Thinking Smart

Managing the Recession's Impact on Affordable Housing

By Allen Feliz, Tax Credit Asset Management, LLC

The worst recession since the Great Depression may be yesterday's news, but the affordable rental housing sector is still reeling from its effects. Although most affordable multifamily rental properties continue to pay their debt service and deliver tax benefits, they are not immune from market pressures caused by the economic downturn and the sluggishness of the recovery. In many markets, affordable housing's customary rent advantage has evaporated and owners, developers, lenders, investors, and housing authorities face unprecedented challenges to maintain occupancy and rental income. In these tumultuous times, local market understanding and attentive management is more important than ever.

The Economy and the Recovery

Most economists agree that while the worst is behind us, the pace of recovery will be slow. Some economists believe that we may face another downturn, particularly in real estate, due to the outstanding volume of CMBS debt that financial institutions may eventually have to write down. But even without a "double-dip," the recession and slow recovery have created huge challenges for the multifamily rental sector. The U.S. economy lost over eight million jobs from January 2008 to October 2009, and it could take five to seven years to return to 2007 employment levels. Recovery is underway: the U.S. economy added over 500,000 jobs from January to March 2010, and national GDP grew for the second consecutive quarter in 1Q 2010 (3.2% annual rate of increase). But despite these encouraging signs, 26 million remain unemployed or underemployed throughout the country.

Impact on Rental Housing and Affordable Housing

Although recovery is underway and capital is starting to flow for new low-income housing tax credit projects, rental markets are still suffering from the recession's effects. The staggering job losses continue to affect demand, as households double up or leave town.

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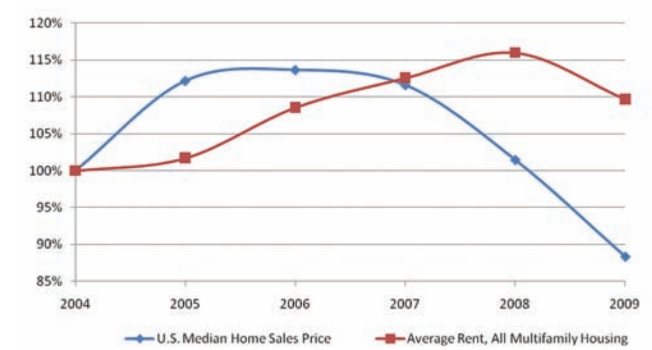
The excess supply of multifamily rental units in many former high-growth markets, along with the shadow rental market (foreclosed or unsold homes and condos), create significant supply pressures. Together, the drop in renter demand and the continuing increase in supply have put downward pressure on rents. House prices declined approximately 34% from their peak in 2006 to 2009, but rents continued to rise until 2008, when they began to drop. Home prices appear to have stabilized but rents may well still be falling.



Notes: Y axis is normalized. 2004 actual median sales price = $195; and 2004 actual average rent =~875
Sources: National Association of Realtors & Marcus & Millichap 2010.

Affordable rental housing has been prone to the same market pressures as conventional multifamily rental housing. In general, LIHTC property revenues, particularly in many former high-growth markets such as Las Vegas and Atlanta, have suffered as the demand for affordable rental units has declined due to increases in job losses and the supply of low-priced housing alternatives. To remain competitive and achieve high occupancy, many LIHTC properties are offering higher rent concessions and incurring more bad debt. In many housing markets, tax credit rents now show little to no advantage over market rents, and managers of affordable properties, for the first time, are facing serious competition for residents. Examples of markets exhibiting these conditions today include Houston, Dallas, Atlanta and Jacksonville.

Affordable Housing's Pockets of Distress

Most tax credit properties are weathering the economic storm better than other real estate asset classes. Many were underwritten with rents sufficiently low that recent declines in rents have been manageable, doing little to imperil operations. There are, however, pockets

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of severe distress, most notably from highly leveraged transactions, deals underwritten in the optimistic years during 2005-2008, and underperforming projects at or near the end of their 15-year LIHTC compliance period. The highly leveraged transactions have less room for error; when revenues decline, the property can quickly go upside down. High leverage, combined with the optimistic underwriting employed just before the crash, produces enormous funding gaps when it comes time to convert to the permanent mortgage. Finally, there are the underperforming end-of-compliance transactions, where the cash flow is not sufficient to pay the debt service, and the borrower has little incentive to continue feeding the deal since the tax credits are no longer at risk.

