

SAUDI ARABIA'S AFFORDABLE HOUSING CHALLENGE

Part 1



With a growing youthful population demographic and a rapid drive towards modernization, Affordable Housing is a key real estate development policy issue facing the Kingdom of Saudi Arabia. An examination of international best-practices along with a keen understanding of the local market can lend insights towards a successful affordable housing policy.

WHAT IS AFFORDABLE HOUSING?

In general, the term “affordable housing” refers to housing provided to a domestic population with restrictions on the price of rent or sale. The restriction, typically represented by a “cap” on the price, is meant to allow households at the lower end of the income spectrum access to the unit.

The “affordability level” is determined by what category of the population can access the housing – e.g. low-income, very low-income, etc. A project affordable to households making the equivalent of USD \$2,000 per month in total household income, is different from a project affordable to households making under USD \$500 per month in total household income. The affordability level is typically determined by a regional or national “housing affordability index” which is set and then updated by a Ministry of Housing or government equivalent agency.

Affordable housing is housing which is deemed affordable to those with a median household income at or below an established threshold as rated by a national government or a local government housing affordability index.

OVERVIEW OF DEVELOPMENT MODELS FOR AFFORDABLE HOUSING PROJECTS

The earliest examples of affordable housing - which is the simplest development model and is still the most common worldwide - are government built and managed projects. In this scenario, the government invests the entirety of the CAPEX necessary to develop the project, and owns the project

after completion. Units are then offered to low-income households for-rent through an application and qualification program.

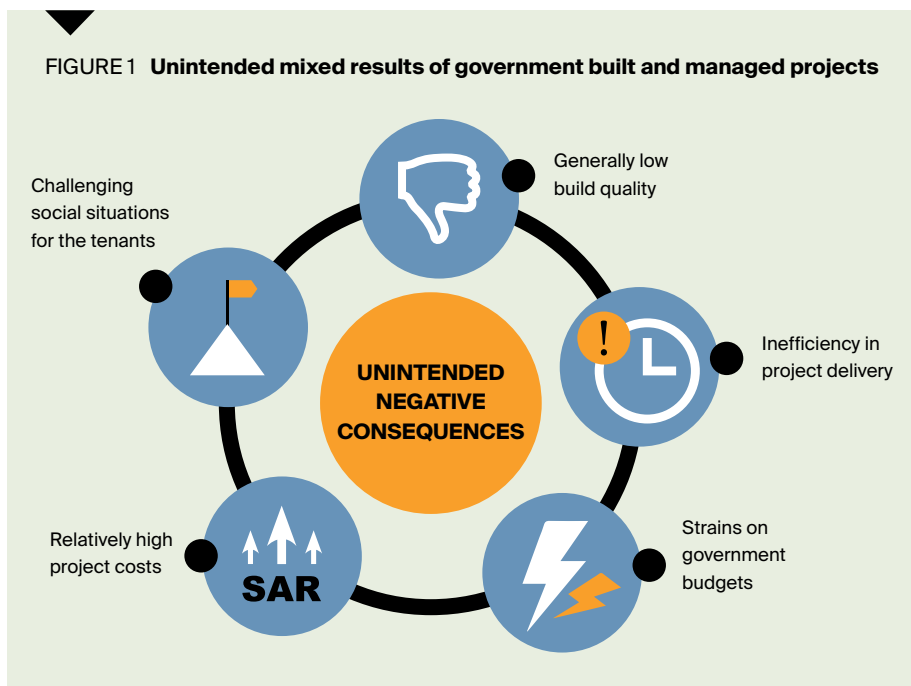
However, this development model in many cases has led to unintended negative consequences:

- Generally low build quality
- Inefficiency in project delivery
- Strains on government budgets
- High project costs relative to similar private-sector build quality
- Challenging social situations for the tenants (concentration of low-income households)

Due to the mixed results, international standards have been shifting away from this model and towards private-sector collaboration models, in order to harness the initiative and efficiency of the private sector. These development models can broadly be divided into two categories:

- **The government provides a subsidy directly to the private sector developer**
The intention is to offset the loss in revenue that the developer will experience by providing the units at a lower than market-rate price point. Subsidies paid to the developer can be through direct CAPEX investments, tax credits, offsets, government infrastructure investment.
- **The government provides a subsidy directly to the end-user**
In this model, the project can be built mostly along a market-rate model, and then the rental payment or mortgage payments (in case of for-sale projects) made by the end user to the developer is subsidized by government funds, allowing the lower-income segments of the population to access the project.

