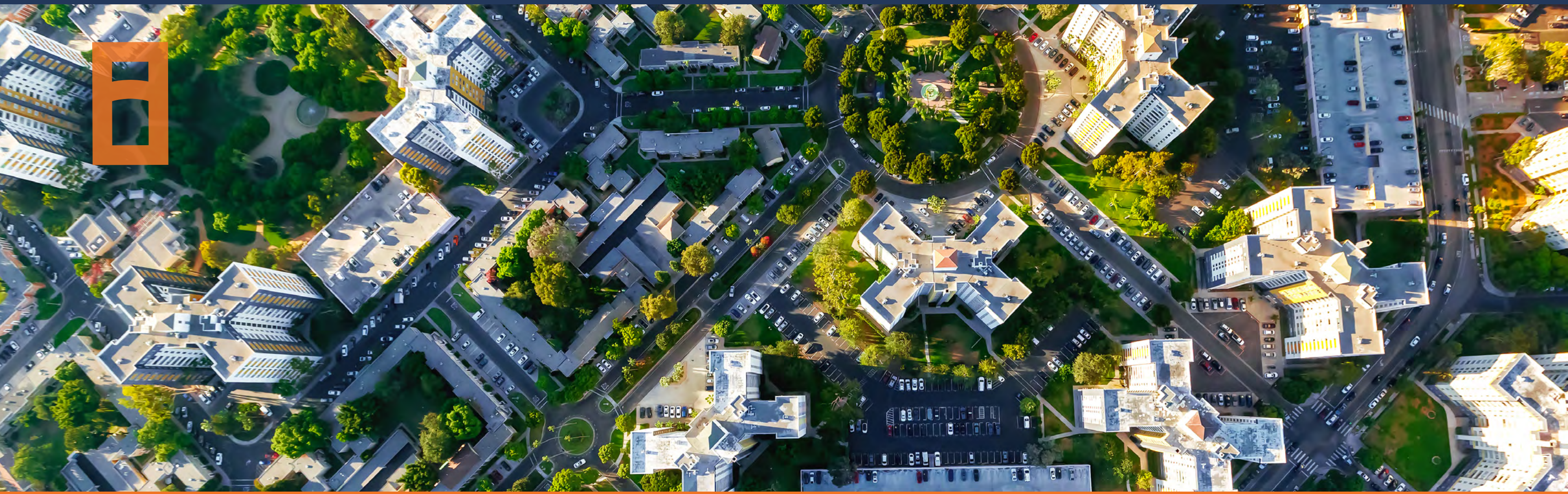
IMPACT COMMUNITY CAPITAL



BRIDGING THE GAP: OPPORTUNITIES IN SHORT-TERM LOANS TO ADDRESS LONG-TERM AFFORDABILITY

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Owners and developers seeking to establish long-term affordability in the multifamily apartment space have long faced the dual burdens of having to compete against market-rate buyers while simultaneously jumping through the hoops of applying for government-sponsored housing credits. Higher borrowing and building costs brought about by rising interest rates and inflation in recent years have only made that job harder.

Transaction activity for apartments, not surprisingly, took a hit last year, falling 61% in 2023 on a year-over-year basis, according to data compiled by MSCI Real Assets.[1] In 2023, the total volume of Federal Housing Administration (FHA) multifamily loans was on track to fall by roughly half from the year prior.[2]

To be sure, the rise in operating costs began to moderate toward the end of the year, as the pace of inflation started to cool, and the broader multifamily market has shown signs of stabilizing.[3] However, operating margins and the margin of safety on executing multifamily affordable housing deals are still narrower than before rates began to climb two years ago. Moreover, the systemic financing burdens that were endemic to this market long before the current rate cycle remain firmly in place.

Against this backdrop, it's more important than ever for sponsors to be able to secure sufficient financing that not only meets their business plans but can also sustain them throughout the arduous process of applying for Low-Income Housing Tax Credit (LIHTC) program allocations or Housing Assistance Payments (HAP) contracts under Section 8 of the U.S. Department of Housing and Urban Development's Housing Voucher program.

Enter the need for short-term affordable housing bridge loans to buy time to lock in long-term affordability.

