State of the Market 50:
Another year in the guru

By David A. Smith

In addition to *State of the Market*, I write *The Guru is In,* a monthly column for *Tax Credit Advisor* (an essential publication for anyone active in the LIHTC arena). Though shorter, more technical, and focused particularly on affordable housing, the *Guru* columns form a useful complement to *State of the Market*, especially when they're bundled together in a year's review.

January: Wanted, a new green capital form to make a market

A mortgage is a wrapper around a bundle of collateral, staking a priority claim on everything inside it. And if that were not enough, many if not most LIHTC properties done today also have junior financing. Further, no matter how soft these junior liens' cash-flow payment provisions, they too are secured by mortgages, second or third or even fourth, and they too tend to accelerate upon sale or refinancing.

Stack them one atop the other and the result is a capital stack so tottery that any disturbance sets off reverberations, and general partners are understandably loth even to touch it.

With such a tottery capital stack, currently available debt sources, inculcated with love of mortgages, are never going to embrace green technology fast enough to create a marketplace we can use. We need something else, and there are three candidates: tax-advantaged equity, pay-

Do I have your attention now?

for-performance equity, or a revival of the chattel-lien loan.

February: "Do I have your attention now?"

My friends in California have just been handed their heads by the California Supreme Court, which upheld the legislature's elimination of the state's redevelopment agencies (RDAs), an action that will eventually recapture $5 billion annually for the cash-strapped state.

The Californians were defending permanently established entities throughout the state. They were stronger statewide than LIHTC is nationwide. They were well organized and committed. They were going against people whom they thought were secretly on their side – a liberal Democratic governor and a liberal legislature. Offered the chance to take half a loaf via a reprieve the legislature enacted contemporaneous with its RDA elimination, they

refused to compromise and chose a trial of strength.

They got obliterated, losing 7-0 on their elimination and 6-1 on their stay of execution.

Do I have your attention now?

March: Virtual property management

Today, when we deliver property management to affordable housing, we are stuck in site-specificity – each property operating as independently as a frontier outpost – even as it is overwhelmingly evident that we should be migrating to a more virtualized property management – because we can, because it will be cheaper, and because it will be better for residents and for affordable housing.

Hub-and-node property management will enable us to manage smaller and rural properties better and cheaper. It will facilitate scaling of capable property managers, and reduce barriers to replacement of underperforming managers. It will create an easy and low-cost means of capturing a rich lode of operating performance data that can be mined for meaningful comparisons (including across program types) and operating optimization. It will enhance the potential for service overlays for specialized populations.

Hub-and-node property management is a better model and it's surprising we haven't adopted it. That it hasn't yet happened is due solely to the absence of a galvanizing change-maker – a visionary philanthropy, a large-scale sponsor, or a government mandate – whose action triggers enough early adopters that the network effects take over.

April: Say goodbye to the 30-year fixed?

A few weeks back an extremely insightful friend of mine, the guru's guru as it were, was musing about the GSEs' future and out of him popped an idea which at the time I rejected with the autonomic response of a knee struck by a rubber hammer: *Do we need a thirty-year fixed-rate mortgage?*

As affordable multifamily capital consumers, all of us *like* the permanent fixed-rate loan, and we'd be sad to see it go. But we don't absolutely need it: if the loan rate were fixed only for fifteen years, or even ten, with a reset tied to an index (e.g. like-term Treasuries), in actual fact we could develop and operate against such a capital environment. We might yearn nostalgically for our vanishing assumable fixed firsts the way some of us reminisce over incandescent light bulbs … and life would go on.

May: The virtues of financial intermediaries

In a world of instantaneous communication, why do financial intermediaries exist?

In 2008-09, when several billion dollars' worth of LIHTC could not be sold at any price, resulting in the well-intentioned but badly ill-conceived Exchange program, we experienced a great syndicator disappearance. If ever there were a moment to disintermediate LIHTC acquisitions, that was it, the more so as the market rapidly returned to basic functionality, with every Ask getting a bid.

Even though the time seemed ripe for greater direct investing, we saw new syndicators sprout like crocuses, and there must have been a reason.

Their value proposition is four discrete activities that are worth more together than separately:

- **Choose** the best fits for each investor's objectives (yield, CRA, safety).
- **Refine and transform** the raw material (real estate ownership) into a product (stream of tax credits) without 'impurities' (risk and volatility).
- **Absorb unquantifiable risk** not in the real estate but in the financially collectible structuring intermediary.
- **Outsource handling charges**. For institutions with administrative chargebacks based on FTEs, it's way more cost-effective to 'pay in rate' by outsourcing the investment functions.

Boiled down to essentials, financial intermediaries provide two core benefits: they save the clients (developers or investors) time and hassle, and they add value through transaction optimization.

Funny, those are the same two core benefits by which Recap has thrived for just under a quarter of a century.

June: Financial tools invented financial man

Which came first, the preservation transaction or the preservation entity?

The entity, chorus the faithful readers as one. *Deals do not just do themselves. It takes developers to find them, finance them, acquire them, and own them.* In one sense, of course, that is true. In another, it is dangerously false.

