Affordable rental housing

A compelling diversification strategy

By Wilfred Cooper Jr.

The United States is facing a housing-affordability crisis decades in the making. The shrinking supply of affordable rental housing has left millions of U.S. senior-citizen and family renters unable to afford a place to live. Bolstered by long-term demographic drivers, existing affordable rental housing offers investors many advantages that contribute to a compelling diversification strategy. Characterized by durable income, attractive cap rates and a healthy hedge against recession, this asset class also provides the opportunity for investors to make a positive social impact.

Growing demand and shrinking supply

Renter households make up a large percentage of American society. As of fourth quarter 2020, renters represented approximately 34 percent of the U.S. population, according to the U.S. Census Bureau. More Americans — a total of 43.3 million households — are renting now than any time in the past 50 years. This is estimated to be more than 100 million individuals and has increased twice as fast as the homeowner population since 2010, climbing 9.1 percent and 4.3 percent, respectively, reports Housing Wire. In the aggregate, renters are poorer than homeowners in the United States and have a median income of $42,500, or roughly 38 percent below the median income of all U.S. households, according to data from the Center on Budget and Policy Priorities and the U.S. Census Bureau.

A cost-burdened renter household is one that pays more than 30 percent of its income in rent. *The State of the Nation's Housing 2020* report, published by the Joint Center for Housing Studies of Harvard University, noted in the United States, cost-burdened renter households stood at 20.4 million in 2019, or 46.3 percent of all renter households

Cost-burdened renters generally have lower incomes and include retirees on fixed incomes, students, and workers in lower-wage jobs, such as retail, sales, food preparation, and construction, among others.

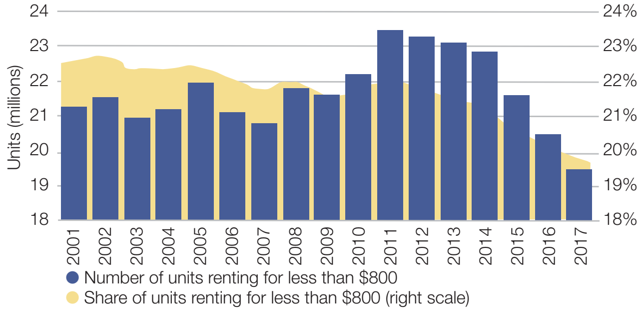
Affordable rental housing, in general terms, is housing that is leased to residents who make 80 percent or less of the median income, with rent that does not exceed 30 percent of such income. The large number of cost-burdened renters is directly related to the shortage of affordable rental housing in the United States. Despite this shortage, the existing supply is shrinking. Data from *The State of the Nation's Housing 2019* shows the supply of affordable units has fallen every year since 2011. A total of 4 million units were removed from the supply over the period of 2011 to 2017.

The U.S. government has tried its hand at addressing the housing affordability shortfall. Programs such as low-income housing tax credit (LIHTC) offer investors federal tax credits for equity investments in the construction and rehabilitation of affordable housing. Other programs, such as the Section 8 housing assistance program and housing choice vouchers administered through the Department of Housing and Urban Development, provide rental subsidies to qualified low-income residents.

Although facilitating the construction of nearly 5 million affordable units over the past 40 years, these federal programs are limited in scope and fall short of the substantial demand for affordable rental housing in the United States. Compounding this are the affordability requirements and subsidies maintained by these programs continue to expire. An estimated 700,000 affordable units will be lost by 2029 because of the scheduled expirations, according to the *2020 Picture of Preservation* report from the Public and Affordable Housing Research Corp. and National Low Income Housing Coalition.

Rather than rebuild affordable housing, developers are building more expensive market-rate housing, luxury condos and other commercial properties due to the high cost of construction, regulatory burdens, and challenges to affordable housing from local community groups.

The low-rent stock has shrunk by 4 million units since 2011



Source: Joint Center for Housing Studies of Harvard University, The State of the Nation's Housing 2019

The investment opportunity

While newer class A apartments and other traditional real estate assets might well constitute the core of an institutional investor's real estate portfolio, existing affordable rental housing offers investors many advantages that contribute to a compelling diversification strategy.

Lower turnover and related costs

Due to the shortage of affordable rental units, these properties tend to have significant waiting lists, particularly in markets with high housing costs. Residents in affordable properties have few equivalent housing options and tend to consider affordable rent as the primary amenity. Consequently, residents tend to be more stable and vacate their units less often, which gives rise to lower turnover compared with market-rate assets. A comparison of vacancy rates for market-rate apartments and affordable housing over the past 15 years illustrates this point.

Predictable income and recession hedge

In general, rent growth in existing affordable rental housing is tied to area median income (AMI). AMIs in the larger markets have been growing in the mid-to-high single digits, according to September 2018 data from the Federal Reserve Bank of St. Louis.

Because AMI is a composite of the past three years of income, rental income projections can be readily predicted, including during times of economic downturns, such as the current pandemic economy. As an added hedge, the Housing and Economic Recovery Act of 2008 — legislation enacted as a result of the most recent recession — prevents rents in many affordable communities from declining during economic recessions. The law essentially protects properties built before 2008 from falling rents, limiting downside risk.

