protecting the bad system that a few of us know how to operate, we should be creating a better system.

Increases rents in line with property needs. Initial rents are adequate. Subsequently, rents are increased modestly each year, in line with inflation in operating costs. Operating costs are well controlled but are not squeezed.

> A long period with no rent increases, followed by a large increase, is *prima facie* evidence of some combination of bad ownership, bad management, and bad regulation, even if the increased rents are sustainable in the market.

Is crime resistant. The property's design incorporates 'defensible space' approaches.

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All common areas are easily observed from several different residents' homes. Lighting is adequate. The management plan, and the budget, include initiatives to create, maintain and enhance residents' social ties to each other.

> If the property ever needs armed foot patrol, it has failed. And so have its owners and managers and regulators.

Is in compliance with reasonable regulatory requirements. Wherever possible, regulatory requirements utilize market mechanisms such as incentives and disincentives. If the property utilizes more than one subsidy or financing program, program requirements are coordinated to eliminate conflicts and redundancies. Compliance is monitored through regular and standardized reviews, performed by qualified third parties who are trusted by owners, residents and regulators but who are independent.

> … and the costs of the third party compliance reviews are built into each property's operating budget.

Incorporates appropriate non-housing services. A successful affordable housing property provides opportunities to deliver no-cost and low-cost services that are needed by large numbers of residents and can be delivered effectively at or through the property. For example, properties for low income families may provide before-school and after-school activities for children, job search or job skill development for adults, or may simply provide space in which third party providers can deliver such programs. To the extent that the property itself should provide the services, the cost to do so is built into the property's operating budget.

> The service package is designed, and periodically redesigned, to produce specific measurable outcomes, for which the owner and manager are accountable.

Generates cash flow for its owner. An affordable housing *property* doesn't need to be wildly profitable, but it does need to generate at least enough positive cash flow to cover the owner's asset management costs and to fund needed reserves. An affordable housing *portfolio* needs to generate enough additional cash so that the successful properties can support properties that are temporarily struggling.

> Many years ago, a co-worker showed me a beautiful building, saying "this is a really good property." However, the building had far too much debt, and was losing thousands of dollars each month. *Wilkins' First Law of Apartments: Good properties are properties that generate positive cash flow.*

So Why Aren't These Properties The Norm?

It seems to me that …

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- It's difficult to produce housing this good, even in the best of circumstances.
- Existing financing and subsidy programs aren't designed to produce housing this good.
- We don't yet have good benchmarks or good performance measurement systems.
- Much of the conventional wisdom about affordable housing is not only unwise but backwards.
- *And, worst of all, as an industry we don't set our sights high enough.*

I hope that this paper stimulates all of us to be part of the solution instead of being part of the problem. Good luck, and good housing!

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The Illusion of 'Affordability'

The following chart illustrates what I call the 'illusion of affordability' (based on various data for Atlanta Georgia). Under prevailing rules of thumb, one could claim that each of the rent and utility figures in the three rightmost columns is 'affordable'. However, these amounts range from just over $300 to more than $1500 per month, versus a $1000 market rent. *One of the problems we face as affordable housing professionals is that one of our key terms – 'affordable' – is virtually meaningless.*

How affordable? At what income level?		Monthly Household Income	Rent and Utilities @ Housing Cost Burden of		
			30%	40%	50%
4 person household Income:					
	80% of area median	$4,207	$1,262	$1,683	$2,103
	60% of area median	$3,155	$947	$1,262	$1,578
	50% of area median	$2,629	$789	$1,052	$1,315
	40% of area median	$2,103	$631	$841	$1,052
	30% of area median	$1,578	$473	$631	$789
	20% of area median	$1,052	$316	$421	$526
$7.00	per hour wage, full time	$1,213	$364	$485	$607
$10.00	per hour wage, full time	$1,733	$520	$693	$867
$15.00	per hour wage, full time	$2,600	$780	$1,040	$1,300
$20.00	per hour wage, full time	$3,467	$1,040	$1,387	$1,734

Notes : Typical market rent for 1000 square foot 3BR unit is $1000 including utilities
The 3BR FMR is $949

We need to develop a more sophisticated and subtle way of talking about affordability.

> A good start would be to recognize that rents above market levels should not be called 'affordable' at all. Another good step would be to recognize that there is no national standard that is appropriate in every locality, and that there is no local standard that is appropriate for every property.