PRESERVATION EQUITY FUND ADVISORS

Preserving affordable housing

More than a return

David "Mac" McWhorter, executive director of the Institute for Real Estate Operating Companies (iREOC), recently spoke with **Ann Caruana** and **Rich Bennion of** Preservation Equity Fund Advisors (PEF Advisors), an affiliate of WNC. An excerpt of their conversation follows.

What is the affordable housing opportunity, and how does preservation affordable housing fit into it?

Rich Bennion: The demand for affordable housing is overwhelming. Half of the 43 million renters in the U.S. make less than 60 percent of area median income (AMI), but only 18 million units are available to meet that need. Despite a growing demand for affordable housing, most of the new development is market rate, which targets people making 150 percent of AMI. In addition, a large number of affordable units are taken out of circulation each year due to obsolescence, disrepair, gentrification or conversion to market rate, further adding to the ever-growing deficit.

Ann Caruana: Our preservation strategy seeks to reduce the amount of existing stock that is taken off the market each year, and thus help stabilize supply. New development relies on a federal housing tax credit program. About 200,000 units are added each year through that program. However, the tax credits expire 15 years after their origination. At that stage, the tax credit investors no longer have a compelling economic reason to remain in the deal. Despite the expiration of the tax credits, however, these assets are required to remain affordable for another 25 to 30 years, depending on the jurisdiction. That means the current operating sponsor has a few choices.

Either they can redeem out their tax credit investors and operate the property as affordable, they can sell to a buyer specializing in owning and operating affordable housing properties, or they can pursue a resyndication in which the owner refinances the property through new tax credits and regulatory agreements. While resyndication is a great option for keeping affordable housing in the mix, there is a limit on this type of tax credit refinancing, and there simply is not enough resyndication money to go around. So, you have a large group of assets that are not getting the capital infusions they so desperately need.

What happens to that group?

Caruana: That is where we come in. We are targeting that portion of the lifecycle where these properties are not currently compelling candidates for resyndication but still need an infusion of capital to bring them up to current standards.

Bennion: There are a lot of degrees of affordability, but we are focused on assets that were primarily built using tax credits, and designed to serve individuals and households making 80 percent or less of AMI. These assets are valuable and need to be kept in the affordable housing stock, yet there is a mismatch, as the tax credits run out while the affordable requirements remain. This creates an opportunity for our investors to realize market-rate returns while preserving affordable housing.

Caruana: We are not talking about naturally occurring low-rent assets. To be truly labeled affordable, the assets must be means tested. If you cannot verify the household income, you don't

CONTRIBUTORS

Ann Caruana
President & Chief Investment Officer
Preservation Equity Fund Advisors

Rich Bennion
Senior Vice President, Capital Markets
Preservation Equity Fund Advisors

know if you are serving low-income tenants or simply people who got a good deal. The large majority of our residents are means tested, so we know for a fact that they are coming in at 80 percent or less of AMI. In fact, most of our residents are actually at 60 percent of AMI or less.

What happens if someone like Preservation Equity Fund Advisors doesn't step in?

Bennion: As we've mentioned, the tax credits eventually expire, but the rents must remain affordable. If we don't come in around year 15, the property would likely fall into disrepair. Then you have a situation where the property is no longer safe and becomes an eyesore both for the residents — who end up having to live there because they have no alternative — and for the community in which it is located. We are a means of preserving this property by keeping it safe, attractive and affordable.

How do you exit the property?

Bennion: We aim to make sure that we don't just preserve affordability during our tenure, but that the asset stays affordable in the future, as well. That means we try to be selective when it comes to whom we sell to, and at the end of our hold period, which is typically about seven to 10 years, we sell the asset to a buyer who will preserve it as affordable. This typically takes one of two forms. One type of buyer views the asset as a good candidate for resyndication, and so they source new tax credits and use that to invest heavily in the property. Where we might invest between $5,000 and $10,000 per unit in capital needs, a group that comes in and resyndicates would spend 10 times that amount. By using tax credits, they push out the life of that affordability another 40 years, which gets written into the title of the property. Our strategy can be imagined as a bridge from one tax credit execution to the next. The second exit would be selling to a nonprofit community group that has a stated mission of protecting and preserving affordability.

A lot of investors are developing ESG guidelines to use as an overlay in their due diligence. How would affordable preservation fit those guidelines?

Caruana: We absolutely fit into the ESG bucket. First, we hire an energy consultant for every asset we purchase to evaluate the systems for retrofits and upgrades that could help reduce energy costs. These retrofits tend to focus on LED lighting changes, low-flow water fixtures, zeroscaping and solar panels. Utility providers will often come in and do these retrofits for relatively little to no cost to us. For example, we have done solar projects, which would normally cost about $3.2 million, at a net cost of around $75,000 to us. These projects have been wildly beneficial to both the residents and us, as owners, with a payback period of one to two years, typically. They have the greatest impact on older buildings, but even in newer stock, we have seen huge savings on water bills, electric bills, landscaping upkeep costs, and so on.

