Demand for **Affordable Housing** Creates **Opportunity For Investors**

Within the commercial real estate sector, a number of property types present viable investment opportunities for institutional investors. As capital allocation in commercial real estate continues to grow, many pension funds and institutions are now seeking investment vehicles that will not only generate strong risk-adjusted returns but also deliver a social impact. ■ When it comes to aligning profits and purpose, nowhere are there greater opportunities for impact and value creation than in the affordable housing sector. Traditionally overlooked by institutional capital, affordable housing has emerged as the newest darling of the commercial real estate market—and for good reason. The limited supply and virtually unlimited demand for affordable housing in rent-burdened markets throughout the nation create tremendous opportunities for attractive yields and long-term growth potential.

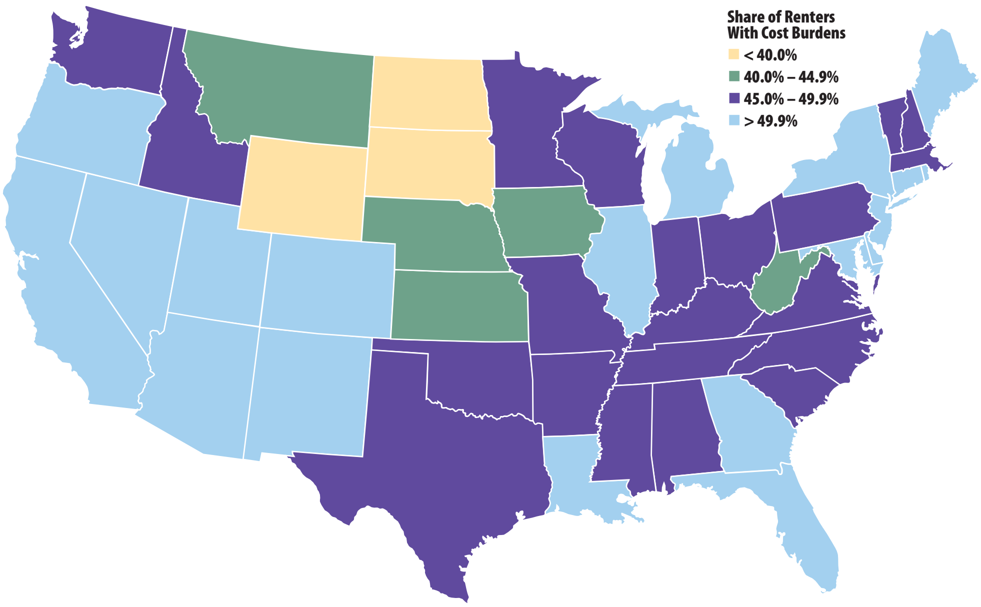

Daryl J. Carter
Avanath
Capital Management


Jun Sakumoto
Avanath
Capital Management


John R. Williams
Avanath
Capital Management

Exhibit 1: Affordable Housing Market

More than half of all renter households in major metros are considered cost burdened.



Source: Joint Center for Housing Studies of Harvard University

Because of this growing rift between rent and income growth, the share of cost-burdened renters has doubled since 1960, resulting in tremendous demand for affordable housing to accommodate this growing market segment.

The challenge, however, is that there is simply not enough affordable product to meet the needs of today's renters. Given the high costs of land and new construction, affordable housing is often cost-prohibitive to develop without government subsidies.

While some corporations are investing in tax credits to assist in the development of new properties that qualify for the Low-Income Housing Tax Credit (LIHTC), there is an even greater need to preserve the existing supply of affordable product. As rent restrictions expire, the number of affordable units coming out of affordability is a growing concern and an area of opportunity for institutional investors.

The National Multifamily Housing Council reports that the US loses approximately 150,000 units because of obsolescence every year, the bulk of which are in the affordable sector. In addition, an estimated two million rent-controlled units will expire over the next decade, 64% of which are supported through the LIHTC program. These units are at risk for redevelopment into market-rate apartments, which will further deepen the trench between supply and demand.

Based on all this activity, institutional investors are beginning to recognize the tremendous investment potential in this niche product type. Further, many institutions now see the shortage of affordable housing as a societal issue that can be addressed through private capital. By acquiring and repositioning existing affordable assets, investors can preserve the dwindling supply of affordable housing for low-income families, while also generating strong, stable cash flow and risk-adjusted returns.

