

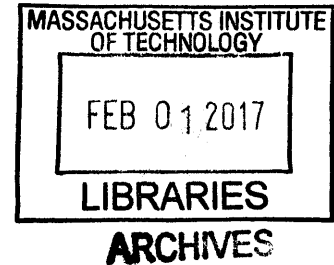
Why Affordable Housing Developers Should Go Public: REITs as an Alternative Source of Capital
for Housing Development

by

Xiang Ying Estelle Chan

B.A., Urban Studies, 2009

Columbia University



Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development

at the

Massachusetts Institute of Technology

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Signature redacted

Signature of Author_____

Xiang Ying Estelle Chan
Center for Real Estate
July 29, 2016

Signature redacted

Certified by_____

Walter N. Torous
Senior Lecturer, Center for Real Estate
Thesis Supervisor

Signature redacted

Accepted by_____

Professor Albert Saiz
Daniel Rose Associate Professor of Urban Economics and
Real Estate, Department of Urban Studies and Center for
Real Estate

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ABSTRACT

The affordable housing crisis in the United States is real and persistent. In the face of growing economic inequality and the failure of public housing programs, American cities need the development industry to deliver more affordable housing units than ever before. Instead, the affordable housing development process is regarded as a fragmented nexus involving multiple public and private sector parties. Raising capital for affordable housing projects is notoriously complex; it is common to see individual apartment buildings funded by a mix of any of the following: public grants, federal tax credits syndicated through private lenders, interest-free debt from community lenders and municipalities, mortgage debt from commercial lenders and private equity. A good affordable housing developer must be adept at understanding the covenants and eligibility requirements of every source of funds as part of the development process, and work with the myriad parties to compete or apply for funds. This long and convoluted process raises high barriers to entry into the industry and slows down the production of a public good. This thesis investigates the possibility of an alternative funding model for affordable housing development and proposes that developers go public to raise capital, adopting the same tried-and-tested method of financing real estate development that commercial developers have relied on for nearly 30 years. This thesis will argue that a REIT can function as an organizing mechanism to simplify the process of raising capital across different pools of institutional equity, private wealth and public funding. By being able to turn to the widest capital markets for fundraising, affordable housing developers can be nimble in choosing when to raise capital and flexible in deploying it to build experimental mixed-income and workforce housing, two typologies of housing that have been identified as helping to make urban areas more inclusive. Through this thesis, I posit that the affordable housing development REIT can serve as the central platform to consolidate the various pools of triple-bottom-line investors and to create for the first time a public market for an asset class that exhibits all the features of a stable, long term core investment.

Thesis Supervisor: Walter N. Torous

Title: Senior Lecturer, Center for Real Estate

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* * *

On a personal note, I will be the first to acknowledge that it would not have been possible to write this thesis without the inspiration of MIT, a quiet desk, and being cheered on from the sidelines by friends and family.

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CHAPTER ONE

The Affordable Housing Crisis in the U.S.

1.1 Setting the Context

The affordable housing crisis in the United States is real and persistent. In the face of growing economic inequality and the failure of public housing programs, instead of tending towards simplicity and straightforwardness, the affordable housing development process has fragmented into a complicated nexus of involvement at the federal, state and municipal levels, operating side-by-side with the often overlapping work of private for-profit and non-profit housing developers, syndicators, community development financial institutions (CDFIs) and corporations (CDCs).

Today, raising capital for affordable housing projects is notoriously complex; it is common to see individual apartment buildings funded by a mix of or all of the following: public grants, federal tax credits syndicated through private lenders, interest-free debt from community lenders and municipalities, and mortgage debt from commercial lenders and private equity. To be a leading affordable housing developer in the market, a developer must be adept at understanding the covenants and eligibility requirements of every source of funds as part of the development process, and work with the myriad parties to compete or apply for funds.

This long and convoluted process raises high barriers to entry into the industry and slows down the production of what should be deemed a public good. As much as affordable housing has been produced largely by private sector players since the late 1980s, it is still not possible to develop, at a large-scale, affordable housing units without tugging on the strings of the public purse, be it through outright grants or through indirect subsidies such as tax credits and tax abatements. Despite the multiple opportunities for innovation, the model of affordable housing development has not deviated far from its 30-year-old publicly-funded, privately-built approach. Even in an atmosphere of real estate disruptions and technological disintermediation, affordable housing is still very much produced through traditional public-private partnerships.

Have there really been no financial innovations to spur the delivery of affordable housing all this while? Not true, strictly speaking, although many of these innovations have simply been the creation of new public policy to financially incentivize the private sector into building affordable housing. The 1986 creation of the Low Income Housing Tax Credits (LIHTC) as part of the Tax

Reform Act stands out as the federal government's primary tool to finance the development of affordable rental housing for low- and moderate-income households by encouraging the investment of private equity into this sector.¹ During the same period, the federal government expanded the availability and use of the Section 8 Housing Choice Voucher Program (a program that had existed in a limited form since 1937) to allow low- and moderate-income renters to rent market-rate units by bridging the shortfall of what they can afford to pay and the prevailing market rents. The effort to harness the powers of the free market to provide affordable housing represented a Reagan-era shift from supply-side to demand-side strategies, even though the Section 8 vouchers are today largely viewed as massive transfer payments made from the public sector to the private.

Major metropolitan areas, where demand for housing was high and land supply and housing production scarce, also played their parts in rolling out their strategies to spur affordable housing production. In Boston, the approval of the Chapter 40B state statute in 1969 allowed local Zoning Boards of Appeals to approve affordable housing developments under flexible rules if at least 20% to 25% of the housing units were affordable, meaning that developers could often seek for zoning reliefs for Floor Area Ratio² or height if they were willing to provide their fair share of affordable housing. In New York, the creation of the Chapter 421a Tax Abatement Program in 1971 allowed developers to be exempt from property taxes if they built multi-family rental housing in underserved areas of the city where market-rate units could still be affordable to middle-income earners, or if they kept 20% of their units affordable if their project was in a Geographic Exclusion Area (highly desirable neighborhoods with high prevailing rents).

Still, despite the positive market responses towards new public policy to increase the delivery of affordable housing units, affordable housing development is still acknowledged to be a deeply specialized slice of the real estate development sector, requiring specialty knowledge of the myriad funding programs and well-cultivated relationships with public agencies and political actors. The LIHTC and Section 8 programs still have requirements and Qualified Allocation Plans (QAPs) that run into hundreds of clauses. Untangling and understanding each and every requirement is the bread-and-butter work of all providers of affordable housing, making the work time-consuming,

¹ Board of Governors of the Federal Reserve System. (2009). *Innovative Ideas for Revitalizing the LIHTC Market*. Federal Reserve Bank of St. Louis.

² FAR is calculated in many jurisdictions as $FAR = \text{Total Built Floor Area} \div \text{Total Lot Area}$

highly technical and requiring of a cabal of project managers, investors and lawyers savvy enough to parse through them. On top of that, each program comes with its attendant financing costs, meaning that public money (or subsidies) don't often come cheap and don't lower the cost of capital for developers. Can these public policies truly be viewed as financial innovations that make it easier to invest in affordable housing and not harder?

This thesis is underpinned by the view that there lies a more elegant method to spur investment into the production of affordable housing, by tapping on a familiar workhorse of the real estate investment industry – the REIT. This thesis argues that another way of raising capital to finance affordable housing is through the process of taking affordable housing developers public and thereby creating affordable housing development REITs. By adopting the REIT organizational structure, affordable housing developers can tap on the growing appetite of socially-conscious, long horizon investors, raise cash off stabilized properties in the public markets and channel these funds into new construction. Indeed, if a developer continues to develop affordable housing at a steady clip, it can continuously turn to the public markets to raise cash each time a new property is stabilized. Essentially, it can almost wholly rely on its asset base to constantly re-capitalize its balance sheet. With financing under their sole purview, pre-development lead times can be cut short and housing units produced faster.

Of course, the fact that affordable housing development REITs are not more common in the market speaks to the existence of major issues that make it hard to take affordable housing developers public – difficulties in valuing affordable housing (which is ultimately a deed-restricted property not at its 'highest and best use'), scarcity of reporting data for affordable housing earnings and indices, the institutionalized inertia towards relying on existing sources of public funds, etc. However, after taking into account these issues, I argue that it is possible to de-mystify the process of financing affordable housing so that this critically-needed real estate product can be viewed as a stable, core investment opportunity, instead of as the hyper-specialized asset class that it is viewed today.

The thesis is organized in the following ways: Chapter One introduces the argument of the thesis, highlights the housing affordability crisis in the U.S. and gives an overview of the history and development of public policies related to the financing and production of affordable housing.

Chapter Two demonstrates in detail how public financing policies such as tax credits, vouchers and grants work and contrasts these policies with the newer, leading-edge private approaches towards financing affordable housing. Continuing on the theme of private sector-led approaches to raising financing, Chapter Three situates the REIT vehicle as one of the successful ways real estate developers have raised equity in the past by tracing the history and evolution of the REIT over the past 60 years. Chapter Four posits that the REIT vehicle is well positioned to take on the challenges of organizing a platform to raise capital from a growing number of socially-conscious triple-bottom-line investors and demonstrates the rationale, structure and strategy for an affordable housing development REIT. Chapter Five concludes the argument and expresses confidence that the market is poised to adopt REITs to finance affordable housing and suggests further research that might be conducted towards making affordable housing development REITs a reality.

1.2 The Affordability Crisis

According to data from the latest U.S. Census, nearly half of all renters pay more than 30% of their incomes towards housing expenses³, 30% of gross income being the expenditure threshold recognized as housing affordability. The National Association of Home Builders report that this is equivalent to 19.4 million households (or 49% of total households renting homes in 2010) being rent-burdened.⁴ Studies show that over the last 30 years, renters across major metropolitan areas have increased their household expenses across all income bands, so that it is not just a crisis of affordability at the lower- and moderate-income levels, it is a nationwide, urban crisis.

In the context of a discussion about affordable housing, I am limiting the focus of this thesis to affordable rental housing rather than for-sale housing, for the reason that a vast majority of affordable housing, be it public housing or private residential developments, are for rent. This is not to say that there is no acknowledgement of the interplay between the supply and demand of rental and for-sale housing vis- à-vis the economic cycle. Instead, I am approaching the discussion from the angle that for-sale housing in major metropolitan areas is largely out of reach for many of the working poor, and hence the supply of for-sale housing does not have as direct an impact on the affordability of rental housing, especially in income bands where nearly nothing is affordable.⁵

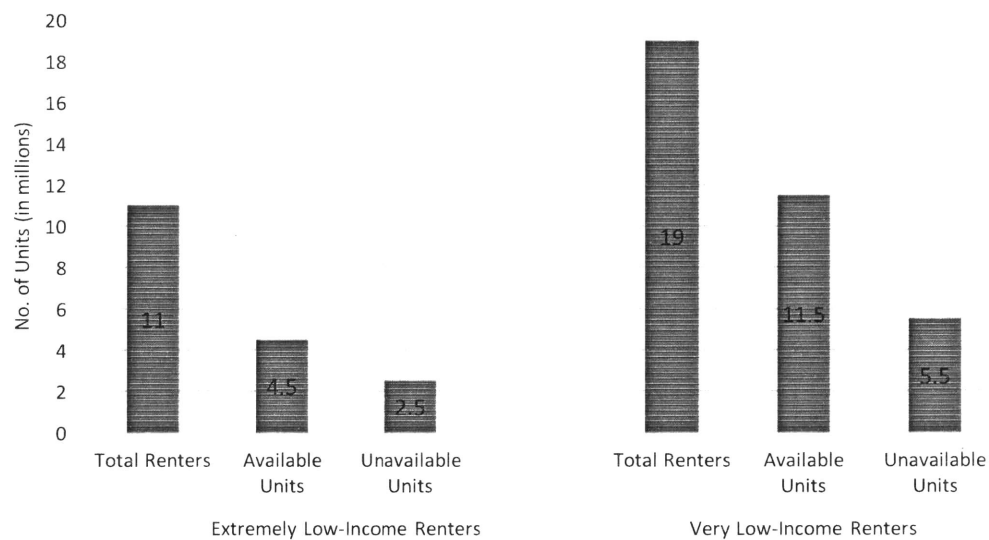
³ Sinai, T. (2014). The Rental Affordability Crisis. *Public Policy Initiative*, 2 (3).

⁴ Black, D. (2014). *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks*. Office of the Comptroller of the Currency, Washington DC.

⁵ Of course, when the supply of for-sale housing suddenly spikes and coincides with a period of easy credit, as we saw during the economic recession from 2008 to 2011, many of the people who might have rented turned towards home ownership. However, the

What Secretary of Housing and Urban Development (HUD) Shaun Donovan calls “the worst rental affordability crisis that this country has ever known” is really a classic economic problem: the mismatch between supply and demand.⁶ Just looking back during the decade between 2001 and 2011 (the years encompassing the Great Recession), renters with extremely low incomes⁷ increased by 3 million to 11.8 million while the total national stock of rental units affordable at this level remained at 7 million.⁸ *Exhibit 1.2a* shows the discrepancy between the supply of affordable units and the numbers of residents with extremely low and low incomes.

Exhibit 1.2a: Low-Income Renters Far Outnumber the Supply of Available Units They Can Afford
(Source: Harvard Joint Center Housing Studies tabulations of HUD, Worst Case Housing Needs: 2015 Report to Congress)



Making matters worse during this period was the fact that many higher-income households who had shifted from ownership to renting competed for rental housing stock, putting further pressure on the supply of market rate units, which priced out more residents such that more had to turn and seek out affordable units.

sudden demand for for-sale housing did not make cities more affordable for low- and moderate-income workers who were renting, because the supply of rental housing in major metropolitan U.S. cities were inherently inelastic. People did not benefit directly from cheaper rental housing just because more people became homeowners. In addition, many of the areas that experienced high foreclosures tended to be in secondary markets, often in the suburbs, rather than in major cities.

⁶ Lowrey, A. (2013, December 9). With Rental Demand Soaring, Poor Are Feeling Squeezed. *The New York Times*.

