Return to List

The Looming Crisis in Affordable Rental Housing (The two sides of the multifamily demand coin)

By: Richard F. Burns, CEO of The NHP Foundation

For multifamily real estate, it is the best of times and the worst of times.

For market rate apartments it is the best of times:

According to a recent report by the real estate research firm, Reis Inc., multifamily market fundamentals are making a rapid recovery:

U.S. Apartment vacancies dropped to a 10-year low in the fourth quarter of 2011, allowing for rent increases that are likely to continue through 2012. The vacancy rate fell to 5.2%, the lowest since the end of 2001, and down from 6.6% a year earlier.

The vacancy rate has declined for seven straight quarters, from a 30-year high of 8% at the end of 2009 to a rate that could be less than 5% in 2012.

The average monthly effective rent (what tenants pay after landlord concessions) climbed 2.3% from a year earlier to $1,009.

According to Reis, the apartment sector is benefitting from some of the lowest figures for new construction on record. For all of 2011, 37,676 units were completed, the lowest annual total in 31 years of Reis data. The previous record was 49,303 units in 1993 during the savings and loan crisis.

A near-term increase in new supply will only serve to satisfy some of the pent up demand of the past two years, without adequately addressing current demand.

Rising foreclosures and stricter mortgage-lending standards have helped make rental housing the best performing segment of commercial real estate for the past two years.

The viability of the market rate apartment sector is expected to continue for several years. According to the U.S. Census Bureau, households with children, the primary driver of the single family market, have fallen from 50% of households to 22% of households, and 76 million "echo boomers" are entering the market, primarily as renters. In fact, the National Multi Housing Council predicts that renters could make up half of all new households this decade more than seven million new renter households.

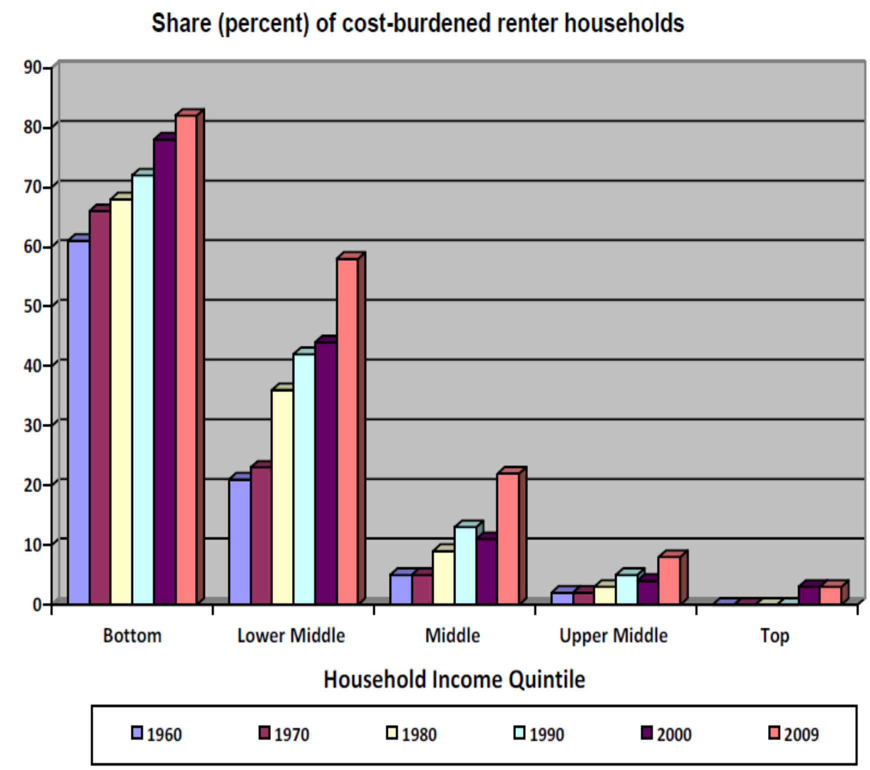
What does all this mean for affordable multifamily housing? It is clearly the worst of times. For purposes of this article, "affordable" refers to apartments that are affordable by families and seniors making between 30% and 80% of the area median income (AMI), while ideally paying not more than 30% of their income for rent. A few facts will shed light on what is becoming a dire situation.

The Harvard University Joint Center for Housing Studies estimates that the affordable housing shortage for people making less than 50 percent of area median incomes has increased sharply, from a deficit of 4.3 million units in 2003 to a deficit of 6.4 million units in 2009.

Their recent study found that 18.6 million American households - renters and homeowners alike - spend more than half their income on housing, up from 13.8 million in 2001.

Figure 1 shows that the situation for the lowest income renters is increasingly dire and affordability problems are creeping up the income scale.

Figure 1.



Sources: JCHS tabulations of US Census Bureau, 2009 American Community Survey; John M. Quigley and Steven Raphael, 2004, "Is Housing Unaffordable? Why Isn't It More Affordable?," Journal of Economic Perspectives 18(1).

The same study reported that more than 25% of the low-cost rental stock has been permanently lost since 1999, primarily because the rents they earn cannot cover the costs of adequate maintenance.