Affordable Housing Opportunity

There's no question that there is a tremendous need for this product type in the US. According to a 2017 report by the Joint Center for Housing Studies of Harvard University, nearly half (48%) of US renters are "cost burdened," meaning they spend more than 30% of their incomes on rent.[1] More than a quarter (26%) of renter households allocate more than half of their incomes toward housing, making them severely cost burdened.

In many coastal markets where the cost of living is significantly higher than in other parts of the nation, the share of cost-burdened renters is as high as 62%. These include markets such as the San Francisco Bay Area, Los Angeles, New York City, and Orlando (Exhibit 1).

Further, while median rental costs in the US increased 12% from 2000 to 2010, median incomes actually *fell* by 7%, further exacerbating the affordable housing crisis, according to a report by Apartment List.[2] Renters during this period experienced the brunt of the Great Recession, the effects of which are still felt to this day.

1. Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing,* 2017, chapter 6.
2. Andrew Woo, "How Have Rents Changed Since 1960?" *Apartment List,* June 14, 2016.

This preservation strategy is a much more cost-effective alternative to new construction and a viable solution to address the nation's affordable housing crisis.

Increased Investor Interest in Affordable Housing

While affordable housing historically has been underserved by institutional capital, there has been a significant increase in investor interest in this product type in the past several years. Three key reasons are driving the increase in capital allocation to this sector.

First, the tightening availability of attractive, market-rate multifamily opportunities is driving investors elsewhere in search of higher yields. As market-rate multifamily grows increasingly expensive and property values continue to climb, returns in this sector are diminishing, making it difficult to achieve the same yields as before.

Affordable and workforce housing properties, on the other hand, have not yet inflated in value to the point where attractive yields cannot be achieved. In fact, investors can acquire an affordable asset well below replacement cost with an average going-in cap rate of 6% as opposed to 3% for a market-rate multifamily investment.

Another reason for this shift is a growing interest in impact investing, especially among institutional investors. As impact investing becomes more widely accepted and understood, many institutions are beginning to seek opportunities to address some of society's biggest challenges, while also generating competitive risk-adjusted returns.

This is especially true in the affordable housing sector. By preserving and enhancing affordable and workforce housing communities throughout the nation, investors can achieve financial returns while also delivering tremendous social benefits to underserved neighborhoods throughout the nation.

Finally, from a core real estate standpoint, investing in affordable housing is one way institutions can diversify and stabilize their portfolios with yield-generating assets that are also resilient to economic pressures. In fact, when the economy falters, average occupancies and the need for affordable housing actually increase, insulating this product type from external factors, especially in rent-burdened markets.

Alternatively, when the economy is thriving and rent increases outpace income growth, demand for affordable housing options remains stronger than ever, resulting in high occupancies and stable cash flow. This sustained demand for affordable housing makes it an increasingly attractive asset class for institutional investors.

Strong Market Fundamentals Drive Financial Returns

The affordable housing sector has consistently demonstrated strong market fundamentals throughout economic cycles. Demand for affordable housing continues to outpace supply, and demographic trends support future growth in this sector.

The median income of a renter in the US is $35,000. Most of the jobs that have been created since the recession have been lower- to middle-income jobs, with annual salaries ranging between $30,000 and $50,000. These include middle-income jobs in fields such as education, construction, and social services.

At the same time, however, 80% of newly developed apartment units in the largest US metros are focused on targeting the luxury segment of the market or renters earning high six-figure incomes, according to national research firm Equilibrium. This disproportionate supply of luxury to workforce inventory propagates a severe lack of affordable housing to support the largest stock of renters.