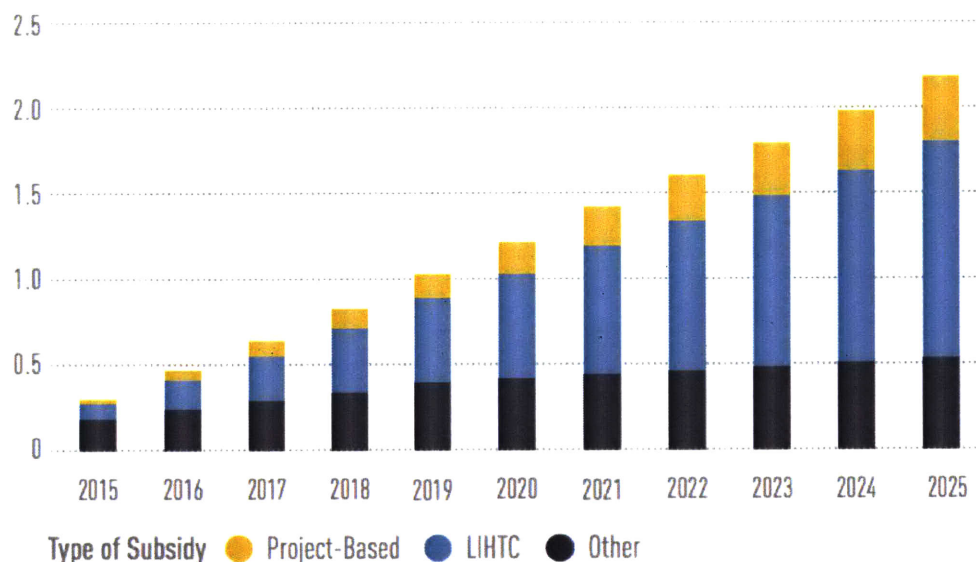
⁷ Defined as renters with less than 30% of area median income (AMI), or about \$19,000.

⁸ Joint Center for Housing Studies of Harvard University. *America's Rental Housing: Evolving Markets and Needs*. Harvard University.

Indeed, this problem will not be going away, since the Joint Center for Housing Studies (JCHS) at Harvard University estimates show that the affordability restriction on an estimated 25 million units of affordable housing subsidized by the federal government are expected to expire by 2025, further compressing the supply of affordable units.⁹ In addition, the JCHS estimates that the overall rental population in the U.S. is likely to grow by 4 million to 4.7 million between 2013 and 2023.¹⁰ Couple this phenomenon with rising land prices, construction costs and vocal community opposition to the building of low-income housing, then the continued compression of the supply of affordable housing is likely to put greater stress on the housing market. When everything trickles down, it will be the working poor that bears the brunt of this acute shortage.

Exhibit 1.2b: Millions of Subsidized Housing Units Are Facing the Expiry of their Affordability Period, 2015 - 2025

(Source: Harvard Joint Center Housing Studies tabulations of National Housing Preservation Database¹¹)



On the demand side, myriad issues are leading to a projected continual growth in demand for rental housing. The shocking experiences from the economic fallout during the 2008 – 2011 recession have highlighted the many risks of homeownership, not least the fact that home values can no longer be viewed as the stable store of wealth they once were, even as a modest hedge

⁹ Pyati, A. (2016, June 3). Impact Investing Platforms Create New Equity Streams for Affordable Housing. *Urban Land*.
¹⁰ Joint Center for Housing Studies of Harvard University. *America's Rental Housing: Evolving Markets and Needs*. Harvard University.
¹¹ Joint Center for Housing Studies of Harvard University. (2015). *The State of the Nation's Housing 2015*.

against inflation. Unforeseen and widespread economic instability created employment situations that put the worker at the whim of firms and factories that relocate, making long-term homeownership undesirable. Demographics-wise, the coming surge of empty-nester baby-boomers turning to renting will coincide with the so-called 'millennial' generation's preference for renting (perhaps as a result of unstable long-term unemployment putting home ownership out of reach), which will further strengthen the demand for renting.

If immigration into the U.S. continues apace, this reliable driver of rental demand will continue to put pressure on the housing market, especially in the major gateway cities receiving these immigrants. *Exhibit 1.2c* illustrates the strength of this demand through the fall in vacancy rates over the past few years nationally as well as in two key high-growth cities, Boston and New York, noting that any vacancy rate below 5% is viewed as a key indicator of a housing shortage crisis.

Exhibit 1.2c: Change in Rental Apartment Vacancy Rates, 2010 - 2013
(Sources: REIS, Census ACS Survey, 2014 New York City Housing and Vacancy Survey)

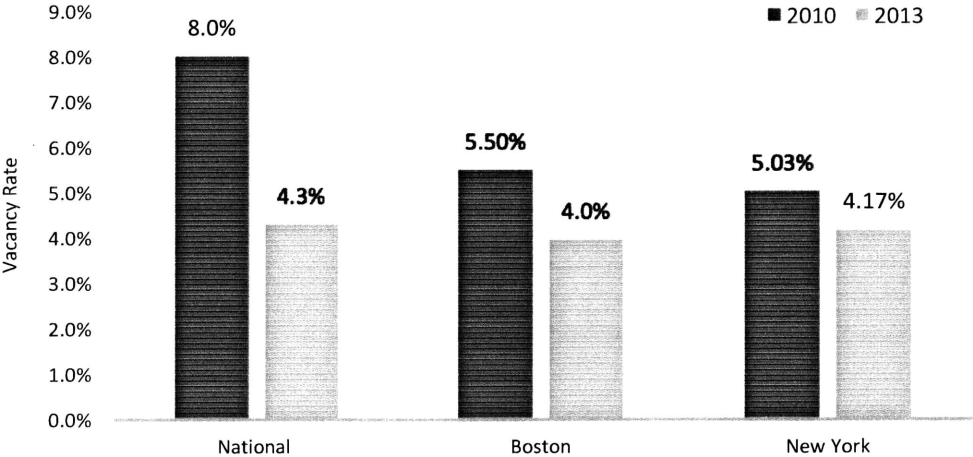
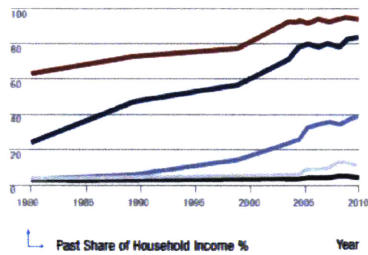


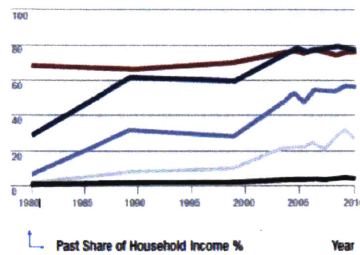
Exhibit 1.2d: Proportion of Households, By Income Category, That Spent More than 30 Percent of their Incomes on Rent, 1980 – 2012

(Source: Todd Sinai, The Rental Affordability Crisis, Public Policy Initiative, Volume 2, Number 3)

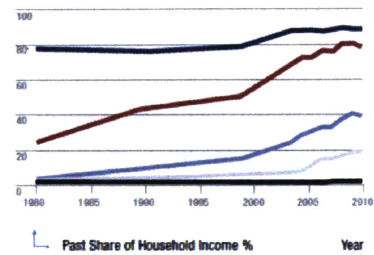
RENT AFFORDABILITY 1980-2012 ATLANTA



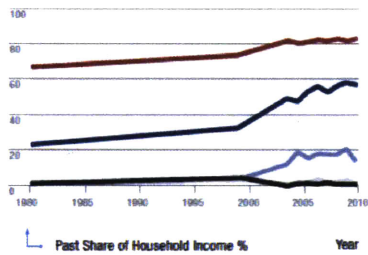
RENT AFFORDABILITY 1980-2012 BOSTON



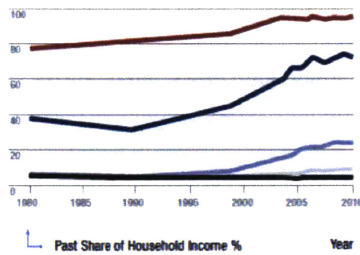
RENT AFFORDABILITY 1980-2012 CHICAGO



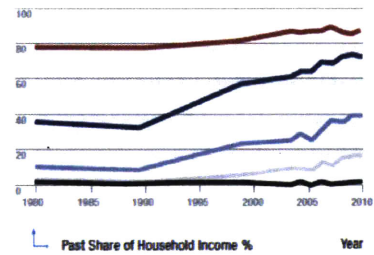
RENT AFFORDABILITY 1980-2012 CLEVELAND



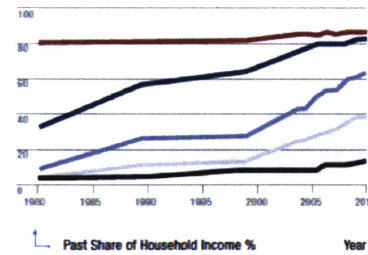
RENT AFFORDABILITY 1980-2012 DALLAS



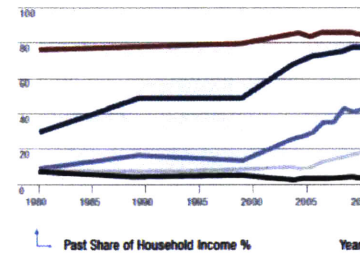
RENT AFFORDABILITY 1980-2012 DENVER



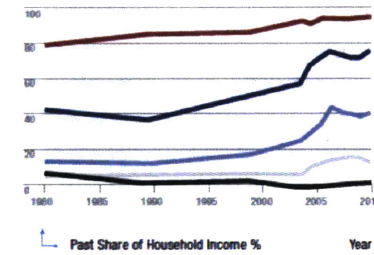
RENT AFFORDABILITY 1980-2012 NEW YORK



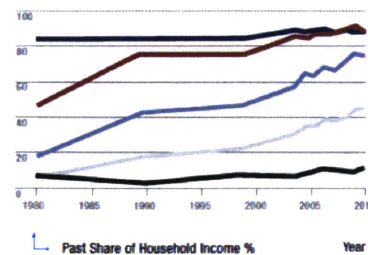
RENT AFFORDABILITY 1980-2012 PHILADELPHIA



RENT AFFORDABILITY 1980-2012 PHOENIX



RENT AFFORDABILITY 1980-2012 SAN FRANCISCO



- < \$20K
- \$20K-35K
- \$35K-50
- \$50K-75
- > \$75K

In a way, the preceding two exhibits sum up the entire crisis. *Exhibit 1.2c* reflects the overall strength of the rental market by showing crisis-level low vacancy rates and indicates that the desire or need to rent is no longer tied to wealth or income levels. On the flip side, *Exhibit 1.2d* reinforces the strength of this demand by reflecting the fact that rents have been climbing faster than income growth, and have been taking up a larger share of household incomes across all income ranges.

Specifically, *Exhibit 1.2d* shows that the lack of affordability has been creeping up the income distribution, where a constantly increasing proportion of households across all income bands in ten major metropolitan areas have spent more than 30% of their incomes on rent, between 1980 and 2012.¹² As can be charted by looking at the maroon (extremely low-income earners) and grey (middle-income earners) lines, this affordability crisis is no longer solely affecting low-income earners. Making matters worse, in Boston, New York and San Francisco, three of the most expensive U.S. cities to rent in today, the affordability rate for the low-income households (those making \$20,000 to \$35,000) have now converged with that of the extremely low-income households (those making less than \$20,000).¹³ If the lack of affordable housing is one bellwether of the poverty trap, then available data suggests that more people have fallen in over the last 30 years.

These trends also highlight the squeeze being felt by many moderate- and middle-income earners, where the ability to earn a living wage is penalized twice, first, by being priced out of the market and second, by exceeding the income thresholds to qualify for public (or heavily subsidized) housing. It is now starting to look as if the newest group bearing the biggest brunt of the affordability crisis are those stuck in the middle: moderate-income earners whose income growth has been outpaced by rent growth.

On the supply side, many economists and housing advocates say that the solution to a housing affordability crisis is to build our way out of it, or to preserve as much supply of affordable housing as possible. This is a deceptively elegant solution, and one that ignores the many realities of the building industry and of geography.

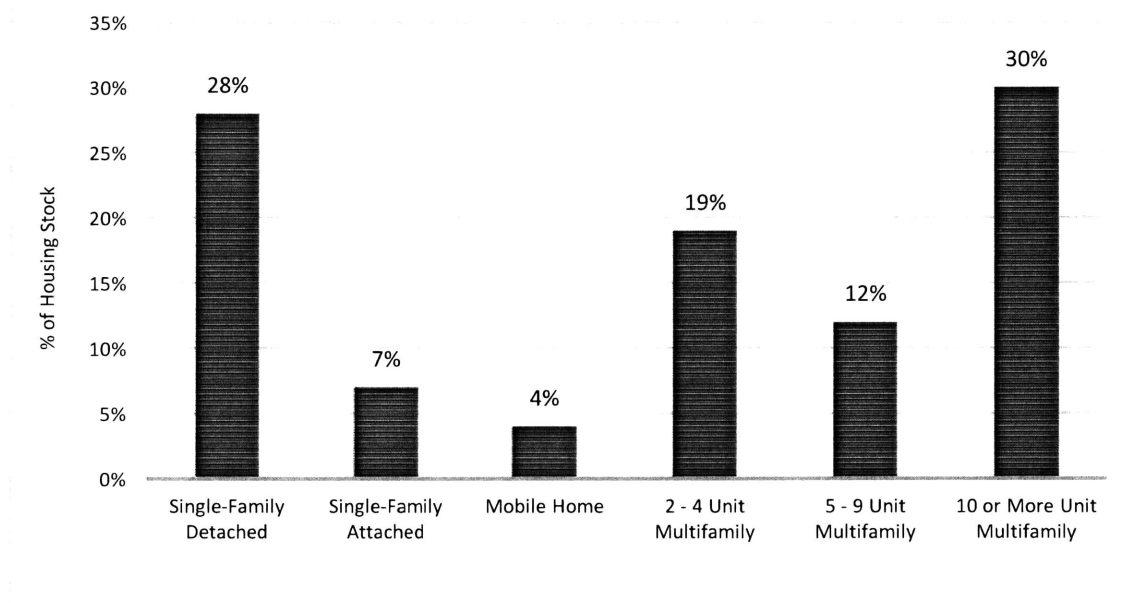
¹² Sinai, T. (2014). The Rental Affordability Crisis. *Public Policy Initiative*, 2 (3).

¹³ Ibid.

First, nearly 40% of new rental properties built tend to be single-family homes, followed by a 20% share of rental properties being small rowhouses or garden apartments with only two to four units. *Exhibit 1.2e* breaks down the types of rental housing that are typically built and shows that, despite the growth of rental demand in the largest, densest U.S. cities, this relatively new phenomenon is not reflected in the proportion of physical products delivered. As a whole, more apartment blocks should be built and prioritized over the construction of large, single-family homes, in order to optimize the number of units produced per acre in the areas that need it the most.

Exhibit 1.2e: Breakdown of Types of Rental Housing Being Built, 2000 – 2010

(Source: U.S. Department of Housing and Urban Development, 2011 America Housing Survey)



However, that runs up against a second restriction, the fact that cities like San Francisco and New York are geographically confined by their shorelines and are inherently land-scarce. There is a limit to which these cities can expand into their hinterlands (Oakland and New Jersey, respectively) before the commute becomes untenable. Add to that the fact that new construction is often hampered by regulation, local politics and environmental contamination, further driving up the costs and uncertainties of construction and resulting in restricting the supply of all housing, not just of affordable housing.