The preservation of existing affordable rentals is critically important. However, while policymakers have been rightly concerned about preserving the nation's subsidized housing stock; attention should also be focused on the privately owned, unsubsidized properties that supply three times as many low-cost units.

The affordability of these unsubsidized, low-cost units is threatened by a plethora of "value-add" institutional capital that has been raised to acquire and upgrade these properties, thereby raising rents and increasing value. Units that are not suitable for value-add upgrading (cannot generate enough additional rent to justify capital investment) suffer a high rate of permanent loss.

One of many examples of units lost to redevelopment can be found in Arlington County, Va. According to Nina Janopaul, President and CEO of Arlington Partnership for Affordable Housing, *"Arlington County is a community of more renters than homeowners. In the last 10 years, we have lost 10,000 units of affordable housing to redevelopment or repositioning for higher incomes."*

New construction and the preservation-rehab of low and moderate income rental housing are constrained by limitations on federal government programs such as projectbased Section 8 rent subsidies; a finite annual supply of available tax credits; the high prices of land and buildings; and the evaporation of affordable housing subsidies at the state and local level due to budget deficits.

It is estimated by the Joint Center that by 2013, more than one million subsidized units will reach the end of their affordable use restrictions, giving property owners the ability to "opt out" of their restrictive contracts.

Without constraints on affordability, and with apartment demand outstripping supply, previously affordable properties with in-fill locations will be ripe for acquisition by valueadd rehab buyers, who will raise rents to levels unaffordable to many of the existing tenants.

As someone who has spent most of his career investing institutional capital in real estate, I can attest to how profitable the business of rehabilitating "B" and "C" grade apartments can be. For the past two years, as the CEO of a nonprofit whose mission is to preserve and create affordable housing for low-to moderate income families and seniors, I have seen first hand the looming crisis in affordable housing - huge unmet demand and shrinking supply.

Sheila Crowley, president of The National Low Income Housing Coalition, reporting on their recent study, stated that there are millions of families whose incomes are so low and their housing costs are so high that all it would take is a few days out of work with a sick child or one high heating bill to push them into homelessness.

She adds, *"I would hope that public officials could be as concerned about this housing crisis as they are about the foreclosure crisis. The scarcity of affordable rental housing for poor people is of similar consequence as the foreclosure crisis for the people affected and the larger economy. Yet it remains one of the most neglected areas of public policy."*

Government supports affordable housing as part of the safety net it provides for its citizens. Unfortunately, it is unlikely that affordable housing will receive the additional funding it needs, as the focus in Washington is on spending cuts.

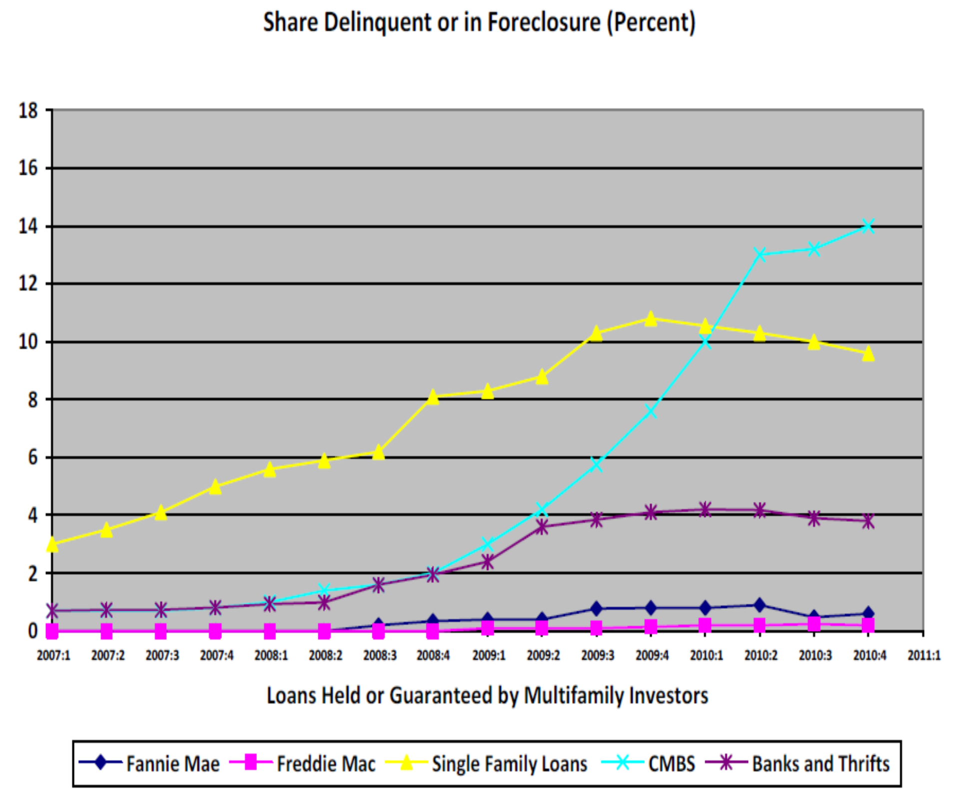
Without additional funding from Congress, the affordable housing community must look to other capital sources. I suggest that large state, municipal, corporate and union pension funds, hedge funds, managers of high net worth capital and charitable foundations must do more to support affordable housing. This does not mean that these institutions should ignore their fiduciary responsibilities or take a loss on their investments, but rather use the strong supply and demand fundamentals of affordable housing to justify providing capital to this sector.

