

NeighborWorks® America Symposium

A New Era in Affordable Housing: Investing for Impact in Sustainable Communities

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Framing Paper

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More than just real estate Investing in housing enterprises and the whole delivery system

By David A. Smith¹

Thesis presented for symposium consideration

Because successful housing communities are organic assets that require ongoing management and stewardship, we need rental housing properties to be held by appropriate mission-oriented owners. Yet our current approach to financing – and hence to development, ownership, and operations – emphasizes the property and takes the owner entity for granted. The tectonic shifts now occurring in affordable housing are exposing weaknesses in stewardship that require a fundamental rethinking of the effective financing and operational structure of long-term mission owners – investing in the housing enterprise, not just the real estate.

1. Time to re-examine investing in our housing *enterprises*

The last two years have revealed severe structural weaknesses in the US affordable housing ecosystem. Disruption in the LIHTC markets was brought about not by fundamental real estate weaknesses in the low end of the market but by unrelated losses by the major financial institutions that had become the LIHTC's unofficial oligopoly of buyers. That, in turn, exposed deep cracks in the capitalization of sponsors (developers and owners), particularly including non-profit Mission Entrepreneurial Entities, whose ability to cope has been severely stressed. No one knows how many developer/owners are undercapitalized and virtually moribund, but everyone concedes the fraction is large.

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These fissures arise because our housing finance ecosystem – affordability resources, debt and equity financing products, regulatory structures, and social resources – is oriented around the individual property, not the mission housing enterprise:

- *Subsidies* are either property-specific or portable with residents, not connected to the enterprise.
- *Financing* is single-purpose vehicle (SPV) exclusively.
- *Regulation* is per-property, with anti-commingling or cross-subsidy rules.
- *Recourse* is to individual properties (mortgages), with no recourse to the sponsor.
- *Services* are normally aimed at residents and delivered/ funded at the property level.

The result is housing enterprises to whom we entrust control over \$100,000,000 in real estate replacement cost (say, 1,000 apartments or so) will often have a liquid net worth below \$1,000,000 – that is, we give entities leverage of 99x to 1 or more over properties where they are in control and have no direct risk. Relative to the burdens policy makers expect them to carry, they are weaklings – under-structured and under-capitalized. Meanwhile, our efforts to 'protect' ourselves against this control/ risk mismatch lead at the property level to layer upon layer of operational and financing restrictions from multiple directions – regulator, first lender, second lender, equity investor, resource allocator, and HUD as subsidy provider above all. Conversely, we hypothecate the hypothetical cash flow so that in the event some is produced, one can be sure the recipient will be a financial stakeholder with little if any connection to the activities that produced said cash flow.

As a consequence of these restrictions, in many affordable properties, no one can do anything except what is mandated. New capital is hard to source; partners that want to exit have no means to do so; agreements cannot be modified because they require consents of multiple parties with non-aligned interests; and the capital stack has many layers of entities that own 100% of the optionality-value upside over which they have no control, while the controlling party has 0% of the upside its activities could generate.

Sundering control from risk, stewardship from upside, has the effect of reducing efficiency and cost-effectiveness. Yet these results flow inescapably from the way in which we allocate resources to the creation of new or the preservation of existing affordable housing properties.

As we repair the disrupted deal-flow pipeline, and as we grapple with the necessity for recapitalizing many properties and many sponsors, we ought to step back from the immediate crises and examine whether our housing value chain – the ecosystem of participants and the financial and legal rules by which they interact with one another – needs fundamental restructuring, and if so how.

2. Scale of the challenge

Before we consider *how* we deliver affordable rental housing in America, we should start with *why* and *where* we need to deliver multifamily affordable rental.

2A. Population growth and urbanization

Affordable housing is integral to urban development because homes are what make cities something more than office parks or shopping malls. Affordable housing is likewise integral to urban redevelopment and renewal because until society can induce people to move their children and their parents into a neighborhood, it will never be a community that protects itself against threats. Finally, rental is critical as it is a low-transaction-cost, high-mobility tenure that better accommodates young people entering the workforce, and fluctuations in employment and demand. Thus, as we grow our cities, we must grow the quantity and diversify the quality (configurations, tenures, income levels) of affordable rental housing.

As conclusively demonstrated by a recent comprehensive Brookings Institution study, *The State of Metropolitan America*, urbanization is proceeding in America as around the world. Even as our population grows, the percentage living in urban areas has risen to 66% and is projected to continue rising. Urbanization – especially in our warmer regions and coasts – is making our cities larger, denser, and less affordable to lower-income households. That places ever greater premiums on workforce housing, transit-oriented development, and retrofitting of public infrastructure. Emphasis on reducing carbon emissions – whether voluntary, mandatory, or tax-incentivized – places greater value on multi-use walkable transit-oriented developments, including multifamily rental. It further makes more valuable such tools as inclusionary zoning, tax abatements, and redevelopment authorities.

Urbanization and the shifting population age pyramid is also increasing the demand for multifamily rentals and changing the nature of that demand. Compared with youth, older people are richer, slower, more cultural, more socially and economically conservative, and with more assets to protect. Smaller childless households – either the aging or those who support the aging – mean workforce housing. They mean employer-assisted housing. They mean group living innovations like modern rooming houses that are neither flophouses nor SROs. They mean transit-oriented development – not to cut down on carbon, but to save us from traffic jams and impoverishing and enervating commutes.

Meanwhile, retiring baby boomers will take their wealth from where they earned it (the cities of yesterday), and they will move it – south, west, and wet – to where they want to spend it (the cities of tomorrow). These aging people represent a huge demographic challenge, and also an economic opportunity, especially for America's recent immigrants, old or young, high-skilled or low-skilled.

2B. Existing affordable housing represents \$1.5 trillion of national infrastructure

B1. The inventory today. With roughly 67% of all US households as owners of homes², out of the remaining 33%, roughly one-fifth – 6% of all tenures nationwide – are affordable rental, an inventory of perhaps 7,000,000 apartments.

Affordable multifamily rental

For this paper, affordable multifamily rental means all tenures that include some form of government financial assistance or regulation. This includes public housing, §202 direct non-profit ownership, §221d3 and §236 regulated for-profit, §515 rural housing, §221d4/8 new construction and substantial rehab, state HFA financed §8, and all forms of LIHTC including volume-cap bond/4% credits.

It therefore excludes (i) conventional 2-5 unit properties, (ii) aging unsubsidized apartments, (iii) temporarily rented single-family detached homes and condominiums, (iv) mobile homes whether rented or owned, and (v) properties that are purely conventional and made affordable solely by the presence of a Housing Choice Voucher recipient as a resident.

Assuming an average replacement cost new of \$150,000³, these homes represent roughly \$1.05 trillion in aggregate investment. The inventory is well established but aging, ranging in age up to 70 years, with an average of perhaps 25-30 years. Aggregate portfolio cash flow⁴ is low, with few properties generating as much as \$1,000 per apartment per year, and many operating at *de facto* breakeven or slightly below. Financing and regulatory restrictions have inhibited and delayed refinancing transactions (or, in the case of legacy public housing, generally precluded them altogether), meaning the properties have an average 'effective' age (that is, compared with new-built or newly renovated properties) of 15-20 years. The inventory's capital backlog (relative to market comparables) is substantial, but unquantified.