Third, the realities of the current distribution of jobs means that it is not possible to turn our backs on cities to avoid the difficulties of building there. Even with the modern high-speed internet, creative cities thrive on the physical clustering of diverse talents and experiences, and thereby artificially restrict the supply of land where affordable housing can be produced. For example, because jobs are to be found in New York City and not Albany, trying to ameliorate the affordability crisis by encouraging construction in the New York state capital would be misguided. Yes, there is land, but it isn't in the place we want it to be.

Lastly, on the point related to the popularity of certain cities, the supply of land for major magnets such as New York, Boston and San Francisco will always be ever 'shrinking', due to the preferences and aspirations of people wanting to live there.¹⁴ Because the incomes of the households who *could* live in New York, Boston or San Francisco are growing faster than the incomes of households who *already* live there, the supply of housing will continuously get squeezed as long as people express their preferences to live in these cities, all else being equal.

1.3 Big 'A' versus small 'a' affordable Housing

Any discussion of housing affordability should include an explanation of Area Median Income (AMI) as a key measure of affordability. For residents in most metropolitan areas, annual household gross incomes are benchmarked against the area's median income, and are banded into categories where earned household incomes are expressed as a percentage of the AMI. For example, affordable apartment units catering to those earning 50% AMI and below are targeted at low-income households earning half or less than half of the area's median income.

The classifications for affordable housing today fall into three main bands:

- | | |
|--|--|
| (1) Moderate Income Housing: | Residents earn between 80% and 120% of AMI |
| (2) Low Income Housing: | Residents earn between 50% and 80% of AMI |
| (3) Very Low Income Housing: | Residents earn lesser than 50% AMI |
| (4) Extremely Low Income Housing:
<i>(as classified only in certain municipalities/jurisdictions)</i> | Residents earn lesser than 30% AMI |

¹⁴ Ibid.

Exhibit 1.3a takes the example of the published Area Median Incomes for New York City in 2016 to demonstrate how the maximum affordable rent is calculated, adjusting for various household sizes and apartment unit sizes.

Exhibit 1.3a: Calculating Area Median Income Bands and its Maximum Affordable Rents

(Source: New York City Department of Housing Preservation & Development¹⁵)

The Area Median Income for New York City in 2016 for a 3-person household is \$81,600. The following table illustrates the published incomes for various AMI bands for different household sizes and calculates the maximum monthly rent a 3-person household will pay.

AMI Bands	Household Size			
	1 person	2 persons	3 persons	4 persons
50% AMI	\$31,750	\$36,250	\$40,800	\$45,300
80% AMI	\$50,800	\$58,000	\$65,280	\$72,480
120% AMI	\$76,200	\$87,000	\$97,920	\$108,720

For example, Adam and Beatrice are working adults close to retirement and each of them makes \$25,000 a year. Their working-age daughter, Catherine, earns \$20,000 a year. Hence, their total household income is:

$$\$25,000 + \$25,000 + \$15,000 = \$65,000$$

As a household of 3, they earn below 80% AMI (\$65,280) and hence can be considered for any housing programs that will place them in to affordable housing units pegged to their incomes.

The largest apartment that Adam, Beatrice and Catherine qualify for is a 2-bedroom unit, given New York City's occupancy rules of 1.5 persons per room (2 bedrooms x 1.5 persons = 3 persons)

The maximum monthly rent (including utilities) that this family pays for is:

$$30\% \times \$65,280 \div 12 = \$1,632$$

If Catherine leaves and establishes her own household, her parents will only qualify for a 1-bedroom unit, given New York City's implied occupancy rules of 1.5 persons per room. Their new household income is \$50,000, which still puts them under 80% AMI for a 2-person household.

The maximum monthly rent (including utilities) that Adam and Beatrice pay for is:

$$30\% \times (0.5 \times \$50,800 + \$58,000) \div 12 = \$1,360^{16}$$

¹⁵ New York City Housing Preservation and Development. (2016). *Tenant Lease Guidelines*. Retrieved July 10, 2016, from <https://www1.nyc.gov/assets/hpd/downloads/pdf/NSP-tenant-lease-guidelines.pdf>

¹⁶ Because a 2-bedroom unit's notional occupancy is only 1.5 persons, the maximum rent for a 2-bedroom unit is derived using the average of the 1-person and 2-persons 80% AMI, rather than derived from the 2-person 80% AMI.

With so many multifamily developers claiming to develop affordable housing units today, either as part of corporate social responsibility or to seek for zoning relief from planning authorities, observers of affordable housing today divide the discussion of affordable housing into Big 'A' versus small 'a' affordability, the former being housing that is affordable to low-income earners and the neediest populations while the latter is pitched towards moderate- to middle-income earners.

Of course, in creating such a dichotomy, the underlying assumption is that true affordable housing, housing that serves the most disadvantaged, deserve the most attention. The common consensus seems to be that Big 'A' affordable housing serves populations earning below 60% AMI, a group that is so varied that it escapes categorization. The homeless, the mentally ill, disabled veterans, the working poor and those down on their luck all fall into this category in need of the most help. Yet, at the same time, the developers of housing for this group are still predominantly public housing authorities or non-profit community development corporations.

It is widely acknowledged that private for-profit developers cannot make affordable housing developments that have 100% of their units reserved for those earning below 60% AMI pencil out without substantial public subsidies.¹⁷ These subsidies are not merely a one-time assistance in the form of grants or tax credit equity to cover development costs, but continuous subsidies across the years of operation in the form of housing vouchers which guarantee a certain level of rental income or tax abatements that reduce yearly operational costs. To make it feasible for private developers to build such housing, the amount of received public assistance will be so great that these properties can almost legitimately be classified as public housing, given the incredible amount of public funding required not only to construct the buildings but to purchase the land.¹⁸

What happens if only half of the building is made affordable? Take for example New York City's pioneer 50/30/20 mixed-income program¹⁹ where half of the units are of Big 'A' and small 'a' affordability levels (30% affordable and 20% Affordable) and the other half of the units at market

¹⁷ Interview with Ms Wanda Chin, Chief Credit Officer at Community Preservation Corporation on April 18, 2016.

¹⁸ Indeed, many of the new mixed-income affordable housing that is built in difficult-to-develop census tracts, i.e. expensive cities like New York City, have only been financially viable when public agencies actually give away the land for a nominal price of \$1. See the Brooklyn Cultural District: Apartments built by Jonathan Rose Companies (<https://commercialobserver.com/2015/02/housing-groups-protest-city-sale-of-1-bklyn-property/>) and the BronxWorks mixed-use housing development being built by The Community Builders (<https://www1.nyc.gov/site/hpd/about/press-releases/2016/01/1-14-16.page>).

¹⁹ 50/30/20 buildings have 50% market rate units, 30% reserved for middle-income tenants ranging from 175% AMI to 200% AMI, and 20% restricted to low-income tenants (40% to 50% AMI).

rate. Commentators have described the difficulties in raising financing for 50/30/20s due to the low stabilized returns and the insufficient amount of market rate units needed to subsidize the affordable units.²⁰ With returns in the single digits and top-line rent growth for the affordable units suppressed in accordance with city ordinances, mixed-income housing that appeals to a broad range of affordability levels is difficult to build and requires special effort to assemble the financing.

In trying to answer the question of whether the market is still producing new Big 'A' affordable housing today, the response seems to be a resounding no. In major cities, many of the Big 'A' affordable housing is older stock, some nearly 30 years old, and is often badly maintained or in need of substantial capital improvements. Building Big 'A' affordable housing seems to have been squarely the bread-and-butter work of public housing authorities. That said, the silver lining in what may seem like bleak prospects for new construction of Big 'A' affordable housing is the fact that cities have now turned their attention towards the preservation of such housing, keeping these units within the supply stream and undertaking substantial rehabilitation to improve older housing stock. Without land costs to worry about, many private developers have found a market niche in preserving and rehabilitating affordable housing, with unlimited tax credit equity available for construction costs and cheaper mortgage financing, given the inherently low risk of such projects. Many developers engaged in tenant-in-place rehabilitations, where renovations are undertaken without displacing residents, often realize that they earn their incomes mainly from the developer's fee, and hence are encouraged to take on greater volumes in order to make money. This, then, hopefully results in more housing stock getting rehabilitated as time passes.

What about small 'a' affordable housing? The discussion thus far has yielded a bias towards Big 'A' affordable housing which has benefitted most from public policies, whereas small 'a' affordable housing tends to be viewed as token gestures towards affordable housing made by for-profit multifamily developers. Often, developers laud the availability of affordable housing units for the 150% to 200% AMI income earners in their developments, which in New York City in 2016 is equivalent to a household income range from \$122,400 to \$163,200 for a family of 3, which by most reasonable standards is an upper middle class family. At the maximum threshold of 30% of annual gross income, this family will pay between \$3,060 to \$4,080 a month for a 2-bedroom

²⁰ Balbi, D. (2015, October 7). *The Challenges of Financing 50/30/20s*. Retrieved July 10, 2016, from The Commercial Observer: <https://commercialobserver.com/2015/10/the-challenges-of-financing-503020s/>

rental, which is practically the prevailing market rate for such units. Is it right to view these as affordable housing units (regardless of the size of the 'A') when they are rented at market rates?

Perhaps not, and this could explain why the discussion surrounding small 'a' affordability has been co-opted by those advocating for the need for more moderately-priced workforce housing, the group that does not qualify for Big 'A' affordable housing and yet is priced out of market rate housing. Workforce housing is often termed as housing for teachers, construction workers, the police force, the fire brigade and such like, people working in crucial but poorly-paid professions that gentrification would have priced out of the city core but are a key element of the workforce of any city. Such residents would fall somewhere in between the 100% to 150% AMI band, where families earning between \$80,000 and \$120,000 cannot afford to pay \$2,000 to \$3,000 for a market rate unit.

This is the group that is hardest to build for, what with the dearth of public policies that serve this income group and the cultural notion that the very definition of being middle class means having obtained enough social mobility to 'graduate' out of subsidized housing. Without being able to qualify for tax credits, tax abatements and most existing public block grants, the financing for moderate-income housing looks identical to that of market rate luxury housing, except for the dimly low returns (if any) that rarely tempt a for-profit developer. In an era where the political rhetoric is dominated by the squeeze felt by the middle classes as income inequality continues to grow unabated, it is for this reason that workforce housing has become the new lightning rod for affordable housing advocates, absent of the Big 'A' versus small 'a' framework.

While this section has delved into an overview of the levels of affordability implied in affordable housing, it has only lightly touched on how affordable housing developments are financed. In order to understand the various financing mechanisms used to develop Big 'A' affordable housing, a quick examination of the existing policies is needed in the next section before I demonstrate the role these policies play in an actual development pro-forma in Chapter Two.

1.4 Public Policies Related to the Financing of Affordable Housing

Given the persistence of the affordability crisis for much of the later half of the twentieth century, what solutions have been used to combat this problem? In the absence of private sector

endeavors to untie this knot, many of the attempts to produce more affordable housing have been public policies enacted since the post-Depression era. Throughout recent history, the responsibility for producing affordable housing has never left the federal government's purview.

Since much scholarship has been devoted to the history of housing and urban policies that have been used to alleviate the housing shortage, instead of being repetitive, this section will summarize the development of housing policies that have influenced the production of affordable housing.

Exhibit 1.4a examines the key milestones and policy changes made in the post-Depression era and provides the underpinning for many of the policies still in place to finance affordable housing today.

Exhibit 1.4a: Major Housing and Urban Development Policies, 1937 – present

(Source: Multiple sources)

The affordable housing policies put in place over the last century have evolved and grown to become more specific and targeted as the nature of the housing and affordability crisis has transformed. The following policies largely follow four phases:

- (1) the acknowledgement of low-income housing as a public good and the creation of public housing authorities to spearhead the production of public housing;**
- (2) the use of slum clearance and redevelopment to deal with the issue of urban blight and to alleviate the unlivable conditions within the urban housing stock;**
- (3) the recognition of equal housing opportunities as part of civil rights for minorities; and**
- (4) the change from public sector to private sector involvement in the production of affordable housing.**

The nomenclature of many housing policies are an alphabet soup – when in use today, they are still often referred to by their acronyms, clause names and numbers.

1934	Federal Housing Administration	The FHA was created in 1934 as the first government agency with the authority to offer federally-backed insurance to insure private banks on long-term mortgage loans made for home purchases and alterations. This reduced the inherent risks of lending for private lending institutions and spurred the availability of (cheaper) credit for homeowners. The ability for more people to borrow spurred the subsequent demand and production of housing. ²¹
1937	Wagner-Steagall Act	The 1937 Housing Act established the local public housing authorities charged with the production, ownership and operation of housing projects funded by the federal government. This housing act set very low maximum income requirements to qualify many poor residents, but ultimately led to high concentrations of poverty within public housing projects. ²²

²¹ Freeman, R. (1996). The 1949 Housing Act versus 'urban renewal'. *Executive Intelligence Review*, 23 (50).

²² The Fair Housing Center of Greater Boston. (n.d.). *1937: Housing Act (Wagner-Steagall Act)*. Retrieved July 10, 2016, from <http://www.bostonfairhousing.org/timeline/1937-Housing-Act.html>

1938 Creation of Fannie Mae

Section 8 of this act first created the policy of “lower income housing assistance,” which authorized the use of federal funds to make assistance payments to public housing authorities to make up for the shortfall in what low-income residents could pay. The much expanded Section 8 housing choice voucher and project-based funding program today takes its namesake from this section of the 1937 act.²³

An amendment to the 1934 National Housing Act in 1938 created Fannie Mae to act as a secondary mortgage market facility that could purchase, hold and sell FHA-insured loans. By purchasing FHA-insured loans from private banks, Fannie Mae helped to create liquidity in the private mortgage market and provided lenders with cash to churn out new home loans, thereby augmenting the benefits of federally-insured home loans. An equivalent government-sponsored enterprise, Freddie Mac, was created in 1970.²⁴

1949 American Housing Act

The 1949 act provided federal financing for slum clearance and urban renewal projects and facilitated the provision of replacement housing for residents affected by neighborhood renewal projects. Nearly \$2 billion of funds were set aside to construct 810,000 public housing units over 6 years, and many displaced residents were shepherded into public housing projects.

Ultimately, this legislation fell far short of its goals and unfortunately exacerbated the housing shortages in some instances as urban renewal removed more housing stock than added to it. Many affected neighborhoods tended to be poor and minority neighborhoods, and such urban renewal efforts came to be viewed as ‘Negro removal’ programs, deepening social inequality and injustice.²⁵

This expanded the efforts of the 1949 act and allowed federal funds to replace slums and areas of urban blight with the development of commercial and industrial districts, in an effort to spur the commercial vitality of inner cities to combat ‘white flight’.²⁶

1954 Housing Act

Section 220 and 221 of the act were intended to expand FHA-backed mortgage insurance for any housing construction loans made towards the creation of replacement housing in urban development areas. However, the areas targeted for renewal were often the same ones that had been ‘redlined’, a practice where financial institutions denied lending to poor residents as they were designated poor investments. Many ‘redlined’ neighborhoods were

²³ Archives of the House Committee on Financial Services. (n.d.). *United States Housing Act of 1937*. Retrieved July 10, 2016, from <http://archives.financialservices.house.gov/banking/usha1937.pdf>

²⁴ Federal Housing Finance Agency Office of the Inspector General. (n.d.). *History of the Government Sponsored Enterprises*. Retrieved July 10, 2016, from <http://fhfaig.gov/LearnMore/History>

²⁵ Freeman, R. (1996). The 1949 Housing Act versus ‘urban renewal’. *Executive Intelligence Review*, 23 (50).

