RECAP
REAL ESTATE ADVISORS

APRIL 30, 2010 ISSUE 27

State of the Market 27: Consolidation and merge-o-phobia

By David A. Smith

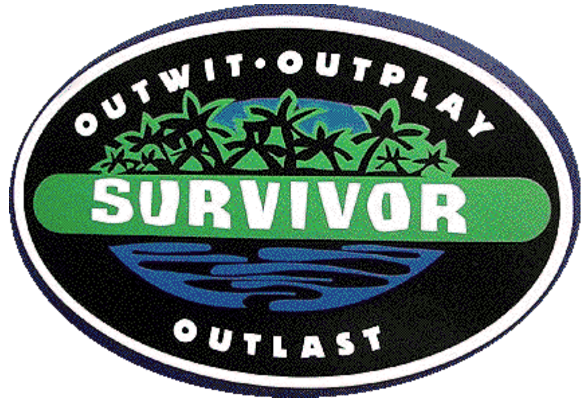
Quietly, the herd is being thinned. It needs to happen faster.

In saying this, I root for no one's demise; my motivation is for a healthy overall ecosystem, industry, and portfolio of properties.

We discreetly inquire about syndicators that we used to know, probing gently for whether they are moribund, ingested by others, or repositioning themselves as born-again asset managers. We wonder which developers, including particularly non-profits, are fighting to keep their organizations together while development fees both shrink and recede further into the uncertain future. Those of us in the industry talk about such things in euphemisms, for there is something unseemly about bluntly asking the question, *is your organization still solvent?*

That some organizations will be going away does not mean the ecosystem is unhealthy; rather, these periodic realignments are critical to restructuring the market for greater efficiency. Nor does loss of a sponsor necessarily mean loss of its portfolio – although untreated sponsor weakness can lead to portfolio illness. A flexible and responsive ecosystem will transition assets from smaller to larger players, with the survivors adding complexity, sophistication, capability and efficiency – and quite often absorbing the business lines, workforce, and corporate culture of the exiting entity.

In short, industry maturation drives consolidation by raising the bar on what it means to be best-in-class or market-competitive.



Forget about your ego; preserve your portfolio, people, and corporate values

Maturing ecosystems force entities to evolve

Over time, business and financial ecosystems become more complex. Financing programs become more sophisticated. Subsidy requirements become more extensive. Capital sources become more detailed and prescriptive. Markets fragment and specialize.

All this is challenging, yet both natural and rational – and it occasions change in the nature and scale of program-participant entities. To survive in an increasingly complex and competitive environment, actors themselves must evolve to greater complexity and specialization, and greater interdependence upon other evolved entities.

Complexity necessarily requires an intellectual infrastructure and an organizational overhead.

Faced with continuous complexity evolution, program participants have two ways they can migrate:

38 Chauncy Street, Suite 600 | Boston, MA 02111
T: 617.338.9484 | F: 617.338.9422
E: info@recapadvisors.com | W: recapadvisors.com

- ***Embrace breadth and become larger***. Breadth usually means geographies and markets covered, activities undertaken, and the ability to combine talents for customized solutions.
- ***Stay small and fast by narrowing your focus***. Focus means a niche program, a niche market, or a niche geography.

Indeed, this natural divergence of individual entities drives them into business value-chain linkages with each other: consolidation compels outsourcing. The multi-capacity entity can seldom afford to maintain primacy of knowledge across dozens of areas, and the boutique can never by itself build the organizational muscle to inhabit the larger markets. They are forced to partner.

Either choice – go big and complex, or small and focused – can work if they are consciously chosen and consistently executed. The thing that fails is to do neither, and stick with the Version 1.0 business model in a Version 2.0 ecosystem.

Especially one undergoing a crunch.

Shakeouts drive consolidations

When the economy is booming, any economic system can prosper; capitalism wins over others because it acts faster to cull the herd when times are tough. In expansions, you harvest market share, but you gain it in recessions.

In our space, the economic gravity of consolidation is inescapable – with fixed resources producing few properties, we will need fewer sponsors to create them, and fewer syndicators to raise their capital. The roughly 25% drop in LIHTC prices – from a 95¢ national average two and a half years ago to maybe a 70¢ average today – means that a quarter fewer properties are being developed (see recent *Affordable Housing Finance* statistics, for instance). Thus, a quarter fewer developers are needed to create them, and there will be a quarter less development fees to go around.

We can't all get one-quarter smaller, so whoever is the bottom quartile will lose out. That economic selection will be accelerated by the other counterparties – whether allocators or investors – who quite properly examine sponsors for their financial feasibility, and de-select those whose balance sheets are puny and whose income statements are under-nourishing.

Consolidations drive shakeouts

As it matures, every industry goes through entity consolidation and value-chain complication. In the conventional sector, for instance, the full-service builder-developer-owner has fragmented into specialist merchant builders, specialist general contractors, and long-term ownership aggregators (REITs).

Value chain linkages have a scaling compatibility – each link has to be within a certain size range of the next-larger, and of the next-smaller. Among the many virtues of LIHTC's value chain is that it spans the smallest – neighborhood-level CDCs that work on individual properties with an extremely strong geographic focus – and the largest – financial institutions and Fortune 500 companies interested only in hundred megabuck wholesale spends.

Scaling changes at one end of the value chain force scaling adjustments throughout. When the largest player, the LIHTC investor, gets larger, all links in that chain have to respond, either by scaling up themselves, or by adding new intermediary links to fill the widening gap.