FIGURE 1 Unintended mixed results of government built and managed projects



DETAILED EXAMINATION OF PRIVATE-SECTOR COLLABORATION MODELS FOR AFFORDABLE HOUSING PROJECTS

This section of the white paper elaborates on private-sector collaboration models which were introduced after government built and managed projects yielded mixed results. The five development models which will be further discussed are shown in the below exhibit. (Figure 2)

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Model #1: Price Cap

Known in the United States as "Section 8" housing, housing projects with price cap stipulations are private-sector built and managed housing which provides units at a lower than market rate to low-income individuals. The government in return pays a subsidy directly to the developer/property owner often amounting to the difference between what the low-income individuals can afford, and the true market value of the unit. The low-income individual or household must go through a screening process, as per the policy set by the government authority, but then executed at the level of the property manager for each individual project. In this development model, conversion of existing market-rate housing stock into affordable housing is possible to include in the program, in addition to the development of new housing projects. (Figure 3)

Model #2: PPP

In the PPP development model, a private sector developer partners with a government agency specifically to develop affordable housing projects which are subsidized through government investment directly into the project. The government investment can take different forms – including tax credits, direct equity investment, subsidized development and

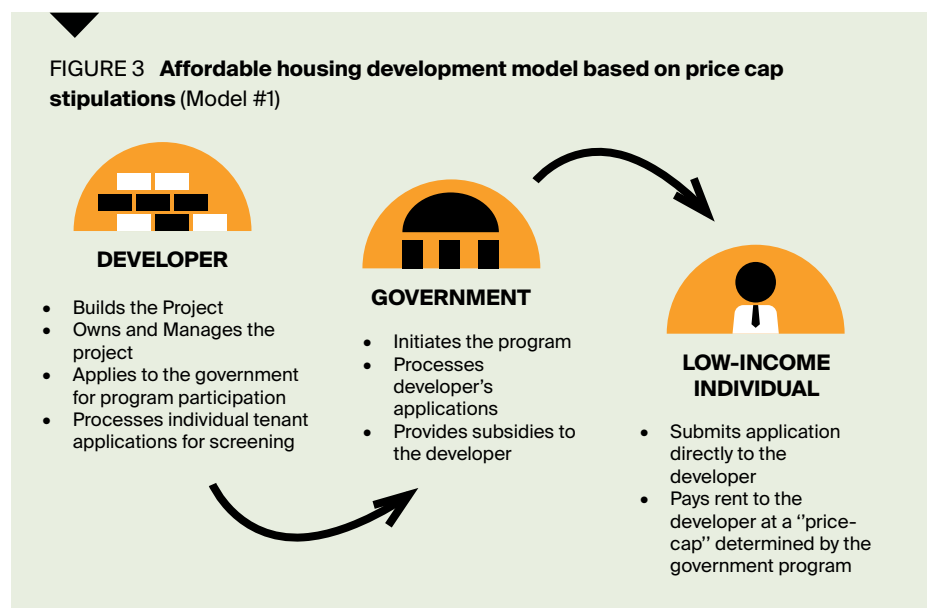
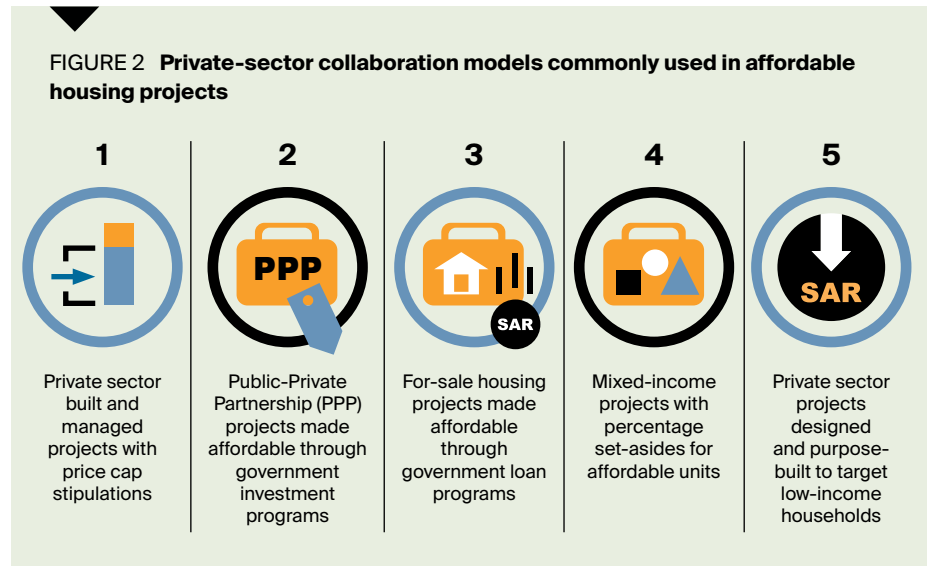
construction loans, etc. The basic idea of this development model is to entice private sector developers to build affordable housing projects through government investment which offsets for the developer, the difference in projected profits from a market-rate project versus an affordable housing project.