B2. Character and distribution of ownership. The inventory is controlled by (a) over 3,000 public housing authorities with 1,200,000 apartments, and (b) perhaps 5,000 private sponsors, 80% or so for-profit and 20% non-profit. While there are some vast concentrations – the New York City Housing Authority controls 180,000 public housing apartments – the portfolio is substantially disaggregated, with the average owner controlling perhaps 500 apartments. Barriers to consolidation are numerous and include:

- Difficulty of refinancing or selling individual properties reduces asset tradeability.
- Regulatory restrictions that dampen the economic benefits of better or worse management make it hard for the super-capable to buy out the less capable.

² At the height of the subprime-financed ownership climb, the United States briefly achieved a 70% homeownership rate, but as we have seen, that rate was illusory as several million households were induced into nominal ownership that they could not afford and indeed could never have afforded. The 2-3% fallback in ownership represents about 5,000,000 homes, a number which correlates quite closely to the unsold foreclosure inventory now clogging our financial system.

³ Author's estimate based on recent-vintage QAP approvals in states around the country.

⁴ Including deposits to mandated replacement reserves but excluding scheduled withdrawals from those reserves.

B3. Challenges today facing the inventory, owner entities, and pipeline. Compared with other asset classes or elements of national infrastructure, housing is distinctive and not interchangeable, combining as it does a financially complex asset with the most basic of human needs. As a result, housing tends to be distinct from other forms of commercial real estate (CRE), owned and operated by a highly specialized class of owners/ managers that exist in parallel with the larger CRE universe.

Today's housing finance ecosystem is facing a confluence of challenges. Some of them – such as portfolio aging and programmatic complexity – have been building for decades. Others – pressure to consolidate – have been looming for the better part of a decade, but have been accelerated by the new developments – our disrupted and not yet self-repaired value chain.

Portfolio aging and complexity. The portfolio's effective age, a byproduct of its limited cash flow and the infrequency of capital transactions, has led to large cohorts of property that face systemic problems of many years' standing. These include:

- *Public housing* needs comprehensive overhaul,⁵ to deal with a large capital backlog variously estimated at \$40 billion or above, as well as the need to modernize operating and management procedures and improve operational efficiency.
- *FmHA §515* properties have owners who can neither stay nor go. They cannot make a profit in property management/ cash flow (properties are small and dispersed), nor can they sell and exit the business without paying a large contingent tax. The result is perhaps 500,000 apartments with demotivated ownership.
- *HUD §202/811* all-elderly non-profit properties face the challenge of small single-ownership sponsors that entered the business 20-30-40 years ago with a goal of doing good, and now find themselves dealing obsolescence in the properties and its ownership, even as the resident population ages in place and needs ever more social services.
- *LIHTC post-Year 15* properties are a rising fraction of the inventory. Investors have passed their point of indifference to recapture yet have no clean or economic exit strategy.

Sponsor consolidation. Over the four-plus decades of large-scale US public-private affordable housing operations, programmatic complexity has steadily increased. New programs are overlain without retiring existing ones; conflicting regulatory requirements tend to be both-and instead of either-or; and aggregate guidance and case history for each one continually accretes.

Resident income certification, entity-level reporting, and management information systems – all have become more complicated, more technology-dependent, and hence more pro-scaling and anti-small ownership. Couple this trend toward greater complexity with the inability of sponsors to accumulate equity from their ownership – a function of the highly customized and levered financing and regulatory

⁵ HUD's Transforming Rental Assistance (TRA) proposal, announced a few months back, seeks to transform public housing from an entity-based to a project-based financing structure, converting operating subsidy and modernization funds into Section 8 and decontrolling individual properties for financing.

overlay burdening each property – and the economics of ownership and management have become progressively worse for the small owners. This drove many of them into being developer-by-necessity, doing each new transaction 'to pay for the last one,' and exposing them to greater risk in the development pipeline.

Pipeline disruption and lack of self-repair. During 2008, the LIHTC pipeline broke, for reasons not of its own making. Large financial institutions suffered massive losses from lending businesses unrelated to LIHTC, eliminating their tax appetite and turning several of them into potential sellers. The disappearance of roughly half the demand, virtually overnight, led to first a gap in pricing, then a precipitous drop, from a national average of 95¢ to 75¢ or less⁶. For more than 1½ years thereafter, pricing was uncertain and fragile. Congress's enactment of the Exchange (swap unsold LIHTC for cash at 85¢) and the TCAP softy loan supplement patched many of the pipeline's holes but did nothing to stimulate new demand – in fact the Exchange/ TCAP uncertainty may have retarded new demand emergence. Today new institutions, chiefly insurance companies, have entered the space because prices have fallen far enough to make yields attractive (as of June, 2010, 10.25% and in some cases above). Though optimism has been renewed, concern lingers, as the Exchange is unlikely to be renewed in 2011⁷, which may lead to a further drop in prices.

The challenge of rural. Rural rental housing forms a particularly important niche component of the affordable housing inventory that receives far too little attention. More than thirty years' continuous program evolution has acted in ways that unwittingly disadvantage rural housing. Capital-stack complications have increased the fixed costs of a new property and hence encouraged larger-cost and larger-size developments that may overbuild small rural markets. Program complexity advantages entities with large IT platforms and administrative infrastructure, again working against smaller-scale groups. Hence it is increasingly difficult to make a small rural property economic to develop, own, operate or manage.

Rural properties face the following distinctive challenges:

- ***Property size below 'natural' management optima.*** Most property managers will agree that 75-100 apartments is a natural 'minimum' size where the property can support its own on-site manager, whereas typical rural properties will range from 24-50 apartments.
- ***Lack of a market rental advantage.*** In rural areas, local market rents are low, often because of a surplus of non-professional stock available for rent (older conventional, mobile homes, and rented single-family housing). New affordable properties are therefore competing for residents against conventional competition and have little built-in rental advantage.

⁶ In short order Fannie Mae, Freddie Mac, Citi, Wachovia, Merrill Lynch, and WaMu either suspended their buying or exited completely. Some sought to become net sellers.

⁷ As of this writing (Jul 1, 2010), the Exchange legislation for 2010 has still not been enacted, being caught up in the Congress's inability to pass so-called 'extender' legislation. With nearly all states having put together their 2010 allocation strategies predicated on the availability of Exchange, its failure to be continued now would create an immediate further disruption in the marketplace.

- **Minimal residual potential.** Between program requirements (e.g. §515's prepayment prohibition, LIHTC's 30-year-plus use restriction), concessionary financing (great for initial feasibility, a barrier to residuals upon conversion), and slow-growth markets, rural property owners can seldom look forward to a payday after 15 or 20 years' operations. That is a demotivator, and a capital inhibitor.
- **Inability to refinance or to transfer.** Without residuals, investors and sponsors cannot economically exit, and because they cannot, the properties starve for capital improvements. Moreover, many properties, especially in the §202 and §515 universes, are controlled by sponsors that would (secretly or publicly) like to exit the business, but cannot because transfers are extremely difficult to arrange, finance, and consummate.
- **Program incompatibility.** In the rural inventory are multiple program types -- §515 Rural Development budget-based rentals, §202 HUD non-profit budget-based rentals, small public housing authorities, rural LIHTC – each of which can be a universe unto itself. The outcome can be portfolios that are far-flung (hence lack scaling economies) and non-consolidated (because the owners are of different types).

