Tax Credit Survey Reveals Strong Market Sector

By Fred H. Copeman and Richard A. Floreani

ABOUT THE AUTHORS

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Since its inception in 1986, the low-income housing tax credit program has been perceived as both a highly effective rental housing development tool and a sound real estate investment. The vibrancy of the tax credit program within the multifamily sector is evidenced by the statistics: it is estimated that the LIHTC program has been responsible for creating over one million apartment units. Until recently, however, there has been little information available regarding the performance of this program.

A recent study, Understanding the Dynamics: A Comprehensive Look at Affordable Housing Tax Credit Properties, has begun to address this problem. Ernst & Young created the largest database of housing credit property performance ever assembled, representing approximately half of all housing credit properties ever developed. Year 2000 financial data from over 7,800 properties representing more than 500,000 apartment units was evaluated. Data sources consisted of investors in and syndicators of housing credit properties, including direct and fund investors, guaranteed and non-guaranteed investments, for-profit and non-profit syndicators, and a wide variety of portfolio sizes. Following are key observations regarding the property performance excerpted from the study.

PROPERTY OPERATING PERFORMANCE

Occupancy, cash flow and hard debt service coverage ratios suggest that the program is producing properties that are performing well in general. Physical occupancy averaged 94%, which is consistent with the 93% to 95% rates typically used for underwriting purposes. The average hard debt coverage ratio (defined as net operating income divided by "must pay" debt service) was 1.35. This exceeds the current 1.15

underwriting standard, although we note that properties are underwritten to a range of coverage ratios.

Several observations emerged from our analysis, including some that are at odds with conventional wisdom about housing credit properties. First, high occupancy does not guarantee strong financial performance. Of those properties experiencing operating difficulties (which we defined as either operating below 90% occupancy, below 1.0 hard debt service coverage, or with negative cash flow), half had below 1.0 debt coverage despite strong occupancy rates. Whether this phenomenon is attributable to lower rental income or higher operating expenses was not determinable by the data provided.

The study data also indicated that older properties did not report higher debt service coverage ratios than more recently developed properties. We expected to see an increase, since net operating income typically grows over the life of the property while debt service remains constant. It is possible that this is due to sluggish financial performance. More likely, though, is that the industry has changed its underwriting standards considerably since the early years of the program, and particularly since conventional debt sources have replaced government sources of permanent financing.

Also to our surprise, the study revealed that housing credit properties financed through the Rural Development Services (formerly Farmer's Home Administration) program, which finances rural properties, tend to operate well above break-even. These properties are generally underwritten to operate at 1.0 hard debt coverage. The average reported for these properties was 1.34.

The performance of properties targeted to families versus senior citizens is a perennial question for many in the housing credit industry. Many believe that properties targeted to the elderly perform better financially because they encounter less unit turnover and require less physical upkeep than those properties that are targeted to families. Study data indicates that occupancy averages were 94.0% and 94.9% for family and senior properties, respectively. Financial performance proved not to be significantly different for these property types, with family properties reporting 1.36 debt coverage and senior properties reporting 1.34.

The study also found that urban properties tend to have a larger hard debt coverage ratio than those in other areas. The average hard debt coverage ratio for urban properties was 1.52, compared to 1.28 for suburban and 1.31 for rural properties. This difference presumably reflects the prevalence of so-called "soft debt" present in urban developments. (Soft debt financing consists of loans, usually from government sources, that are payable only from available cash flow until the loan matures.) Occupancy rates for properties in all three areas ranged from 93.5% to 95.3%.

The study also examined the incidence of property underperformance. As noted above, we defined this as either operating below 90% occupancy, below 1.0 hard debt service coverage, or with negative cash flow. Despite the strong average performance figures, a surprising number of properties have operating issues: 18% were below 90% occupancy, 29% operated below 1.0 debt coverage, and 31% operated with negative cash flow. The causes of these issues were not addressed by the study; however, issues typically center around two factors: underwritten rents are not supportable in the market, or operating costs exceed underwriting estimates. We also note that some properties experience temporary operating issues and others are chronic. Since the survey data was for one year only, this important distinction could not be measured from this data.

FORECLOSURE RISK

One of the most significant data points analyzed was the incidence of foreclosure in housing credit properties. Foreclosure of a housing credit property by its lender represents a tax credit recapture event for investors. Though foreclosures in housing tax credit properties were thought to be rare, no published data was available to support this belief. The survey indicates that only ten of the surveyed properties were foreclosed upon, or tendered a deed in lieu of foreclosure, since the program's inception. This represents 0.14% of the properties since the program's inception, or an annualized foreclosure rate of 0.01%. This compares very favorably to other asset classes. Data from the American Council of Life Insurers indicates that the next lowest foreclosure rate was for 1-4 family market rate properties, which have a 0.42% foreclosure rate. Retail property was 0.9%, office property was 1.94%, industrial property was 0.91%, and hotel property was 1.41%.

Perhaps the most paradoxical finding was the low incidence of foreclosure coupled with the high incidence of below 1.0 debt coverage. Intuitively, one would assume that having insufficient income to pay expenses and debt service would ultimately lead to more foreclosures, but this clearly has not occurred. We suspect that this is due to several layers of financial protections along with other factors that are not captured in the data. These include the following: property management fee deferrals, maintenance deferrals, operating reserves, operating deficit guarantees, investment tier working capital reserves, and debt workouts.

CONCLUSIONS

Overall, housing credit properties appear to be operating well as a class in terms of occupancy and financial measures. Foreclosure rates have been demonstrated to be remarkable low. An unexpectedly large number of properties, however, are operating with low occupancy or are encountering operating deficits.

As noted, significantly more study needed in this area. Understanding and quantifying the true magnitude and significance of the operating problems, their impact on investors and lenders, and the methods by which properties receive financial support would be helpful places to start.