The private sector developer is provided extra motivation to participate in the PPP program due to the projected high occupancy rates typical in affordable housing projects versus market-rate projects. Whereas an 80% to 85% occupancy rate is common in market-rate projects, affordable housing projects can often be modelled with 98% to 100% occupancy levels; and this increase in occupancy rates directly correlates to increases in project ROI for the developer.

An additional point to consider is that, affordable housing projects are typically considered stable and low-risk, income-generating assets – due in large part to the aforementioned high occupancy rate. Therefore, these projects become prime candidates for acquisition by investment funds and REITS. Therefore, private sector developers participating in PPP programs can typically expect to exit the project upon reaching stable occupancy through selling the asset to a Fund, and thus recoup their initial investment and increase their project IRR as compared to a similar market-rate project. (Figure 4)

Model #3: For-sale Housing

A development model which has been gaining popularity in recent years including in Saudi Arabia is to offer affordable housing along a for-sale



business model. The key advantage to this development model is that it allows low-income individuals to actually participate in home ownership and all the associated benefits, rather than simply for-rent housing options.

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The basic structure is that a private sector developer builds a for-sale housing project at pre-determined price points which are close-to market rates and still allow the developer to achieve an acceptable profit on the project. The government then provides subsidies directly to the low-income individual in the form of down payment assistance and subsidized loan terms, which then allows the low-income

individual to access the housing. At times, this development model is combined with other development models; for example, the government could both directly invest in the project (PPP model) AND offer subsidized loans for low-income individuals.

One key consideration with government loan programs is the pre-determined price-point; the model is ineffective if the price-point is too far below established market-rates and therefore this development model works best with mid-low-income population segments, and not very-low-income population segments. Another consideration is that low-income individuals and households are inherently less likely to be able to purchase their own home. Even with a government subsidy program, success rates of the individuals being able to repay mortgages over a long-term horizon are mixed. (Figure 5)

A third consideration is the issue of re-sale. Depending on the degree of variation between the pre-determined price point and the market-price of the unit, government programs often place re-sale restrictions on the units to avoid low-income individuals purchasing a home and then quickly re-selling ("flipping") the house at a higher market price to a private-sector investor at a profit. Some examples of re-sale restrictions utilized on successful projects internationally include: (Figure 6)

- Restricting any re-sale for a period of 5 or 10 years

- Placing permanent price restrictions on the unit (e.g. a maximum 3% price increase per year or in-line with estimated inflation) so that the unit remains theoretically "permanently affordable" even to new buyers in the future
- Placing restrictions on buyers i.e. stipulating that any new buyer must also be a low-income individual qualified through the government screening process

