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State of the Market 31: Building Stronger Sponsors

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Two years after the financial crunch ruptured the affordable housing production pipeline, bit by bit it is being rebuilt: allocations are being awarded, gap resources are re-emerging, construction loans are being made, and demand for LIHTC is back. But a value chain is more than a single link, so even as demand recovers, we need to ask, which part of the affordable housing value chain is most in need of upgrade?

- Not investors – higher yields have surfaced new ones.
- Not allocators – they have large capital reserves on which to draw, and evergreen resource flows.
- Not debt financiers – Fannie, Freddie, FHA and the HFAs are and have been lending.
- No, the overloaded circuit in our system is the *sponsors*.

Because successful affordable housing communities are organic assets that require ongoing management and stewardship, we need rental housing properties to be held by appropriate mission-oriented owners. Yet our current approach to financing – and hence to development, ownership, and operations – emphasizes the property and takes the owner entity for granted. The ruptured pipeline has exposed weaknesses in stewardship that require a fundamental rethinking of the effective financing and operational structure of long-term mission owners – investing in the housing enterprise, not just the real estate.

This was hammered home during an intensive day-long symposium, *A New Era in Affordable Housing, Investing for Impact in Sustainable Communities*, hosted by NeighborWorks in Philadelphia during mid-August[1]. What we discussed that day has direct implications for anyone with capital, business, or reputation at risk in affordable housing.

"Is your sponsor overloaded?"

As a symposium speaker put it, "If the entities aren't sustained, then the housing is not sustained" – and the entities are under-capitalized and under-powered now.

Multifamily rental housing is a complex business asset requiring sophisticated management

The scale of our affordable-housing infrastructure is vast. By our rough estimates,

[1] My framing paper may be downloaded at http://www.nw.org/network/neighborworksprogs/multifamily/documents/FramingPaper1-DavidSmith.pdf, along with a full listing of all papers at http://www.nw.org/network/neighborworksprogs/multifamily/symposia.asp.

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over the last fifty years or so the United States has invested the equivalent of $1.0 trillion in present-value to create over 4,500,000 apartments of 'permanently' affordable multifamily rental housing, representing 3-4% of all households nationwide. That is an enormous sum, effectively larger because many of these properties are truly irreplaceable – changes in location (urbanization), zoning, and urban development laws mean that if they disappeared they could not be recreated.

Over that same interval, the properties themselves have become more complex to operate in three ways.

Physical technology. Between energy conservation and broadband/ information telephony, the building itself is less a box and more a machine. Further, to accommodate the changing demography of a city-based flexi-workforce (profiled in *State of the Market 30*), bedrooms are repurposed into home offices with concomitant beefing up required of the electrical, mechanical, and broadband systems.

Financial technology. Federal, state and local programs must be combined with subsidy, loans, tax credits and incentives in a way unique to each property.

Regulatory and operational technology. Virtually every financial resource comes with its own programmatic requirements, none of which will defer to the others. Meanwhile, mixing of incomes and even uses is increasingly common. The resulting thicket of regulations means that compliance, renting and leasing, and resident services are all integrated together in the business of delivering value to customers (residents) and partners (capital providers).

These changes require sponsor and owner entities to become more sophisticated.

Have they?

Stronger sponsors needed – yesterday

The last two years have revealed severe structural weaknesses in the US affordable housing ecosystem. Disruption in the LIHTC markets was brought about not by fundamental real estate weaknesses in the low end of the market but by unrelated losses by the major financial institutions that had become the LIHTC's unofficial oligopoly of buyers. That, in turn, exposed deep cracks in the capitalization of sponsors (developers and owners), particularly including non-profit Mission Entrepreneurial Entities, whose ability to cope has been severely stressed. No one knows how many developer-owners are undercapitalized and virtually moribund, but everyone concedes the fraction is large.

For lenders and investors, an undercapitalized sponsor is a scary proposition. Housing enterprises to whom we entrust control over $100,000,000 in real estate replacement cost (say, 1,000 apartments or so) will often have a liquid net worth below $1,000,000 – that is, we give entities leverage of 99x to 1 or more over properties where they are in control and have no direct risk. Relative to the burdens policy makers expect them to carry, they are weaklings – under-structured and under-capitalized. Meanwhile, our efforts to 'protect' ourselves against this control/ risk mismatch lead at the property level to layer upon layer of operational and financing restrictions from multiple directions – regulator, first lender, second lender, equity investor, resource allocator, and HUD as subsidy provider above all. Any cash flow usually goes to a financial stakeholder with little if any connection to the activities that produced said cash flow.

These risks are more than hypothetical. We have already seen several developers implode, and equity syndicators disintegrate or be acquired for $1 – and no one would be astonished to read about another insolvency tomorrow. In short, some fraction of the inventory is being controlled by sickly or wounded sponsors, whose future crumple could imperil portfolios 10x or 50x their size.

A market recovery will not fix these problems. Some fundamental restructuring is necessary.