For science-fiction author Arthur C. Clarke, man's discovery of primitive tools – preserving and using fire, cutting with stone axes – was the catalyst that lifted us from grunting pre-sentient hominids into a civilization and society of tool users, hence tool makers, and hence language inventors. In the same way, affordable housing's use of government-provided tools (laws and money) has been the evolutionary spur for us as individuals to develop the roles, businesses, and companies that now dominate our ecosystem.

A hen is only an egg's device for making another egg. A preservation transaction is only a property's mechanism for attracting new subsidy resources to itself, and a preservation entity is only a pollinating bee bringing those resources to the property needing them. Change the policy environment, change the laws and the money, and some entities thrive while others wither away.

July: Value-engineering property costs

To control LIHTC development costs, we need to look beyond physical technology and re-engineer our financial technology – namely, the affordable housing development value chain.

A value chain is a set of procedures and links that, taken together, convert raw materials (laws, capital, and subsidy) into finished products (namely, affordable homes and apartments). Today's LIHTC value chain is badly inefficient because it is festooned with gimmicks, requirements, tertiary and even quaternary mandates and details, each added in the belief that just one incremental wafer-thin requirement wouldn't make any difference to viability.

At the California Housing Consortium's annual policy forum, six of us brave souls identified five clusters of financial-technology innovations that could easily cut total development costs in half: land zoning and density bonuses; design

elimination of luxury amenities; consolidate financing sources to reduce assembly costs; eliminate non-market construction requirements; and streamline the processing sequence. (Particulars are in the article.)

August: When to partner

Next to 'resource,' 'partner' is about the most overused word in today's affordable housing. Judging by the email announcements, everybody is partnering with everybody else – and yet, most of these usages are euphemisms for crasser bargains: I get money from you, I hire you, you find business for me, you and I use each other for our own unshared objectives.

Real partnering is genuinely rare.

Partner only with entities that have something you permanently envy. Jealousy is an evil trait – we wish to deprive someone else of something they have and we lack. *Envy*, on the other hand, can be benign so long as we're aware of it, and in fact many compliments have their roots in socializing envy.

Partnership means a shared journey into the unknown across time and risk, and for us to remain partners throughout that shared journey, we want always to be pleased with our business traveling companion.

September: How to partner

How to partner. *Align incentives by keeping it simple and shared*. Contracting is not about sharing: you do your job, I pay you. In partnering, the more elements we share, the more intertwined our interests become, the fewer distinctions we make, and the easier it is to concentrate on achieving and optimizing our goal.

When to go your separate ways. *Split up when there's no longer contributing value from* <u>*each*</u> *partner.* Document in advance how you will split, and perhaps more importantly, how you both will be aware of *when* it's time to split.

October: The Metaphysics of Tax Credit Risks

In *Historic Boardwalk Hall,* the tax court found "that there was no true entrepreneurial risk faced by the investors." In other words, the Court asserted metaphysics, claiming to perceive a fundamental reality at odds with the parties' stated intent and contractual constructs.

Metaphysical contradictions abound in any tax code, especially tax credits. We sell tax credits, except they're not booked as sale proceeds. We get below-market soft loans that no one expects to repay for decades if ever, and count them as valid debt based on gauzy and ethereal calculus. We say entities are non-profit-controlled when the non-profit has the rights of a child in a car seat. We say tax credit equity value should be counted *in* for eligible-basis appraisals but *out* for real estate tax appraisals. All these are metaphysical contradictions that we have come to accept without thinking.

November: The People Niche

In affordable housing, many of the people we are seeking to reach aren't capable of being self-sufficient, and we're committed to housing them as part of an overall goal of improving or supporting their self-sufficiency.

Increasingly, LIHTC properties focus on the last group – those not self-sufficient – and what unites all these LIHTC niche properties is the use of rental housing as the nexus of social services, the

gateway through which service providers reach large numbers of worthy people that we as an American society have decided deserve help. Bringing the services to the housing, instead of the housing to the services, is cheaper, better for residents, and more customizable.

For all these sub-populations, our value proposition is not simply ‘decent, safe and sanitary” housing, a standard that was enough in 1949 but is not enough today. Rather, our proposition is *Plus*:

- Housing *plus* services as an integrated and coordinated ladder toward self-sufficiency.
- Housing *plus* job training, or *plus* wellness activities, or *plus* English as a Second Language, or *plus* recovery from substance abuse, or *plus* after-school tutoring.

In all cases, the *plus* is particular to the property's target population, important to their life and well-being, and part and parcel of the housing delivery.

December: New Market: Tax Credits?

The election's over, so tax credits are safe for four years … aren't they?

Not quite; they're safe from frontal assault, but extremely vulnerable to a flanking action, and for the life of me I can't think of what to do to mitigate the political risk.

If none of the tax increase options [discussed in the column] are adopted, there's still the old favorite: closing loopholes, especially the corporate kind.

You say it can't happen? I say to you, 1986.