In my experience, when affordable housing is discussed with investors in the private sector, they often envision run down public housing, which is typically not the case. Similarly, a discussion of how low income housing tax credits work will often cause the listener's eyes to glaze over. It would be illuminating for these investors to discover that the majority of affordable properties provide safe, clean apartments for the tenants and to understand how the tax credit program works as an effective equity financing tool.

The public outrage over tax payer dollars supporting Fannie Mae and Freddie Mac has reached a feverish pitch. Figure 2 shows, that in actual fact, the problems occurred in their single family divisions, while the multifamily divisions of both entities have operated profitably, with extremely low foreclosure rates. It is within Fannie's and Freddie's multifamily lending programs where the greatest investment in affordable housing takes place, further evidence of the viability of affordable multifamily properties as loan security.

Dismembering the multifamily divisions of Fannie and Freddie could create a serious capital shortfall. I question whether the private sector can be a suitable, consistent replacement for the GSEs' multifamily divisions, especially for affordable rental properties.

Figure 2.



Sources: Mortgage Bankers Association, National Delinquency Survey and Commercial/Multifamily Mortgage Delinquency Rates; Moody's Multifamily CMBS Delinquency Tracker; Federal Deposit Insurance Corporation, Quarterly Loan Portfolio Performance Indicators.

So, how does an institutional investor who has a fiduciary responsibility to earn the highest riskadjusted return for its investors, participate in affordable multifamily housing investments? There are at least four ways that come to mind:

To the extent pension funds or other institutional investors are investing in a value-add apartment strategy, they should allocate some percentage of that invested capital for lending to affordable housing investments, thereby helping to preserve part of the affordable housing stock while they are raising rents elsewhere, making those apartments less affordable.

Pension funds and other institutional investors should make loans with lower interest rates and lower debt service coverage requirements, reflecting the inherent lower risk of the security. Many of the beneficiaries of their funds live in affordable housing.

The same institutions could provide bridge financing for developers/investors acquiring properties that are candidates for rehab/preservation, allowing the sponsor the time needed to line up equity and debt financing. The loan might have a feature that allows the lender to receive additional interest at the time the tax credit rehab takes place and the loan is paid off, typically in 12 to 24 months.

Instead of making outright grants, charitable foundations could make “soft dollar loans” that allow preservation deals to work. This money was formerly available from state and federal programs which no longer have adequate funding. These loans would be subordinate to other debt, carry a very low rate of interest and may not be repaid until the end of the 15 year initial compliance period. However, unlike an outright grant, there would be a return on and a return of capital.

Generating additional capital for affordable housing could come from using federal and state government incentives. Banks are active players in the affordable housing arena. To a great extent, they have been motivated by the need for Community Reinvestment Act (CRA) credit, less stringent reserve requirements and the purchase of tax credits, either for their own account or for syndicated pools they manage. If the federal government would design incentives to entice institutional and high net worth investors to seek affordable housing investments, it could greatly expand the capital pool. Examples could be: a dollar-for-dollar exemption from unrelated business taxable income for pension funds and easing the “passive investor rule” for high net worth individuals.

Fortunately, this country has a deep infrastructure of for-profit and nonprofit developers who, with increased funding, could quickly ramp up the creation and preservation of affordable multifamily units. Likewise, there are a number of affordable housing lenders who, with access to additional capital, could leverage their knowledge and underwriting skills to expand their existing programs. At The NHP Foundation we are closing the first of what we hope will be a series of funds with a major financial institution. Its investment strategy is the rehabilitation and preservation of existing affordable multifamily housing.

New capital to help alleviate the severe shortage of affordable rental housing can come about in numerous ways. At a minimum, a combination of: a) creative government stimulus through incentives; b) greater receptivity to learning about affordable housing by institutional investors and high net worth money managers; and c) more compelling, targeted strategies by the existing affordable housing investors and lenders to attract funds from those capital sources would begin to motivate greater private sector investment.

The looming crisis in affordable housing impacts the country sociologically, politically and economically. Without additional capital for the preservation of existing properties and investment in new development, the severe shortage of affordable housing is only going to get worse.

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Senate Subcommittee Approves FY 2013 T-HUD Appropriations Bill

The Senate Appropriations Subcommittee on Transportation, Housing and Urban Development (T-HUD) yesterday marked up a FY 2013 appropriations bill and approved the measure by a vote of 15-1. The bill proposes to fund Department of Transportation and Department of Housing and Urban Development (HUD) programs at a level of $53.4 billion, which is $3.9 billion (7 percent) less than the FY 2012 enacted level of $57.3 billion. read more