AFFORDABLE HOUSING THROUGH NON-PROFIT/ PRIVATE-PUBLIC PARTNERSHIPS

by Rocky Tarantello, CRE, & John Seymour

ABOUT THE AUTHORS

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In less than five years, the Southern California Housing Development Corporation (SCHDC) of Rancho Cucamonga, California, has accomplished something extraordinary. Without the benefit of initial seed capital and structured as a private non-profit 501C(3) corporation, SCHDC has acquired and rehabilitated close to 2,500 rental housing units with a current approximate market value of over $100 million and approximately $40 million in equity. What makes this accomplishment even more remarkable is that 60 percent of the units qualify as low to moderate income affordable housing and all were acquired through a series of public/private partnerships. Since this kind of success breeds success, SCHDC expects to replicate their success throughout the nation by acquiring and rehabilitating 750-1,000 additional units per year into the foreseeable future.

THE GROWING NEED FOR COUNSELING

Public agencies frequently engage the services of real estate counselors to assess affordable housing needs, evaluate housing market conditions, analyze joint-venture proposals and financial projections, or make a variety of other recommendations regarding the potential success of the public/private venture. Prior project failures have caused understandable skepticism, as many have become gang controlled, drug infested slums. Few have truly flourished and succeeded. Hence, limited public funds must be invested wisely as demand for affordable housing swells. Current estimates peg the nation's supply of affordable housing units at 9.4 million, down from 10.3 million in the last decade, according to the U.S. Housing & Urban Development Department (HUD). Yet as early as 1990, HUD estimated that 12.5 million renter households were in need of affordable rentals, 5.4 million of these paying 50 percent or more of their annual income for rent. The subsidized Section 8 Federal program has provided a mere 1.25 million units, 840,000 of which are under Housing Assistance Programs all scheduled to expire by the year 2003. The estimated cost to renew these subsidies is $16 billion, while the total current budget for all HUD programs is $24.2 billion. By rough approximation, at least two-to-three million affordable housing units are currently needed in addition to those already available. The recent success of SCHDC strongly suggests that real estate counselors can greatly assist their housing agency clients by seeking out viable non-profits and applying many of the same principles systematically employed by SCHDC.

NON-PROFITS AND LOCAL GOVERNMENTS ARE NATURAL PARTNERS

For-profit real estate developers and investors are understandably motivated by the profit incentive. They tend to favor new construction over riskier rehabilitation projects and market rate rental housing versus low to moderate income rentals. Unfortunately, this frequently results in a misalignment of objectives with local governments. Local governments' primary incentives are preservation of existing housing stock and neighborhood revitalization, resulting in reduced costs for required public services (fire, police, etc.), and increased housing opportunities in the low to moderate income range.

Through non-profit/local government partnerships, local governments contribute debt or equity capital and the non-profit contributes management expertise and operating experience in the acquisition and development of affordable housing along with significant neighborhood revitalization benefits. The advantage of these revitalization projects are that they tend to be politically viable, avoid local resident resistance, maintain the existing housing stock, and accomplish these objectives at substantially lower costs. For example, a typical new construction affordable housing project in Southern California may cost $110,000 to $150,000 per unit while the typical revitalization project should fall in the $50,000-$75,000 per unit range. The typical partnership also provides for operating profits to be reinvested in the project rather than paid out as investment returns as in a typical for-profit project. Consequently, non-profit/local government partnerships provide an excellent vehicle for *creating* and *maintaining* affordable housing.

At present, most affordable housing programs have been fostered at either the federal or state level. However, it is local government which best understands the needs of local constituents and community development objectives. For this reason,

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despite existing federal, state, and local government cooperative programs, more affordable housing funds need to be shifted from federal and state programs, to the local level.

