Affordable Housing Finance 101

Patrick McAnaney

Somerset Development Company

May 9, 2024

Presentation Outline

1. Understanding the Tools
2. Example: Building a 3 Bedroom Affordable Apartment
3. Affordable vs. Market-Rate Projects: Competition or Cooperation?

1. Affordable Housing Finance 101

Understanding the Tools

Like Buying a Home, New Buildings Are Financed With Debt and Equity

Debt

- When Buying a Home: Depends on Monthly Income and Interest Rates
- When Building a Building: Depends on Income (Rent minus Expenses)
- For Affordable Projects: Lower Rents → Lower Income → Smaller Loan

Equity

- When Buying a Home: Down Payment
- When Building a Building: Often Raised From Institutional Investors
  - Often Expect 15-18% Annual Return – Premium vs. Real Estate Stocks
- For Affordable Projects, Equity Returns Usually Not Sufficient to Attract Investors
- Instead, affordable housing developers often use **Low Income Housing Tax Credits (LIHTC)**

Low Income Housing Tax Credits (LIHTC)

- Created in 1986 as part of a broader tax reform bill
- Goal is to **provide equity investment** to support affordable housing projects
- Investors (companies) provide funding to projects in exchange for a reduction in their **corporate tax bill**
- Most investors are banks that can use the program to meet federal legal requirements to invest in historically neglected communities (**Community Reinvestment Act**)

Low Income Housing Tax Credits (LIHTC)

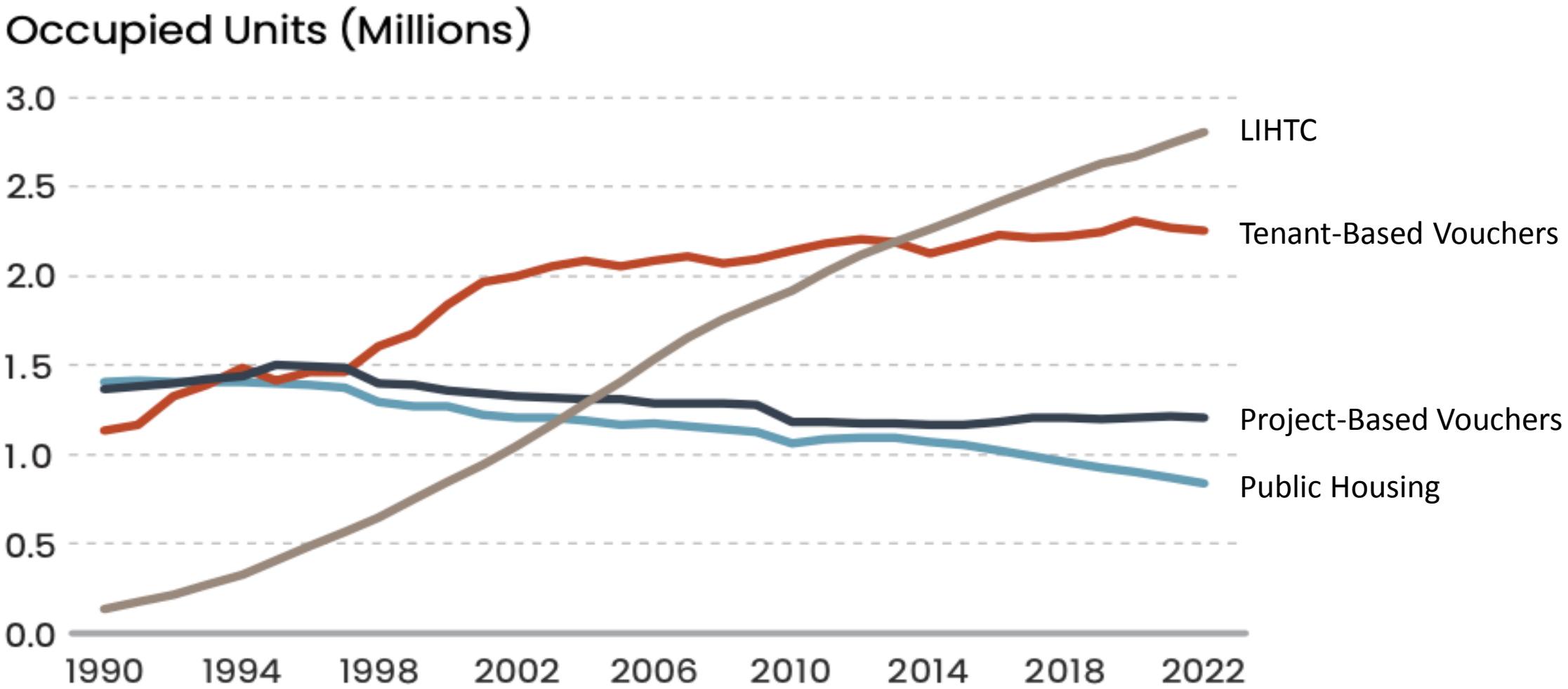
- The investor **provides equity investment** in the project **in exchange for the credits**

