

PRESERVING HOUSING CREDIT INVESTMENT

*THE STATE OF HOUSING CREDIT PROPERTIES AND
LESSONS LEARNED FOR THE EXTENDED USE PERIOD*

By Lydia Tom and Ben Nichols



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Lydia Tom is Senior Advisor – Community Revitalization, Enterprise Community Partners
Ben Nichols is Vice President – Solutions, Enterprise Community Partners

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ABOUT ENTERPRISE COMMUNITY PARTNERS

Enterprise works with partners nationwide to build opportunity. We create and advocate for affordable homes in thriving communities linked to jobs, good schools, health care and transportation. We lend funds, finance development, and manage and build affordable housing, while shaping new strategies, solutions and policy. Over more than 30 years, Enterprise has created 300,000 homes, invested nearly \$14 billion and touched millions of lives. Join us at www.EnterpriseCommunity.org.

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CONTENTS

Executive Summary	4
Introduction	6
Survey Results	7
Local Best Practices	14

EXECUTIVE SUMMARY

When Low-Income Housing Tax Credit (Housing Credit) properties reach the end of their initial 15-year compliance period, how are they performing? What level of capital improvements do they need? How will they do in the years beyond the compliance period, the “extended use period,” which preserves rental affordability for at least an additional 15 years as required by current federal regulations? Can they access private capital for any needed recapitalization?

In this paper, Enterprise Community Partners presents recent data that responds to these questions and shares how some state and local housing agencies around the country are addressing the post-Year 15 Housing Credit properties. While the condition of the Housing Credit portfolio at Year 15 is strong, as properties age into a second 15-year period of rent restrictions and beyond, the ability for some of those properties to be able to afford to make improvements while maintaining affordability is clearly a challenge. Some of these local best practices point to solutions demonstrating programmatic and regulatory flexibility, new resources as well as resyndication where appropriate. These all set the stage for an ongoing dialogue of addressing what will be a growing challenge for the community development field.

Currently, over 80,000 Housing Credit units finish their initial 15-year compliance period each year. This number will grow to over 100,000 next year. In the typical disposition at Year 16, the Housing Credit investor exits the investment and the general partner becomes the sole owner of the affordable housing property. Since the Housing Credit started less than 30 years ago, we are only now getting a glimpse into how properties are operating after their initial 15-year compliance period.

To take a first comprehensive look at the post-Year 15 portfolio, the U.S. Department of Housing and Urban Development (HUD) commissioned a study focused on over 11,500 properties representing over 411,000 units that reached Year 15 by 2009 – properties placed in service between 1987 and 1994. The results of the study by Abt and Associates were published in 2012 in a paper called [“What Happens to Low-Income Housing Tax Credit Properties at Year 15 and Beyond?”](#)

Abt’s research found that **nearly all the properties remained affordable and are owned by the same general partner or sponsor. The majority of these properties is in good physical condition and has only limited immediate capital needs.** The Abt study indicates that there are some physical and operational needs that cannot be met with current cash flow and reserves.

In addition to participating in the Abt study, Enterprise surveyed 340 general partner organizations in late 2012 to learn more about how the properties in which Enterprise invested are performing post-Year 15. As background, Enterprise has invested consistently with high-mission sponsors, mostly nonprofits, since the inception of the Housing Credit program. The

The Low-Income Housing Tax Credit (Housing Credit) is the nation's largest and most successful affordable rental housing production program. Since its creation in the Tax Reform Act of 1986, the Housing Credit has meant:

- **\$100 billion in private investment capital leveraged**
- **2.6 million homes affordable for low-income families**
- **95,000 jobs supported annually**

In 2010, 50% of all multifamily housing starts were financed through the Housing Credit program.*

*Source: National Association of Home Builders (NAHB)

portfolio reflects deep affordability. In the last five years, for example, 47 percent of nearly 26,000 units were underwritten at or below 30 percent of median income. Of the largely urban portfolio that is past Year 15, nearly half (47 percent) of the projects had originally received tax credit equity for new construction, just over 30 percent were substantial or “gut” rehabilitations, with the balance (approximately 20 percent) being moderate rehabilitations.