Do these investments meet other ESG parameters?

Caruana: Affordable rent is the number one social benefit, but we also attempt to provide several social service programs, such as after-school daycare programs, shuttle services for seniors, English-as-a-second-language programs, computer centers and libraries, and all sorts of additional services that can help to improve the lives of our residents and their accessibility to quality lifestyles.

Bennion: Because we do means testing of our residents, we have the data and the metrics to demonstrate that our investment is impacting people who are most at risk. For example, we know that across the almost 700 units in one of our funds, there are 225 disabled individuals. We also know the average income for our residents is around 28 percent of AMI. So, we are able to give assurances to our investors that their dollars are really reaching those people with the greatest need.

How does affordable housing benefit the community?

Caruana: A mix of housing options strengthens a community and makes it more livable. You want the people that work in that area — retail workers, service workers, medical clerks, and even police, fire, nurses, librarians, teachers — to be able to live in that area. Having workers live in the community is a better option than the alternative of shuttling people in, which creates more traffic and congestion, and a lower quality of life. Community members often think of affordable housing as run-down, transient, crime-filled projects. This is a major misconception. Most of the affordable housing deals look exactly like the market-rate deal down the street. You would never know the difference.

Bennion: When people move into an affordable community, they will go to great lengths to protect and preserve that housing. They will invest in the community and commit to ensuring that it is a safe, wonderful place to live. They tend to stay a long time and long-term residency is a benefit to any community.

Caruana: Tenant turnover at our properties is typically 10 percent to 20 percent versus market-rate assets that turn over at higher than 60 percent rates. Having long-term tenancy in a community ultimately helps create stability, pride in where residents live and vigilant neighbors.

What do you look for when sourcing these assets?

Caruana: Location is probably No. 1. We have a data analytics platform that analyzes 70 different metrics across 3,000 counties nationwide. These metrics include things like job growth, AMI growth, population growth, the gap between rents at 60 percent AMI versus the market-rate rents in an area. There are some obvious areas on our list — New York, San Francisco, Los Angeles — but our analytics are finding those attractive secondary and tertiary markets that are becoming less affordable and might have some of the best investment opportunities. Besides being part of the truly affordable stock, a targeted asset needs to have some level of operational or physical deficiency that we can correct and add value for our investors.

You mentioned investors. Why would an investor want to invest specifically in a preservation affordable strategy?

Bennion: The investors with whom our strategy resonates are drawn toward the unique combination of apartment exposure, affordable housing and impact investing. The old canard that you had to give up returns to do good no longer applies. These are investors that want to have a positive impact and still achieve an economic return.

Caruana: We also have CRA-motivated (Community Reinvestment Act) investors, such as banks, that are required to invest in their local communities.

Bennion: The CRA requires that their investments serve the public welfare, and these investments qualify in that regard. So, by investing in the preservation of affordable housing, they are meeting the needs of the community, satisfying regulatory requirements and still achieve an economic return.

Why is the risk profile for affordable housing so low?

Caruana: First of all, the vacancy rate is miniscule. We are talking a 2 percent vacancy versus a 5 percent vacancy in the market-rate properties. In addition, the tenant pool is sticky. Waiting lists for affordable housing often have more than 100 names on them and take years for a person to move to the top. Finally, as Rich mentioned earlier, our tenants will do everything they can to stay in their apartment. Our portfolio was 98 percent collected during the pandemic when you had market-rate portfolios at 90 percent collected — and sometimes even lower.

Bennion: One of the things that our investors value is that we are coming at this from an affordable housing specialist mindset. We aren't a multifamily manager dabbling in affordable housing. Our team is able to leverage more than 50 years of expertise, relationships and an expansive network in the affordable housing space, and apply that to our preservation strategy. That comes through in how we identify properties, how we execute in creating value on the ground, to understanding where our capital investment can be the most impactful for the property and for the residents. It also comes through in our relationships with investment sales brokers, both for deal flow and when we go to sell. We really have an operational and an execution advantage because we are affordable housing people first and foremost.

OVERVIEW

Since 2017, Preservation Equity Fund Advisors, LLC (PEF Advisors) has focused on acquiring and preserving existing affordable housing in high-cost markets through private equity funding. PEF Advisors is an affiliate of the WNC family of companies, with access to WNC's more than 50 years' experience in acquiring more than 1,700 properties representing $15.1 billion in affordable housing nationwide, including through tax credit and/or preservation equity strategies.

CONTACT

pefinfo@pefadvisors.com | 714.662.5565
www.pefadvisors.com