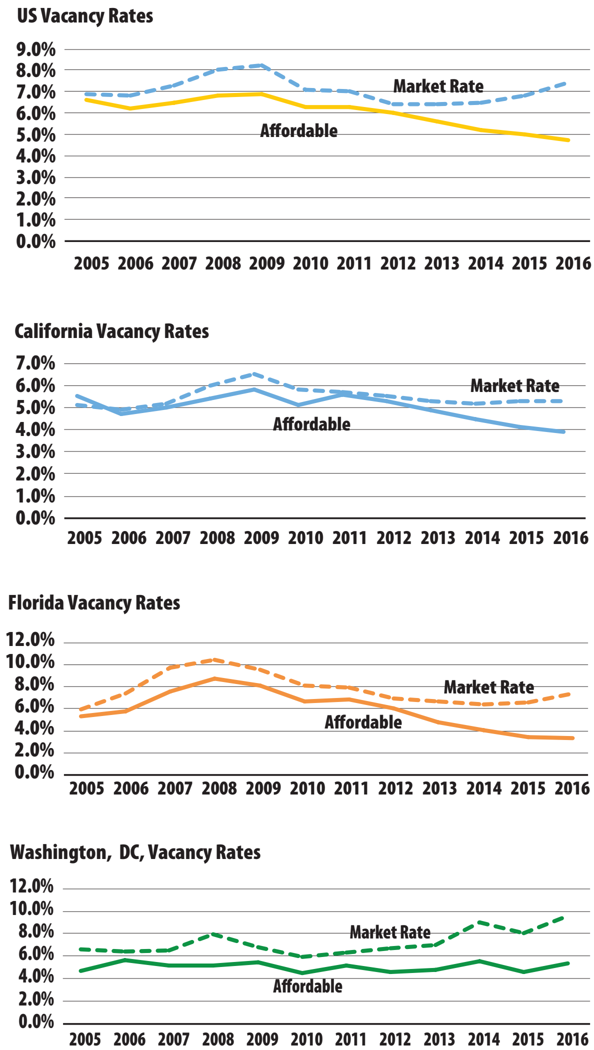
Further, while the market-rate multifamily market has seen an uptick in vacancies coinciding with the delivery of new luxury products, affordable housing occupancy remains robust. Historically, average occupancies for affordable housing have exceeded occupancies for market-rate housing. On a national scale, vacancies for market-rate housing have averaged 5%, whereas vacancies for affordable housing average around 4% (Exhibit 2). In expensive markets such as California, Florida, and Washington, DC, affordable housing vacancies hover as low as 2%.

Many affordable portfolios maintain occupancy rates of 98% or higher with minimal turnover. Whereas the average market-rate multifamily community has a turnover rate of 50% to 70%, affordable housing communities typically have a much lower turnover of 15% to 20%. This lower turnover rate improves operational efficiencies and contributes to the overall stability of each asset, driving net operating income and risk-adjusted returns.

In addition to high occupancies and low turnover, strong economic growth will continue to drive the affordable housing investment market for the remainder of 2017 and beyond.

Like other asset classes, affordable housing is poised for value creation and rent appreciation as incomes grow over time. There is a common misconception that because rent-stabilized housing prohibits significant rental increases, affordable housing cannot generate the strongest returns. As the economy strengthens and income growth continues, however, incomes in high-growth markets will naturally

Exhibit 2: Vacancy Rates of Affordable and Market-Rate Rentals



Source: CoStar

rise, presenting an opportunity to sustain moderate rent growth over time while maintaining affordability relative to AMIs.

Why Haven't Institutional Investors Invested in Affordable Multifamily?

Despite the compelling rationale for this asset sector, why do so few investors consider affordable housing investments?

- **Negative Perceptions of Asset Class Based on Historical "Myths":** Most investors perceive there are greater operational risks—greater tenant delinquencies, greater safety/crime issues, and greater "wear and tear" on property—because of the resident profile. Many of these myths relate to the history of public housing in the US—the negative histories of Cabrini Green and Robert Taylor Homes in Chicago and Pruitt-Igoe in St. Louis. The reality is that the dearth of affordable rentals and the high demand results in high resident "stickiness," where default rates and turnover rates are significantly lower than market properties, which results in lower operational risks.
- **Complexity:** Apartment properties with rent restrictions, Section 8 overlays, or other affordable features have governance structures that require strict compliance. Some investors simply don't want to take the risk of maintaining compliance. These risks are mitigated with sponsors and/or property managers that have specific expertise in affordable compliance.
- **Specific Neighborhoods/Submarket:** Institutional capital typically targets "A" locations—Midtown Manhattan, Downtown San Francisco, Downtown Los Angeles, Chicago's Lakefront, and Downtown Seattle, for example. More-affordable locations near major employment centers do not receive the same institutional capital focus, such as West Oakland (CA), Long Beach (CA), Bedford-Stuyvesant (NY), and Kent (WA). Properties in these "less-glamorous" locations can be purchased at a more attractive cost basis, allowing them to have more affordable rents. Interestingly, while perceived to be less desirable than Los Angeles or Orange County, Long Beach is located in the geographic center of Los Angeles/Orange County.
- **Unique Property Types:** Many affordable properties are situated in unique configurations, often in smaller buildings. Some have minimal parking, although this is mitigated by excellent access to public transportation. Avanath owns about 400 rent-stabilized units in Brooklyn, with the largest building comprising only 52 units. Sourcing and managing portfolios of smaller properties requires a specialized platform and a customized approached.