- Total credits generated (i.e. total equity) is calculated based on project's **Total Development Costs**
  - Excludes ineligible uses, such as most legal fees, bank fees, taxes

- The investor then becomes a **co-owner** of the property
  - Usually, investor becomes the "Limited Partner"
  - Developer is the "General Partner" who operates building on behalf of investor
  - Both investor and developer share in cash flow proceeds

- Program timeline:
  - Investor receives credits for **first 10 years** ("Credit Period")
  - Credits can be revoked if property not in compliance with program during **first 15 years** ("Compliance Period")
  - Apartments must remain affordable for **30 years** ("Extended Use Period" after Compliance Period)
  - Typically, investors want to **sell their share and exit the deal** after Year 15 – view LIHTC as a 15 year investment

LIHTC and Vouchers Have Become the Largest Rental Assistance Programs



Source: Harvard Center for Joint Housing Studies

Additional Gap Financing

- Mortgages and LIHTC equity are usually **not sufficient** to fully cover costs

- Projects need to find ways to fill this "**gap**" between Sources and Uses

- Three sources of gap financing:

    1. Grants
    2. Operating Subsidies
    3. Subordinate Debt ("Second" Mortgage)

1. Grants

- Often depend on a specific aspect of the project, such as green building goals or specific population served
- Can be from private foundations or local and state governments
- There are also federal grant programs, such as Community Development Block Grants (CBDG) and the Home Investment Partnership Program (HOME)
- Often, developers have to **line up several grants** to fill the gap

2. Operating Subsidies

- **Project-Based Vouchers**: The government supplements tenant rent for a particular unit

- Depending on length of the contract, Project-Based Vouchers can count as a stable long-term revenue source for the project, so the voucher **boosts income** and supports a **larger mortgage → Reduces gap financing need**

- **Tax abatement:** Reduces property tax bills, lowering operating expenses

- By reducing expenses, the tax abatement **boosts income** and supports a **larger mortgage → Reduces gap financing need**

3. Subordinate Debt

- Subordinate Debt is a **second mortgage** that gets paid off only after the first mortgage
- Many local jurisdictions create **revolving loan funds** to provide gap financing this way
- Generally **better financing terms** than regular banks or other lenders: lower interest rates and more flexible repayment terms
- By providing this gap financing as a loan rather than a grant, the local jurisdiction can grow its fund over time so **proceeds are reinvested** to support more affordable housing projects

Affordable Housing Development: Sources and Uses

	Sources		**Uses**
	First Mortgage		Land/Property Acquisition
	LIHTC Equity		Construction Costs (“Hard”)
	Green Building Grant		Design, Permitting, and Legal Costs (“Soft”)
+	Local Government Subordinate Debt		Financing Costs
			Reserves (Construction and Operations)
		+	Developer Fee
	Total Funding Sources	=	**Total Development Costs**

2. Example: Building a 3 Bedroom Affordable Apartment

Model Assumptions

- **Apartment Size**: 1,000 sq. ft.
- **Affordability**: 50% of Area Median Income (AMI), ~$71,000 income for 4 people
- **Building Type**: Low-rise wood frame apartment, $245 per sq. ft. construction costs
- **Operating Subsidy**: 100% Property Tax Abatement (available to non-profits)
- **Acquisition Cost**: $0, Land given away for free (more info on land value later)
- **Mortgage Terms**: 5.5% APR, 40 year amortization

Operating Budget

Gross Rent: $1,960 monthly (50% AMI limit with no tenant-paid utilities)

Net Rent: $1,810 monthly ($150 deduction for tenant-paid utilities)

Annual Rent: $1,810 * 12 = $21,720

Annual Operating Expenses: $9,000

Net Operating Income (NOI): $21,720 - $9,000 = **$12,720**

Development Budget

Total Square Footage: 1,176 (assumes 85% is "core" residential space → 1,176 * 85% = 1,000)

Construction Costs: $245 per sq. ft.