What does the post-recovery sponsor look like?

In a phrase: *smarter, faster, stronger, more connected.*

Scale. When one link in a hybrid value chain scales up (e.g., investors), all the others have to scale up commensurately, otherwise the value-chain handoffs fail – so with affordable housing, the 'optimal' size of owners and managers tends to grow. Entities must have the administrative and IT platform to support programmatic diversity, combinations, and complexity. The necessity for this internal staff backbone implies a certain minimum organizational size, and that in turn implies a certain organizational gross revenue, effective operating margin, and ongoing equity.

Touch and handoffs. The best developers have comprehensive knowledge of the handful of markets in which they develop, and are consistently able to out-compete resource-hunting interlopers in those markets. But management, ownership, financing and capital assembly/ capital cost all scale upwards to the national level, because they compete on systemization of procedures and consequent optimization of costs and Net Operating Income. This implies that development's natural end-state is merchant building, with handoffs to large long-term operators who specialize in ownership – the model that has prevailed in conventional apartments in both the US (REITs) and UK (pension funds).

Civic incumbents. As long-term investments, apartments require long-term relationships with other parties. Capable sponsors are recognized as permanent incumbents in their metropolitan ecosystems, vested with public trust based on their track record of properties successfully completed and operated, reliable interaction with private and public partners and counterparties, responsible activity in the face of challenges, market innovation, and judicious use of public money. That trust and reputation are hard-won and usually protected at significant cost, with better sponsors usually going beyond the letter of project-financed documents to intervene in and support properties within their portfolio.

Permanent and expanding interface between government and citizens. Government once thought it could do everything; now we find that government works better if it contracts point-of-service delivery. Stronger sponsors broaden their points of contact with the poor families and elderly who are their principal customers, adding services either directly through the entity or more commonly contracted with a third-party provider like a social-service agency. Either way, they increasingly become the delivery point for public services – the 'outsourced interface' between government's resources and customers' needs.

Networked to specialists. Some complex functions are required only rarely. It doesn't make sense to staff for such intermittent loads – a better solution is to have contractual relationships with specialty providers. Many of Recap's best customers – both in their relationship with us and their success in the field – are partners of years and decades' standing. The tasks come and go, the challenges constantly change – what remains constant is their constant need for changing parts of our expertise, and our value for a changing subset of their portfolios.

How do we get there?

Recessions force evolution via natural selection, because merely-average businesses can no longer hang on in a universe of shrinking resources – one has to be better. Driven by money power, the new post-selection generation of sponsors will emerge from these imperatives.

Repurpose entities as public stewards. Trusted, well-organized, well-capitalized entities blend funding streams together to create multi-purpose solutions that are beyond the capability of government entities to conceive and execute. Though motivated by organizational mission and economics, they are every bit as effective public stewards as government or charities.

Orient around customer-centricity. Instead of seeing large entities as principally landlords – the house itself as the physical end product, forward-looking sponsors view themselves as being in service businesses that have permanent locations, serving essential needs of two classes of customers: *residents* who receive a menu of public social resources, housing being the essential but by no means the only one; and *capital providers* who put money to work for double-bottom-line outcomes (which deliver better risk-adjusted returns, via stability, with positive brand externalities instead of negative ones).

Secure permanent equity, permanently at risk. CDFI's grew because their founding equity – provided to the institution, not to any particular property – was designed to be permanent capital, and was restricted for use in revolving and growing the portfolios. Capital's exit was not built-in, rather it emerged naturally because the CDFIs were able to deliver annual return and ongoing value appreciation. When those things happen, equity does not need a pre-structured exit, the exit takes care of itself: for every investor that wants out, someone wants to buy in.

Embrace entity-level accountability in exchange for enterprise finance. In real estate finance, we hyper-regulate the property and with little practical sponsor-level accountability (SPE's with limited capital controlling general partner, highly restricted rights to remove). As a result, the current system dis-incentivizes equity accumulation in sponsors even as it over-levers developments. That is an unsustainable combination that carries large systemic risks. Far more robust would be to reverse the emphasis: impose significant requirements at the entity level (as in CDFIs or DUS licensees), so as to allow substantial freedom at the level of individual properties or assets.

Conclusion

Who needs whom more? Just as a hen is only an egg's device for making another egg, a capital consumer (the sponsor) is the device by which a capital provider turns increased money into better outcomes. Capital and subsidy providers cannot do this for themselves, so they need capital consumers as outcome providers, while they themselves are outcome consumers. Each needs the other. Ergo the capital providers (including subsidy providers and hence regulators) need to strengthen the capital consumers, so that those capital consumers can be better outcome producers.

As one of the NeighborWorks symposium participants said, "Non-profit is a tax designation, not a business model." It's time to build up our more capable sponsors, even as they must evolve toward being permanently committed and permanently at risk. If the entities are well managed and well capitalized, that will ensure that they build more properties – without them, not only they but the inventory, and the whole system, are in peril.