OPPORTUNITIES TO PLUG THE AFFORDABILITY GAP

Affordable housing is an asset where supply and demand pressures are diverging, which may explain why institutional investors' interest in this space has been growing lately.[4] A survey conducted last year by WMRE found that among real estate investments, multifamily properties were the most popular, favored by 60% of institutional investors, driven by a particular focus in affordable and attainable housing.[5]

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1 *"MSCI: Apartment Sales Drop 61%,"* Multifamily Dive. Feb. 5, 2024.
2 *"HUD Sees 'Massive Drop' in Multifamily Deal Volume, Slowing Housing Production,"* Bisnow. May 8, 2023.
3 *"Midyear Outlook Shows Multifamily Demand Returning Slowly in Uncertain Economic Climate,"* Freddie Mac. Aug. 3, 2023.
4 *"Affordable Housing Gap Spells Opportunity,"* Private Equity Real Estate. June 5, 2023.
5 *"Multifamily, Industrial Remain Top Choices for Institutional Investors,"* Wealthmanagement.com. Aug. 10, 2023.

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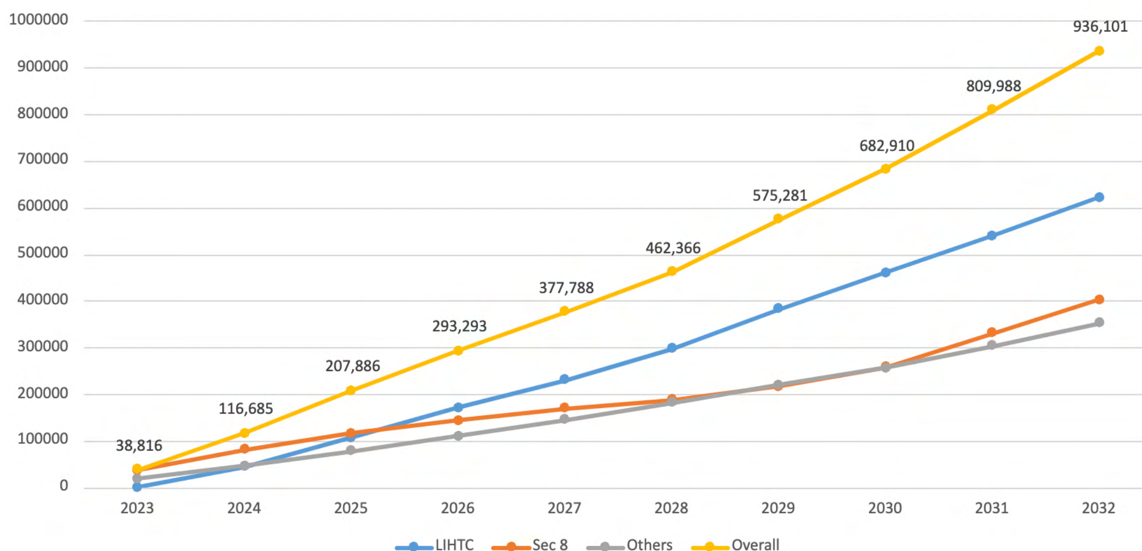
This shouldn't come as a big surprise. Affordable housing is an acyclical asset, where the need for accessible and available housing grows regardless of economic circumstance. In good times, when the economy is flourishing and incomes are rising, the inevitable rise in real estate prices typically drives the need for affordability. In difficult times, when the labor market weakens and incomes are pressured, demand continues to grow, driven by financial distress. That was the case during the Covid shutdowns, when the number of "cost-burdened" households—those who have to spend more than 30% of their income on housing—climbed to a record 22.4 million in 2022, according to Harvard's Joint Center for Housing Studies.[6] Among renter households, half (50%) are now cost-burdened while more than 12.1 million households are severely cost-burdened, meaning they must spend more than 50% of their income on housing expenses.[7]

Figure 1: Federally-Assisted Homes with Affordability Restrictions Expiring by 2032



As demand is growing, though, supply is threatening to go in the opposite direction. Over the next two years, affordability restrictions that are currently in place on 448,000 federally assisted homes are set to expire. Over the next five years, that figure is expected to climb to well over 1 million affordable housing units.[8]

This comes at a time when the U.S. is already facing a shortage of 7.3 million affordable and available rental homes. The result: There are "only 33 affordable and available homes for every 100 extremely low-income renter households," according to The National Low Income Housing Coalition's Gap Report.[9] In some major markets such as Las Vegas, Orlando, Dallas-Fort Worth, Houston, San Diego, Phoenix, and Los Angeles, the situation is even more dire, with 20 or fewer affordable rental homes per 100 renter households.[10]

EXPANDING AFFORDABLE HOUSING INVESTMENTS

Against this supply challenge, bridge loans can play a pivotal role in attracting new investors to the affordable housing market segment: due to bridge loans' short duration, investors have the opportunity to participate in what is otherwise typically a long-duration asset. Not only does this grow the universe of institutional investors who can now invest in affordable housing at scale, it expands the types of investment strategies that provide long term affordability.

