State of the Market 54:
What do you see here?

By David A. Smith

When it comes to understanding the affordable housing industry's zeitgeist, nothing beats the annual *AHF Live* conference: while the panels are the notional attraction, everyone is *really* there to meet everyone else, and amid the nonstop deal-making, deal-mythmaking, and deal-fibbing one can hear the most revealing things in what is said and what is *unsaid*.

Herewith from Chicago, what I heard, saw, and thought.

Thank you for sharing that, Part 1

[Overheard from a cellphone conversation.] "They either have the funding or they don't. … We've been talking for months and months and months about these deals. … *Now* they tell us?"

"It took seven years to get the VA to execute a lease to the property so we could develop it."

"We closed a tax-exempt-bond deal without deep subsidy in 2008, and now we're actually closing one today. That's a gap of five years."

"Prevailing wage pretty much ruins your feasibility. Of course Davis-Bacon wages vary greatly around the country and by county. It may be entrenched in the big cities, but look a little farther out."

"When we do a tax-exempt bond deal, there are roughly eight things we check. If we get seven of the eight, the deal is probably viable. If you get all eight, you might actually make some money."

*Maybe it's upside down … or maybe **you're** upside down*

What's the price of land in terra incognita?

To their immense credit, speakers and audience members alike were forthcoming about the curious asset classes and property niches they were seeking to explore and colonize, including:

- *Volume cap without subsidy*. In some locations, the gap between market rents and LIHTC is small, land prices are low, and volume cap is plentiful. There one can make the numbers work with classical two-source financing: volume cap bonds and equity from 4% tax credits. It takes searching and a sharp pencil on the (real) operating expenses, but the deals are out there.
- *Conventional apartments into affordable housing*. In much of America, LIHTC rent caps are higher than local market – and in many of these markets, older Class B– through C– conventional property needs

an upgrade of physical configuration, building systems, management, and ownership.

- *Non-residential property into housing*. In the quest for post-zoning raw material (see *Zoning approval is a renewable asset* below), developers are coming to see *any* empty well-located structure that's lost its original business purpose as potential future housing, especially if it has plenty of plumbing. So a moribund downtown hospital is reanimated into elderly housing, and an old garment factory is stitched into urban hipster apartments.
- *Repurposing of dead malls*. As the internet dematerializes the retail business, many a shopping mall has gone utterly dark, leaving behind an immense big-box structure surrounded by acres of parking. While such facilities don't lend themselves to housing people, they do work admirably for housing people's *goods*. Indeed, converting a big-box corpse into interior self-storage serves multiple purposes: it reanimates a space that has otherwise gone dormant, makes use of the building-level HVAC systems; and because the property is platted, serviced, built and parking-provided, it paradrops over the normal NIMBY barricades (zoning, land-use, and environmental).
- *Privatizing public housing via RAD*. Slowly the affordable housing market is waking up to the reality of RAD's unannounced revolution. In only a year and a half, RAD has moved from a Wild Idea to Do-It-Again, as RAD transactions were among the conference's most proven performers.

As *State of the Market* readers know, Recap has long since colonized the reinvention of public housing via RAD; we have roughly a dozen RAD properties in process and more in the proposal pipeline. And RAD is *still* the most promising game in town, especially for private affordable housing developers looking for under-valued and value-additive real estate.

Everything is subtext, isn't it?

Panel titles are polite euphemisms for the unvoiced fears that our mind rewrites into subtitles, such as these from AHF Live:

Uncovering new financing sources
Our deal doesn't work anymore, so please tell us how to find free money … quick!

Developer diversification
Nothing pencils out but I've still got staff, overhead, and loans to pay, so give me a wild idea to keep them busy.

Choosing the best debt financing strategy in an unpredictable market
Interest rates won't rise before I get my deal closed … will they?

Capitol Hill Update: Tax reform
News from Washington is always bad, so please tell me there isn't any.

Brainstorming innovative strategies
'Innovative' sounds much better than unproven, and 'brainstorming' means somebody else will go first.

Exit strategies 101
Can I exit my investors and lenders without exiting myself?

