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Investors Have Strong Opportunity with Affordable Housing Transactions

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Between now and 2020, half of the 2 million affordable housing units in the United States will reach Year 15, the point when the current low-income housing tax credit (LIHTC) compliance period expires, according to the U.S. Department of Housing and Urban Development. As a result, interest in recapitalizing LIHTC properties will grow, and new capital should benefit both residents and owners of affordable multifamily housing. It will also provide new opportunities for investors.

Now is a good time for owners to invest in multifamily real estate. Low interest rates, rebounding property values in many regions and continued demand for multifamily housing create an attractive atmosphere for investing. LIHTC properties are perhaps the most stable asset class within commercial real estate because of public support in the form of tax offsets for owners and investors, rental rates cushioned against potential downward market pressure, and significant demand from eligible tenants.

Even with favorable conditions for investing in LIHTC properties, investors must consider many factors as they go through their underwriting process. These are commercial real estate properties, and investors must focus on the fundamentals of each property, as well as the accounting and compliance requirements associated with the tax credits. Here are some best practices to keep in mind.

All Real Estate is Local

Real estate investors know this, but it's important for affordable housing investors to remember that not all real estate markets are stable and not all affordable housing units are equal. In certain parts of the country, especially high-priced urban areas, the premium for a LIHTC unit is dramatic. In parts of New York City or Boston, the maximum LIHTC rent can be as much as 45 percent to 60 percent below the market value for comparable units. Raw land and existing buildings are also quite expensive there, which means few if any developers are likely to provide competing low-income housing. High barriers to entry and low rents relative to the market materially reduce the risk to LIHTC investors.

In other places, however, barriers to entry are much lower. For instance, in some southeastern U.S. markets, the maximum LIHTC rents offer little discount to market rate, and the cost to build new multifamily units also may be relatively low. In those cases, consider the likelihood that someone may put up a new building across the street or convert an existing building to LIHTC units–and make sure your asset would remain marketable. In these markets, tenants have more options and demand from qualified tenants is not as stable, so investments have more risk.

Evaluate Maintenance and Long-Term Capital Expenses

LIHTC investments are for 15 years. During that time, a lot can happen and usually does. The investing partners must be prepared for ongoing maintenance and capital improvements. In addition, consider what amenities the tenants need now and may demand in the future, such

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as high-efficiency mechanical equipment, on-site parking, in-unit washers and dryers, free Wi-Fi or common areas with computer access or big-screen TVs.

Keep in mind that during a 15-year period there will be one or two economic cycles when there may be more units available than there are eligible renters, putting tenants in the driver's seat. When that happens, tenants will favor the units with better and more amenities. To attract high-quality tenants over the long term, the partnership must allocate resources to the maintenance and upgrades that renter's demand.

Consider Going Green

Recapitalizing with new tax credits may allow upgrades to green technology to enhance operating performance. When it comes to environmental upgrades, such as improved insulation and high-efficiency kitchen appliances, many commercial real estate owners question the value, as the benefit often goes to the tenant in the form of lower utility costs.

However, going green improves marketability by providing a hedge against higher utility costs for tenants while reducing the utility expenses born by the property owner. Consider that common areas in apartment buildings may include community rooms with TVs and computers, and many others have elevators or fitness centers. The property owner is responsible for those costs and measures such as replacing windows or installing upgraded HVAC systems and lighting ensure lower energy expenses over the long term. Also, building codes are continuously being upgraded in communities across the country, and refinancing with tax credits is an opportunity to get ahead of the curve on functional obsolescence. If you don't install low-flow toilets now, you may have to do it later, when the investment will not generate tax credits. In addition, tenants care about utility costs as well as environmentally friendly design. So incorporating more green technologies may make your units more marketable and ultimately more profitable.

Keep Up with Public Programs that Provide Operating, Capital Support

There are a number of programs across the nation that provide direct benefits to tenants who qualify for affordable housing units. The most common examples are Section 8 and the new Rental Assistance Demonstration (RAD) program, both of which offer rental support for low-income households and thereby support the operations of affordable multifamily housing. These programs are vital to serving the lowest income levels. They also reduce risk for investors and add stability to the LIHTC market.

RAD has improved the risk profile and access to private capital for public housing, which often serves the lowest income levels. In its traditional form, a public housing unit is revenue neutral; its net operating income (NOI) is zero, so there is nothing for an investor to capitalize. Straight public housing transactions still happen, and Bank of America Merrill Lynch has successfully invested in many, but RAD materially improves the landscape for investors because those transactions generate NOI.

In additional to operating support, several state and local governments provide capital subsidy programs to support affordable multifamily housing. For instance, New York, California, Massachusetts and several other states have subordinate, deferred payment debt programs and state specific tax credits that reduce the debt burden of the property. More capital and less debt means improved asset quality for both owners and tenants.

Conclusion

As we look to the wave of refinancing LIHTC properties that has already begun, transactions closing today are going to benefit from historically high tax credit prices, as well as historically low interest rates. But, there are many other considerations investors in LIHTCs must consider as they price a transaction and head into negotiations. The LIHTC program currently provides homes for more than 2 million families and individuals around the country. As about half of these assets reach the end of their 15-year cycle, we look forward to many innovative investment opportunities that will provide high-quality, safe and affordable housing for millions of people for many more years to come.

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