One can envision a multi-county sponsor, expert in multiple program types, that becomes the consolidated owner of all rural properties regardless of heritage and programmatic restrictions – but with the current regulatory configurations it is difficult to conceive how this could be accomplished.

3. Tectonic shifts are changing the system

The US affordable multifamily rental housing ecosystem is a hybrid value chain⁸ with four symbiotic species:

- Subsidy and resource providers: government, chiefly the Federal government.
- Capital providers: lenders and investors.
- Capital conduits: housing finance agencies (HFAs) and community development financial institutions (CDFIs).
- Capital consumers: sponsors, developers, and owners. We are particularly interested in those identified as Mission Entrepreneurial Entities (MEEs) that pursue a double bottom line – good economics and good social outcomes.

⁸ A short primer description of the LIHTC allocation system, and how it operates as a hybrid value chain, is presented in Exhibit 1.

The capital consumers are under profound stress brought about by recent disruptions in the hybrid value chain by which they access the resources they need.

Mission Entrepreneurial Entities (MEEs)

A housing MEE is an entity that delivers tangible and visible affordable housing solutions according to three defining attributes:

- **Mission.** Entered the field to make positive change.
- **Entrepreneurial.** Achieve their results via entrepreneurship, as actors in the space, taking risks, persuading public and private actors to do things (approve proposals, provide capital).
- **Entity.** Enterprises that must cover their expenses, pay capable staff, and make cash profits, else they cannot continue pursuing their mission outcomes.

MEEs are furthered divisible into:

- **Neighborhood MEE.** Focused on empowering residents and meeting visible needs in a single neighborhood: US CDCs, UK voluntary associations.
- **Production MEE.** Focused on growing a sustainable business such as affordable housing and resident-oriented social services. US portfolio-oriented non-profits, UK professional housing associations.

A comprehensive book-length study of MEEs is Christman, Asquith, and Smith, *Mission Entrepreneurial Entities, Essential Actors in Affordable Housing Delivery*⁹.

3A. Fundamentally unchanged for nearly half a century, the affordable housing value chain fractured in 2008 and has only partially self-repaired

Difficult though it may be to believe, our multifamily rental affordable housing ecosystem has changed little in nearly half a century. Equity syndication and public-private partnerships – using private tax-motivated capital to provide the first-loss hard equity that buttressed high-leverage public government debt – was invented between 1962 and 1968, with the emergence of HUD's first great production wave. That spawned two decades of tax-deduction-oriented shelter investments, all of which were wiped out by the same 1986 Tax Reform Act which created the Low Income Housing Tax Credit. Today the principal multifamily resource, involved in over 95% of all new production (including preservation), LIHTC is about to celebrate its 25th anniversary, little changed from the original statutory creation.

The only significant change in that quarter-century was the CRA-fueled emergence of large financial institutions (banks and insurance companies) as principal investor class. The symbiosis of CRA's emphasis on reinvestment *outcomes* and the LIHTC's equity-oriented investment in tax-advantaged dividend-like *benefits* led to a seemingly ever-improving duality where yields kept being pushed downward, prices kept rising, and certainty of execution was the norm. It also resulted in an extraordinary – and, in hindsight, unhealthy – concentration of the investor class. By 2007, for example,

⁹ To obtain an electronic copy free, see http://www.affordablehousinginstitute.org/AHI_MEE_report_order.php.

fewer than ten financial institutions took up more than 85% of all LIHTC sold in America, more than \$6 billion in total.

Investor concentration proved a catastrophic systemic weakness when enormous losses from non-affordable parts of their business wiped out their profits and, with it, their LIHTC investment appetite.

3B. The pipeline rupture has exposed broader systemic weaknesses

Disruption of the LIHTC pipeline has revealed the weakness of the current business model. Sponsors that cannot finance their next transaction have found themselves caught asset-rich and cash-starved. They may own land in development, or have spent predevelopment money for intangible assets (e.g. site control, development plans, tax credit applications) whose value has dropped and may disappear entirely if the transaction does not proceed. A sense of discouragement little short of desperation has settled over many sponsors, for whom the alternative to closing their two-years-in-the-making transaction is insolvency. Survival is the order of the day; few have much time for larger ecosystemic considerations.

3C. Ecosystemic shifts change not just relative numbers but whole species

When a financial or business ecosystem suffers a severe disruption, several things invariably follow in its wake:

1. ***Government more intrusive.*** Catastrophes being a precondition to fundamental financial reform, a financial catastrophe invariably leads to a host of new regulations. Capital and liquidity requirements, mandatory disclosures, registration and licensing of participants, all tend to expand to cover the new and heretofore-unregulated activities.
2. ***Greater commitment to corporate social responsibility.*** In the populist fervor program participants, who are seen to have done well while others were doing badly or to have profited from 'sharp practice,' are expected to make greater commitments in the name of what we now call 'corporate social responsibility.' This may take many forms, either in taxation, mandates, or otherwise.
3. ***Compaction and consolidation.*** Less-robust enterprises – smaller, over-leveraged, under-capacitated, over-extended – give way to stronger enterprises. Normally this supersession is accomplished via acquisition of assets or merger or entities, and is typically induced by capital providers that have debt and equity at risk in properties the less-robust sponsor is no longer capable of operating successfully¹⁰.
4. ***Entity emergence and extinction.*** Government's more activist role creates new business opportunities that give rise to whole new species of actors. So as housing authorities were invented during the Depression, state housing finance agencies rose to prominence with LIHTC and volume-cap bonds.

¹⁰ The challenges of consolidating in a recessionary environment were explored by this author in *State of the Market 27, Consolidation and Merge-o-phobia, April, 2010*, available at http://www.recapadvisors.com/docs/Recap_Real_Estate_Advisors_State_of_the_Market_27.pdf

A short schematic of the four great cataclysms of American housing finance over the last century is given in Table 1 below, together with our speculations on the new entities and businesses likely to emerge.

Table 1
Four housing-financial cataclysms and their consequences
(Speculations are in italics)

<u>Year and event</u>	<u>Government interventions</u>	<u>Ecosystemic evolutionary response</u>
1934 Great Depression	Creation of FHA Creation of public housing	Mortgage insurance lenders Housing authorities
1967 Urban riots	Creation of HUD Hard-debt lending programs Resident income subsidy	Public-private rental City/ state redevelopment authorities Equity syndication Tax motivated investors
1986 S&L bailout	FIRREA; appraisers certified Creation of LIHTC CRA adds teeth (bank acquisitions) HMDA, RESPA	Rise of the HFAs Soft equity (via LIHTC). Corporate CRA-motivated investors
2009 Global credit crisis	TARP GSE conservatorship <i>Millage tax on banks' existence</i> CRA 2.0	<i>Mission Entrepreneurial Entities¹¹</i> <i>Consolidation and networks</i> <i>Merchant-building value chain</i> <i>Enterprise finance for ownership</i>

While it is dangerous to make predictions, especially about the future, we highlight six likely consequences of the financial reform that is certain, in one form or another, to follow the 2009 shakeout:

1. *Millage tax on banks' existence.* All banks will somehow be assessed a tax on their assets, in effect a 'user fee' for the credit enhancement that backstopped their deposits.
2. *CRA two point zero.* The Community Reinvestment Act, over thirty years old, is due for a comprehensive update, likely to be undertaken in 2011.
3. *Mission Entrepreneurial Entities.* Convergent evolution in the for-profit and non-profit sector is making double-bottom-line thinking a necessity.
4. *Consolidation and networks.* To be explored in ¶8 of this paper.