FIGURE 5 Affordable housing development model based on for-sale housing projects (Model #3)

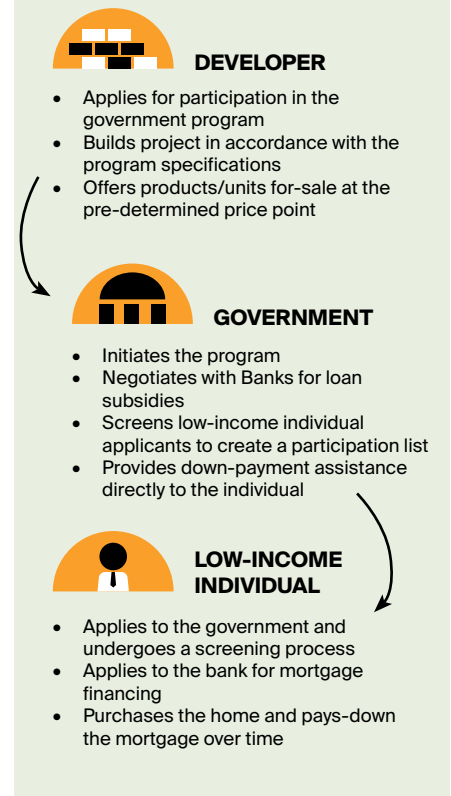
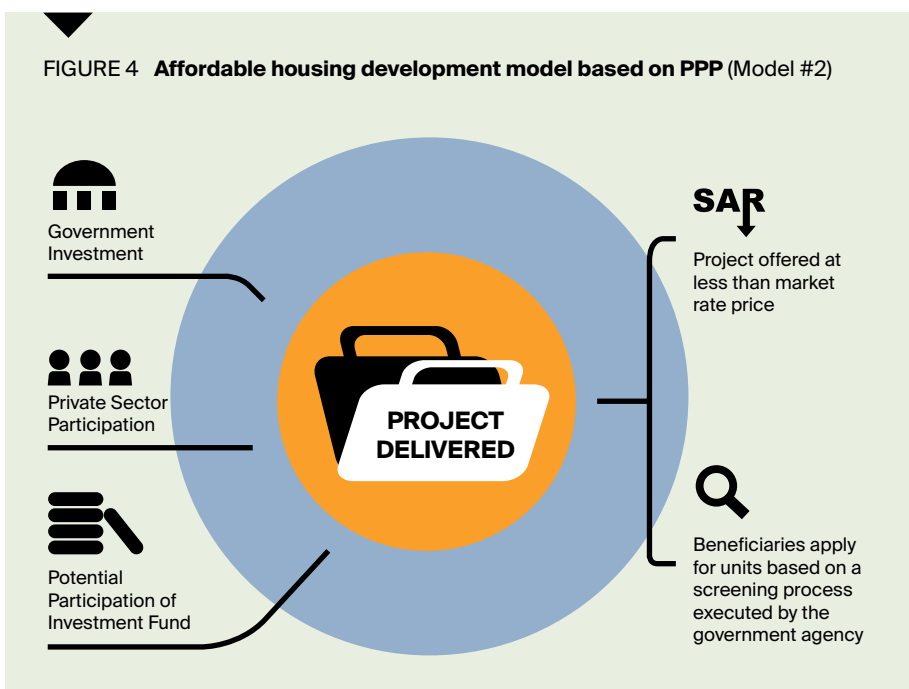


FIGURE 4 Affordable housing development model based on PPP (Model #2)



The basic structure of a for-sale development model is that a private sector developer builds a for-sale housing project at pre-determined price points which are close-to market rates and still allow the developer to achieve an acceptable profit on the project.