Affordable rental housing in markets that have been insulated from the recession-induced market pressures discussed above, such as New York and San Francisco, has continued to enjoy sufficient rent advantage, along with steady demand from low-income renters and capital providers. Recovery in other markets, on the other hand, particularly in former high-growth markets marred by major job losses and an oversupply of affordable alternatives, is likely to take a long time. Examples of these "long-haul" markets are Atlanta, Las Vegas, Phoenix, and parts of Florida such as Tampa, Orlando, and Jacksonville. In Atlanta, for instance, downward pressure on property revenues has caused a narrowing gap between conventional and tax credit rents. In fact, in some parts of Atlanta home mortgage payments are as low as affordable rents. Property managers in "long haul" markets have been overwhelmed as they try to keep units occupied and rents high enough to cover operating expenses and debt service.

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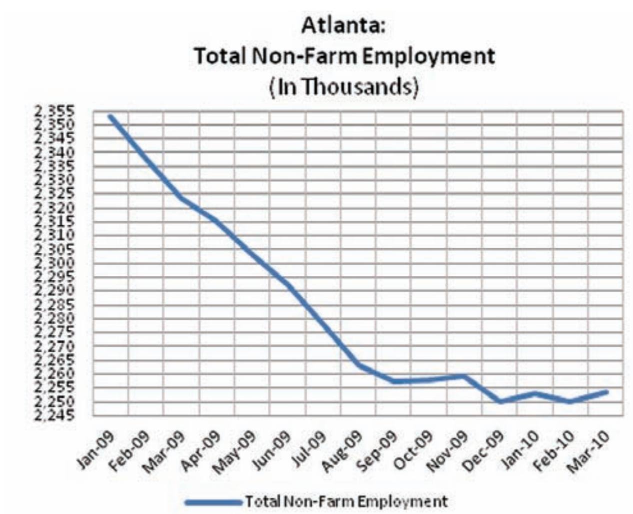
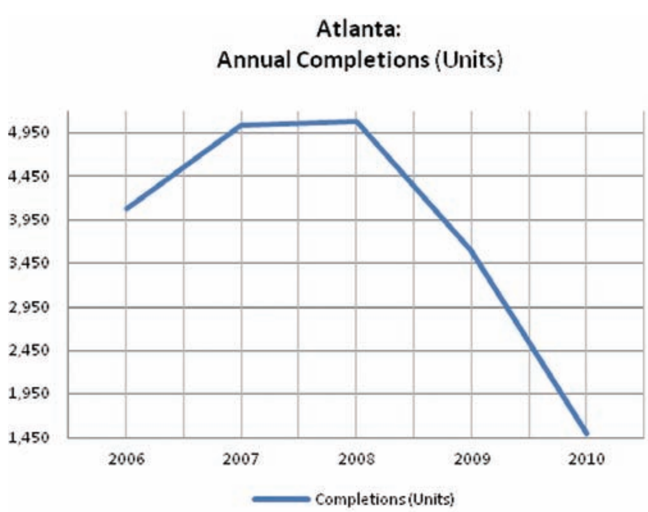


Source: Marcus & Millichap, National Apartment Report 2009 & 2010.



Source: Bureau of Labor Statistics. Databases..

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Lessons and Advice

In both "long haul" and "recovering" markets, managers of affordable rental properties are more challenged than ever. They can no longer rely on their rent advantage to insulate them from market pressures. They need to identify and understand all of their competition – not just other nearby LIHTC properties, but also market-rate properties and empty condos across town. They need to know the supply of competing units in their market, current rent levels, concessions, amenities, market trends, etc. They need to work harder to attract and retain residents. Property management has never been easy, but it is now even more challenging.

The same goes for developers planning new LIHTC properties. They need to be cognizant of conditions, supply, and trends in the housing markets they target or consider, to optimize their prospects for shaping a successful deal. Note: Opportunities may exist not only in strong markets but in niches within some weak markets as well.

In general, affordable rental housing continues to perform well, and the recession's downward pressures on property revenues are starting to ease in a number of markets. However, the current financial obstacles for affordable rental properties are not likely to go away soon. In fact, with a sluggish recovery and financially challenged sponsors the pockets of distress could continue to expand. The existing level of distress (and potential growth) in affordable rental housing underscores the critical importance of solid management and the need to fully understand markets during this turbulent and uncertain period, in order to achieve and maintain strong operational performance or to turn around troubled deals.

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