Construction Contingency: 7% of total construction budget

Design, Permitting and Other "Soft" Costs: 15% of total construction budget

Financing Costs (Construction Interest, Fees): 12% of total construction budget

Total Development Costs: (1,176 * $245) * (1 + 7% + 15% + 12%) = **$386,081**

Financing Sources

NOI: $12,720 (See Operating Budget)

First Mortgage: $171,265 (Calculation based off NOI, 5.5% interest, 40 year amortization)

LIHTC Equity: $127,742 (Calculation based off Development Budget, LIHTC credit pricing)

Total Sources: $171,265 + $127,742 = **$299,007**

Note: Specific formulas for mortgage sizing and LIHTC equity not shown

Sources and Uses

Sources		**Uses**
First Mortgage = $171,265		Land Acquisition = $0
4% LIHTC Equity = $127,742		Construction Costs = $288,120
Gap = $87,074	+	Soft Costs = $43,218
		Financing Costs = $34,574
		Construction Contingency = $20,168
	+	Developer Fee = $0
Total Funding Sources = $386,081	=	**Total Development Costs = $386,081**

Understanding the Gap

- **Key Takeaway**: It costs more to build an affordable 3-bedroom apartment than that unit earns in rent to pay for its construction

- Factoring in average land costs (~$100,000 per unit), the gap realistically is closer to **$187,074** rather than $87,074

- The model also assumes $0 in operating reserves (dangerous for long-term management) and $0 in developer fee (developer earns no revenue)

  - **Not realistic** assumptions

  - Brings gap above **$200,000**

Other Factors Affecting The "Gap"

- **Construction Costs**:
  - Taller buildings that use steel and concrete (above 5 stories) have **higher costs** per square foot, resulting in a larger gap
  - $325 rather than the $245 in our wood frame example
  - Davis Bacon federal wage rules for 5+ story buildings push this up to $350+
  - Underground parking also **very expensive** ($50,000-$70,000 per space)

Other Factors Affecting The "Gap"

- **Deeper Income Targeting**:
  - Deeper affordability (ex: 30% AMI) will reduce revenue → **Smaller mortgage**
  - This can be offset with **operating subsidies**, usually reserved for 0-30% AMI
- **Interest Rates**:
  - Higher interest rates → **Smaller mortgage**
  - Over last two years, **big increases in interest rates** have dramatically increased gap financing costs per affordable unit

3. Affordable vs. Market-Rate Housing

Competition or Cooperation?

Land Value Basics

- A single piece of land is **exclusive**: only one development can be created on a given site
- When multiple, mutually exclusive projects bid on land, **only one can be selected**
- Ex: A specific plot of land can be a farm or a building or a park, but not **all three at once**
- Land value is determined by the "**highest and best use**" – the use of the land that will result in the maximum price

"Highest and Best Use" Analysis

- When different projects are modeled for the same piece of land, land value is determined by whatever the project can **afford to pay** for the site
    - Assume that all other factors (construction costs, projected rents and expenses) are **inputs**
    - Land price is the **output** of the model
- Ex: Three projects considered for a vacant lot:
    - Apartment building can afford to pay **$5 million**
    - Office building can afford to pay **$4 million**
    - Factory can afford to pay **$2 million**
- The land is valued at **$5 million** based on the expected "highest and best use" as apartments
- Because the office and factory projects cannot pay $5 million for the project (based on financial models), they are **financially unviable** and thus cannot proceed

