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State of the Market 24: Cash in Clunkers? Rethinking the affordable-housing investment vehicle

By David A. Smith

Most of these are newer than our LIHTC owner entities

For all our talk about trading in used vehicles of transportation, spare a thought for the used vehicles of investment.

Cash For Clunkers was based on the idea that, if we swapped out obsolete vehicles and replaced them with newer, more efficient models, we could stimulate the economy and improve our physical ecology. The same reasoning should be applied to investment vehicles. The transportation containers in which financial products come are (debt side), REMICs, collateralized debt obligations (CDOs), securitized tranches thereof, (equity side) LLC's, limited partnerships, REITs, and so on. The financial vehicle constrains our upside when times are good and hamstrings our flexibility when times are bad.

While we lay much of the blame for our current capital crunch at the feet of greedy banks, spare a thought for the anachronistic vehicles themselves – and more importantly, how reinventing those vehicles can reinvigorate and de-risk ownership of complex real estate assets.

Doubt me? Then read on.

Clunker vehicles: the debt side

The last decade's great invention was securitization, and its secondary expression, derivatives like CDSs and re-REMICs.

(Okay, maybe things got a *leetle* out of control …)

As everyone knows by now, securitization created debt slices, each with a particular priority and maturity, each sold each to its respective highest bidder. In theory, it improved on whole-loan packaging– and that theory was and is correct. But, lost in all that slicing was this: slicing up economics also sliced up control. When the debt is being timely paid, sliced control is undamaging, but when the debt defaults – or is at risk of default – then suddenly the inability to make a decision on the lender's behalf becomes a value-destroying impairment. Touch and knowledge are divorced from ability to act, which in turn is fractured among multiple parties who now discover their conflicting interests.

At one end of the securitization pipe, the loan servicer, who is closest to the asset, and the borrower, who has the knowledge and touch necessary to choose the best strategy, have no authority to modify the loan except as granted by the investing lender. At the pipe's other end, the "investing lender" (as defined in the documents) has in turn suffered permanent schizophrenia, being chopped into multiple personalities (tranches) each with its own place in the capital stack, its own objectives, and its own self-interest in self-preservation at the expense of other tranches. Tranche warfare is no mere pun, it's an accurate description of the internecine struggles that took down the John Hancock Tower and now threaten Stuyvesant Town/ Peter Cooper Village.

Put simply, by subdividing the unitary debt position into fragmentary tranches, securitization:

- ***Distances the economic beneficiaries from touch*** on the assets, so that the people who gain or lose money based on property-level decisions are remote from knowledge of that property.
- ***Chops up decision-making authority*** so that at any given moment, a different securities holder may have control … and that determination may require a court to adjudicate.

Why don't these debt vehicles have the feature of returning control to the most-effective participant when default looms?

Actually, they can have it – I did it twenty-five years ago in some affordable housing resyndication secondary notes. The issue of creditor control was baked into the note instrument itself. Instead of a pure and independent slice, each noteholder received an interest in a trust which held the unitary note. The trust provided that even if a particular selling partner held a slice, that slice was subject to a master control slice held by a single party (the selling general partner) likely to be closest to the asset. Fifteen years later, when the notes came due and needed restructuring, we were able to negotiate with a single party who could bind all the noteholders.

We could do this prospectively with all new securitization notes issued – what about securities long since sold and in investor hands?

When Detroit finds a defect in cars it's already sold, it issues a recall and brings them all in for free retrofit and defect correction. Congress could do that here: enact legislation amending the bankruptcy code to give courts the power to puree the tranches. Upon the filing in Chapter 11 by a single-asset debtor, and a petition by the loan servicer in a manner analogous to an interpleader, the court could have authority to treat all the securities holders as having fractional interests in the unitary loan, equal to their proportion share of the initial net present value of originally scheduled loan payments.

Clunker vehicles: the equity side, property level

The equity side has its own clunker vehicles.

Project versus enterprise finance

A developer/ owner entity with multiple properties is both an operating business (the service functions group) and an asset portfolio (the individual transactions). Both the business and the portfolio need financing, which can be provided two ways:

- ***Project finance***. Every tub on its own bottom, as the saying goes. Each transaction owned by a special-purpose entity (SPE), normally controlled by a development-company limited-capitalization stop-loss subsidiary (aka the "shell"). Great for limiting developer risk; terrible for capital flexibility, since any change in the highly negotiated capital stack requires consents up and down the line.
- ***Enterprise finance***. All the assets in one big ownership entity that in turn receives a single line of credit or revolving facility. On the plus side, the revolver is flexible; as the portfolio becomes more valuable the loan can be easily increased. Against that, the pool is effectively cross-collateralized; one bad property can sink the whole portfolio – and the commingling of funds in economic fact makes property-level accounting more abstract and less real.

The UK uses enterprise finance almost to exclusion; in the US, project finance is dominant. In fact, the only popular US enterprise-finance vehicle is the REIT, which even today is anachronistic. Invented in 1960, REITs are heavily circumscribed by the Internal Revenue Code which gives them life. Because of the 90%-of-net-income-distribution requirement, they have difficulty growing their portfolios, and they are driven to contort their service profile since fees – the natural characterization most reflective of economic reality – are 'bad income.'