²⁶ Flanagan, R. M. (1997). The Housing Act of 1954 The Sea Change in National Urban Policy. *Urban Affairs Review*, 33 (2), 265 - 286.

historically neglected, minority neighborhoods. No loans were made under Section 220 and 221.²⁷

1961 Omnibus Housing Bill

The 1961 bill created a cabinet-level Department of Housing and Urban Affairs, the predecessor to today's Department of Housing and Urban Development (HUD), placing urban issues at the forefront of federal policy-making for the first time. This bill rejected the previous approach towards urban revitalization as large-scale and comprehensive, and displayed a funding preference for housing preservation, and introduced funding for middle-income earners and senior housing for the first time.

1965 Housing and Urban Development Act

The 1965 act espoused the principles of Johnson's Great Society campaign to eliminate poverty and racial injustice, and in trying to shift federal subsidies away from public housing which ghettoizes the poor into privately-produced housing, the act authorized funding for a rent-supplement program, which expanded significantly on the ideas in Section 8 of the 1937 act and which forms the basis of the Section 8 program today.

Under Section 236, the Leased Housing Program created a rent-supplement funding scheme, where qualified tenants (who met the income eligibility, or were elderly, physically handicapped, displaced by an urban redevelopment project or living in substandard housing) would pay 25% of their income in rent, with the remaining balance paid by the federal government directly to the housing provider.

1968 Fair Housing Act

This landmark act prohibited discrimination by housing providers, municipalities, lenders and mortgage insurance companies on the basis of race, color, religion or national origin. This included making illegal the practices of 'redlining' and the inclusion of racially-restrictive covenants into deeds. The Fair Housing Act also outlawed any discrimination in housing-related activities, such as advertising and zoning practices.²⁸

1974 Housing and Community Development Act

The HCD act consolidated all urban funding programs under the Community Development Block Grants framework (Title I), which were distributed by a formula taking into account population figures, poverty level, age of housing stock, level of overcrowding and lag in economic growth.

Municipalities and community groups eligible to apply for funding were free to direct the funding to a multitude of activities, as long as they met the broad national objectives of the program. Section 108 loan guarantees, backed by the full faith and credit of the federal government, could be applied to loans taken to acquire land for new construction or preservation of affordable housing.

²⁷ Discrimination Against Minorities in the Federal Housing Programs. (1956). *Indiana Law Journal*, 31 (4), Article 5.

²⁸ Fair Housing Center of Greater Boston. (n.d.). **1968: Federal Fair Housing Act**. Retrieved July 11, 2016, from <http://www.bostonfairhousing.org/timeline/1968-Fair-Housing-Act.html>

		<p>Section 8 rental assistance programs were officially expanded in 1974 into what is the predominant subsidy program used today, with project-based vouchers or tenant-based vouchers (Housing Choice Voucher Program). Qualified tenants paid 30% of their income for rent – either to public housing authorities or to private landlords – and the remainder would be paid by the Federal Government in the form of a Housing Assistance Payment (HAP).</p> <p>By the mid-1980s, political sentiment had turned away from favoring heavily-subsidized public housing towards the use of free market mechanisms to provide affordable housing.</p>
1986	Tax Reform Act	<p>One of the key creations of the new tax code was Section 42, the Low Income Housing Tax Credit (LIHTC) mechanism, intended to spur private investment into affordable housing, by providing equity investors a dollar-for-dollar tax credit over a period of 10 years, as long as the property was in compliance (i.e. remained affordable). LIHTC 4% credits for rehabilitation and 9% credits for new construction mushroomed an entire sub-sector of the financial industry dedicated to the bidding and syndicating of tax credits.</p>
1990	Cranston-Gonzalez National Affordable Housing Act	<p>The act created the HOME Investments Partnership Program, a federal block grant program that earmarked funding to states and local authorities to be used exclusively for affordable housing-related activities.</p> <p>HOME funds were outright grants that could be used to finance the rehabilitation of owner-occupied housing, to provide assistance to low-income home buyers, and for the acquisition and rehabilitation of affordable housing developments.²⁹</p>
1992	Independent Agencies Appropriations Act	<p>The HOPE VI Program was created out of this act to revitalize the most severely distressed public housing projects, out of the recognition that previous public housing efforts had failed to lift disadvantaged communities out of poverty. HOPE VI shifted the government focus to the creation of mixed-income housing in the pursuit of New Urbanist principles of social and spatial equitability, and provided grants towards activities that met these criteria.</p> <p>HOPE VI was de-funded by the George W. Bush administration and replaced with the Choice Neighborhoods Program during the Obama administration.</p>
2009	American Recovery and Revitalization Act	<p>In response to the greatest economic crisis since 1939, the federal government authorized the emergency funding of \$787 billion to revitalize the economy, with \$13.61 billion earmarked for HUD projects related to investments into energy efficiency, affordable housing and community development.</p>

²⁹ Jones, K. (2014, September 11). An Overview of the HOME Investment Partnerships Program. *Congressional Research Service Report for Congress*.

Under ARRA, additional funds under the Tax Credit Assistance Program and the Project-Based Rental Assistance were approved to encourage the production and preservation of affordable housing units and to expand the coverage of Section 8 vouchers to low-income tenants.³⁰

Chapter One concludes by asserting that the housing affordability crisis in the U.S. has been prolonged, persistent and shows no evidence of abating. If solutions to combat the social inequality caused by stagnant incomes and the lingering financial stress from the Great Recession are not found, it is highly likely that the poverty trap will continue to swallow more into its midst, and have spillover effects into the prosperity of the overall American economy. Taking for a fact that households will continue to view a roof as a necessary good, the expenditure of increasing proportions of household income on housing expenditure may reduce the consumption of other goods over time, if rent growth outstrips income growth. Holding households hostage to their rent checks is not a desirable prospect for a consumption-driven U.S. economy. The rest of the chapters in this thesis go on to propose a private-sector led solution to the affordability crisis, by employing REIT equity in the development of affordable housing.

³⁰ U.S. Department of Housing and Urban Development. (n.d.). *HUD Implementation of the Recovery Act*. Retrieved July 11, 2016, from <http://portal.hud.gov/hudportal/HUD?src=/recovery/about>

CHAPTER TWO

Public and Private Approaches to Financing Affordable Housing

Chapter Two is divided into two parts, with the first half demonstrating how the U.S. government currently finances affordable housing through a sampling of its current policies; the second half will give an overview of some of the private sector approaches that are being tested to finance affordable housing without direct government investment.

2.1 The Public Approach: LIHTC, HOME/CDBG Funds and Section 8

All of the following public financing methods were created through policies discussed in *Exhibit 1.4a*, and which are still widely used today. They represent the most common ways of financing affordable housing for public housing authorities, non-profit community groups and private multifamily developers.

Low Income Housing Tax Credits (LIHTC) Program

Today, the LIHTC program remains the primary source of financing for both the construction and preservation of affordable housing. LIHTC credits are predominantly the way Big 'A' affordable housing is built and preserved today, because the LIHTC program has maintained an eligibility restriction at an income level of 60% AMI, and hence can only be used to produce or preserve low-income and very-low income housing for families, seniors and the special needs population. Since its creation in 1986, more than 2.4 million units of low-income housing have been produced for these households.³¹

The LIHTC program is considered to be an indirect subsidy which promotes private investment by providing a dollar-for-dollar credit against an investor's federal tax liability. LIHTC credits are administered at the state level, with each state receiving an annual allotment of tax credits based on its population count. Each state designates an agency to manage and allocate the credits to applicants in accordance with its Qualified Allocation Plan (QAP). In certain metropolitan areas where the deal flow is large, a city-level agency is also assigned to oversee the volume of applications. Each state's QAP will often encompass certain policy agendas, in order to direct investment towards specific distressed or new neighborhoods.

³¹ Black, D. (2014). Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks. Office of the Comptroller of the Currency, Washington DC.

LIHTC tax credits are calculated as a percentage of costs incurred in developing the project, which gives rise to the names of the two types of LIHTC credits: 9% credits and 4% credits. 9% credits are used for new construction projects while 4% credits are used for housing rehabilitation and preservation projects. The tax credit amount is claimed annually over a 10-year period by the investor.

The amount of 9% credits is limited, and is therefore distributed on a competitive basis, with state housing finance agencies assigning a point system to proposed projects in order to assess the level of alignment with state (or city) housing objectives. It is rare for any development proposal to obtain an allotment of 9% credits on its first try; more commonly, projects go through multiple rounds of application before they receive their 9% credits, thereby adding pre-development risk and uncertainty to the project, as many private lenders prefer lending to projects only *after* they have received tax credit allotment, regardless of whether the lender is interested in providing equity for those tax credits or not. Having a project qualify for the LIHTC program seems to be a mark of confidence, or at least risk mitigation, for any affordable housing project.

Notionally, there is no limit to the amount of 4% tax credits available to developers, although there is a stipulation that 50% or more of any rehabilitation project's eligible costs be financed with tax-exempt bonds (TE bonds), of which there are annual limits at the state level. The competition to obtain bonds is competitive and requires a project sponsor or developer to submit to a similar competitive process as for the 9% bonds, effectively limiting the amount of available 4% credits. Because the 4% credits are shallower than the 9% credits, meaning that they raise lesser equity, rehabilitation projects will typically seek additional co-funding through alternative sources such as the Federal Home Loan Bank Affordable Housing Program, HOME or CDBG funds, in addition to any agency loans or private grants.³² *Exhibit 2.1a* is a LIHTC calculator that explains how 9% and 4% credits are calculated and illustrates that for a given total development cost (TDC) of \$18 million, the 4% credits only raise 40% of TDC as opposed to 60% of TDC for the 9% credits.

³² Black, D. (2014). Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks. Office of the Comptroller of the Currency, Washington DC.

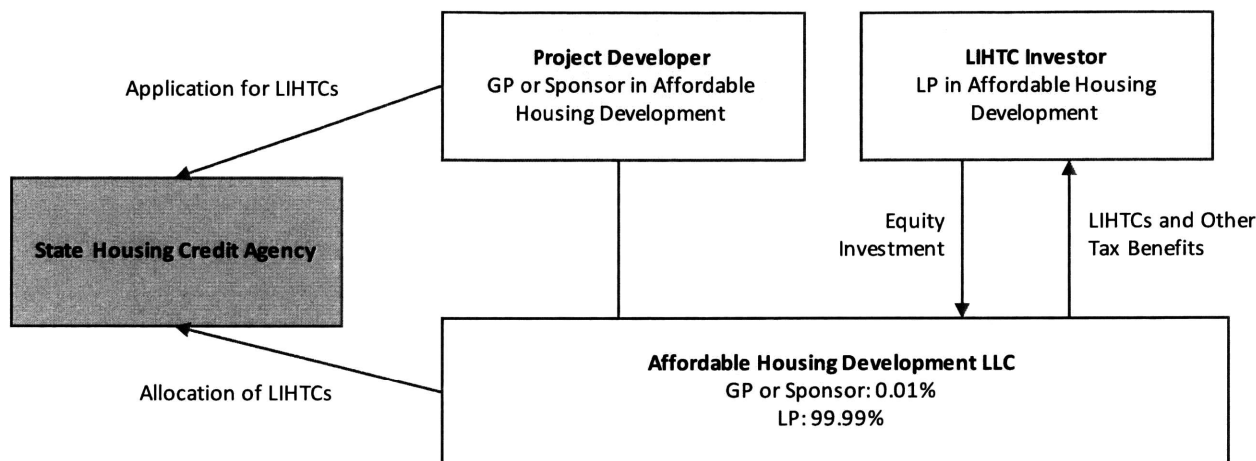
Exhibit 2.1a: LIHTC Calculator to Derive Amount of 9% and 4% Credits for Hypothetical Development

New Construction (9% credits)			
A	Total Development Cost	\$18,000,000	
B	Less: Acquisition	(\$1)	
B	Less: Marketing Costs	(\$10,000)	
B	Less: Permanent Financing + Tax Credit Fees	(\$525,000)	
B	Less: Reserves	(\$1,800,000)	
C	LIHTC Eligible Costs	\$15,664,999	A - Bs
D	Less: Non-eligible financing	\$0	
E	Eligible Basis	\$15,664,999	C - D
F	Applicable Fraction	1.00	
G	Basis Boost Multiplier (for 9% only)	1.30	
H	Adjusted Qualified Basis	\$20,364,499	E x F x G
I	Tax Credit Rate	9%	
J	Annual Credits	\$1,832,805	H x I
K	State annual project cap (9% only)	\$1,000,000	
L	Total Credits over 10 years	\$10,000,000	Lesser of (J x 10) or \$1 x 10 mil
M	Price Per Credit	\$1.05	
N	9% Syndication Proceeds	\$10,500,000	L x M

Building Rehabilitation (4% credits)			
A	Total Development Cost	\$18,000,000	
B	Less: Acquisition	(\$1)	
B	Less: Marketing Costs	(\$10,000)	
B	Less: Permanent Financing + Tax Credit Fees	(\$347,763)	
B	Less: Reserves	(\$1,800,000)	
C	LIHTC Eligible Costs	\$15,842,236	A - Bs
D	Less: Non-eligible financing	\$0	
E	Eligible Basis	\$15,842,236	C - D
F	Applicable Fraction	1.00	
G	Adjusted Qualified Basis	\$15,842,236	E x F
H	Tax Credit Rate	4%	
I	Annual Credits	\$633,689	G x H
J	Total Credits over 10 years	\$6,336,894	I x 10
K	Price Per Credit	\$1.11	
L	4% Syndication Proceeds	\$7,033,953	J x K

Exhibit 2.1b: Typical Legal Structure for Direct Investment into LIHTC-Financed Project

(Source: Black, D. (2014). *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks*. Office of the Comptroller of the Currency, Washington DC.)