HUD's Abt study and Enterprise's survey show similar results in terms of projects being overwhelmingly in good physical condition and performing financially in a satisfactory way at Year 15. Abt reports the vast majority of Housing Credit properties continue to function in much the same way, providing affordable housing of the same quality at the same rent levels with the amount of work done not extensive enough to characterize as recapitalization. Enterprise's look at the extended use period suggests that some properties serving lower income households may face difficulties finding the resources to renew aging systems. Challenges may be greater as mission-oriented housing owners, many of them nonprofits, are committed to permanent affordability.

Enterprise uses the survey data in this paper as a starting point to look at the entire portfolio, focused on the issues of long-term affordability and the preservation of the stock for lower income households. An Enterprise portfolio-wide analysis concluded that seven in 10 projects will not have value in excess of debt and many properties will require capital in excess of reserves. These results are also seen in the survey and Abt study. Almost half of the property owners surveyed responded that the properties do not generate positive cash flow. The HUD-commissioned Abt Study similarly stated, “The experts we interviewed agreed that these reserves are usually insufficient after 15 years ... to cover current needs for renovation and upgrading.”

These two findings suggest that **very limited financing choices exist throughout the extended use period for properties with modest recapitalization or capital improvement needs.** Currently, the best choice seems to be a resyndication with a new Housing Credit allocation. However, the use of Housing Credits to preserve and extend the affordability of existing affordable housing competes with other Housing Credit properties, including public housing revitalization and new projects (both as adaptive reuse of existing buildings and new construction). The Housing Credit was created to address affordable housing needs that the private market could not effectively serve. It incentivized a public-private partnership that includes affordability for 30 years. In order to preserve this inventory, more investment will be required. Ensuring the physical and economic stability of these assets through their extended use periods will require innovative uses of limited public subsidy by states and municipalities.

Enterprise will release additional tools and research on this topic. Our focus will be to provide ideas, best practices and strategies to prompt discussion among owners, public stakeholders and investors to promote and generate solutions to maintain these invaluable assets.

INTRODUCTION

Since it was enacted in 1986, the Housing Credit program has created more than 2.6 million affordable homes, adding 100,000 units and creating 95,000 jobs annually. Leveraging nearly \$100 billion in private investment, it has become the primary engine for affordable housing production.

The current rules governing the Housing Credit require affordability restrictions to remain in place for a minimum of 30 years. The first 15 years, the “initial compliance period,” is when investors receiving Housing Credits are subject to recapture if the housing falls out of compliance. After this initial compliance period, most investors will transition out of their ownership position in the property and the general partner/sponsor typically becomes the sole owner at this time. The second 15 years are referred to as the “extended use period.” In many cases, there are additional and sometimes longer commitments to affordability that come from states and localities.

The preservation of units in the extended use portfolio will be important as the industry strives for a balanced housing approach that also meets the persistent and growing need for affordable rental housing. While more affordable housing must be created to serve the 10 million renter families still paying more than half their income for housing, the affordable housing already created must be preserved if the nation is to avoid losing ground.



In late 2012, Enterprise surveyed owners/sponsors of Housing Credit projects previously syndicated with Enterprise which had reached Year 15 to gather information on the current status of these projects, document what had transpired, and identify trends, challenges and opportunities to preserve these valuable assets. This was an opportunity to give voice to innovations that have preserved this housing and identify any unmet needs and challenges faced by an aging inventory. In addition, Enterprise studied all the properties in its current Housing Credit portfolio to project out the financial condition of the portfolio after the initial 15 year Housing Credit compliance period.

What follows are the results of the owner survey and the findings of the Enterprise portfolio study as well as property trends and public funder best practices from across the field based on interviews and discussions with owners, public stakeholders and investors.

SURVEY RESULTS

In late 2012, Enterprise sent out a survey to all of the general partner sponsors who had a project complete the initial compliance period and where Enterprise's investors had exited the limited partnership between 2003 and 2012. This means properties were 16 to 24 years removed from their original Housing Credit development. The survey was sent to 340 project owners with responses from 71 sponsors representing 98 properties for a total of 3,958 units. While Enterprise found similar survey results to Abt Associates in the HUD commissioned study, Enterprise sees trends in the data which may signal concerns on the horizon for a significant portion of this portfolio.