Model #4: Mixed-income

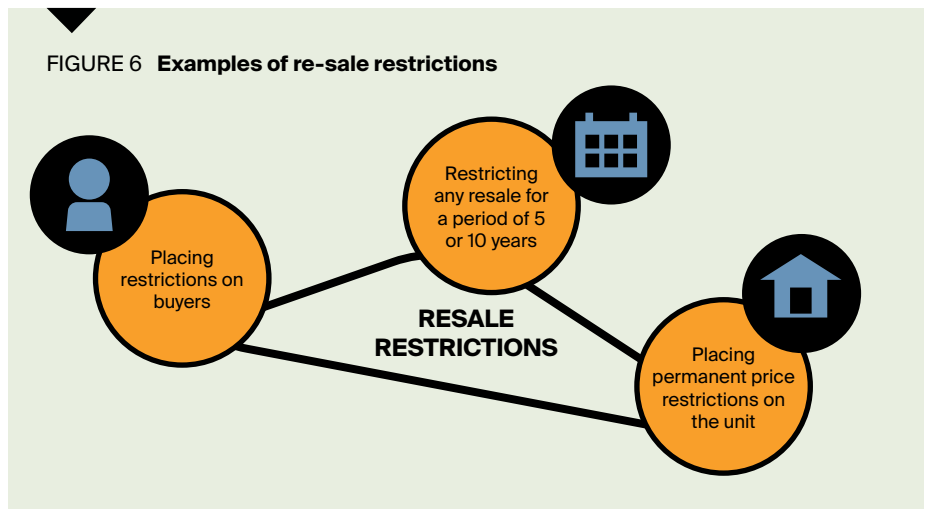
One of the most popular development models for affordable housing internationally is the mixed-income project model. The premise of this development model is to incorporate affordable housing within market-rate projects; this approach has several advantages:

- Allows low-income individuals to live within a market-rate environment which has positive social consequences for the low-income individual
- By incorporating affordable housing within a market-rate project, the financial burden is somewhat reduced as the units which are market-rate generate profit which can then be used to subsidize the percentage set-aside of affordable units
- The approach requires the least amount of government bureaucracy to administer and the least amount of direct government investment and thus is the most sustainable model from a budget perspective (Figure 7)

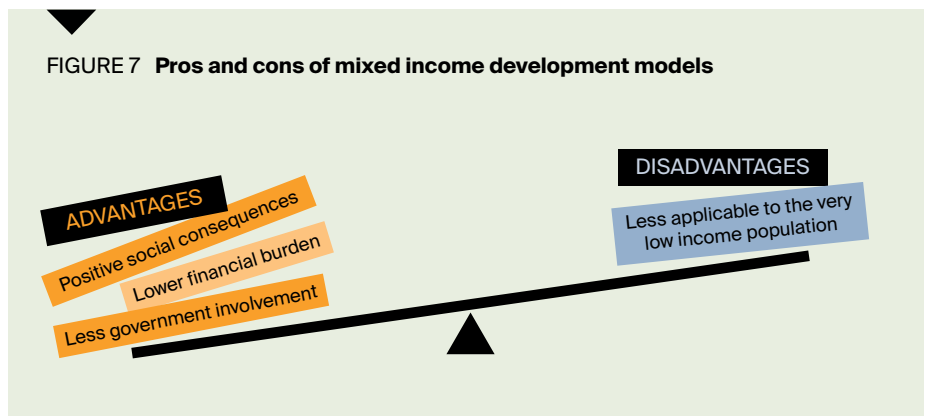
This model is typically accomplished through a percentage allocation requirement; for example, a government regulation would require that all new housing development projects set-aside 20% of the total number of units built at an affordable rate.

In markets where there is already an under-supply of even market-rate housing and therefore private sector developers are assumed to already be making a healthy profit, very little government subsidy is required to initiate the program. Essentially, the regulation is implemented and the loss in rent from the affordable units are essentially absorbed by the developer as a project cost or a small reduction in profits. This is especially true if the percentage set-aside is small, such as a 10% set-aside requirement – setting aside 10% of the units at an affordable rate will typically not deteriorate the developer’s profits enough to discourage new projects.