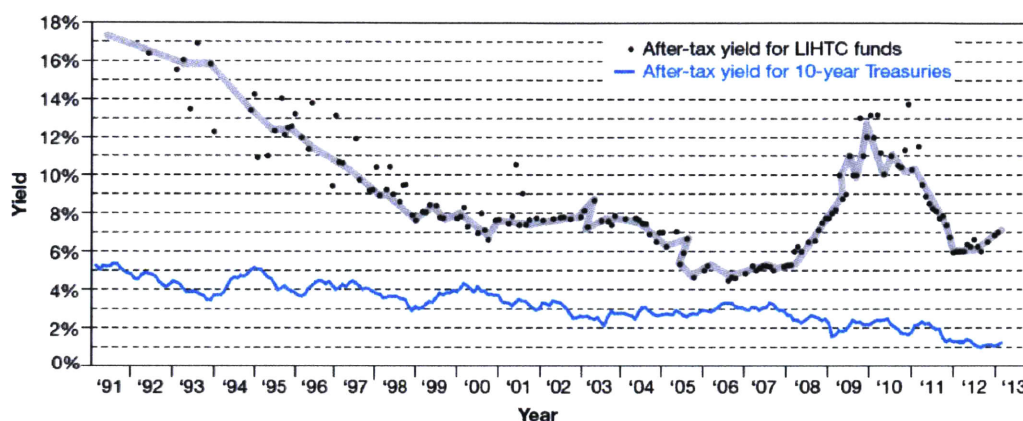
The LIHTC program’s eligibility requirements also means that project sponsors applying for LIHTC funding must follow the 40/60 test or the 20/50 test, where all units receiving LIHTC equity must have 40% or more households earning no more than 60% AMI or 20% or more households earning no more than 50% AMI. Finally, 10% of the total units being built or preserved must be reserved for households earning less than 30% AMI.³³

Banks have traditionally been willing investors into LIHTC developments, with historic returns on investments and loans into LIHTC projects being a lot more competitive when compared to other investment vehicles. *Exhibit 2.1c* compares the after-tax yield on LIHTC investments with the after-tax yield on 10-year U.S. Treasuries and demonstrates that the former has consistently outperformed the latter.

³³ Kroger, J. (2014). *Novogradac LIHTC Property Management Handbook - 2014 Edition*. San Francisco: Novogradac & Company LLP.

Exhibit 2.1c: Comparative Returns for LIHTC Investments and 10-year Treasuries, 1991 – 2013

(Source: From Treasury Department and industry survey data compiled by Richard Floreani, Carlisle Tax Credit Partners, June 2011).



In order for LIHTC equity investors to remain eligible for tax credits throughout the ten-year period, the underlying properties must continue to meet the state's relevant QAP for as long as the building is within the service period. The fact that LIHTC investors have managed to beat the after-tax yields for 10-year U.S. Treasuries for so many years suggests that the intrinsic nature of the LIHTC deal is very stable. In fact, looking at the data in *Exhibit 2.1c*, LIHTC yields have been counter-cyclical, rising during periods of recession and dipping during periods of strong growth, although consistently outperforming U.S. Treasuries over 20 years.

Given that Treasury securities tend to represent low-risk stable investments in the market, the inference is that the returns we observe in *Exhibit 2.1c* can be treated as risk-adjusted returns and in turn demonstrates how well the market views the stability of affordable housing. LIHTC-funded affordable housing units have little to no foreclosure risk, since demand is huge and the owner/operators' businesses are closely scrutinized by public agencies. Lastly, LIHTC equity investors also obtain CRA consideration³⁴ for contributing to community development activities and puts lenders in contact with greater business opportunities to make bridge, construction or permanent loans to contractors and developers involved in the LIHTC transaction.

³⁴ Title VIII (Community Reinvestment Act) of the Housing and Community Development Act of 1977 allows banks and financial institutions to claim CRA tax credits for carrying out activities that help to meet the credit needs of the communities in which they operate.

All in all, LIHTC has been crucial in the creation of millions of affordable units since its inception. It has spurred greater private sector involvement and has effectively transferred the bulk of the production of affordable housing to private developers. In addition, it has also led the way in creating investor demand for a type of indirect investment into the affordable housing asset class.

Benefits aside, the application process for an allotment of LIHTC credits is highly competitive and the average project waits 18 months to receive an allocation of tax credits. Even though LIHTC is well-established, it is a cumbersome way to raise financing and operates under a very complex set of rules. No deviation in the quality of the product is allowed and very little flexibility is granted to the developer in structuring its capital stack. Notwithstanding the above, the fact remains that the LIHTC allocation process can sometimes be influenced by prevailing politics, thereby adding greater uncertainty into the development process. Crucially, LIHTC is also an expensive source of capital. The bipartisan nonprofit group Committee for a Responsible Federal Budget estimates that it is the fourth most expensive corporate tax break, and that eliminating LIHTC could finance a 0.3% reduction in corporate tax rates.³⁵

HOME and CDBG Grants

Like the LIHTC program, the HOME Investments Partnership Program (HOME) and the Community Development Block Grant (CDBG) are sources of capital that developers can tap on to fund their development costs and lower the debt load the affordable housing property takes on. HOME and CDBG funding can come in the form of outright grants (i.e. equity) or in the form of soft debt (i.e. 0% interest loans with a 30-year balloon payment). In the former, the HOME and CDBG take up equity positions in the capital stack, and in the latter, the HOME and CDBG mortgages take up second lien positions on the property after the first mortgage lender.

HOME funds are more specifically targeted to finance affordable housing activities, whereas CDBG grants have a broader objective of community development, of which the provision of affordable housing is a goal. Every jurisdiction has its own set of funding limits and eligibility requirements for the HOME and CDBG funds, such that it cannot be effectively summarized here. However, HOME-assisted housing units tend to be targeted at benefitting households with incomes at or below 80%

³⁵ Committee for a Responsible Federal Budget. (2013, November 7). *The Tax Break-Down: The Low-Income Housing Tax Credit*. Retrieved July 20, 2016, from <http://crfb.org/blogs/tax-break-down-low-income-housing-tax-credit>

AMI, whereas CDBG funds are used to assist households from the very low income thresholds up to the moderate income thresholds. *Exhibit 2.1d* shows a hypothetical development scenario in which HOME and CDBG funds are part of the capital stack.

Exhibit 2.1d: Hypothetical Affordable Housing Development Capital Stack with CDBG and HOME Funds

	New Wing		Existing Building Rehab	
			Total	
Hard Debt				
Permanent Loan/Tax-exempt Bonds	\$	15,753,835	\$	36,690,071
Soft Debt				
MA Affordable Housing Trust Fund	\$	1,000,000	\$	100,000
Cambridge Affordable Housing Trust Fund	\$	500,000	\$	-
Cambridge CDBG	\$	500,000	\$	100,000
Cambridge HOME	\$	500,000	\$	100,000
CATHNP	\$	650,000	\$	-
Housing Innovations Fund	\$	-	\$	100,000
FHLB Affordable Housing Program	\$	500,000	\$	-
Community Based Housing Program Loan	\$	250,000	\$	-
LIHTC Equity				
LIHTC 9% equity	\$	10,500,000	\$	-
LIHTC 4% equity	\$	-	\$	45,146,076
Equity				
Deferred Developer Fee	\$	3,185,076	\$	8,414,134
CHA Sponsor Loan for Acquisition	\$	-	\$	35,000,000
CHA Program Note	\$	-	\$	-
TOTAL SOURCES	\$	33,335,834	\$	125,655,479



For all the benefits that CDBG and HOME grants provide, most jurisdictions impose strict caps on the amount of grants that a single project can receive. Often, they range from a \$100,000 to a \$500,000 cap, with some projects eligible for larger one-off grants. For a hypothetical project that has a \$33 million TDC (borrowing from the example above in *Exhibit 2.1d*), these grants are a drop in the bucket. Not only that, since developers are encouraged to layer on more grant programs to complement CDBG and HOME grants, developers become subject to even more government regulation, for every additional program they apply for. The allocation process for CDBG and HOME grants is every bit as difficult and political as it is for LIHTC, making such sources of capital the very opposite of nimble, flexible and assured.

Section 8 Housing Choice Voucher Program

The Section 8 Housing Choice Voucher Program is typically administered locally by public housing agencies, which receive federal funds from HUD on an annual basis. Section 8 vouchers are meant to help those on the very low end of the income spectrum – households that qualify for Section 8 cannot earn more than 50% AMI. Section 8 vouchers come in two forms: project-based vouchers which are tied to a specific unit in an affordable housing project or tenant-based vouchers which are portable and can be used at different properties, as long as the housing unit meets the requirements of the program. Public housing authorities are allowed to project-base up to 20% of their allocated vouchers in order to tie them to specific public projects to fund development or rehabilitation work.

How Section 8 works is that rent paid to the landlord of an affordable housing unit is split into two components:

- (1) Housing Assistant Payment (HAP)
- (2) Household's Rental Payment

A family eligible for the Section 8 voucher selects a unit that meets the minimum standard for health and safety, and which is subsequently subject to inspections by the local housing authorities. The local authority then enters into a HAP contract with the landlord, agreeing to pay a monthly subsidy directly to the landlord in accordance with the Voucher Payment Standard (VPS) set by HUD for each geographic location. The VPS often hovers close to (and could exceed) the established Fair Market Rent in the area, and represents the maximum amount that can be made

as a HAP to the landlord. Families or households are responsible for paying 30% of their annual income towards rent, and the difference between the rent charged by the landlord and the amount paid by households is the actual HAP subsidy. If a family selects a unit that is charging rent exceeding what it can afford (defined as a household spending more than 40% of gross income on rent) and the maximum VPS amount, then household will be responsible for making up the shortfall. If a household is found to be able to put more than 40% of its household income towards rent, it would stand to lose its Section 8 voucher allocation.

Unlike LIHTC and the HOME and CDBG grants, which help to raise development capital during the pre-development stage of the project, Section 8 vouchers finance affordable housing during the cash flow stage. In effect, this means that developers running their financial pro-forma to determine the financial viability of any affordable housing development can charge the Fair Market Rent as their top line revenue, without having to make a distinction between the HAP and what households would pay. The developer is essentially guaranteed market rents on a monthly basis, and allowed to escalate its gross income at the same rate as the prevailing rental escalation rate, ranging between 1% to 2.5% on an annual basis. This kind of subsidy works on a rolling basis, and spurs the development or rehabilitation of affordable housing by assuring a certain level of income. Couple this fact with a 0% vacancy rate for affordable housing properties, then a developer's attention will only need to be turned towards managing the daily operational costs of the property in order to generate higher returns.

Exhibit 2.1e: Pro-formas for Affordable Housing Developments with Section 8 Vouchers Look Identical to Market Rate Properties

10-YEAR CASH FLOW

Assumptions	
Rental growth	2%
Vacancy	
Section 8 Project-Based Voucher	3%
Retail	5%
Office	5%
Parking	5%
Operation expenses	3%
Debt service coverage ratio	1.2

Supportable First Mortgage	
Existing Building	\$36,690,071
New Wing + Parking	\$ 15,753,835
Mixed Use Block	\$8,354,927
30-year rate	4.75%
Term (years)	30

#	1	2	3	4	5	6	7	8	9	10
Year	From 06/2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Gross Incomes										
New Wing	\$ -	\$ -	\$ -	\$ 1,916,104	\$ 1,954,426	\$ 1,993,514	\$ 2,033,384	\$ 2,074,052	\$ 2,115,533	\$ 2,157,844
Existing Building	\$ 2,638,801	\$ 4,614,132	\$ 4,706,415	\$ 3,200,362	\$ 3,264,369	\$ 3,329,657	\$ 5,730,768	\$ 5,845,384	\$ 5,962,292	\$ 6,081,537
Mixed Use Block	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 529,008	\$ 1,079,177	\$ 1,100,761	\$ 1,122,776	\$ 1,145,231
Parking	\$ -	\$ -	\$ -	\$ 118,368	\$ 120,735	\$ 123,150	\$ 125,613	\$ 128,125	\$ 130,688	\$ 133,302
TOTAL	\$ 2,638,801	\$ 4,614,132	\$ 4,706,415	\$ 5,234,834	\$ 5,339,530	\$ 5,975,329	\$ 8,968,943	\$ 9,148,322	\$ 9,331,288	\$ 9,517,914

Estimates show that the amount of government funding allocated to Section 8 voucher payments are three times the amount of foregone tax income the federal government loses from distributing LIHTC allocations.³⁶ Because of the large number of Section 8 vouchers in use, many developers have made businesses out of renting only to Section 8 voucher holders. Still, the supply of vouchers is limited. Households often spend years on the waiting list before they receive their vouchers, and few new vouchers are released in years when state budgets for community and housing issues are slashed. Although tenant-based vouchers are portable, developers rarely undertake new construction in the hopes of attracting only Section 8 voucher holders. It is more common for developers to rehabilitate older multifamily properties where Section 8 households already live because this rental income is assured. Given this, it is hard to classify Section 8 vouchers as a steady stream of capital for new development, since it is not likely that federal government allocations to the Section 8 program will increase substantially.

2.2 The Private Approach: Private Debt Funds, Equity, SIBs and Crowdfunding

As documented in Chapter One, the mismatch in the supply and demand for affordable housing has persisted long enough that demand for low-income and moderate-income housing has far outstripped the ability of the federal government to finance and subsidize the development of more housing units.

In the face of this gap, private sector and non-profit organizations have demonstrated that a market opportunity exists to meet these social needs and have responded to the complexity of public financing programs by becoming creative and flexible in their approaches towards the same issue. CDFIs, pension funds, charitable foundations, faith-based groups and social-impact investors have long explored innovative ways to generate capital for affordable housing development and preservation since the 1970s, in the beginning as a complement to government programs, today, increasingly as a more effective way to achieve specific community development goals.³⁷

³⁶ Committee for a Responsible Federal Budget. (2013, November 7). *The Tax Break-Down: The Low-Income Housing Tax Credit*. Retrieved July 20, 2016, from <http://crfb.org/blogs/tax-break-down-low-income-housing-tax-credit>

³⁷ Williams, S. (2015). *Preserving Multifamily Workforce and Affordable Housing: New Approaches for Investing in a Vital National Asset*. Washington, DC: Urban Land Institute.

Below Market Debt Funds

Below market debt instruments have emerged and scaled significantly in the last decade, since the structure of such financing vehicles resemble closest to private lenders. These tend to be funds established through partnerships between private non-profits or philanthropic institutions and public agencies in order to provide developers with low-cost loans to purchase land, fund development or rehabilitation work.

Below market funds originate loans directly or through CDFIs, and blend government and philanthropic capital (grants or soft debt) with conventional debt from private lenders. The government and foundation capital serves as credit enhancement for the conventional debt, enabling the fund to offer loan products to developers with better terms than the borrowers would otherwise be able to get in the market. With these favorable terms, affordable housing developers can compete in markets where they would typically be outbid, especially since these markets tend to have high land value that lend themselves more naturally to market rate developments. Below market funds also tend to be ‘revolving’ in nature, meaning that they are set up to make new loans as prior loans are repaid, or in certain cases, to be sold off to GSEs such as Freddie Mac Multifamily to be repackaged into mortgage-backed securities, thereby freeing up more capital for the fund to lend out.³⁸

Most below-market debt funds also generate their largest deal flow in major markets, which tend to have active, high-capacity local government agencies involved in housing and community issues as well as a significant concentration of philanthropic capital dedicated to housing and community interests. Not only do they require significant start-up capital – up to 18 months of start-up time and \$1 million in costs – these debt funds also require deep and continuing relationships between multiple entities in order to continue their work.³⁹

Some major players in the market have illustrious beginnings: the Community Preservation Corporation, initiated in 1974 with seed funding from David Rockefeller, was created through a

³⁸ Freddie Mac's K-Series Multifamily Mortgage Pass-Through Certificates, or “K Deals,” is one of the more notable products through which mortgage-backed securities are sold backed by multifamily affordable housing. The K-Deals, in particular, focus on “occupied, stabilized and completed multifamily properties” and have originated \$138.3 billion in certificate issuance since 2009 when the program was started. Source: Freddie Mac Multifamily. (2016). *Freddie Mac Multifamily Securitization*.