¹¹ An extensive exploration and analysis of the role of housing Mission Entrepreneurial Entities (MEEs) in the US and UK, and a comparison of the US and UK ecosystems, is provided by the Affordable Housing Institute in its book, *Mission Entrepreneurial Entities: Essential Actors in Affordable Housing Delivery*, available at http://www.affordablehousinginstitute.org/AHI_MEE_report_order.php.

5. *Merchant-building value chain.* Development of affordable housing is high-complexity and place-specific, factors that dis-incentivize scale. Ownership and operations, by contrast, standardize and scale. In the REIT sector, development has been separated from ownership through the emergence of capable merchant builders. We can anticipate something similar in affordable housing.
6. *Enterprise finance for ownership.* Another feature of REITs and large public funds, enterprise finance is low-cost and high-flexibility, provided that the enterprise doing the financing is large scale and has substantial capital. In an enterprise-finance model, competence is a byproduct of these financing attributes, since providers of large capital will insist upon it at all times.

Two other trends, unrelated to the current financial crunch, are also likely to influence the housing policy landscape:

7. *Carbon tax/ green imperatives.* Emphasis on low-carbon and green energy usage will increase through a combination of mandates and taxes. Even assuming cap-and-trade never comes into effect, taxing carbon is too politically appealing and too useful as a revenue-raiser to be avoided for long.
8. *Transit-oriented zoning and infrastructure.* The 'next city,' as Brookings calls it, must build around transportation less predicated on the internal combustion engine. That means mass transit, higher density around transport nodes, and retrofitting suitable metropolitan infrastructure to accommodate. Such transit-oriented income-mixed development is also consistent with poverty de-concentration, locating affordable rental in economically functional submarkets rather than warehousing the poor in concentrated locations isolated from civic and economic life.

4. Financing drives development and operations

*What makes these rockets go up? Money. No bucks, no Buck Rogers.
– The Right Stuff*

We build what gets financed; and we finance what gets subsidized.

4A. Subsidy resources dictate property capital forms

The US affordable housing system uses project finance, high leverage, non-recourse debt, and significant soft-capital subsidies. All of these features reinforce each other:

- *Project finance.* Every property is financed as a single-purpose entity (SPE) whose financing sources, whether debt or equity, are specific to that property.
- *High leverage.* Hard debt is normally at a coverage ratio of 115% or less, often much less.¹²

¹² In the immediate post-crunch environment, coverage ratios have risen to 125% or so. We think this is a temporary phenomenon; certainly it is unrepresentative of the previous two decades and is causing significant restructuring of pipeline properties.

- *Non-recourse debt.* Hard debt is non-recourse, which has the effect of allowing the associated tax basis to be distributed among the investing limited partners. Investors are limited partners who gain a passthrough of income or losses, but no liability for the SPE's debts.
- *Soft equity* is funded by selling LIHTC to investors for cash, paid in installments over time.
- *Soft debt for additional affordability.* Typically the property also benefits from a soft loan (accruing, payable out of future cash flow/ residuals¹³).

The necessity for assembling multiple independent project-finance sources means that funding silos dictate development structures. Properties become exclusively residential (because, for example, combining New Markets Tax Credits with LIHTC is difficult), and additionally, exclusively affordable (because syndicating a partial LIHTC position is more difficult than syndicating a 100% LIHTC property). Concentrating the affordability in this way increases the per-home costs.¹⁴

4B. Sponsors evolve into subsidy scavengers

These funding silos also dictate the organic evolution and organizational forms of sponsors and Mission Entrepreneurial Entities. The typical US affordable housing owner is organized first and foremost around the development function. Development executives are the highest paid; development consumes the most organizational resources; development (and resource assembly) is the most valuable skill. This emphasis on development tends to shortchange the organization of other strengths, and leaves property management, asset management, and the CFO role under-resourced.

Development's uncertainty also leads to a brass-ring mentality. The pursuit of any new property is an expensive proposition – say \$50,000 in direct out-of-pocket costs and an equal amount in overhead and lost-opportunity executive time, for a total bet of \$100,000 per application – and is uncertain, with perhaps two out of every three applications failing each year. This means that developers who *do* win an allocation need that property's cash profits¹⁵ to pay for the several non-recoverable costs.

Funding silos also dictate organic evolution and organizational forms. We have housing-development-specialist MEEs because the scavenging for resources is so difficult and project-specific.

¹³ That this capital is soft debt, repayable to lenders rather than available for the property or its sponsor, is an outcome of two aspects of our project-financed delivery model. (a) The importance of tax benefits to create soft equity. Debt creates taxable basis that in turns generates higher tax benefits, whether deductions or LIHTCs). (b) Belief by government capital providers that they should recover upside so as to do the next socially-desirable thing – because, implicitly, the sponsor cannot be trusted to do this. Such a presumption makes sense if the sponsor is a pure for-profit, unregulated at the entity level, but if the sponsor is a non-profit, it rather than the capital provider may well be a better judge of how to redeploy cash flow and residuals – *and* such an adjustment will align incentives where the current system misaligns them.

¹⁴ Similarly, touching any affordability resource – such as HOME or CDBG – brings along with it regulations and impositions (e.g. Davis-Bacon, prevailing wage) applicable to the entire development, not just the ratable share funded by the incremental resource. Complexity of financing the capital stack thus drives up both the soft *and* the hard costs.

¹⁵ It has become accepted practice for LIHTC allocators to include a developer's fee in the uses of funds, often at an amount equal to 10% or 15% of the total development cost. That such a fee is acknowledged up front is a tacit recognition of the absence of sufficient long-term incentives. The development fee, however, is seldom paid fully in cash; anywhere from 20% to 70% of it is 'deferred development fee,' payable only as future cash flow becomes available.

4C. Funding structures 'crowd out' innovative mixed-purpose and mixed-service properties

Highly specified program rules tend to 'crowd out' service augmentation. In elderly properties, for example, it seems desirable to bring light wellness services into the property; yet housing allowances such as Section 8 vouchers make no provision for social services, and Medicare cannot be used to pay accommodation expenses. Similar challenges arise when trying to finance 'flats over shops,' mixed retail/office/residential, and so on.

4D. Undercapitalizing sponsor entities places whole portfolios at risk in a downturn

So thin are the cash and collateral margins on which many LIHTC sponsors operate, particularly non-profit ones, that the disruption of a single transaction can imperil the organization's whole existence. We see this in:

- The extraordinary lengths to which sponsors have gone to keep alive complicated transactions in the current disruption, and the extraordinary concessions and transitional resources allocators have extended to those sponsors.
- The consolidation being urged by allocators and investors upon smaller sponsors.
- The necessity for many non-profit sponsors to receive small annual general operating grants merely to sustain their basic operations.
- The absence in such sponsors of a recurring-income business (e.g. property management, Section 8 voucher administration) that could cover operating costs during fallow development periods.

An ecosystem in which sponsors *must* do one or more new transactions per year merely to keep body and soul together is incredibly vulnerable to fluctuations in the capital markets. This is an excessive level of ecosystemic risk for the delivery of a commodity (quality affordable rental housing) deemed necessary to urban vitality and national economic competitiveness.

That being the case:

How do we change things to reduce ecosystemic risk from undercapitalized sponsors?

