State of the Market 49:
Affordable housing's orphan properties

By David A. Smith

All of us in affordable housing are stakeholders in a system that is failing the needs of more than 2,000,000 apartments nationwide – existing properties that were long ago developed, and now are owned, occupied, and managed, but sliding from decline and deterioration into decay. When they were being created, these properties received lavish attention. Now they're overlooked or bypassed by policy makers and resource providers, even as they are unable to maintain themselves, or to tap financial transactions that could revitalize them. Largely forgotten though increasingly essential, their neglect at the policy waste and resource level represents a huge waste.

Where do orphan properties come from?

Affordable housing properties in the US use project finance, not enterprise-level corporate finance. Unlike REITs, where all properties are owned by a single entity that accesses one master loan facility, each affordable housing property has its own single-purpose vehicle ownership entity, its own subsidy structure, its own regulatory agreement, its own first mortgage loan, its own junior financing liens, and on and on. Everything about that property is specific to that property, and none of it is transferable.

The specificity is good news at the beginning. Thereafter, it's bad news.

At inception, each particular is negotiable and negotiated, and as anyone knows who's reviewed the financial projections for a new LIHTC

Everyone has forgotten about us.

property, we achieve extraordinary granularity of transaction structure. That's the good news.

The bad news comes as soon after the financial closing as something unexpected arises, because all those oh-so-precise clauses are now so many strands of an unbreakable web that binds the property to a particular course for action, one that worked in the before time, and may doom the property now – or, more commonly, condemn the property to years and eventually decades of being an orphan.

What distinguishes an orphan property?

An orphan is an existing property, slowly declining into obsolescence, that is no one's urgent priority though everyone knows one unlucky event will turn it into a full-blown crisis. Orphans struggle with one or more handicaps:

- ***Physical obsolescence*** that makes it imprudent to open up the building's skin

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for anything short of a gut rehab. Electrical systems designed before microwaves, broadband, or big-screen televisions. Plumbing in two-pipe systems, or that uses PVCs. Narrow corridors or small doorways. Large kitchens with big empty space. Bathrooms with embedded tubs or under-sized sinks, vanities, and cabinets. Legacy asbestos-containing materials (ACMs) or lead-based paint that has been encapsulated.

- ***Overly engineered financing*** that prevents refinancing or recapitalization. Debt that cannot be repaid, contractually or because of ruinous yield maintenance. A multi-mortgage capital stack with diverse and distant debt holders. Deferred financing that is hopelessly out of money.
- ***Suffocating use agreements*** that block eligibility for new resources. Extended-use agreements that go beyond the property's physical life. Public housing's negative-NOI-dependency covenants. Qualified Contracts whose rules squelch potential economic value. Deep income targeting that is infeasible without income subsidy. Procedural hurdles (e.g. notice laws, rights to match) that although defensible in theory in practice represent palisades defending a castle no one wants to assault.
- ***Toothless enforcement mechanisms*** that has lost their bite due to changing circumstances. Threats of LIHTC recapture after Year 15. HUD or state agency previous participation denial or administrative sanctions on entities that have exited affordable housing.
- ***Misaligned sharing arrangements*** that fail to compensate risk-taking or thrift, and instead reward sloth. A divergence between control (held by the managing general partner) and economics (limited partners or noteholders). Deferred development fees unlikely ever to be fully paid.
- ***Demotivated ownership*** that's lost its market knowledge and has become content just to cash the management checks. General partners who no longer do new affordable housing transactions. Limited partners with no knowledge of LIHTC market, no activity or removal rights, nor any ability to compel property sale. Corporate investors who find themselves drowning in tax-loss carryforwards and now-useless tax deferred assets. Identity-of-interest companies run by the founder's next generation from their house somewhere warm, wet, or west, far from the property.
- ***Tax barriers to exit*** that motivate investors to shuffle off this mortal coil before the property does.

Some decades after completion, the orphan property has become functionally unconscious, where the current (old) rules compel the status quo, motivations and incentives that worked so well in the property's youth have been exhausted, and no participant will tackle the challenges.

Types of orphan properties

Today in America, we have at least six types of orphan properties:

- ***Legacy public housing***, especially those owned by smaller authorities (of which there are more than 2,500 nationwide). Generally built in two great waves: family properties just before World War II, and then in the early 1960s a second wave, some family and many elderly. Thus they are 50+ to 70+ years old, solidly built for bygone times. This inventory carries a huge unfunded mandate – its capital backlog that HUD has estimated at $26 billion (and I believe is more likely $50 billion). Often well located. Frequently managed with operational and financial-control systems in vogue when Eisenhower was president. Maybe 750,000 of them nationwide, in perhaps 5,000 properties.

- ***Section 202 elderly***, smaller high-rises built by faith-based groups, mainly in the 1960s and 1970s. Typically 40-50 apartments, often on land provided by a church or synagogue. Owned by individual non-profit corporations whose board members are often as old as the average resident. The most delightful people with the most obsolete physical configurations, a window into the past of tiny apartments and low-wattage electronics. Perhaps 250,000 apartments in 5,000 properties.