They said Columbus was crazy

On my panel about Innovative financing sources, I proffered a Six-Step Approach to Creating a New Product Line:

1. *Disbelief*. "I can't believe our original business isn't working." Before one will redirect substantial organizational resources into a new business line, we have to perceive, if not necessarily accept, that the old bread-and-butter business simply isn't working.
2. *Desperation*. "We've got to do *something*." Companies are platforms of sunk costs and required overhead expenditures; unless they're willing to close up shop, they must always be bringing income. Necessity may be invention's mother; desperation is its father.
3. *Wild ideas*. "It's a floor wax! It's a dessert topping! You're both right!" By definition, anything new either has never been done before or done so long ago no one remembers. Any time the idea is first voiced, it will seem wild; if it doesn't seem wild enough, it's certainly not innovative enough.
4. *Serendipity*. "Every pearl begins with a piece of grit." In nearly four decades of doing affordable housing transactions, I've never seen one that was perfectly cookie-cutter. For our wild idea to gain traction with other parties (sellers, lenders, resource allocators), they too must have an unusual problem or feature they're trying to addressing. Put together two desperate people and you sometimes have serendipity.
5. *Boat-burning*. "March or die." Everyone who's ever developed, financed, or banked a transaction knows both that there is never certainty about the path but there comes a point when the leadership must display certainty of result that we *will* close, come hell or high water. It may not be true; the leader may even know it's not true; but the leader must act as if it's true, or it won't be.
6. *Do It Again?* "Once more, with feeling." Somehow, if only because everyone has invested too much to turn back now, the transaction finally closes. When that happens, after the exhausted elation and relief, the pioneer can recognize the next raw-material property that could be a good candidate. What seemed unrepeatable now seems like the first of a series.

Thank you for sharing that, Part 2

"Can you imagine being at HUD these days? I've been on some HUD staff LinkedIn pages and they're publicly counting down the days 'til pension vesting. Is that blatant or what?"

"We can no longer live off the development fees in properties where there are deeper rent skewing requirements in the QAPs."

"I'll use the government's own bogus statistics to validate my bogus statistics."

Zoning approval is a renewable asset

As the zoning barriers rise (see *More's the Laws, State of the Market 37, April 2011)*, the value of previously built structures rises dramatically. Even if the building has lost its original purpose, even if its internal systems must be gutted and built anew, the property's intangible assets – location, in-place zoning approvals, height or

setback variances – have increasing economic worth, *especially* when the building's repurposing is from non-residential property into affordable housing, because then the derelict is turned from a local economic deadweight into a jobs and sales generator.

With increased American urbanization, most of our population growth is in cities. And because people cannot sleep in the cloud, residential housing is the one asset class that the internet will not destabilize. As a result, in many downtowns the only thing booming is housing.

Very few metropolitan areas can grow exclusively through greenfield development. Today everything urban is brownfield, transit-oriented, or adaptive reuse. Even energy conservation is in on the act, as environmentalists discover to their surprise that the 'embedded energy' or 'sunk carbon footprint' of a building shell means renovation is more environmentally friendly than demolition and rebuilding.

In short, that's not a derelict factory; it's future affordable housing.

Trust is our most precious asset

If the future of affordable housing development lies in redevelopment of regulated urban spaces, then the core competency of affordable housing developers is overcoming political barriers to new production.

"We had to work incredibly closely with the city" – variations of this statement were said by speaker after speaker as they described tortuous development processes, seemingly endless public hearings, reports and filings and procedural obstacles. Most such stories were told briskly, matter-of-factly, because everyone recognized that they are unremarkable tales in a nation where as-of-right zoning has gone extinct.

Affordable housing development used to be about achievable rents and reducible construction costs. Now it's about gaining, using, and preserving stakeholders' trust, and using that trust and our own trustworthiness as a catalyst to summon discretionary resources, turn them into positive real estate and policy outcomes (by again deploying our trustworthiness in the capital markets), and then harvest new trust (from the visible successful outcome) and reinvest that trust into the next transaction.

Thank you for sharing that, Part 3

"It must still be a recession; the soft drink cans are half-sized."