5. What does a post-recapitalized housing enterprise look like?

Making affordable housing work implies strengthening the class of sponsors and Mission Entrepreneurial Entities who in their activity convert programs and resources into new affordable homes for rent.¹⁶

¹⁶ The challenges of creating effective Mission Entrepreneurial Entities, and the problems if they are not appropriately conceived and incubated, are explored in detail in Christman, Asquith, and Smith, *Mission Entrepreneurial Entities: Essential Actors in Affordable Housing Delivery*, available at http://www.affordablehousinginstitute.org/AHI_MEE_report_order.php.

5A. Scale, size, and professionalism

As cities become larger and more complex – economically and in their physical uses of urban land – the 'optimal' size of the urban housing sponsor tends to grow. Entities must have the administrative and IT platform to support programmatic complexity and the combination of multiple programs. The necessity for this internal staff backbone implies a certain minimum organizational size, and that in turn implies a certain organizational gross revenue, effective operating margin, and ongoing equity.

When one link in a hybrid value chain scales up (e.g. investors), all the others have to scale up commensurately, otherwise the value-chain handoffs fail.¹⁷

5B. Deep granular market knowledge and 'touch'

Urban markets are complex, requiring up-to-the-minute knowledge across multiple dimensions: economic fluctuations, changes in rent levels and customer preferences, availability of resources, political and policy priorities, employment demands and supply, land and properties for sale or needing rehab, and so on. Four decades of affordable housing experience show that the best developers have comprehensive knowledge of the handful of markets in which they develop, and are consistently able to out-compete interlopers who swoop in hoping to capture resources.

As against this emphasis on touch and locality, management, ownership, financing and capital assembly/capital cost all scale upwards, and are not as sensitive to local touch as they are to systemization of procedures and consequent optimization of costs and Net Operating Income. Logically, this implies that development's natural end-state is merchant building, with handoffs to large long-term operators who specialize in ownership. This is in fact the model that has prevailed in conventional apartments in both the US (REITs) and UK (pension funds).

It has yet to emerge in affordable housing. Exploring why would be productive. See the questions posed in ¶9 of this paper.

5C. Civic incumbency and civic-leader confidence

Capable sponsors are recognized as permanent incumbents in their metropolitan ecosystems; over time, they become vested with public and private trust earned through a track record of properties successfully completed and operated, reliable interaction with private and public partners and counterparties, responsible activity in the face of challenges, market innovation, and judicious use of public resources. That trust and reputation are hard-won and usually protected at significant cost, with better sponsors usually going beyond the letter of project-financed documents to intervene in and support properties within their portfolio. They recognize, and their civic counterparties recognize, that in exchange for being

¹⁷ Readers above a certain age will recall the old stereo challenge: amplifier, speakers, and turntable. Improving any one component would immediately reveal limitations in the other two, compelling a system-wide upgrade. A similar dynamic is at work in the codependency of personal computer hardware (greater speed) and software (larger RAM and processing requirements), where each new software release renders obsolescent and unacceptably slow the hardware that ran the old software perfectly well.

the beneficiary of public resources, a capable metropolitan sponsor must from time to time commit its own resources – management brainpower, liquid capital, and reputation risk – to tackling the important and unknown.

5D. Housing MEEs as the permanent and expanding interface between programs and citizens

In 1937, when the Federal government first moved into multifamily affordable rental housing, it was as a direct provider via the public housing system. Direct ownership of dedicated affordable rental is, in fact, the universal first-order government intervention around the world, with UK council housing, France's HLM towers, and others. Gradually this gave way to private ownership with public oversight, either via predominantly for-profit (US) or non-profit (UK) entities that are regulated, possibly licensed, and generally certified by government as eligible landlords and managers.

Over time, these entities broaden their points of contact with the poor families and elderly who are their principal customers. They add services, either directly through the entity or more commonly contracted with a third-party provider (like a social-service agency). Either way, the Mission Entrepreneurial Entity increasingly becomes the delivery point for public services – the 'outsourced interface' between government's resources and customers' needs.

In this service-delivery model lies the potential for the emergence of a recurring-income, well capitalized permanently viable US MEE sector along the lines prevalent in the UK's Housing Association sector.

6. Where we need to go: properties

Most of the inventory was originally developed with a limited purpose and time dimension: purpose limited to housing, time dimension usually projected at 20 or 15 years. Since then the purpose have expanded, housing as a nexus of social service delivery, and the time horizons have continuously extended, with preservation an increasing priority. Against these new missions, properties need physical, operational, and financing retrofitting to be configured for the indefinite future.

6A. Property as economic asset: reforming the public housing system

Nowhere is the need for retrofitting more evident than in the nation's roughly 1,200,000 public housing apartments, which have operated since inception under a regulatory schema that hamstring them with negative Net Operating Income, no property-level reserves, and an inability to finance major capital improvements or renovations. The result is an inventory with a massive capital backlog – variously estimated at \$20-40 billion, quite probably higher – that also needs a complete overhaul of its ownership and operational structure, so as to incentivize improvements that also preserve mission.

HUD has entered this space with its proposed Transforming Rental Assistance initiative predicated on three ideas worth highlighting:

1. Housing authorities should be treated as social entrepreneurs like any other form of owner, and given the same flexibility, resources, and responsibilities as other mission entities like non-profits.
2. Housing authority rents should be pegged to market, as part of leveling the playing field among HUD's programs so as to permit streamlining, consolidation, and consistency.
3. Before housing authority properties can be put into market competition, they need a one-time major capital injection to enable them to correct years if not decades of chronic underfunding through the current system of operating subsidy and modernization funds, in effect reparations for previous neglect.

The end result of TRA, if implemented as envisioned, could be housing authorities that suddenly appear as place-based MEEs serving communities not necessarily reached by established non-profit MEEs, and capable of taking on other cohorts of property (like the FmHA §515's and HUD §202's) distributed throughout heartland America.

6B. Property as service nexus: need for physical retrofitting

As urbanization places a greater premium on the high-density low-carbon use of urban land, the result has been, for the development of affordable housing (and many other land uses), ever-increasing complexity, processing time, mitigation required of real and potential externalities, and soft costs. The increased difficulty of creating *new* affordable housing places ever-greater value on *existing* affordable housing, much of which could not be replicated on-site if it were destroyed by a catastrophe, because its redevelopment would be precluded by building codes, down-zoning, environmental considerations, or other new requirements from which the existing property is exempted via grandfathering. This means that once properties *are* established in their communities, we should be looking for ways to expand their utility for their communities and their residences.

Converging with this trend is that of service enrichment of existing housing. Whether (a) family properties that add services such as adult literacy, job training, school readiness, after school, health (nutrition and exercise), day care, or drug counseling among their on-site services, or (b) elderly properties with wellness and activities, either way the property becomes much more than shelter – it is the nexus of family support and social delivery.

Many properties need retrofitting to achieve this. Community rooms are inadequate and under-funded. Lounges may need industrial kitchens added. Available in-property office or social-gathering space is too small to accommodate the desired uses.

6C. Retrofitting in light of new social imperatives, such as greening

Old properties may be established, but they are also obsolescent. Some of this is style – no one bemoans the loss of turquoise-and-avocado appliances, or the retirement of deep-pile orange-and-brown shag carpeting. Some of it derives from the evolving modern home, with its greater wattage rates, need for broadband, and emphasis on reconfigured kitchens. Some of it reflects changing societal priorities, as in the emphasis on energy conservation, green technology, and indoor air quality.