6 *"America's Rental Housing 2024,"* Joint Center for Housing Studies of Harvard University.
7 *"Share of Income Needed to Pay Rent Increased the Most for Low-Income Households from 2019 to 2021,"* U.S. Census Bureau. March 2, 2023.
8 *Ibid.*
9 *"The Gap: A Shortage of Affordable Homes,"* The National Low Income Housing Coalition, March 2023.
10 *Ibid.*
Figure 1 *IMPACT tabulation of NHPD, retrieved September 2023. Note: All others include units funded by HOME, HUD insured, Mod Rehab, Product Based Vouchers, Public Housing, RHS 515, RHS 538, Section 202, Section 236, State Subsidy. Properties are excluded if their subsidy status is inactive or inconclusive, or if their subsidy end date is after 2023.*

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Affordable housing bridge loans, with a typical term of less than five years, may be considered riskier vehicles than securitized debt, municipal bonds, and permanent loans from a credit risk perspective, owing to the fact that short-term, first mortgage loans to preserve multifamily affordable rental housing are not rated. However, this is offset by the higher credit spreads provided by these loans, allowing for a relatively attractive risk/return profile. Moreover, affordable housing debt has historically exhibited stable property performance, owing to the acyclical demand for affordable housing as well as government rent subsidies that can serve as a backstop for low-income renters in economic downturns.

Physical occupancy for affordable multifamily housing, for example, has remained consistently above 96% since 2008, despite the impact of both the global financial crisis and the global pandemic, according to the Cohn Reznick Affordable Housing Credit Study. In 2022, the most recent year for which there is data, occupancy stood at 97.2%. The same has been true for economic occupancy rates, with collected rents as a percentage of gross potential rents staying in a tight range between 96% and 97% from 2013 through 2022.[11]

Meanwhile, the cumulative foreclosure rate for LIHTC properties and other housing with affordability restrictions through federal tax credits hasn't exceeded 1% for the past 22 years. In 2022, the foreclosure rate stood at just 0.5%, below the delinquency rate for FDIC-insured multifamily properties. Another sign of stability: The median debt coverage ratio for affordable housing tax credit properties stands at 1.38. In fact, for most affordable housing tax credit properties, lending standards require a debt-to-coverage ratio of 1.15 to 1.20 to convert the construction loan to permanent financing. This helps explain why these investments have historically been able to attract debt investors who might not otherwise be drawn to the affordable housing space.[12]

Figure 2: Cumulative Foreclosure Rate by Property Count

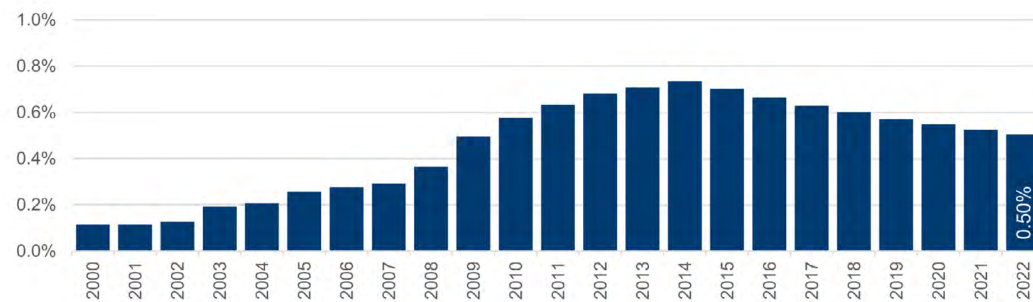
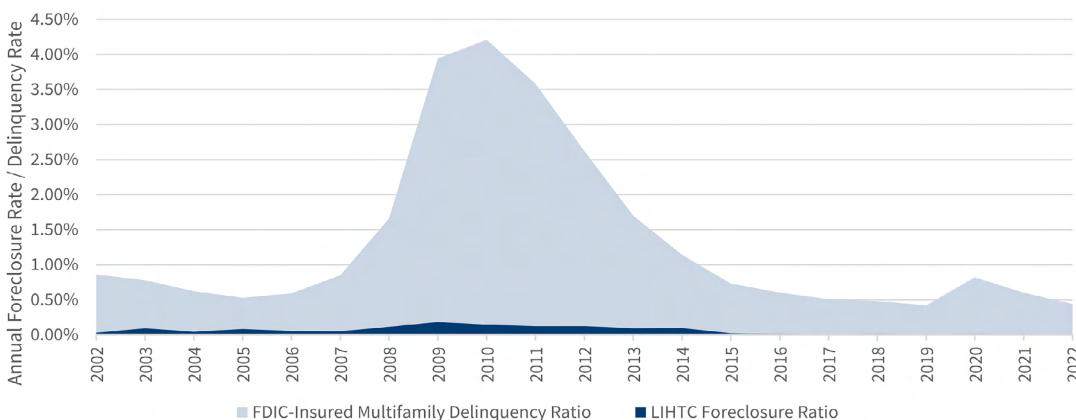