Weaknesses in project finance

Project financing has its own challenges. Requiring each property to finance its own customized capital stack *ab initio* increases soft costs (capital assembly search, accountants, lawyers). It expands documentation and requires lengthy custom negotiation of the boundaries between capital sources. It encourages a brass-ring mentality on the debt: since you get only one shot, might as well lever it up! Complexity overruns scale: so much brain damage for so few apartments. As a result, per-apartment total development costs rise and rise.

At the level of asset management, multiple capital sources mean minimal financing flexibility. Should the property wobble, the same fractured control evident in securitizations manifests in the debt-equity stacks as well. Anti-control provisions negotiated in to the documents to keep the balance sheet FIN 46 distant prove to be barriers to self-preservation. Tax-motivated investors, the caboose on the capital train, can have a veto over financial transactions. Sometimes they gain no upside from success but pay a penalty upon sale, so they are literally a drag on every other part. They can't even give their interests away for adverse tax consequences, and we have the macabre spectacle of old individual investors cackling that they want the property to last longer than they do. The extensive packaging presents portfolio consolidation and rationalization around geography, tenure, or tenancy.

Clunker vehicles: affordable housing funds

All the preceding equity-vehicle limitations are taken to their extreme in the fund-level approach to Low Income Housing Tax Credits. Not only do we have a constrained ownership vehicle – the special-purpose entity (SPE) that has eight sources of funds for 45 apartments in a tertiary city – but we then box the boxes into larger investment funds that further distance investors from the assets, in four principal varieties.

Imagine for the moment that you've landed at the airport of a town you've never visited before. You have four choices of vehicle. Even though they all offer to take you to the same destinations, each offers a different value proposition of choice, convenience, and cost.

The shuttle van (multi-investor fund). If you're likely to be going where other people go – a convention, say, or the big hotels – and if cost is a principal consideration, you take the shuttle van. You have the comfort of knowing other travelers, who all *seem* to be experienced, are already in the van with you. So you're not going to choose the route – surely the van fleet is configured for popular stops?

That's the multi-investor fund; corporations who wanted a generic slice of LIHTC buy into a blind pool offered by an established syndicator with a proven track record. Investment and yield parameters are specified, as are fees. The limited partners have few rights and are expected to make few decisions. The route is predictable.

The narrated tour bus (multi-investor specialist fund). On your ride, you might like commentary – see the animals in their native habitat, visit the restaurants "only locals know." To your shuttle van, therefore, you add a tour guide, and there may be cultural-experience stops along the way. It may cost a little more, but the experience is worth it.

That's the specialist fund – either a regional equity fund, or a non-profit-oriented mission fund, or any other subgroup. In addition to the same attributes sought for sponsors of the generic multi-investor fund, companies look for demonstrated expertise in the asset subclass and affinity for the non-profit mission.

Car and driver (private-label fund). Then comes a time where you know the city well enough, or have the cash to spare, that you have no interest in the company of others; you know your desired destination, you want the speed and maybe the flexibility to change the route, or to add another destination, or to go somewhere interesting to you and not others.

That's the private-label fund. A large corporate investor pairs up with a syndicator (usually a boutique) on a bespoke-tailoring basis: the syndicator sources transactions, presents them to the investor for approval (often the investor does a separate underwriting), handles the acquisition, and provides ongoing asset management. The 'fund' becomes as large or as small as the investor's desires and product availability dictate. Of course the result is likely to be FIN 46 consolidation.

Rent-a-car (direct investing). Finally, if it's a town you know and you plan to be there a while, you might rent your own car: pick it up at the airport, drive and navigate yourself. All the optionality, all the control – and all the responsibility if it breaks down, gets towed, or is issued a ticket.

That's direct investing: the corporation pulls all the functions in-house, creating a department to source, underwrite, close and asset-manage the investments.

Which is right for you? No vehicle is without flaws. In real transportation vehicles, dropoff is easy; not so in LIHTC. All of them make it easy to get *in* to the investment vehicle; all of them are hard to extricate from. Making service providers (fund syndicators, local developers) into partners vests them with incumbency that can lead to complacency and even rent-seeking or obstructionist behaviors.

Is there a better way?

In America, project-finance thinking is bred in the bone – enterprise finance is limited to the public markets (REITs), which are understandably gun-shy about leverage and whose limitations I've mentioned above. For affordable housing, HUD and state HFA rules dictate SPE ownership entities, making any portfolio-level assembly simply a stacked collection of boxes rather than a true portfolio. We've become so expert at putting things in boxes that, when trouble strikes, we want to rearrange the boxes rather than opening them and – gasp – fixing their contents.

The global credit crunch is not just changing individual winners and losers, it's remaking the whole ecosystem by which we deliver multifamily residential housing, particularly affordable housing. If we are committed to restoring the asset class to financial viability, we have to acknowledge that the investment vehicles by which we have packaged, invested in, and held these properties are themselves anachronistic products of a bygone era, and start from first principles to design new vehicles that realign control and optionality with risk and accountability.