³⁹ Williams, S. (2015). Preserving Multifamily Workforce and Affordable Housing: New Approaches for Investing in a Vital National Asset. Washington, DC: Urban Land Institute.

joint agreement between the New York City government and the city's leading commercial banks to restore and rebuild the city's aging neighborhoods.⁴⁰ More recently, the city of Los Angeles partnered with the Rockefeller and Ahmanson Foundations in 2008 to create the New Generation Fund to spur development of affordable housing in LA in order to combat homelessness and increase the stock of low-income and workforce housing. Also in California, the Bay Area Transit-Oriented Affordable Housing Fund was established in 2011 by a coalition of Bay Area government agencies, nonprofits and foundations to provide short-term and medium-term funds for acquisition, pre-development, construction and mini-permanent loans.

There is a strong likelihood that its adoption of the same strategies used by the residential mortgage-backed securities market is the reason why below market debt funds have been one of the most successful private-led initiatives in the raising of capital for affordable housing. Although the one-time start-up costs are high, such businesses scale quickly and easily once they tap into a network of experienced CDFIs and owner-operators. Borrowers (i.e. developers) are free to negotiate the various terms for lending and can choose a fund whose social objectives hews closest to their development goals. For the developers, the underwriting process is quick and the costs of capital cheaper than conventional debt. Were such funds to become a more mainstream source of capital for affordable housing, they could potentially reduce a developer's dependency on public subsidies.

Private Equity

Private equity involvement in the production of affordable housing builds on one of the most traditional forms of raising capital in real estate – the typical GP-LP partnership structure – where equity investors can range from individual philanthropists and high net worth individuals/families all the way to direct investment from private foundations, pension funds and highly-sophisticated outfits such as the Blackstone Group.⁴¹ In essence, the use of private equity in affordable housing is not so much a leading-edge method of raising capital as it is the co-opting of an existing fund raising method into a non-market rate business. It is especially useful to note that private equity

⁴⁰ Bagli, C. V. (2012, March 14). Lured by Visions of Real Estate Profits, Nonprofit Group Stumbled. *New York Times*.

⁴¹ Blackstone's agreement to preserve middle-income housing in the Stuyvesant Town complex in the middle of Manhattan was considered a coup for affordable housing advocates, although the fate of long-term affordability after 2020 is suspect. Source: Bagli, C. V. (2015, October 19). Stuyvesant Town Said to Be Near Sale That Will Preserve Middle-Class Housing. *New York Times*.

involvement in affordable housing has come into its own only in the last decade, a period where the market has been flush with capital looking for diversification opportunities.

Beginning in the 2010s, institutional private equity, especially pension funds, have started to be conscious of the social impact of their investments, in an effort to halt the investment of employee savings into real estate developments that result in gentrification, which in turn price out the same employees contributing to the pension system. It is the classic problem of having one's money used against one. In response, some of the biggest pension systems, like California Public Employees' Retirement System (CalPERS) and the New York City Employee's Retirement System (NYCERS), have increased their commitments to invest in affordable housing, with the latter committed to increasing such investments to \$1 billion over the next 10 years.⁴²

Additionally, more private equity is entering the market in the form of funds spun off from firms which had their roots as successful housing developers, such as the Richman Group and Jonathan Rose Companies, which have both established independent funds to invest equity into affordable and mixed-use mixed-income housing projects. The presence of these funds are effectively testing the market demand for social impact, triple-bottom-line investing, in which investors take lower returns than typical for private real estate deals. In good years, such investors might have to forgo returns ranging from 15% to 25% for private real estate deals in favor of affordable housing deals bringing a typical 6% to 12% cash-on-cash return.

Surprisingly, some affordable housing developers that invest in mixed-income housing rather than just affordable housing, such as the Rose Affordable Housing preservation Fund LLC (a subsidiary of Jonathan Rose Companies), have set internal investment return thresholds as high as 15%.⁴³ In such cases, the argument behind not pursuing the goal of profit-maximizing hinges on the fact that affordable housing deals are relatively risk-free and yet can still attract higher returns than debt-side investments.

The continued success of such private equity outfits will depend on the firm's ability to be flexible and responsive to market conditions as well as their ability to articulate to their investors why the

⁴² Mayor's Office, City of New York. Housing New York: A Five-Borough, Ten-Year Plan.

⁴³ As conveyed to the author during a conversation with then-Chief Financial Officer of Jonathan Rose Companies, Sanjay Chauhan, January 2016.

opportunity cost of investing in affordable housing is worth it. Simply put, they should find investors who are ready to jump on the bandwagon. But, the larger question yet to be answered is: will so-called social impact investors still seek market returns at the end of the day or will they put their money where their mouths are and tolerate lower returns in exchange for benefits to the community? The fate of private equity as a source of capital for affordable housing rests on the choices social impact investors make.

Social Impact Bonds (SIBs)

SIBs, despite the nomenclature, are not debt instruments, but are known as “Pay for Success” contracts in which private investors pay for and assume the risk of undertaking a social improvement or community development program to deliver certain measurable results based on public objectives. Government authorities will only compensate the private investor if independent evaluators determine that the initiative has achieved certain benefits for society and generate savings for the public sector. A burgeoning SIB movement has grown from the United Kingdom and taken root in Massachusetts and California, although at the time of this writing no SIBs have been used to undertake the capital-intensive work of building or preserving affordable housing.

Given the scope of the concept, I would suggest that SIBs might be best used for preservation projects that have a complementary social aspect added to it. For example, affordable housing developers might enter into SIB contracts with city agencies to rehabilitate X amount of affordable units and Y amount of public school classrooms within Z district every two years. In essence, affordable housing developers entering into SIBs will only need revolving bridge loans to tide them through the development period, with them earning their development fee based on the spread between the SIB contracted compensation and their development costs. On the down side, such affordable housing developers become no different than construction managers, and the question of who would own and operate these housing units or classrooms remain unanswered.

Crowdfunding

Crowdfunding, the most untested of all private initiatives to fund affordable housing, is still today a very small share of the \$1 billion in capital that was raised for commercial real estate acquisition

and development purposes from online platforms in 2014.⁴⁴ With an expected growth of the size of these funds to \$2.5 billion in coming years, it is expected that new social impact start-ups might turn to such unconventional capital as seed funding. Like private equity, crowdfunding can be deployed quickly, although the risky nature of such peer-to-peer lending might require returns higher than what affordable housing developers can provide. That said, it is very possible that developers who are crowdfunded could enter into joint ventures with private equity to spread the risk, with crowdfunders taking the riskiest equity position but commanding the highest return within the capital stack.

Conclusion

This chapter has reviewed the two approaches to funding affordable housing and has articulated the strengths and weaknesses of the various programs. In general, public funding programs such as LIHTC, Section 8, HOME and CDBG funds are stable, guaranteed sources of funds, and are regarded as being so risk-free that private investors often flock to co-invest in projects already funded through these public programs. That said, public funding takes a long time to be approved, is subject to a long list of compliances and is an expensive source of capital from the taxpayer's point of view.

On the other end, private sources of debt and equity have increasingly demonstrated that they can be viable sources of capital for developers without tapping on public subsidies. Such hybrid sources of capital allow developers to select from the instrument most aligned with their interests and to freely negotiate the terms of engagement. Essentially, private lending and equity in affordable housing are not so different from what already takes place in the market, and has shown that it can be nimble and flexible, with opportunities to scale. They do not come with stringent compliance requirements nor do they depend heavily on the public purse. While SIBs and crowdfunding are still fairly untested in the market and have yet to demonstrate if they can scale sufficiently to provide enough capital for what is a capital-intensive activity, the fact that there is a growing investor appetite for affordable housing indicates that it is perhaps timely to begin considering equity sources raised outside the boardroom.

⁴⁴ Williams, S. (2015). *Preserving Multifamily Workforce and Affordable Housing: New Approaches for Investing in a Vital National Asset*. Washington, DC: Urban Land Institute.

To make the argument that affordable housing developers should increasingly turn to private sources of capital, we need to acknowledge that public funding is complex, inflexible, capped and political. Shouldn't capital that is nimbler and needs fewer compliance procedures be seen as an advantage? Can we tap on existing market mechanisms to fund affordable housing? Other than private debt and equity funds, is there a better set-up that can help organize and bring together the growing number of socially-conscious investors? Chapter Three will introduce the history of the REIT vehicle and demonstrate the ability of the REIT to serve this purpose.

CHAPTER THREE

The Development and Role of Real Estate Investment Trusts

In order to piece together the concept of a workable affordable housing development REIT, Chapter Three will first cover the broad history and function of the U.S. REIT and then introduce the business models of two existing, non-development affordable housing REITs: Community Development Trust (CDT) and the Housing and Partnership Equity Trust (HPET). Chapter Three and Four will then build on the preceding two chapters to forward the argument of how an affordable housing development REIT can speed up the production of more affordable housing by streamlining the process of raising capital.

3.1 An Overview of REITs

Introduction

Real estate, as an asset class, has always been acknowledged as a different animal as compared to stocks, bonds and Treasuries. Investing in real estate requires a substantial base of local knowledge about microeconomic conditions, market demand and supply, land use and tax law, architecture and building codes, all of which would be difficult to acquire for the typical retail investor. In the 1960s, the Real Estate Investment Trust (REIT) structure was created to feed the appetite of the investing public for investments into real property that did not require such an arduous effort.

Over the past six decades, REITs have proliferated and matured into a crucial investment tool for any diversified investment portfolio, for large pension funds and small retirement funds alike. As of May 2016, REITs own \$1.8 trillion worth of commercial real estate in the United States, with a market capitalization of \$993 billion for all REITs listed on the FTSE NAREIT All REITs Index (*Exhibit 3.1a*).⁴⁵ When benchmarked to the major trading indices, the post-Great Recession performance of REITs has beaten two out of three indices, with a 5-year compounded total returns at 11.59% (*Exhibit 3.1b*).⁴⁶ When tracked since 1972, when such data was first available, the average returns for all REITs on the FTSE NAREIT US Real Estate Index was 11.89%, outperforming the annual

⁴⁵ National Association of Real Estate Investment Trusts. (2016). *REITWatch*. Washington, DC: National Association of Real Estate Investment Trusts.

⁴⁶ National Association of Real Estate Investment Trusts. (n.d.). *Annual Proxy Data*. Retrieved June 6, 2016, from <https://www.reit.com/data-research/data/annual-proxy-data>

average returns over the same time period for the S&P 500, the 3-month Treasury bill and 10-year Treasury bonds (*Exhibit 3.1c*).⁴⁷

Exhibit 3.1a: Total Market Capitalization for FTSE NAREIT All REITs Index, May 2016

(Source: NAREIT)

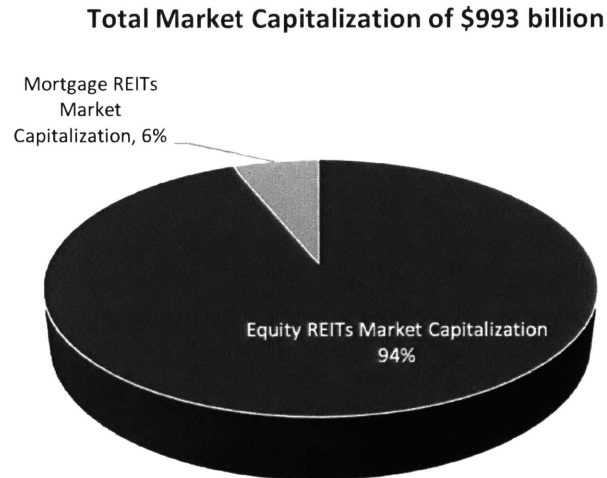
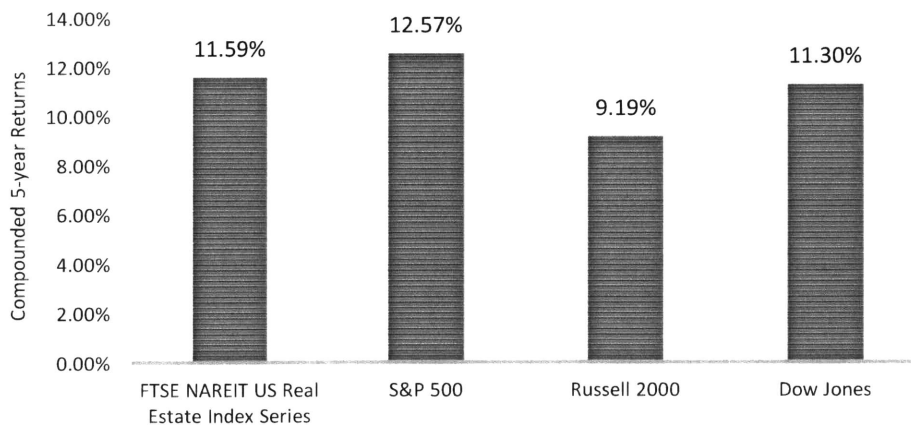


Exhibit 3.1b: Comparative 5-Year Investment Returns for NAREIT Index Versus Other Indices

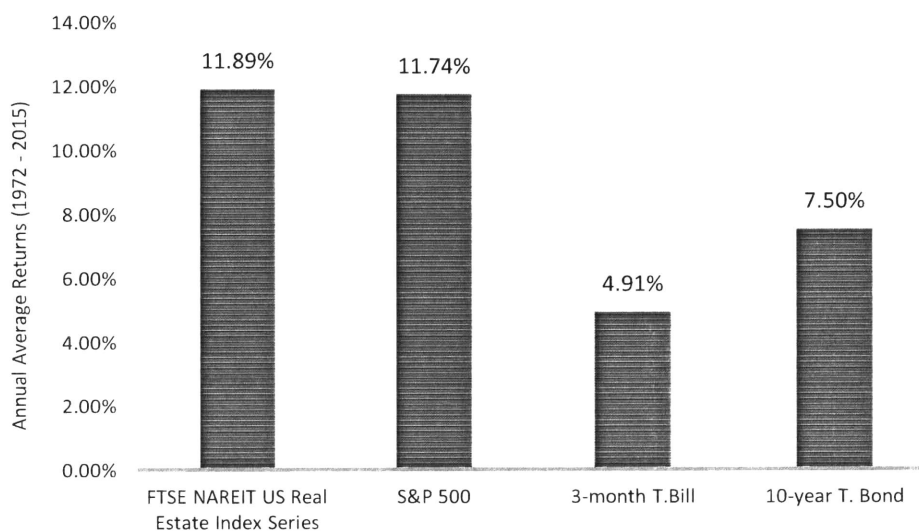
(Source: NAREIT)



⁴⁷ National Association of Real Estate Investment Trusts. (n.d.). *FTSE NAREIT U.S. Real Estate Index Historical Values & Returns*. Retrieved June 6, 2016, from <https://www.reit.com/data-research/reit-indexes/ftse-nareit-us-real-estate-index-historical-values-returns> and Federal Reserve Economic Data. (n.d.). *Annual Returns on Stock, Treasury Bonds and Treasury Bills since 1928*. Retrieved June 6, 2016, from http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Exhibit 3.1c: Annual Returns for the FTSE NAREIT US Real Estate Index Series as compared to S&P 500, Treasury bills and bonds, 1972 – 2015

(Source: NAREIT)



The Beginnings of REITs in the United States

Although the REIT structure recognizable today dates back to the 1960 Act created by Congress which allowed individual investors the opportunity to invest in professionally-managed real estate through publicly-traded securities, REITs were by no means invented then. The first limited liability entity that could own real estate was created by the State of Massachusetts in 1854, with the creation of a “business trust” that could pool capital from disparate sources to develop and own real estate projects.⁴⁸ The main attraction for owning real estate under a business trust was the fact that as a pass-through entity, it could avoid double-taxation and provide tax-advantaged status for property investors.