Multifamily residential property represents an enormous latent opportunity for retrofits, particularly green retrofits that have heretofore been infeasible partly because the technology does not yet pay for itself, and partly because the highly encumbered project-finance model makes placement of new debt or pledging of a slice of above-the-line NOI incredibly difficult if not administratively impossible absent a comprehensive refinancing or recapitalization.

6D. Diversifying the income mix

LIHTC was enacted on the policy presumption that income levels above 60% of Area Median could afford market rent from conventional properties. A quarter-century later, this presumption holds true in the vast majority of *geographic* America – the majority of counties – but is increasingly false in *demographic* America – our growing and densifying cities. The result is a gap – above 60% AMI and below the AMI level needed to afford market housing – that varies in size throughout urban America but is unquestionably widening generally.¹⁸

That gap is being sporadically filled by state and especially metropolitan efforts to create permanent rental "workforce housing" (colloquially defined as above LIHTC cap and below local market), an effort that requires eschewing Federal resources, none of which are available to this income band.

A case can therefore be made for allowing some of the existing preserved inventory to rise up to a workforce housing level (affordability at 80%, 95% or even 110% of AMI, depending on market) and using the resulting boost in NOI to fund other initiatives and programs suggested above. This would better distribute the housing cost and tenure levels, plugging an unnatural and programmatically-created gap.

6E. Accumulated property value as embedded sponsor equity

In every other form of privately owned real estate, among the principal long-term benefits and incentives of ownership is the ability to accrete equity through inflation, principal amortization, and equity buildup. (Something like two-thirds of all new US business startups tap home equity as a source of initial capital.) The project-finance model used in the current LIHTC hybrid value chain makes this effectively impossible, boiling away residual potential through a combination of:

- Long-term use agreements, precluding conversion
- Large limited partner positions, which have the right to veto any sale that fails to produce at least exit tax liability, an amount out of reach for many properties
- Soft debt, whose accrued but unpaid interest results in large deferred-debt payments that would capture any residual

The effect is to make sponsors and controlling partners indentured property custodians, able to make dozens if not hundreds of operational decisions, none of which are likely to profit them organizationally

¹⁸ Shakeouts in high-end multifamily ownership product – condominiums and co-ops – have temporarily brought down market rental levels in many cities, but that is a transitory illusion of affordability, as the rentals are short-term and likely to revert to occupant ownership as soon as the housing markets strengthen.

regardless of whether they are genius or folly. Aside from its de-motivational costs, which are hard to quantify but certainly large, it removes the most essential incentive of real estate ownership – appreciation – leaving mature entities no better capitalized than new ones.

6F. Using MEE sponsors as the acquirers and owners of choice

In America, most rental housing that ordinary people consider affordable is, in fact, purely market housing whose rents are simply low enough to be afforded by people in the income range of 50% to 80% of Area Median Income. Indeed, today the amount of this housing is greater, because softness in the high end (including unsold condominiums and foreclosures) is creating a temporarily affordability window.

Either way, existing unregulated properties – the temporarily-affordable or the affordable-by-market – could be turned into permanently affordable housing through acquisition. Such acquisition can be a critical neighborhood stabilizer – again, either against deterioration and disinvestment (rampant foreclosures) in weaker markets or against gentrification and conversion in stronger markets. The entities ideally suited for this role, both by position in the value chain and by commitment to mission, are the MEE sponsors already operating regulated affordable housing.

7. Where we need to go: owners

A retrofitted and more complex property inventory demands a stronger, larger, smarter population of owners.

7A. Repurposing properties as public stewards

We have already seen that trusted metropolitan well-organized and well-capitalized MEEs blend funding streams together to create multi-purpose solutions that are beyond the capability of government entities to conceive and execute. We are also discovering that when they hold properties for the long term, they can redevelop the property into a higher-density more sophisticated use while taking affordability into consideration.

Arlington Housing Corporation of Arlington, VA offers an innovative example. Owner of several properties built twenty years ago, each within a five-minute walk to a Metro stop, AHC turned the need for recapitalization into a redevelopment opportunity, making each into higher-density affordable. In one case AHC added condominiums to the land, creating profits that were used to cross-subsidize additional affordable apartments; in other it swapped land with an office developer, allowing the office site better density and enhancing aggregate affordability by adding more apartments. In each case, as the long-term owner with a Mission Entrepreneurial Entity focus, AHC had the right motivation (mission) and the financial and professional resources (entrepreneurial) to do the job.

7B. Evolving entities to be more customer-centric

Instead of seeing large housing MEEs as principally landlords that also provide ancillary services, it may prove as valid to view them as serving essential needs of two classes of customers:

Residents. On behalf of government, acting as its intermediary or contractual agent, MEEs can deliver to a target population public social resources, of which housing is the anchor but by no means the only one. Foundation Communities in Austin, TX, for example, is a major supplier of after-school programs at its properties; it measures and delivers strong academic performance. It also provides Earned Income Tax Credit centers not just for its residents but for the wider community around its properties. Services that can be locationally delivered at scale include, without implied limitation, those to these populations:

- *Children and youth.* Drug counseling, after-school tutoring and test preparation, anti-violence education, and recreation.
- *Elderly.* Health classes and screenings, health care for seniors, wellness programs, and socializing activities.
- *Lower-income.* Day care for preschoolers, GSD and ESL courses, adult literacy, job education, and family counseling.
- *Special needs populations,* including supportive housing for recovering substance abusers, HIV/ AIDS populations, and the disabled.

Capital providers. As capital providers become larger and more removed from individual markets, they increase their 'unit of investment' below which it is uneconomical to deploy capital. Yet in affordable housing and community development, unit deployments can be smaller than these mega-thresholds, so the large capital providers (e.g. pension funds) need capital intermediaries to manage their money in a 'fund of funds' or 'scout' model. If the Mission Entrepreneurial Entity is also expert in the asset class (e.g. affordable housing) and politically established and respected, then it can be a wiser investor both economically (fewer bad investments) and politically (less unpleasant negative publicity). A socially motivated investment manager can potentially deliver better risk-adjusted returns (via stability) with positive brand externalities instead of negative ones¹⁹.

7C. Strengthening owners and the *Strength Matters* initiative

As discussed above, the current system dis-incentivizes equity accumulation in sponsors even as it overleverages developments. That is an unsustainable combination that carries large systemic risks, because weak sponsors can infect properties into weakness. Conversely, a sponsor with capacity and liquid available equity – equity that is permanently at risk of property performance – is worth many multiples of its value in portfolio performance.

¹⁹ Readers may consider as cautionary examples Stuyvesant Town (New York City) and Park Merced (San Francisco). Both are large-scale rent-stabilized properties acquired, using institutional capital, by a sponsor that intended to convert them gradually to market ownership and use. Unfortunately, both properties' conversions have gone awry, leading to terrible financial returns (default and looming foreclosure, particularly in Stuyvesant Town) and dreadful publicity for the investing entities.

That insight forms the basis for the STRENGTH MATTERS® initiative. Sponsored by NeighborWorks America (NW), Housing Partnership Network (HPN), Stewards of Affordable Housing for the Future (SAHF), and supported by the MacArthur Foundation it postulates:

Strength matters from a public policy standpoint: If government were to rely more on the strong nonprofits with their additional capacity and healthy balance sheets, the public sector could experience more efficient program management and better programmatic outcomes. The missions of these nonprofits and federal, state, and local government are very closely aligned. Public policy should consciously focus on creating a dynamic system that allows organizations to grow and develop the capacity and scale essential to strong performance, effective program delivery and increased benefits to the populations that affordable housing policy is designed to serve.