“Soft” government assistance is often provided in these cases – for example, government-backed loans which are offered at slightly lower rates to these projects. In some cases, the banks themselves are also asked to contribute to the initiative by taking slightly less margins on development loans for these projects, which are regulated by a government initiative. However, in cases where market



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dynamics do not support the absorption of an affordable housing set-aside model, or in cases where the mandated set-aside percentage is higher (such as 20% to 30%), government subsidies are usually required in order to make the project financially feasible for the private sector developer.

Because the affordable units are wrapped into a market-rate project, the form of government subsidy is often indirect as opposed to the more direct form of subsidy in other affordable housing development models. Some examples of indirect subsidies include:

- Reduction or elimination in municipality and government approval fees typical to a development project if the developer agrees to the affordable set-aside

- Government investment in infrastructure that the project would need (e.g. government builds a substation thus reducing project costs; government widens a road or constructs a parking structure). This has the effect of both enhancing the area with improved infrastructure, as well as assisting the project’s financial feasibility. In addition, it is still an indirect subsidy as the government is not investing equity directly into the project.
- Government development loans at substantially reduced interest rates
- Increases in FAR allowing the developer to build more total GFA and thus rentable area if they include the percentage affordable housing

set-aside (thus giving these projects an advantage over other competing market-rate projects)

Once again, this approach has not seen success for the very-low-income population segment as the difference in rental rates between a market-rate project and what is affordable to very-low-income individuals and households is too great for the project to bear without significantly reducing projected developer profit. In addition, there is the issue of the very-low-income population segment often having special needs and unique circumstances that are not accounted for in the project – a key example being public transportation. (Exhibit 8)

Model #5: Purpose-built

The most recent trend in the affordable housing paradigm is private sector developers initiating, on their own and without any government program, projects which target mid-low-income households and individuals. However, this development model has only taken-hold in certain markets where conditions are specifically aligned. In addition, to-date this development model has only been seen in cases where the target is mid-low-income individuals and households, and not low-income or very-low-income households.

The basic premise is that private sector developers see an opportunity to develop a project with a more basic construction

style and limited amenities and then offer this product at a rate which is specifically affordable to mid-low-income households. While the profit margins on such projects for the developer are lower, this is offset by positive factors – such as higher occupancy rates (due to a supply/demand mismatch between available housing options for this population segment), lower overall project costs which lowers financing costs, more basic construction styles and methodologies which lowers soft costs, and the ability to sell-off the completed asset to funds or REITs due to the more stable nature of the rental dynamics as compared to luxury or high-end housing projects.

(END OF PART 1 – TO BE CONTINUED)

TCN will soon release Part 2 in which we will elaborate on best in class affordable housing policy considerations and some insights how they could be of benefit to the Kingdom of Saudi Arabia.

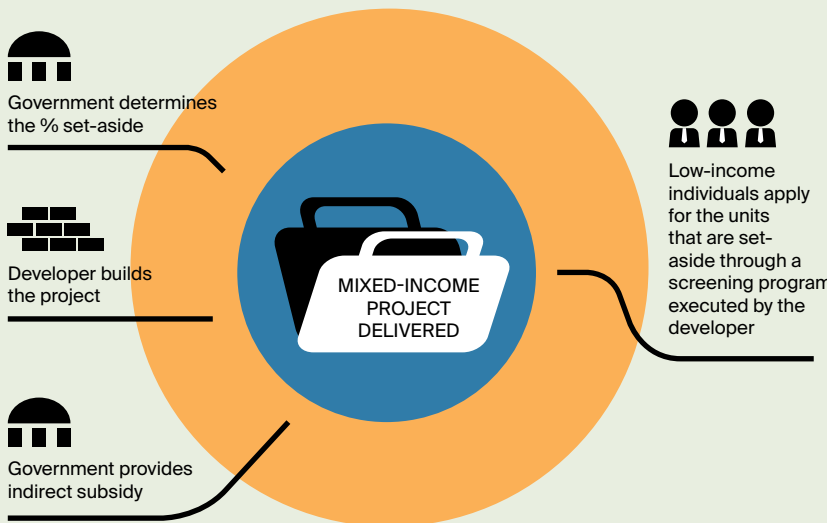


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FIGURE 6 Affordable housing development model based on mixed-income projects (Model #4)



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