Figure 3: Annual LIHTC Foreclosure Rate vs. Conventional Multifamily Delinquency Rate



THE CUMULATIVE FORECLOSURE RATE FOR LIHTC PROPERTIES AND OTHER HOUSING WITH AFFORDABILITY RESTRICTIONS HAS **NOT EXCEEDED 1% FOR THE PAST 22 YEARS.**

11 *Affordable Housing Credit Study: A Comprehensive LIHTC Property Performance Report.* Cohn Reznick. November 2023.
12 *Ibid.*
Figures 2 and 3 *Affordable Housing Credit Study: A Comprehensive LIHTC Property Performance Report.* Cohn Reznick. November 2023.

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The case for short-term affordable housing mortgages is equally compelling. According to Freddie Mac's published database, shorter-term affordable housing loans perform similarly to Freddie Mac's flagship market-rate 10-year loan product. In fact, loans of five years or less, by original term to maturity, have a loan default rate of just 0.27%.[13]

A SHORT-TERM VEHICLE FOR LONG-TERM AFFORDABILITY

While bridge loans tend to be relatively small, with an average loan size of less than $30 million, this financing can play a pivotal role in maintaining affordability—especially when existing owners may be looking to exit at the end of their current affordable restriction period.

The LIHTC program issues tax credits for the purchase, rehabilitation, or construction of rental housing benefitting lower-income households in exchange for locking in long-term restricted affordability. At the end of those restriction periods, one route to maintain and extend affordability is through resyndication, where existing or new owners can bid for a new allocation of credits to rehabilitate and preserve an existing LIHTC property. New allocations don't simply extend affordability, they create opportunities to make improvements on the assets that create economic, environmental and social impacts for residents and sponsors.

The process of applying for new allocations and subsidies, however, isn't always straight-forward. Part of that stems from existing caps for housing tax credit allocations by state and district. Cohn Reznick's analysis found that "in many states, the ratio of submitted applications for 9% tax credits to the credits the state distributes is 3:1." As a result of this highly competitive landscape, "many developers must submit and resubmit applications, modifying their development plans to better align their project proposals with stated policy goals, ultimately improving the competitiveness of their project, before receiving a credit reservation," according to the report.[14]

Short-term bridge loans allow sponsors to begin the process of rehabilitation at the onset of this time-consuming resyndication process, while buying as much as five additional years of affordability beyond the original restriction period. During that time, sponsors can commence refurbishment of the properties and finalize the details on their permanent financing while seeking new LIHTC allocations and other rent-subsidy contracts that can then secure an additional 15-year, or more, window of affordability.

THE CASE FOR AFFORDABLE HOUSING BRIDGE LOANS

The social and economic case for affordable housing investment is clear, which is why institutional investors have lately been drawn to this space. A 2023 survey by Nuveen found that one third of institutional investors are already investing or plan to invest in affordable housing as part of their impact investing strategy. The only impact priorities cited more frequently were the energy transition and infrastructure projects.[15]

For most institutional investors, though, it's the financial return on affordable housing investment that's the focal point. Affordable housing bridge loans can appeal to a wide array of institutional investors looking to access this asset class, over the short term and in scale, while potentially earning attractive risk-adjusted returns throughout an entire economic cycle.

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13 Freddie Mac Multifamily Loan Performance Database as of 3/31/23 and Freddie Mac Mortgage Security Credit Risk Performance Presentation as of 7/31/23.
14 *Affordable Housing Credit Study: A Comprehensive LIHTC Property Performance Report.* Cohn Reznick. November 2023.
15 *Equilibrium: Nuveen's 2023 Global Institutional Investor Survey.*

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