8. Where we need to go: the integrated geographically distributed network

Though we commonly think of sponsors needing money more than money needs sponsors, in fact the needs are mutual.

A capital consumer is the device by which a capital provider turns increased money into better outcomes. Capital providers and subsidy providers cannot do this for themselves – forty-plus years of national portfolio performance have conclusively demonstrated this. Capital consumers are outcome providers; and capital providers are outcome consumers. Each needs the other. Ergo the capital providers need to strengthen the capital consumers, so that those capital consumers can be better outcome producers.

A hen is only an egg's device for making another egg. As alluded to in ¶7B above, sponsor MEEs are the means by which bodies who can't lay eggs (financial entities) get eggs laid (properties created). Capital consumers need the grain (finance and subsidy); capital providers need the eggs (successful property outcomes).

8A. A network of capable autonomous but coordinated nodes

If we accept the hypothesis that capable larger-scale Mission Entrepreneurial Entities have an essential role as the 'last mile' delivery of government social programs and resources, then it follows logically that these entities must somehow represent and be configured into a network that covers the entire country – the effective coast-to-coast locally-distributed implementation capacity that government desperately needs.²⁰ That network-of-entities model is implied and all but summoned by the conclusion of Brookings' major and important new report, *The State of Metropolitan America*:

New demographic realities must be met with new governance arrangements. Especially in light of the deep fiscal crisis facing states and local governments, the lines between cities and suburbs—

²⁰ Nowhere is government's need for capable local counterparties more visible than in the Neighborhood Stabilization Program (NSP), where government is trying to stem the disinvestment resulting from epidemic foreclosures through delivery of capital into local governments, only to find that these entities have enormous difficulty translating the money they receive into houses acquired, homeowners protected, and neighborhoods actually stabilized.

and the long, fruitless history of battles and mistrust between them—must be transcended, in all types of metropolitan areas.

Local leaders must forge regional solutions to newly shared regional challenges, such as linking the supply and demand sides of the labor market to benefit disadvantaged workers. They must **undertake greater collaboration in the delivery of services**, or outright combine outdated, inefficient local government units such as school districts. And they must act like metropolitan areas in dealing with their states, consolidating their influence on common issues that affect the well-being of their populations.

That is a manifesto for the Strength Matters initiative and for the emergence of a network of consciously-collaborating members that span local jurisdictions already, without the necessity for persuading balky government administrative entities to collaborate across sectors and levels of government. These entities can be the messenger RNA, or the antibody to political lassitude, that the system needs. Nobody else in the ecosystem can consume capital efficiently – turn money into desirable public-policy outcomes with a moral safe harbor (as the political Good Housekeeping Seal of Approval).

8B. Sponsors with permanent equity, and equity at permanent risk

In conventional multifamily development, sponsors are large-scale and have substantial equity capital. To develop new properties, they put equity at risk, and recoup it either at sale (if merchant builders) or through appreciation (if long-term enterprise financed owners such as REITs). Their portfolios also serve as a source of controllable fee opportunities to build worthwhile businesses providing essential services²¹ – property management, asset management, social services.

That same capitalization and equity investment philosophy applies to affordable housing in the UK, where housing associations routinely use their significant working capital for predevelopment costs, and leave a portion of invested capital as equity in newly completed properties added to their portfolio.

Having meaningful liquid equity that is permanently available means sponsors can deploy capital quickly into new ventures or into the stabilization or recapitalization of existing properties. Their ability to act fast, with autonomy, is a huge asset to them and to their capital providers.

Financial, lending, and subsidy structures should encourage capable sponsors to accumulate large amounts of capital that is permanently available and permanently at risk in their portfolios.

²¹ So deeply ingrained is our project-financed, regulate-the-entity model that service provision by affiliated entities is regarded with deep suspicion by HUD and state regulatory agencies. In reality, if the asset were properly regulated (outcomes not process, and affordability not cost), then delivery of services through affiliated entities would be seen as a strength rather than a potential weakness.

8C. Regulation oriented around sponsors rather than properties

It is a curious feature of US affordable multifamily rental housing governance that we multiply restrict each *property's* capitalization and use of funds but minimally restrict the *sponsor's* capitalization and use of funds. Yet that need not be intrinsically the case.

Implicit in the non-profit designation is the concept of *entity governance* rather than property governance. Non-profits in other sectors can and do operate multiple properties (think hospitals) or multiple business lines (think universities) all under the mantle of their general non-profit designation.

It may be one thing to have an affordable property heavily circumscribed where the owner's motivation is not assured, because the owner is a for-profit, where excess capital will be extracted and not necessarily obligated back (assuming non-recourse financing). It is quite another to duplicate restrictions at the property level in cases where the owner has already self-restricted at the entity level, by taking a public-policy pledge (electing to be a non-profit). In the latter case – non-profits accumulating equity – the proceeds once extracted from Property A can be used only for public purposes, such as to develop new Property B, making more affordable housing from the same resource set.

It is therefore fully plausible to imagine a Mission Entrepreneurial Entity approach to regulation involving these components:

- *Non-profit* sponsor MEEs that are committed to using their accumulated equity for mission purposes.
- *Equity accumulated* in the sponsor entity, increasing in real terms over time.
- *Regulation* at the sponsor level, focused on outcomes more than processes.
- *Real risk* borne by the sponsor, both in first-loss equity and quite possibly in recourse (or fully collateralized) debt.

9. Questions for exploration

If a problem cannot be solved, enlarge it.

– Dwight David Eisenhower

This framing paper has sought to expand from the immediate problem – a disrupted LIHTC hybrid value chain – into the larger and more important problem – strengthening the ecosystem of entities that develop, finance, own and operate affordable multifamily rental housing. The paper is deliberately open-ended. It raises possibilities without knowing how to accomplish them, asks questions for which we lack the answers, including these:

9A. Is a stronger ecosystem possible? Is this a better vision?

For program participants working within a value chain, there is a temptation to believe that the chain exists in its current form because it must exist in that form, and that any difficulties, whether acknowledged or mentally overlooked, can be remedied (if at all) by tweaking the rules. Certainly change

is wrenching, requiring as it does changes in multiple links in the value chain simultaneously – but then, so is the situation in which we find ourselves.

It is impossible to make strategic change in an incumbent system unless significant stakeholders are convinced that such change is desirable.

Is a reconfigured ecosystem – oriented around large, capable MEE sponsors that cover the entire country and have meaningful equity that they can place at risk – is that system *desirable*?

9B. What does the multi-service *platform* look like?

Already, housing non-profits have been innovating by expanding their businesses into additional social services desired by government to be delivered to people who happen to be these properties' residents. They have done this on their own, out of a sense of mission to their residents, and with no particular paradigm in mind, nor any funding schema to encourage their expansion and growth. There is thus no reason to conclude that they have yet achieved a fully optimal platform configuration for these business activities.

How should a Mission Entrepreneurial Entity be configured so that it delivers multiple services to a common customer group, organized around their residency in an affordable housing property?

9C. What does the multi-service *property nexus* look like?