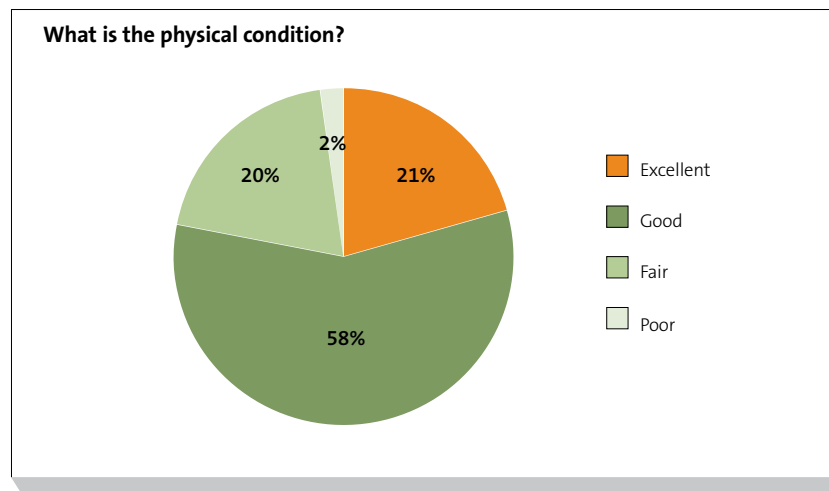
The following is the profile of the Enterprise-surveyed Housing Credit properties.

AFFORDABILITY: ALMOST ALL PROPERTIES REMAIN AFFORDABLE

As with the Abt study, the Enterprise survey found that **the overwhelming majority of properties remain affordable: 97 percent of the properties continue as affordable housing and 92 percent are owned by the same organization or an affiliated entity.**

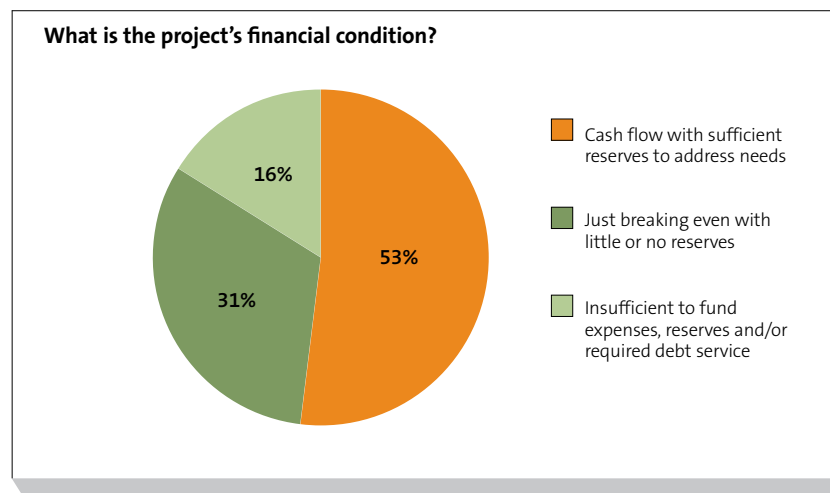
PHYSICAL CONDITION: MAJORITY ARE IN EXCELLENT TO GOOD CONDITION

When asked what the current physical condition is, owners had four choices: excellent, good, fair and poor. Only 2 percent answered that the property is currently in poor condition. As shown in the pie chart below, the majority (58 percent) of the properties were viewed as Good by their owners with Excellent and Fair with 20 percent each. Therefore, nearly 80 percent are rated as being in either Good or Excellent condition after more than 15 years of operation.



FINANCIAL CONDITION: MAJORITY VIABLE FOR ANOTHER 15 YEARS, WITH SOME QUESTIONS

Property owners were asked, “What is the property’s financial condition?” The three answer choices were: 1) it generates cash flows with sufficient reserves, 2) it just breaks even with little or no reserves or 3) it has insufficient cash flow to fund expenses, reserves and required debt service. Just over 50 percent of the properties are generating positive cash flow and have sufficient reserves. And while only 16 percent responded that the projects have insufficient cash flow, another 31 percent cannot service any additional hard debt with their current financial status. As for the 16 percent with insufficient cash flow, 79 percent of the sponsors said they subsidize the property’s operations, and 64 percent have already funded capital improvements.