While traditionally misunderstood and perceived as complex, affordable housing actually provides competitive returns within a low-risk environment. Owners/operators with track records in this space have effectively proved that the platform works by improving operational efficiencies and achieving attractive yields.

Impact Investing Gains Momentum

As investment strategies evolve in response to market needs, investors are deploying more capital to underserved sectors and are increasing their allocations to impact investment funds.

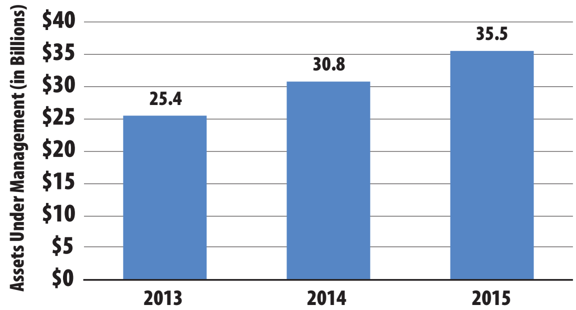
According to a survey by Global Impact Investing Network, assets under management in the impact investment sector grew from $25.4 billion to $35.5 billion between 2013 and 2015 (Exhibit 3).[3]

Several reasons explain this increase in institutional interest. First, there is a growing consensus that many societal issues, such as housing, health care, and education, can be addressed through private equity. Impact investing serves as a market-based solution to fill the gap left by government-funded programs and philanthropic organizations.

Second, there is an acknowledgment that impact investments offer comparable risk-adjusted returns to traditional ventures. In fact, more than half the participants in the Global Impact Investment Survey reported they invest to achieve risk-adjusted returns and find that impact investments consistently meet and even exceed financial expectations.

Ultimately, the rise of impact investing has provided additional equity streams to reclaim and rehabilitate existing affordable assets. Within the affordable housing sector in particular, there are ample opportunities to advance social objectives without compromising returns.

Exhibit 3: Global Impact Investments from 2013–2015



Source: Global Impact Investment Network

The Bigger Picture—It Starts With Housing

From a macro level, safe, clean, and affordable housing is the foundation for economically viable neighborhoods. Preserving affordable housing is critical to the growth of communities and the economy at large.

The fact is, housing is a big expense for low-income families. The shortage of quality affordable housing options is a major pressure point for these households. When a family spends more than half its income on rent, its members have difficulty thriving, especially when they are not building equity or able to save money toward homeownership. Beyond this, there are other negative ancillary effects of overly expensive housing:

- Severely cost-burdened households often delay health-care decisions and sacrifice other necessities to pay rent. According to the 2017 Joint Center for Housing Studies report, these households spend 53% less on food, health care, and transportation than households that are not cost burdened.[4] For health care alone, severely cost-burdened families with children spend 75% less on health care than their counterparts living in affordable housing.
- Low-income, cost-burdened families typically sacrifice location and quality of living for affordability, resulting in longer commute times and poor living conditions. These families commute on average three times farther than those that are not rent burdened, according to the Joint Center for Housing Studies.

The implications extend far beyond these individual families and impact entire communities. Longer commutes mean higher carbon emissions, and delayed health care can place enormous stress on the nation's health-care system. By investing in the preservation of affordable housing, investors can help alleviate some of these pressures.

The Bottom Line

Looking ahead, the affordable housing market will continue to grow as institutional investors continue to achieve positive bottom-line results from their investments. A compelling opportunity exists for institutional investors to respond to this dire need and to do so in a way that is both sustainable and profitable for their bottom line. The growing demand for this asset class means that quality affordable housing will always be nearly full, which translates to stable cash flow. Further, this product type is insulated from market cycles, thereby mitigating risk and consistently generating attractive yields for investors.

Beyond the provision of deeply needed affordable housing, investors can restore and transform communities that historically have been underserved by institutional capital. Financial returns are simply an added reward for helping these communities thrive. ■

Daryl J. Carter is Founder, Chairman, and Chief Executive Officer; Jun Sakumoto is Chief Operating Officer; and John R. Williams is President and Chief Investment Officer of Avanath Capital Management.

3. Abhilash Mudaliar, Aliana Pineiro, and Rachel Bass, *Impact Investing Trends: Evidence of a Growing Industry,* Global Impact Investing Network, December 2016.
4. Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing,* 2017, chapter 6.