Similarly to the evolution of Mission Entrepreneurial Entity participants, the properties in which they provide services are by no means configured for optimal service delivery. In fact, we know they are *not* physically configured for such long-term service – they are physical real estate, which does not change of its own volition, and they were built anywhere from 15 to 40 years ago, long before these service possibilities were envisioned, much less funded.

There has been no readily available capital source for such retrofitting, particularly as much of the retrofitting physical cost will be non-recoverable. So the properties exist as time capsules of what we thought poor people would be grateful to live in, circa 1995 or 1985 or 1975 – not what we need for 2015 or 2025 or 2035.

If we had the resources, how would we reconfigure existing affordable housing properties so as to facilitate integrated service delivery to residents? How much would this cost, and where might the necessary capital come from?

9D. How do we migrate MEEs and properties toward each other?

It's hard to start a new service in a property unless the property offers a venue for that service; conversely, it's difficult to raise the capital and negotiate the permissions to repurpose a property without a credible

vision of the services to be delivered into a renovated and retrofitted property. Somehow the service delivery and the physical property need to be evolved in concert with one another.

What changes in properties will facilitate MEE sponsors adding sustainable new services?
What changes in service funding streams and business models will facilitate the financing of physically restructuring properties?

9E. What are the challenges/ obstacles?

An industry cannot expect policy makers or resource providers to do its thinking for it. Nor can we expect individual stakeholders to abandon their business interests solely out of an altruistic urge to make a system can be better. Our system grew up the way it did in part because, interval by interval, that was the line of least resistance given the facts then prevailing ("they seemed like a good idea at the time"). Unmaking those choices overcoming obstacles: programmatic or regulatory rules, established patterns of doing business, expectations and practices of other stakeholders such as capital providers. We cannot do everything at once, but unless we do some things of meaningful scale, the system will devolve back to its current configuration, with all the risks and inefficiencies that entails.

What are the chief obstacles to remaking the system, and what actions could be taken unilaterally, or without changes in legislation, that would encourage the system to evolve in a better direction?

9F. Do we need to rethink zoning and financing?

Zoning in America favors the homestead model: one plot, one use, one house, one family, one car. That we have largely homogenous, car-friendly, suburbs should be no surprise. Yet as America urbanizes, and we infill more locations plus create more mid-rise and high-rise dwellings, we increasingly prefer multi-storey, mixed-use, mixed-income, multi-family housing that may need no car at all. Such uses are de-selected by our financing schemes, and by our zoning regimes.

How do we now produce zoning and financing schemas that facilitate income-integrated, community-centric dwellings and buildings?

7G. How should we invest in entities?

We have the system we do because of the choices we made. The project-finance, high-leverage, low-economic-incentives model of affordable housing development finance that we now have is a legacy that is a deliberate and consciously chosen outcome of:

- Our legacy ecosystem – when this model was invented, few if any capable sponsors were non-profits and the science of Mission Entrepreneurial Entity growth and management had not been invented.
- Our credit systems – especially mortgage insurance under particular Federal programs.
- Our tax incentives – especially depreciation and LIHTC.

- Our land use policies – zoning and real estate tax abatements for particular uses).

Changes in mortgage programs, income tax provisions, and land use could entirely remake the incentives, and over time remake the ecosystem.

What financing, subsidy, and taxation structures would strengthen entities via delivery of new and improved housing and service delivery modules? How can we restructure the investing model so that policy makers get efficient outcomes for their subsidy, and capital providers get reliable and market-competitive risk-adjusted returns on their capital? How do we effectively invest in *entities*?

Exhibit 1
LIHTC equity syndication as a hybrid value chain

In the parlance pioneered by the Ashoka Foundation, a 'hybrid value chain' is a set of business linkages that delivers a double-bottom-line result. Using the Low Income Housing Tax Credit (LIHTC) to raise soft equity that completes the capitalization of new affordable housing²² is a hybrid value chain because it blends public and private resources to deliver property results that must meet economic criteria (paying debt service and delivering investor yields) and social criteria (affordability at stipulated rents/ incomes for stipulated periods).

At over \$6 billion in average annual equity raised, the LIHTC is one of the world's largest volume and longest-lived examples of a hybrid value chain. Seeing the LIHTC in this way is powerful in two directions:

- *Exporting understanding.* Showing LIHTC as a hybrid value chain makes it accessible to domestic policy makers and international experts and stakeholders interested in it as a potential model for their own affordable housing production.
- *Importing.* The value-chain typology enables US stakeholders, including program participants, to talk about the LIHTC as a system, and step outside the parochial self-interest that characterizes of much of the debate.

The LIHTC value chain²³ involves eight steps among four principal participants and one essential indirect one (Treasury):

1. **Sponsor** identifies and conceives a transaction, and secures site control.
 - Sponsor spends money, takes risks.
2. Sponsor secures a forward commitment for permanent debt from a **market lender**.
3. As required (usually), Sponsor also secures soft debt commitments.
4. Sponsor applies for LIHTC from the **allocator**, out of the allocator's annual allowance as provided in the LIHTC code (Section 42).
5. Sponsor wins LIHTC allocation.
6. Sponsor secures equity commitment from a **LIHTC investor**.
7. Sponsor closes financing, acquires land, starts construction/ rehab.
8. When the property is complete and occupied, the sponsor so certifies to the allocator, and issues a tax savings certificate honored by the **Treasury**.

LIHTC's enactment in 1986, and its effective coupling with the CRA investment test in the late 1980s, called forth the growth and scaling of new entity-level actors and participants. **State housing finance agencies**, given pride of place in the system by virtue of their allocation authority under individual state-designed Qualified Allocation Plans, rose over the ensuing decade to become the nation's most powerful

²² For verbal convenience, we will include preservation-related properties as 'new' affordable housing, since by definition the pre-LIHTC property was at risk of losing its affordability.

²³ A good visual walkthrough of the LIHTC allocation and award system is provided in <http://www.hartcredit.org.uk/Tour/tour.html>.

affordable housing participants. Large financial institutions as **corporate investors**, led by Fannie Mae and Freddie Mac, gradually displaced all other LIHTC buyers, leading by 2005 to a situation where the top twenty investors acquired over 95% of all LIHTC nationwide.

Hybrid value chains create intriguing complementarity. Where else can a local non-profit and a national bank come together to invest in a single transaction where each is pursuing a rational business interest? Where else can New York City based institutions become directly involved with small elderly properties in rural middle America? These unexpected partnerships breed byproduct value. Without LIHTC, it remains unclear how large financial institutions would meet the CRA investment test; and without LIHTC, it remains unclear how governmental bodies would assure the high degree of outcome compliance with very low administrative costs as is enabled by LIHTC disallowance-and-recapture system.

A hybrid value chain also creates unexpected and desirable alliance. When the value chain disrupted in 2008-2009, numerous stakeholder groups reached out to each other in an effort to keep the system viable, temporarily setting aside their competitive urges in the interests of ecosystemic health and longer-term public policy considerations.

Two important principles emerge from the LIHTC experience:

- Hybrid value chains can turn a mob (every stakeholder out for itself) into a pack (where stakeholders can collaborate if the hybrid value chain itself is under attack).
- Evergreen resource flows will impel scaling and professionalism if and to the extent that said resource flows are (a) large, and (b) complex. Complex flows take complex organizations to optimize them, and natural evolutionary/ competitive pressure will yield positive evolution.

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