THE INTEGRAL CONNECTION BETWEEN FINANCIAL AND PHYSICAL CONDITION

Nearly 90 percent of the units that generate positive cash flow and have adequate reserves are in excellent or good condition. Properties that generate positive cash flow are more likely to be in excellent condition while ones that barely meet expenses or have insufficient cash flow from operations are more likely to be in fair condition. Experience suggests that this is a negatively reinforcing cycle, as a property in poorer condition is less likely to compete successfully in the market or attract and maintain residents, in turn further driving down revenue and increasing costs. This underlines the fact that the properties most in need of recapitalization are often the least likely to be able to finance the necessary work without some form of subsidy. **Without innovative financial solutions and subsidies, these properties are in competition for limited Housing Credits and subsidy funding or will require owners to cover shortfalls.** These options will negatively impact the preservation of existing affordable housing units and the production of additional affordable housing units.

CAPITAL NEEDS

The Enterprise survey also took a look at the potential capital needs for properties during the extended use period. First, 65 percent of respondents to the question, “Have you completed a capital needs assessment?” answered Yes. Of those respondents 24 percent (or 16 percent of the total) mentioned that they completed a green capital needs assessment (CNA). Enterprise recommends doing green CNAs whenever possible. In addition to the standard CNA, a green CNA offers energy efficient and green building improvements as well as the potential utility savings which could generate positive cash flow from operations for a property and provide healthier living environments for residents. Given the costs of these assessments, the fact that a majority of owners have done them indicates their commitment to good asset management and stewardship of their real estate assets.

When asked, “Have you completed physical renovations?” 40 percent of property owners said Yes, 44 percent said No and only 16 percent answered None Needed. It is important to note that after 16 to 24 years, some level of capital improvements is necessary for most properties. For those that have already completed renovations:

- A significant majority (73 percent) performed the work within the last year or it is currently ongoing.
- 57 percent said the renovations were for immediate capital needs and to create fit and efficient housing for the rest of the extended use period and beyond.
- The scope of work in more than three quarters of cases was for less than \$10,000 per unit with 53 percent below \$5,000 per unit.
- When asked if the completed work met all the immediate capital needs, 55 percent said Yes. For those who answered No, half said that the properties needed at least an additional \$5,000 per unit in work.
- For the properties that needed more work, only a quarter of them generate positive cash flow and have sufficient reserves while the other 75 percent either broke even or had insufficient cash flow without reserves.

For those properties that have not yet completed physical renovations:

- 41 percent cited that the property did not have enough reserves and cash flow to make the improvements.
- 75 percent said they need more than \$5,000 per unit in work.

REFINANCING OPTIONS

In response to a question about financing, 21 owners answered that they have restructured the debt on the properties. The partners then answered the open ended question of how they restructured. Answers varied widely, but here are the most common answers (properties may have used more than one of the below strategies):

Refinanced Property	29%
State/City Debt Forgiven or Refinanced	29%
Refinanced Debt at Tax Exempt Rate or 0%	14%
Sponsor Paid the Loan Off or Took on Recourse	14%
Tax Exempt Bond Financing or Resyndication	14%

Of these strategies, only two represent what one could consider market solutions: refinancing and resyndication. Positive operating cash flow and flexible subordinate debt are needed for a property to be refinanced while a new allocation of Housing Credits is needed for resyndication. The other three require concessions from at least one of three parties: the lender, public funder or owner.

KEY CHALLENGES

Property owners were asked the open ended question, “What has been the biggest Year 15 challenge?” The top five responses follow:

Lack of Renovation Funds	35%
No Cash Flow from Property Operations	16%
Too Much Debt/Cannot Refinance Soft Debt	14%
Reserve Balances Are Too Low	10%
Staff Unfamiliar with Year 15 Process	10%

These responses highlight the lack of sufficient funding sources available to properties. Without financing opportunities, these properties could cause financial hardship for their owners.

THE EXTENDED USE HOUSING CREDIT PORTFOLIO

During the extended use period, **most properties continue to generate positive cash flow or break even but are increasingly unable to contribute to reserves.** Many owners will be challenged to maintain these homes as quality assets to complete the 30 year affordability period. The extended use Housing Credit portfolio can be segmented into three broad categories with varying characteristics with individual case by case specifics.

First are those properties in excellent to good physical and financial shape that will require no additional resources. Typically, these were originally new construction or gut rehabilitations and had been well maintained and managed through their initial 15 year compliance period. They are larger projects with affordabilities at 50-60 percent of area median income or with project based rental assistance that enables deeper targeting for affordability and healthy cash flow to allow for reserve contributions and cushion to accommodate escalating expenses. When needed, many of these properties have the opportunity to recapitalize/refinance with traditional debt capital.