However, the Supreme Court’s decision on *Morrissey v. Commissioner* in 1935 held that business trusts had sufficient corporate characteristics that did not exempt them from corporate income tax, thereby removing the distinctions between corporations and business trusts.⁴⁹ It was not till later in

⁴⁸ Levy, D., Gianou, N., & Jones, K. (2015). *Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles*.

⁴⁹ *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

the twentieth century that REITs would then be legally allowed to operate as truly tax-exempt entities.

President Eisenhower's signing of the REIT-enabling act as part of the Cigar Excise Extension Act of 1960 enabled the creation of the investment vehicle that would allow private investors to invest in large-scale portfolios of properties from multiple asset classes through the purchase and sale of liquid securities. Large, income-bearing commercial real estate properties were now within the reach of the larger investment community (individual investors in addition to wealthy and institutional investors), thereby commoditizing what used to be complex, multi-faceted real property into purchasable equities.⁵⁰ Just as smaller investors were now allowed to pool together resources to acquire real estate interests, on the flip side, REITs now provided a way for commercial property to obtain equity capital financing via the public stock market.

At the entity level, the main benefit of the REIT organizational structure was its ability to claim tax-exempt status from corporate income tax, as long as the entity fulfills the criteria to retain REIT status. Essentially, REITs can be viewed as the mutual funds of the real estate industry, since their key defining characteristic lies in being pass-through entities distributing most of their income and capital gains.

What is a REIT?

A REIT is defined by the Internal Revenue Code⁵¹ as "a corporation, trust, or association, that operates like a mutual fund, except that REITs own real estate and mortgages, as opposed to stocks, bonds and other securities."⁵² A REIT, in essence, is like any corporate organization, except that in order to qualify for for tax benefits, it must meet specific organizational structure requirements and must pass several tests.⁵³

⁵⁰ National Association of Real Estate Investment Trusts. (n.d.). *What is a REIT?* Retrieved May 31, 2016, from <https://www.reit.com/investing/reit-basics/what-reit>

⁵¹ Internal Revenue Code Sections 856 to 860.

⁵² *Bridges v. Autozone Properties, Inc.*, 900 So. 2d 784, 795 (La. 2005).

⁵³ Stonecipher, J. (2007). From One Pocket to the Other: The Abuse of Real Estate Investment Trusts Deductions. *Missouri Law Review*, 72 (4).

Exhibit 3.1d: Requirements to Qualify as a REIT

The following table summarizes the structure and tests required to qualify as a REIT.

(1) Trust	A REIT must be organized as a trust
(2) Trustees	A REIT must be managed by trustees
(3) Transferability	A REIT's shares must be freely transferable
(4) 100 Shareholder Test	A REIT must be held by at least 100 beneficiaries
(5) 5/50 Test	Five or fewer individual owners cannot own more than 50% of the value of the REIT's stock during the last half of its taxable year
(6) Asset Test	A REIT's must have at least 75% of its total assets be in real estate, mortgages, cash, or federal government securities
(7) 75% Income Test	A REIT must derive at least 75% of its gross income from passive income sources such as dividends, interest, rents from real property and gains from sale of properties in non-prohibited transactions. Non-real estate income from "prohibited transactions" is subject to a 100% tax
(8) 95% Income Test	A REIT must derive at least 95% of its gross income from items that meet the 75% income test, from other dividends, interest and gains from sale of stock or securities that are not considered "prohibited transactions."
(9) Distribution Test	A REIT must distribute at least 90% of taxable income annually as dividends to shareholders

In general, REITs could be classified as equity REITs or mortgage REITs or a combination of both. Equity REITs are primarily engaged in the business of earning rental incomes from the development and management of real properties. Over time, many equity REITs have developed specific strategies, with some classifying themselves as acquisition, development, value-creation or joint-venture REITs. Mortgage REITs invest primarily in mortgage notes secured by real property and earn their income through mortgage payments. Hybrid REITs hold some combination of debt and equity investments.

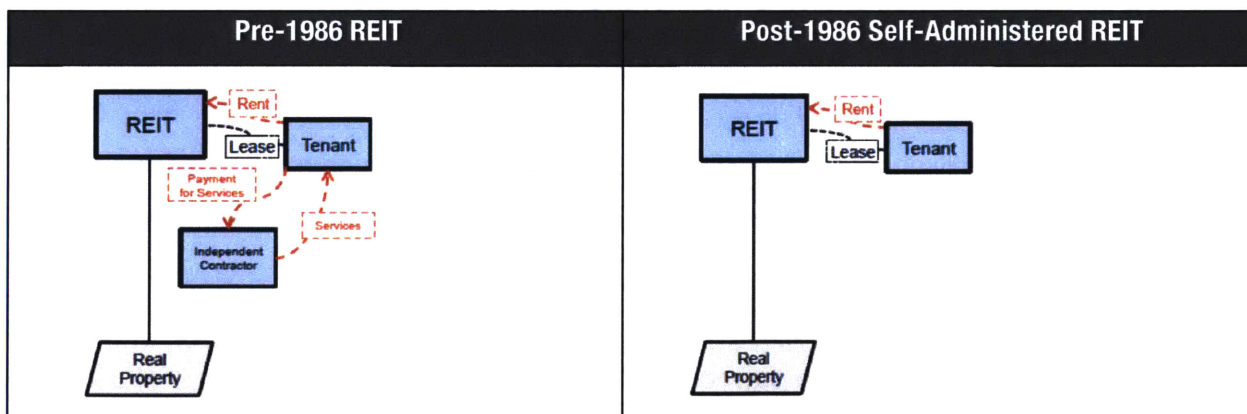
The Early Years of REITs

Such stringent restrictions on a REIT’s ability to earn income dampened the growth and market demand for REITs, with only 10 REITs of any meaningful size existing during the 1960s,⁵⁴ while the first REIT to be publicly listed on the New York Stock Exchange, Continental Mortgage Investors, came in June 1965.⁵⁵

It was acknowledged that these restrictions rose out of the Eisenhower administration’s concerns that REITs could be incentivized towards monopolistic behavior after being granted tax-exempt status if regulations did not ensure that they remained passive investment vehicles. Up until changes to REIT regulations in the 1986 Tax Reform Act, REITs could not be “self-administered” and could not actively operate or manage real estate assets. In short, REITs would have to employ independent property managers to run and operate their properties. Given that independent property managers were incentivized to operate properties at the lowest cost, this profit maximization objective did not align with the interests of the REIT shareholders which was to derive the highest net asset value from a well-run, well-positioned asset.⁵⁶ *Exhibit 3.1e* demonstrates the difference between a pre-1986 REIT with operating restrictions and a post-1986 self-administered REIT.

Exhibit 3.1e: Pre-1986 and Post-1986 REIT Operating Restrictions

(Source: Levy, D., Gianou, N., & Jones, K. (2015). *Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles.*



⁵⁴ Block, R. L. (2006). *Investing in REITs: Real Estate Investment Trusts*. New York: Bloomberg Press.

⁵⁵ National Association of Real Estate Investment Trusts. (n.d.). *REIT Industry Timeline*. Retrieved June 6, 2016, from <https://www.reit.com/investing/reit-basics/reit-industry-timeline#3>

⁵⁶ Boos, P. E. (2014). Runaway REIT Train? Impact of Recent IRS Rulings. *Tax Notes*.

Another reason for the slow growth of REITs in the early years was due to the structure of the pre-1986 tax code, which allowed real estate investors to offset their income with mortgage interest deductions, depreciation deductions and any passive investment losses i.e. paper losses generated by the property. Investors into real estate were incentivized to own real estate directly through partnerships instead of through REITs in order to benefit from the paper losses, as REITs did not allow losses to pass through from the entity level to the shareholders. Without the benefit of sheltering an investor from tax, there wasn't much initial attraction to the REIT vehicle.

The Modern REIT Era

The 1986 Tax Reform Act heralded major changes to REIT regulations that "liberalized" the notion of REITs as passive entities. REITs were now allowed to self-administer and provide the type of customary services⁵⁷ associated with real estate ownership and operation, while still allowing the income earned from providing said customary services to be classified as "rents from real property".⁵⁸ This allowed REITs to become actively involved in the day-to-day running of their properties, thereby aligning tenant services to the shareholder interest, and allowing improvements to be made to the property in a way that could lead to appreciation in shareholder value. Non-customary services, however, still needed to be provided through independent contractors that REITs had no direct control over.⁵⁹

However, the 1986 tax reform coincided with an economic recession and the savings and loan crisis which dampened real estate investment. The modern REIT did not take off until the 1990s, when real estate investors began to tap on REITs as the best way (sometimes, the only way) to access public capital. This boom in the REIT industry was demonstrated by the tenfold growth in market capitalization between 1992 and 1998, from \$13 billion to \$150 billion.⁶⁰

Much of this sudden boom can be attributed to the 1993 to 1994 initial public offering (IPO) boom that took place amidst a bullish growth spurt in the economy, in which investors looked at REITs as a vehicle to raise funds to refinance maturing mortgages or to take advantage of buying

⁵⁷ Services directly related to the day-to-day operations of real property, such as elevator maintenance, common area maintenance, etc.
⁵⁸ Joint Committee on Taxation. (1987). *General Explanation of the Tax Reform Act of 1986*. Washington, DC: U.S. Government Printing Office.

⁵⁹ Non-customary services refer to services provided to a tenant at his or her convenience, but which are not directly related to the day-to-day operations of real property, such as cable television connections and dry cleaning services, etc.

⁶⁰ Wern, C. E. (2000). The Stapled REIT on Ice: Congress' 1998 Freeze of the Grandfather Exception for Stapled REITs. *Capital University Law Review* (722).

opportunities just as the economy was coming out of the recession. Following the oversupply of space in the property market as a legacy of the building boom in the 1980s, many developers were left with highly leveraged assets financed by short-term construction financing without prospects of permanent financing to take out the construction loans. Without any access to private equity, many of these developers were forced to go public to raise equity and recapitalize their balance sheets.⁶¹ As a result, many of the firms choosing the IPO route were not new, but were well-established real estate developers.

It has been argued that the transformation of so many private real estate firms into publicly-listed REITs has permanently altered the state of the real estate market. REITs no longer tapped only on the capital of individual investors, who had longed to gain access to large-scale investment-grade real estate portfolios, but had also attracted the attention of institutional investors. As such, institutional investors helped to fuel a boom in REIT IPOs during this period, and subsequently, in secondary security offerings (SEO) in 1996 and 1997.⁶² During this era, REITs evolved out of being viewed as mutual funds into stocks, with REIT share prices being priced at roughly a 30% premium to net asset value during the boom years.⁶³

Creation of the Taxable REIT Subsidiary

By the late 1990s, it was clear that REITs had gained credibility on the public exchanges as a viable corporate structure, particularly in its ability to access huge amounts of capital from the public markets and in its enjoyment of tax-exempt status. To further fuel this REIT growth, more legislative amendments brought about by the REIT Modernization Act in 1999 allowed REITs to form and own a taxable REIT subsidiary (TRS), thereby allowing them to engage in activities and provide services to tenants that had previously been prohibited by IRS rules. A TRS is a subsidiary of a REIT that elects, jointly with the REIT, to be treated as a TRS.⁶⁴ Taxable REIT subsidiaries could provide a wide range of non-customary real estate management services (including development services) to tenants without resorting to the use of third-party contractors. These activities would not be attributed to the parent REIT, even if the parent REIT collected rent for properties that could partly be traced to the TRS's activities.⁶⁵ While TRS did liberalize the ability of

⁶¹ Geltner, D. M., Clayton, J., Miller, N. G., & Eichholtz, P. (2014). *Commercial Real Estate: Analysis and Investments*. Mason, Ohio: OnCourse Learning.

⁶² Ibid.

⁶³ Ibid.

⁶⁴ Internal Revenue Code Sections 856 (1) (1).

⁶⁵ Nugent, R. M. (2015, March). REIT Spinoffs: Passive REITs, Active Businesses. *Tax Notes*, 1513.

REITs to provide tenant and development services, no more than 20% of the REIT's assets could be attributed to the ownership of securities in a TRS.

With REITs now becoming more competitive as asset owners and managers, REITs became a more attractive investment choice than other forms of property ownership because they were allowed greater control over the tenant services offered and, up to a limit, had the ability to earn additional non-rental income, i.e. development fees.⁶⁶

By the 2000s, REITs had established themselves as an investment option for real estate investors to gain long-term exposure to real estate and for stock investors to seek high dividend yields, portfolio diversification or protection from inflation.⁶⁷ Within a handful of years after the TRS-enabling legislation, over 700 TRSs had been created and TRS assets grew to \$68.2 billion. REITs that had suffered a drop in share prices when capital markets chased the dot-com bubble resurged to popularity during this period before the precipitous crash in the Great Recession years.

Post-Recession, REITs have made a strong recovery and have increased in market capitalization from their all-time low in 2008 by five times⁶⁸ and are poised to remain an engine of growth and stalwart source of capital in the real estate industry.

3.2 REIT Earnings & Valuation

In order to argue that affordable housing developers should go public and list as REITs, it is important to understand one of the key features of the IPO process – the valuation of the REIT. Even under the best of circumstances, it is sometimes difficult to value commercial properties, where the highest and best uses have been achieved. This difficulty is magnified in the case of affordable housing, which is deed-restricted by nature, and is therefore one of the major issues that explains why there have not been any publicly-listed affordable housing development REITs. Before delving into a more substantial discussion of this drawback in Chapter Four, this section will introduce the basic mechanics of REIT earnings measures and valuation.