Comparing Land Value for Apartment Projects

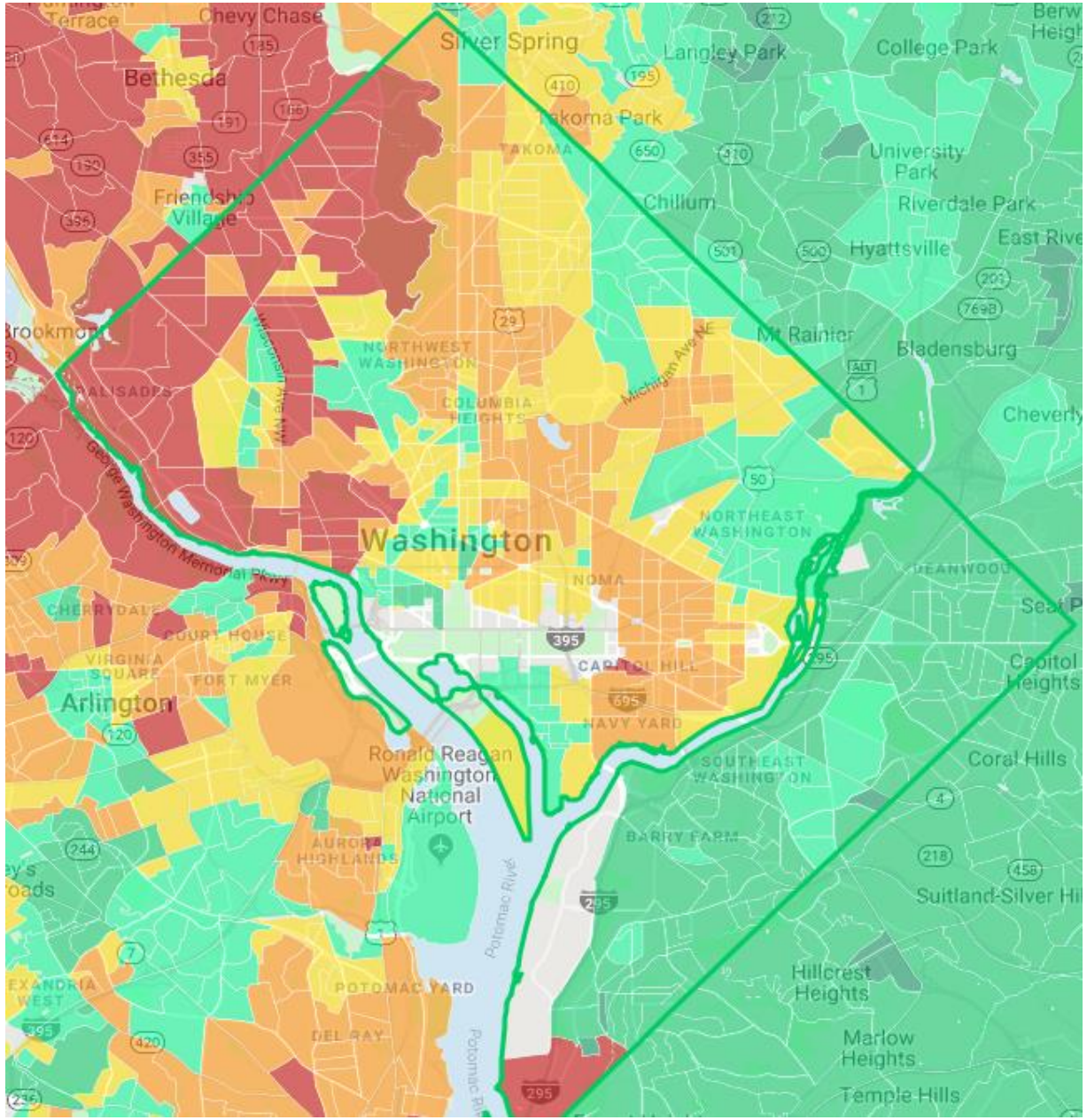
- Highest and Best Use analysis also applies to comparisons **between similar projects**
- Ex: Compare three proposals for a 180-unit 4 story building with same unit mix
  - Project 1 Rents: $1,900 for studio, $2,400 for 1 BR, $3,400 for 2 BR units
  - Project 2 Rents: $1,500 for studio, $2,000 for 1 BR, $3,000 for 2 BR units
  - Project 3 Rents: $1,200 for studio, $1,800 for 1 BR, $2,500 for 2 BR units
- All other inputs **held constant**: construction costs, interest rates, equity returns, etc
- Resulting land value (output of model):
  - Project 1: **$17.5 million**
  - Project 2: **$5 million**
  - Project 3: **$0** (Actually, negative → "Gap" financing needed)
- As a result, the land is worth **$17.5 million** and **only Project 1 is viable**

Implications of Land Value Analysis

- This "Highest and Best Use" Analysis helps explain why cheaper market-rate projects are **not getting built in areas with high demand**
- Because high-rent projects are able to **outbid** lower-rent projects for land, high demand for housing in certain neighborhoods makes building cheaper housing in those neighborhoods **financially unfeasible**
- But **increasing supply lowers rents overall**, which brings down land values and makes both market-rate *and* affordable housing projects more viable
- Increasing supply makes it **easier to finance affordable housing projects**

Median Listing Price

< $75K $1.5M+



Source: Trulia.com

Conclusion

- To build dedicated deeply affordable housing, **significant amounts of subsidy are needed**
  - Federal: Low Income Housing Tax Credits and Tax-Exempt "Private Activity Bonds"
  - State/Local: Subordinate Debt, Operating Subsidies, Property Tax Abatements
- Even removing "**Speculation**" (Land Value) and "**Developer Profit**" (Developer Fee) from the Sources and Uses equation, affordable housing projects still require subsidy
- Affordable housing development is dramatically impacted by **macroeconomic conditions** (inflation, interest rates, land values)
- Market rate and affordable housing are **not either/or**
  - Increasing supply helps to lower land prices and make affordable housing more viable