Another segment has no viable strategy going forward short of resyndication. These are typically smaller projects, have loans from states and/or localities equal to or in excess of market value of the properties and experience lower rental income or higher service-related costs without project-based rental assistance. The physical needs exceed current reserves, and operations generally do not generate positive cash flow.

The remaining subset is in the middle. Most properties need only a moderate scope of rehabilitation of \$10,000 per unit or less with no way to refinance this improvement. Properties may have no positive cash flow or may have debt in excess of value, so traditional debt is not an option. Many of these properties apply to resyndicate for several reasons. Owners and developers are familiar with the Housing Credit structure and they earn a developer fee by resyndicating while public funders have little incentive ranging from public purpose to visibility to allocate precious resources to properties which do not receive a Housing Credit allocation. Addressing these disincentives will be important to creating multiple financing alternatives, including allowing capital subsidies to flow easier to preserve properties without resyndication. These include renegotiating subsidies, forgiving existing public debt to provide access to private financing and allowing reserves across multiple projects to serve a portfolio where stronger performers can support more challenged ones.

Enterprise Community Investment analyzed its syndicated portfolio and provided a summary of its methodology and findings to Enterprise Community Partners for the purpose of informing this paper.

LIMITATION OF TRADITIONAL REFINANCING FOR MOST MATURING HOUSING CREDIT PROPERTIES

The analysis includes the projected value of all the Housing Credit partnerships at Year 15. As noted earlier, the Enterprise portfolio may not be representative of the entire Housing Credit portfolio. This analysis covered 1,134 partnerships consisting of 68,873 units and the methodology used for this review is the same as that used when Enterprise determines the value of individual partnerships after the initial compliance period. The Net Asset Approach to valuing a partnership is as follows:

1. Determine the value of the real estate asset owned by the partnership.
2. Calculate the net assets by adding all of the partnership's assets, including but not limited to the real estate, cash and reserves, and subtracting from this number all associated liabilities, including but not limited to all hard and soft debt, accounts payable and any fees payable; the net total of this calculation represents the value of the partnership.

Inherent in the methodology is a calculation of the value of the real estate asset held by each partnership. Typically the real estate represents the most significant asset held by the partnership. Separating the real estate value is important in order to determine the ability to recapitalize (refinance) a given property. The methodology used to estimate the value of each real estate asset is the Income Approach to value, in which net operating income (NOI) is capitalized into value by applying a market derived capitalization rate ("cap rate").

The analysis found:

- 28 percent of real estate assets will have value in excess of debt at Year 15
- 22 percent of properties will potentially be able to refinance with a traditional mortgage at Year 15, based on an 80 percent loan to value ratio

Enterprise has analyzed the projected operating and replacement reserve balances held by the partnerships. At Year 15, the average operating reserve balance is \$5,055 per unit while the replacement reserve balance is \$3,110 per unit. To the extent that reserves are other partnership assets they may be part of the negotiation at Year 15 and not always convey with a real estate purchase. Some conclusions from the reserves data:

- As mentioned above, only 28 percent of the real estate assets will have value in excess of debt at Year 15; therefore reserves would be needed to finance any needed repairs.
- Of the owners surveyed on post-Year 15 performance, 47 percent of properties had capital improvement needs greater than \$5,000 per unit. Comparing that result to the portfolio's average replacement reserve balance of \$3,110, many properties will need to make use of those resources and more as projects age.

With a portfolio where only 22 percent of the properties will potentially be able to refinance with a traditional mortgage at or shortly after Year 15, public funders, owners and investors need to seek solutions beyond traditional refinancing that are critical to preserving these units.

PUBLIC STAKEHOLDERS: PRESERVING THE AFFORDABLE HOUSING THEY HELPED CREATE

Innovation at the state and local level has been key to the success of the Housing Credit program and the growth and sustainability of today's affordable housing stock. Unified funding rounds and corresponding subsidy awards have facilitated the growth of an affordable housing infrastructure that includes a significant nonprofit housing sector as well as a for-profit affordable housing industry that would not be as robust without them. The volume and scale of the Housing Credit production would have been impossible without this additional public support.

As guardians of public investment, the leadership of public stakeholders will be critical to the extended preservation of the Housing Credit portfolio.