- ***Section 515 in rural areas***, financed by the Farmers Home Administration (FmHA, now the Rural Housing Service of the US Department of Agriculture). Family-style, most typically 24 or 48 apartments in two and three-story breezeway-style walkups, built in non-urban areas, some of which have since been engulfed by expanding coastal metropolises. Between initial regulatory agreements (post-1989 properties) and the largely-forgotten Emergency Low Income Housing Preservation Act (ELIHPA), they are legally or contractually barred from prepaying their FmHA loans and going market. Though eligible for a form of FmHA preservation, that program is inadequately appropriated, so the properties wait in extended limbo. They may be too small to manage profitably, because they cannot support an onsite resident manager or superintendent. The local general partner interest can have negative value. Possibly 250,000 apartments nationwide in 7,500 properties.

- ***HUD older assisted budget-based rent properties***, financed under §221(d)(3) or §236, and for one reason or another unable to partake of the preservation incentives available under ELIHPA or its successor, the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA), whose funding was suspended in 1996. Although operated by for-profit entities, typically with individuals as original limited partners, these are physically and operationally similar to the §202's mentioned above, and largely bereft of

transaction potential. Perhaps 200,000 apartments in 1,250 properties.

- ***Post-mark-to-market (M2M) properties*** with large secondary notes. While M2M (1997-~2002) was an entirely sensible program that provided a workable and fair restructuring solution for thousands of properties, it left as its aftermath a host of soft secondary notes, bearing interest and payable from 75% of available cash flow, with an acceleration on refinancing or sale. HUD (still) holds these notes – though I once pitched HUD that they all be bundled up and sold (preferably to someone like Recap, for instance) to facilitate or accelerate recapitalization transactions. Another 250,000 apartments, maybe 1,500 properties.
- ***Post-Year-15 LIHTC properties*** with no viable exit strategy. With extended use agreements (or their predecessor, Qualified Contracts) acting to prevent any change in use, the corporate investor limited partners have no prospect of meaningful residual value. At the same time, the corporations will have large negative capital accounts, so disposition will be taxable income for them, and in the meantime, they are immune to LIHTC recapture because the period has lapsed. So they sit as passive investors, occupying P&L space. Probably 350,000 apartments in 3,000 properties, rising by roughly 100,000 a year.

This adds up to more than 23,000 orphan properties, 2,000,000 orphan apartments. (They are uncounted[1] because they are largely undefined and largely overlooked.) Collectively they represent perhaps $160 billion of replacement cost, if they could be replaced at all. They're a precious national resource, and they are suffering from a national policy of benign neglect.

What happens to orphans?

For orphans, the baseline is senescence. They decline until they reach one of two end states: physical collapse or rescue.

- ***Physical collapse***. There comes a point when the existing structures are more expensive to renovate than it would cost to build new housing from the foundations up. This happens when a property's systems, especially plumbing and electrical, are just so substandard throughout that there is no point replacing any given link in the chain – you are better served by replacing the entire thing, end to end. When you are opening up so many building surfaces – wall, floors, and joists – the cost to maintain partial systems in place is greater than just dismantling them for scrap. The aggregate structure now has negative physical value.

  In my experience, negative value arrives when the structure is older than about 45. As such, the legacy public housing is on the verge of systemic, portfolio-wide breakdown, and the §202's are not far

[1] All figures in this section are personal rough-justice estimates based on experience and some knowledge of the databases; do not rely on them!

behind. That's why RAD, HUD's public housing Rental Assistance Demonstration, is essential – without it, many of these public housing properties will slowly crumble.

- ***Rescue***. For negative-value properties, rescue means demolition/ rebuilding with the resources in place. This has already happened with two cohorts: on-post military housing and HOPE VI. In both cases, the orphan property was swept up like Annie by a Daddy Warbucks with a fistful of new cash (volume-cap bonds, LIHTC allocations, soft financing from not-yet-insolvent state governments) to afford a completely reinvented transaction.

Orphans hoping for rescue have only one problem: less than 1 orphan in 50 gets recapitalized yearly. Today's LIHTC annually funds about 80,000 apartments, and new production consumes at least half of the national allocations; the orphans lose much too often.

What affordable housing's orphans need

Orphans lack resources to save themselves. They need three things:

- *Guardians*. Capable, proven ownership entities motivated to save orphans. Licensed, regulated, financially transparent, governed with integrity, and approved for defined geographies.
- *Guardianship orphanage*. Expandable portfolio-ownership structures that make it cost-effective and profitable to take in and nurture the next orphan property, preferably with enterprise-level regulation instead of property-level restrictions.
- *Guardianship monetary incentives*. Advantaged access to financial resource to facilitate transfer. Seller exemption from contingent exit taxes, mandatory rollover of subordinate financing not impaired by the acquisition, annual asset management fees payable 'above the line' as operating expenses, and potentially higher property management fees as well.

Money's important, but money comes third; the ownership structure comes first. If we want a model for how it could work, look no farther than the United Kingdom, which has operated just such a system effectively for more than two decades.

Conclusion: time to act

If we're serious about affordable housing, it's time for legislators, appropriators, allocators, and portfolio owners to rediscover America's orphan properties, to make them a priority, and to rethink and remove the legacy legal, regulatory, administrative and financial structures that are condemning them to policy neglect.

Otherwise we'll watch $160 billion worth of existing affordable housing fall into crisis before we know it.

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