SOURCES FOR DEBT AND EQUITY CAPITAL

At present, there are several possible sources for required debt and equity capital which local governments may assist in procuring to finance the "typical" non-profit/local government affordable housing project. At Southern California Housing Development Corporation, each of the following sources has been employed at one time or another depending upon the unique circumstances of each individual project, the local political climate, and the community in which it is located:

1. *Local Economic Development and Housing Set Aside Funds* - these are Redevelopment Funds representing direct investment equity dollars;
2. *Tax Exempt Bonds* - provides first mortgage financing at 200 basis points or more below conventional mortgage rates for qualifying non-profit organizations;
3. *Local Community Development Block Grants Funds (CDBG)* - federal funds that can provide direct equity investment or pre-development expenditures;
4. *Federal HOME funds* - providing local government housing funds that for the most part are "without strings," but require compliance with Federal Davis-Bacon labor laws which could increase construction costs by 10 percent to 15 percent;
5. *Federal Reserve Bank AHP Grants* - direct equity investment funds restricted to low-income units only;
6. *Low Income Housing Tax Credits (LIHTC)* - provide private investor yields of 12 percent -16 percent and therefore encourages direct equity investments in non-profit affordable housing projects; and

7. *Community Reinvestment Act (CRA) Loans* - providing both conventional first and second mortgage loans underwritten with less stringent underwriting guidelines and offering more favorable mortgage rates.

Political will and commitment to neighborhood revitalization play an intregal role in which, if any, of the above resources will be available. In exchange for local political support and investment capital assistance, the non-profit housing provider assumes all responsibility for planning, development, construction, marketing, lease-up, and ongoing management. "Tight" operating and maintenance agreements protect the financial interests of the city while net operating cash flows are returned to the city and the property reserve fund accounts for on-going maintenance and capital improvements.

Equally important is a *mutual* commitment to mixed-income projects with a mix of market rate and affordable units, which more accurately reflect the true demographics of the neighborhood without the typical stigma of low-income housing. This generally requires that 40-60 percent of the units are available exclusively at market rental rates.

NEED FOR A STRONG AND EXPERIENCED NON-PROFIT

Through the years, most non-profit housing providers have completed only one or a few selected and usually small- to medium-sized projects. Frequently sponsored by local community groups, churches or other existing non-profit entities, most of these organizations have huge hearts, but lack the professional development and management experience required to successfully undertake one, much less several affordable housing projects. Hence, despite the non-profit status, a professionally strong organization is required to carry out each of the following requisites:

1. research and acquisitions;
2. construction and project development;
3. finance, accounting, and funds control;
4. property management;
5. general administration; and
6. resident assistance social programs

Not only must the organization be committed to "financially" sound projects, but must also be committed to improve the overall quality of life for its residents. The organizational objectives of a non-profit should go beyond safe, clean, and affordable housing. In the case of SCHDC, a separate 501C(3) Private Foundation, Hope through Housing, was established to deliver and fund social programs within its rental communities. By surveying residents at each of its locations, the foundation selectively provides child care, job training, after school tutoring, computer rooms, health fairs, senior activities, summer camps, and other programs tailored to the specific needs of each community and its residents. Hence, the non-profit partner must be an experienced and competent real estate company with the capacity and desire to provide a host of traditionally unrelated social services, ultimately resulting in greater tenant satisfaction, retention, and stabilized operating cash flows.

STRICT UNDERWRITING AND SELECTION ARE THE KEY

Since the typical non-profit/local government venture intends to hold the property into perpetuity, the underwriting guidelines necessary to insure long-term viability are strict. A problem property can not simply be disposed of, as the case would be with a for-profit entity. We suggest the following guidelines as a *minimum:*

1. A minimum project size of 100 units in order to insure cost effective operations and management;
2. 1.15 minimum debt service coverage ratio;
3. $2,800-$3,200/unit annual maintenance allowance;
4. meticulous accounting for adequate reserves for replacement;
5. all rehab design and construction to be completed with a 30-year life expectancy; and
6. adequate property management fees to ensure close supervision and strong tenant relations.

Affordable rental housing failures are generally caused by inadequate financing, poor construction, or poor management. The SCHDC underwriting philosophy is predicated on the desire to provide a quality mixed-income rental community that is financially strong, excellently managed, well maintained, secure, and responsive to tenant needs. This cannot be accomplished everywhere, in all cases. But it can be accomplished in most communities with a strong desire to clean up their deteriorating neighborhoods and revitalize older housing; the willingness to provide adequate funding; and the commitment to partner with only those who are objectively aligned with the needs of their community and the ability to do it right. REI