In meetings with state and local housing agencies around the country, Enterprise has heard leaders offer ideas to address preservation challenges for Housing Credit properties. They see the need for involvement and stewardship of these assets. As one public agency leader pointed out, "We're more than a lender." Below are some of the themes that were consistent across agencies, followed by local best practices:

- Proactive asset management and planning throughout the 30 year affordability period will maximize the chances to get ahead of the curve to target the best strategies and resources for the greatest impact on the portfolio. Knowing which projects are performing well or can access traditional financing will enable public stakeholders and owners to focus creative problem solving and resources on those with limited or no viable refinancing options.
- Regulatory flexibility may enable a subset of properties to refinance, while public debt restructuring or forgiveness will maximize traditional refinancing options for properties whose capital needs are modest.
- Innovative financial products must be developed to help those properties that currently have very limited choices. Public stakeholders will play a role in developing and supporting these products just as they have with the Housing Credit. There is no one-size-fits-all solution, so creativity and innovation are at a premium. A modest investment in the near term will benefit the physical and financial viability of many properties down the road. Without any reinvestment, these properties will increasingly become at risk and the cost of recapitalizing may become out of reach.

LOCAL BEST PRACTICES

There are local best practices that offer solutions to preserve maturing Housing Credit portfolios.

Portland, Ore., gives consideration to debt forgiveness or flexibility on existing terms and conditions of “soft” debt for properties committing to longer term affordability that are deemed “distressed” and could not access refinancing otherwise. These approaches allow flexibility and commitment to preservation without requiring additional public dollars, an important consideration in today’s resource constrained environment.



I love my house, my neighbors and the neighborhood. It’s all I’ve ever wanted.

— Allyne, Cleveland homebuyer

In Ohio, The Ohio Housing Finance Agency (OHFA), the City of Cleveland, Enterprise, Neighborhood Progress Inc. and the National Equity Fund (NEF) partnered to pool nearly \$2 million to assist 25 properties that needed help with disposition plans for long-term viability. Funds covered capital improvements, debt reduction of private first mortgages that included write downs by lenders and temporary operating subsidies. Participating CDCs received in kind technical assistance from partners like Cleveland Housing Network and NPI. The partnership assisted 164 units of rental housing and 780 units of lease purchase were assisted, which enabled 40 tenants to become homeowners and another 30-40 tenants are in process to own shortly. Neighborhood Housing Services raised additional funds to assist eligible homebuyers.

The Pennsylvania Housing Finance Agency has a multi-pronged approach and closely oversees its portfolio to assess the best match of project needs with solutions, including allocating 9 percent Housing Credits to the projects that score competitively as preservation projects (maximum of three in 2013) and additional criteria like potential loss to market of project based rental assistance, strategic investment and prioritized income and/or special populations. Developers have bundled several expiring Housing Credit projects across different local jurisdictions with tax exempt bond financing and 4 percent credits. This has required developers to renegotiate existing loans and regulatory agreements while accommodating new “soft” debt for modest physical improvement projects. Smart Rehab, a state subsidy, is available for projects that can benefit from modest physical improvements that will improve energy efficiency and performance.

New York City's Department of Housing Preservation and Development (HPD) has structured Year 15 strategies for preservation, which includes a full menu of products, services and technical assistance, including: transfers of ownership and ownership interest, real estate tax exemptions, mortgage extensions, restructuring, workouts, up to \$15,000 per unit funding for capital work and reserves, restructuring rents, bundling properties together, management improvements or changes and selected resyndication, as appropriate. Since the inception of the Year 15 program in 2007, HPD has repositioned and preserved the affordability of more than 110 projects encompassing over 7,000 expiring Housing Credit units. 10,000 additional units have reached or will reach Year 16 by 2015. HPD has required extended affordability for an additional 15 years or more for extending terms of existing subsidies and providing subsidies, where current reserves were insufficient to fund needed capital improvements.

There are many other innovative solutions. For example, Oakland, Calif., has allowed a nonprofit to pool reserves for a portfolio of affordable housing to allow stronger performing projects to assist more challenged ones.

In conclusion, the continued affordability and strong physical condition of the Housing Credit portfolio at Year 15 is a testament to the success of the program. The challenge is how to maintain the quality and meet modest capital improvement needs across the entire spectrum of properties as well as preserve these assets as they age.