Of course consolidation upward creates stresses and strains in the consolidating organization; they're called growing pains.

At Recap, we faced this ourselves 4 ½ years ago, and made the strategic choice to grow via being acquired upwards (see box). In hindsight, our decision looks even wiser than it did at the time, for with our establishment as a business unit in a larger platform, we are able to take on new challenges and deliver new value. We moved up, and by moving up, strengthened our core capabilities.

Recap: case study in scaling up

For 18 years, Recap operated as a distinctive and highly successful independent boutique – yet in 2007 we voluntarily sold ourselves up into a larger platform. We did so because we had concluded, in late 2005, that we had to get bigger and more specially diversified in advance of the coming downturn.

But we had to get bigger *smart*. We wanted to gain complementary skills without losing our unique and entrepreneurial culture. We need this because in downturns, people will pay you money to take over their problems – and if you want to make money by buying other people's troubles, you need capital to absorb the financial vicissitudes, physical condition capabilities to reposition properties smartly, and property management to turn around operations. So we sold into the entity owning the nation's largest private third-party property manager, Riverstone Residential, with over 160,000 apartments nationwide. Having ourselves been bought, we then reciprocated by buying On-site Insight, bringing capital planning into our platform.

The new integrated platform has produced immediate benefits. Our larger platform allows internalized specialization, which allows externalized customization. The Green CNA, which we designed and have launched in conjunction with Enterprise, the US Green Building Council, and others, is a sophisticated and complex product that simply cannot be produced to proper quality by any company much smaller than ours.

Why don't entities consolidate?

Done right, consolidation strengthens ecosystems, driving down indirect costs through combination, scaling, and automation of administrative functions. Two entities cannot live quite as cheaply as one, but they can live as cheaply as one and a half.

Why then don't more people do it?

A development-driven model and the anti-scaling structure of LIHTC development resources. Most affordable housing entities are developers first and foremost. Development becomes the core business competency, attracting the largest share of organizational brainpower and horsepower. For affordable housing, development-related resources are anti-scale. Each state's program is unique and requires highly specific and current knowledge. State and local soft-debt capital sources, necessary in most markets, likewise add their own layers of programmatic complexity and political sensitivity. To win in a localized information market, the sponsors have to focus on the small, which makes it nearly impossible for anyone to be an effective LIHTC developer in more than a handful of cities at once.

Absence of role models. Consolidation came to hospitals twenty-five years ago; in conventional apartments, it arrived fifteen years back, with the emergence of rapidly-growing REITs. Banks began their headlong rush to consolidation a decade hence. In LIHTC, we have almost no examples, and no one wants to be first.

Challenges of integrating organic assets. Corporate culture, employee philosophy and employment practices, executive responsibilities and systems integration are all issues not faced in straight property or asset acquisitions.

Doubts about fairness. Combining our entity and our assets into your entity inevitably involves the question of valuing our worth relative to yours. This is often contentious; even when the transaction is accomplished via a pooling of interests (you get my scrip, I get yours), questions of relative fairness are not easy to reconcile. Perhaps more surprisingly, this is true even when both entities are non-profits.

Fear of the unknown. Consolidation is the unknown, the undiscovered company from whose board no traveler returns.

Equating consolidation with extinction. The organization that grows up around a developer becomes an external manifestation of its founding principals. Many an entrepreneur hesitates before consolidation, in the legitimate concern that what makes the entity unique or valuable will be lost in the homogenizing blender of Engulf and Devour.

Ego. If one entity is the consolidated rather than the consolidator, has one somehow lost the game?

All these concerns are understandable; collectively, they add up to a phobia that our industry has to overcome.

Another vision of consolidation: the UK's Housing-Association model

Imagine a large-scale regional housing provider that is vertically integrated, customer-centric, enterprise-financed, and universally regarded as absolutely integral to affordable housing and social program delivery. Imagine that almost every large city in the nation has one or more such entities, each controlling thousands of apartments, all overseen by a strong regulatory infrastructure that imposes transparent, consistent reporting.

If it sounds impossible to you, book a flight to London, and let me arrange a tour for you of UK housing associations.

The British affordable housing ecosystem is dominated by regional and large housing associations whose scale, sophistication, and service orientation can put many of ours to shame. Relative to population, the average UK housing association is roughly ten times the size of US non-profits, and – meaning no disrespect to our home-grown institutions – with a concomitant increase in service delivery.

Even if we wanted to, we couldn't import the UK system – it grew out of a uniquely British heritage and regulatory ecosystem and has taken decades to build – *but* we can look to it for alternate-universe examples of what we want the US ecosystem to be, and how we want to grow strong and consolidated sponsors, developers, owners, and investors.

We can also use it as a thought experiment to envision a cure for our own merge-o-phobia.

Consolidation is inevitable

Our industry has more too-small entities than we need. Consolidation will be good for the industry and good for the inventory. It'll be tough on some egos, and it's always better if done voluntarily.

If you're a resource allocator, the choices you make will select survivors. If you're a capital provider or investor, you will want both to drive consolidation and see it coming before it arrives. And if you're a capital consumer or service provider, you'll want to pick your landing spot while you still have choice over it.

Consolidation is going to happen – the question is whether continuing financial pressure force it upon us, or whether we in the industry have the courage, vision, and selflessness to lead and shape it.