Among the more defensive locations to acquire existing affordable communities are high-cost markets where material discounts exist between affordable rents and market rents. These markets are characterized by gaps of 20 percent between affordable apartments and market-rate apartments. Such gaps provide a buffer during recessionary times because, as market rents fall, which they tend to do during recessions, they remain higher than affordable rents. Because affordable rental units in these markets are usually a scarce commodity, residents value affordable-housing options and are reluctant to give them up.

Barriers to entry and cap rates

To invest successfully in existing affordable rental housing requires working in a complex regulatory environment. Unlike market-rate apartments, subsidized affordable properties typically must comply with federal, state and/or local regulations. These regulations can impact many aspects of a property's ownership and operations, and can include rent restrictions, tenant income limits, transfers of interests, and distributions, among others.

Due to these restrictions, affordable rental properties generally warrant higher cap rates in most markets. Depending on the market, asset quality, and regulatory complexity, premiums can range from 50 basis points to 150 basis points over market-rate assets. The average cap rate graph illustrates the spread in cap rates between class A and B/C assets, the latter of which includes affordable apartments.

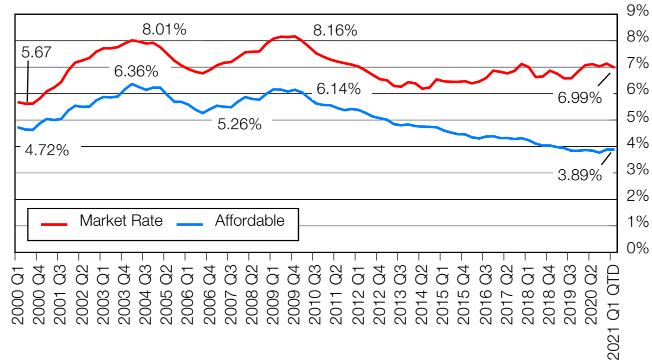
Although higher cap rates are typically associated with higher risk in the multifamily space, these premiums are available on affordable assets due to the complexity and expertise needed to acquire, own and operate them. Finding a sponsor versed in these complexities is a critical component to investing successfully in affordable rental housing.

Operating inefficiencies

Investors seeking stable income growth and residual value appreciation can benefit from operating inefficiencies in the affordable-housing rental market. This is due to structural inefficiencies inherent in the tax-driven incentives associated with this type of housing.

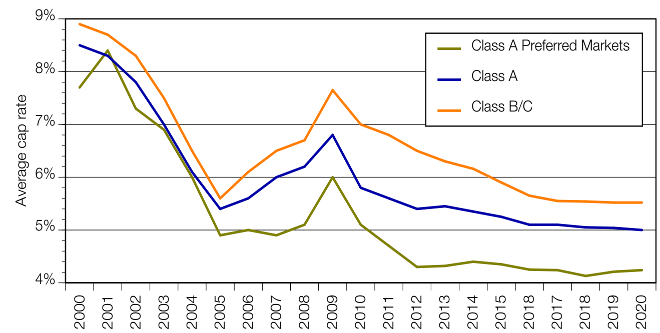
Over the past 30 years, most affordable-housing developments were financed using LIHTCs. The primary benefits of LIHTC properties are federal tax credits and tax losses (deductions) from depreciation and interest expense. LIHTC investors do not expect or receive cash flow or material proceeds when these properties are sold. Consequently, LIHTC properties are underwritten slightly above break-even cash flow. Developer incentives, similarly, are funded by equity from the sale of tax credits and permanent loan proceeds, and are in the form of cash developer fees based on the total development cost. Operators are usually affiliated with the developers and tend to focus on tenant compliance, not cash flow, to ensure the tax credits are not jeopardized by recapture. In the end, partners and operators have little reason to focus on cash flow and residual value creation.

Vacancy rates



Sources: WNC data analysis of CoStar data, CoStar Group; Note: U.S. affordable and market-rate apartment complexes of 25 units or more

Average cap rates



Source: Public and Affordable Housing Research Corp. and National Low Income Housing Coalition, 2020 Picture of Preservation

The social impact

Safe, clean and affordable housing is fundamental to the well-being of an individual, a family and the community as a whole. It contributes to a household's ability to obtain basic necessities, including food, clothing and healthcare, and is a path to greater independence and financial freedom. Millions of families, senior citizens and veterans in the United States struggle to keep a roof over their heads, however, because they cannot afford their rent. In communities across the nation, rents continue to rise while affordable rental housing units are being demolished and converted to market-rate apartments and other more expensive real estate. By investing in existing affordable housing, investors can have a positive social impact by preserving a resource that is fundamental to those in need and provides a foundation to improve lives and communities.

Conclusion

Structural characteristics of affordable housing make it a compelling diversification strategy for investors. The growing demand and shrinking supply of affordable rental housing, resulting in lower turnover and predictable income, contribute to its attractiveness and resiliency as an investment. Yet to invest in existing affordable rental housing is also a strategy that will preserve a resource that has and will continue to have a positive impact on the well-being of individuals, families and communities for years to come.

Wilfred Cooper Jr. is president and CEO of **WNC & Associates.**