⁶⁶ Boos, P. E. (2014). Runaway REIT Train? Impact of Recent IRS Rulings. *Tax Notes*.

⁶⁷ Geltner, D. M., Clayton, J., Miller, N. G., & Eichholtz, P. (2014). *Commercial Real Estate: Analysis and Investments*. Mason, Ohio: OnCourse Learning.

⁶⁸ NAREIT. (n.d.). *US REIT Industry Equity Market Cap: Historical REIT Industry Market Capitalization, 1972-2014*. Retrieved July 13, 2016, from <https://www.reit.com/data-research/data/us-reit-industry-equity-market-cap>

The Parallel Markets: Stocks versus Real Property

REITs, in straddling between the worlds of stocks and real estate, can be viewed in two different ways: firstly, as a stream of future cash flows generated by well-managed properties, and second, as a portfolio of real properties that in themselves have intrinsic value and use.⁶⁹ What this means is that we can examine a REIT's value either through its ability to generate future cash flow, or through the value of its current physical assets, both of which rest on the sourcing of the right data (i.e cash flow analysis or the valuation of close substitutes in the private real estate market).

However, the real estate industry often faces an information asymmetry, where the average REIT investor is not privy to the abovementioned sources of data. Therefore, another way of thinking about it, according to Brad Case, the Senior Vice President of Research & Industry Information at the National Association of Real Estate Investment Trusts (NAREIT), the leading industry group for REITs, is that because the public REIT answers to its marginal shareholder, its value at that particular point is the price paid by the profit-maximizing purchaser of the last share.⁷⁰ Within an efficient market, as the stock exchange so often is, the "Law of One Price" holds and that last share price must be the value of the REIT at that time.

Luckily, even without direct information about any property's streams of future cash flows, the stock market in general values stocks by viewing companies as future cash flows anyway, meaning that any developer wanting to go public has a clear enough methodology to develop its internal valuation before testing whether the market will support it.

REIT Earnings Measures

The way REITs report their income differs significantly from other forms of publicly-traded corporations – REITs use the GAAP net income measure, with GAAP being short for generally accepted accounting principles, an accrual method of accounting that diverges from the cash accounting method. Due to this, accrued depreciation expenses (which are not actual cash outflows) under GAAP shield considerable amounts of REIT cash flow from being reflected as taxable income, because depreciation expenses allowed by the IRS may often be larger than the

⁶⁹ Geltner, D. M., Clayton, J., Miller, N. G., & Eichholtz, P. (2014). *Commercial Real Estate: Analysis and Investments*. Mason, Ohio: OnCourse Learning.

⁷⁰ Interview with Mr Brad Case, Senior Vice President of Research & Industry Information at the National Association of Real Estate Investment Trusts on June 1, 2016.

actual loss in property value due to wear-and-tear or obsolescence. Even if real property as an asset class is subject to large depreciation expenses, often, properties do not depreciate in accordance with the straight-line depreciation methodology adopted by the IRS. As such, to reconcile itself to the earnings methodology reported by most other publicly-traded companies, the REIT industry has adopted a special measure of earnings known as Funds From Operations (FFO) as an alternative to the GAAP net income metric. *Exhibit 3.2a* contrasts the use of FFO and Adjusted FFO (AFFO) for REITs versus the Net Income measure derived directly from a property's cash flow.

Exhibit 3.2a: Property versus REIT Income Measures

(Source: Geltner, D. M., Clayton, J., Miller, N. G., & Eichholtz, P. (2014). Commercial Real Estate: Analysis and Investments. Mason, Ohio: OnCourse Learning.)

The following example illustrates how earnings at the property level versus at the REIT level would be reported. All figures are hypothetical and are in millions.			
Property Level Cash Flow		REIT Level Cash Flow	
Potential Gross Income	\$200	Potential Gross Income	\$200
Vacancy	- \$10	Vacancy	- \$10
Operating Expenses	- \$70	Operating Expenses	- \$70
Net Operating Income (NOI)	\$120	Net Operating Income (NOI)	\$120
		Firm Operating Expenses	- \$2
		EBITDA	\$118
Interest Expense	- \$40	Interest Expense	- \$40
		Funds From Operations (FFO)	\$78
Depreciation Expense	- \$20	Depreciation Expense	- \$20
GAAP Net Income	\$60	GAAP Net Income	\$58
adding back Depreciation	\$20	adding back Depreciation	\$20
Capital Expenditures	- \$15	Capital Expenditures	- \$15
Earnings Before Tax Cash Flow	\$65	Adjusted Funds from Operations (AFFO)	\$63

A few things should be noted from the above table. First, A REIT's EBITDA, earnings before interest, taxes, depreciation and amortization, gives us a close approximation to the equivalent measure of Net Operating Income (NOI) for an underlying property, but is also an earning measure that is widely reported by different companies across different industries, thereby allowing REITs to participate in value and earnings measures such as the EBITDA margin, Value/EBITDA multiple, CapEx/EBITDA ratio, etc. Second, FFO gives a good indication of a REIT's earnings after interest and before depreciation, as an indication of free-and-clear cash flow before taxes. Third, in the above example, a minimum of 90% of GAAP Net Income must be distributed as dividends, indicating a minimum distribution of \$52.2 million which results in a Dividend/FFO ratio of 67% and a Dividend/AFFO ratio of 83%. Fourth, by subtracting the minimum distribution amount from the AFFO, we know that the REIT will be able to ploughback at least \$10.8 million into new acquisitions and development.

REIT Valuation Measures

By adopting the Discounted Cash Flow method used to value an underlying property, a REIT can derive its value by discounting the stream of dividends that stockholders of that REIT expect to get by an appropriate cap rate:

$$Value = \sum_{t=1}^{\infty} \frac{Dividend_t}{(1+r)^t}$$

or more simply, if we assume a constant dividend,

$$Value = \frac{Dividend}{Cap\ Rate}$$

Alternatively, the Net Asset Value approach can also be used to derive the value of a REIT, based on the net value of its existing asset base, which is then divided per share to derive the NAV per share. This is then compared to REIT share prices in the stock market, and a premium or discount is added to account for expectations of future growth (or lack of growth) achieved through good management strategy and sound corporate governance.⁷¹

⁷¹ Green Street Advisors. (2014). REIT Valuation: The NAV-based Pricing Model.

The following formula summarizes the NAV approach:

$$Value = \frac{(Total\ Assets - REIT\ Liabilities)}{No.\ of\ Shares} + Premium$$

There is strong debate as to which methodology gives a better sense of a REIT's intrinsic value, with financial advisors often using one method to countercheck the other. But, like all real estate valuation methodologies, a REIT's worth is ultimately subject to the forces of demand and supply, and the true price is whatever price the market will take.

3.3 Public versus Private REITs

Not all REITs are registered with the Securities and Exchange Commission (SEC) and trade on public exchanges. A fair proportion of all U.S. REITs are private REITs, meaning that information on its governance, earnings and dividend payouts do not have to be filed publicly. The main difference between the set-up of private and public REITs is the strategy employed: many private REITs are used primarily to enable its investors to circumvent tax events, by transferring properties in exchange for preferred shares without triggering a tax on gains. Public REITs, on the other hand, are mainly set up to access public capital in a tax-efficient manner.

All REITs, whether private or public, must adhere to the Internal Revenue Service's (IRS) regulations to qualify for REIT status. Therefore, all REITs must remain in compliance with the various asset, income and distribution tests as required by the Internal Revenue Code. However, because public REITs publish their earnings and distribution information, such market data serves as a signaling effect to investors and provides the basis on which the investing community judges whether the firm is growing or underperforming. Therein lies another distinction between the private and public REIT – private REITs are not required to publicize their earnings and performance to a wider audience and hence do not face the day-to-day pressure of answering to its shareholders.

Additionally, because private REITs do not have to publicly maintain share value, they sometimes operate in the same manner as investment funds and not as developers, where private REITs take on the role of the money partner and not the general partner. Publicly traded REITs, on the other hand, tend to adopt more visible strategies to appease shareholders' desire to maximize profits,

with equity REITs tending to fall into the categories of acquisition or development REITs (or a hybrid of both).

It cannot be said whether a private REIT or a public REIT functions better. The set up and structure of the REIT depends on its intended purpose and scale. There is a reason why private REITs tend to be smaller and resemble investment funds, because they are not intended to scale and because it has sufficient access to private capital. Public REITs, in contrast, go through the IPO process to access the widest possible capital market even if they also have to face the disadvantages of answering to its shareholders. This key distinction is the reason behind why this thesis argues for affordable housing developers to go public, in order to increase exposure to the capital markets and to decrease dependence on the public purse.

As will be seen in the case studies discussed in the next section, the two existing affordable housing REITs are private non-development REITs, one of which was set up to facilitate property exchanges and the second set up to pool pre-identified sources of private equity. Both function more as investment funds rather than as developers. Ultimately, there is as yet no affordable housing development REIT set up to tap on the capital available in the public markets.

3.4 Existing Affordable Housing REITs

It is critical, at this juncture, to note that there are REITs in the market that do hold affordable housing properties on their asset base, two of the more prominent ones being multifamily development REITs like AvalonBay Communities, Inc. and Forest City Realty Trust. That said, these REITs do not specialize in affordable housing, and are not very useful to the current discussion.

This section will demonstrate how REITs have also become involved in private sector-led approaches to fund-raising for affordable housing development, in addition to those methods shared in Chapter Two. That said, even after cataloguing all the current private approaches to raising financing, there is still no existing investment vehicle that allows affordable housing developers to access the greater capital markets.

Community Development Trust

Community Development Trust (CDT) was launched in 1998 to provide long-term capital for the preservation and development of affordable housing. Headquartered in New York City, it has now invested over \$1.2 billion across 43 states to support the creation and preservation of over 40,000 units of affordable housing. It is the larger of the two affordable housing REITs discussed in this section, and on top of that, CDT is one of the largest and best capitalized community development financial institutions (CDFIs) in the U.S.⁷²

CDT got its start as a mortgage investor, which bought, repackaged and sold loans from community development groups initially and eventually expanded into the securitization of these loans by investing its own capital into the first-loss piece to provide credit enhancement. As the business grew and expanded, the need to attract more capital resulted in the founders of CDT turning to the REIT vehicle to raise capital. CDT was conceptualized as the first REIT that would focus on community development and raised \$31.75 million during its first private placement offering in 1999. Many of the investors that bought CDT's first tranche of common stock were already leaders in affordable housing and community development, many of whom were private high net worth individuals who contributed property in exchange for shares in CDT, as many had found it much more attractive to hold private REIT stock over real property after 1986, when the Tax Reform Act's regulations did not allow them to offset their taxable income by taking depreciation deductions on these properties.

CDT remains a private REIT today, even though the organization has internally set a reporting standard that adheres closely to the compliance requirements of a publicly listed REIT. It has two main businesses, a debt program and an equity program, making it essentially a hybrid REIT. The debt program does direct lending and buys mortgage-backed securities off the secondary market. The debt side invests in the first-loss piece within the credit tranche, and uses this credit enhancement to generate higher prices for the bonds in the investment-grade tranches. Many investors with CDT's debt side tend to be big banks trying to expand their lending base into smaller regional banks, where many of these mortgages were generated.

⁷² Community Development Trust. (n.d.). Retrieved July 14, 2016, from History of the CDT: <http://www.cdt.biz/about-us/history/>

The equity program is responsible for acquisitions, with its main strategy being investing into underpriced affordable housing properties where the prevailing rents were below market rate, taking the properties through rehabilitation, and then raising the rents after capital improvements (although they would still remain affordable to the tenants through housing assistance payments). In addition, because CDT is a certified CDFI, it can borrow at attractive rates and participate in joint venture projects as the Limited Partner, thereby being able to lend at higher rates of return, and arbitrage on the yield spread to make a profit.

Financially, CDT is thriving. In 2015, it deployed \$36.3 million in capital and increased its annual cash flow by \$3.1 million, both record highs in the firm's 18-year history. CDT also closed on the largest equity investment it has ever made - \$17.1 million – and raised the NAV of the company to more than \$230 million. Additionally, it has paid out a regular dividend since 2001, which was increased by 17.6% in 2014 and by 5% in 2015.⁷³ On top of that, it made a special dividend distribution in February 2016, the third in eight years. Its recent annualized cash-on-cash returns range in the 7% to 9%, which while respectable in an industry sector not known for high returns, is actually quite laudable, when considering the fact that these are risk-adjusted returns for a very stable asset class. Still, because the typical real estate investor hungers for quick and fast returns, CDT's investment partners tend to come from a limited pool – those who have patient capital who are in it for the long run.⁷⁴

When asked what the benefit of being organized as a REIT was as opposed to an investment company specializing in affordable housing, Brian Dowling, Senior Vice President of Community Investments listed tax efficiency as the main reason. The reasons that CDT cites for not wanting to go public are legitimate: first, the misalignment of interests between the profit-maximizing private investor and the social mission of CDT might not allow CDT to invest more than necessary to ensure the creation of a good-quality, long-lasting product; second, the pressure of answering to investors who might not understand CDT's mission-based work and thereby expose the business to board room politics; third, the risk of inadvertently altering internal investment criteria due to the

⁷³ Community Development Trust. (2016, February 1). *The Community Development Trust Announces Special Dividend and Stock Conversion*. Retrieved July 14, 2016, from <http://www.cdt.biz/news/the-community-development-trust-announces-special-dividend-and-stock-conversion/>

⁷⁴ Interview with Mr Brian Dowling, Senior Vice President of Community Investments at Community Development Trust on May 17, 2016.

pressure to chase higher returns rather than to invest in good, long term properties. At the end of the day, the private REIT structure has worked to CDT's great benefit and will no doubt remain.

Housing Partnership Equity Trust

Launched in 2013, the Housing Partnership Equity Trust (HPET) was formed as a "social-purpose REIT" to provide a ready source of long term, low cost capital, enabling it to quickly deploy private capital to acquire naturally-occurring affordable housing properties in high-growth areas.⁷⁵ So-called naturally-occurring units are units that are not subsidized by the government but have a natural price point that makes them more affordable when compared with market rate units, most likely because the structure is old (40 years old and older in many cases) or that its current owner had not kept up proper maintenance on the unit.

As seed capital, HPET received \$100 million in initial funding from five investors – Citibank, Morgan Stanley, Prudential Financial, the MacArthur Foundation and the Ford Foundation – which all share in the mission of making triple-bottom-line investments that are financially, socially and environmentally beneficial to communities in need of low-income housing. Indeed, the trust's mission is to have its cake and eat it too, aiming to preserve affordable housing, create sustainable returns through energy efficiency upgrades and achieve an economic return to its investors through consistent long term dividends.⁷⁶

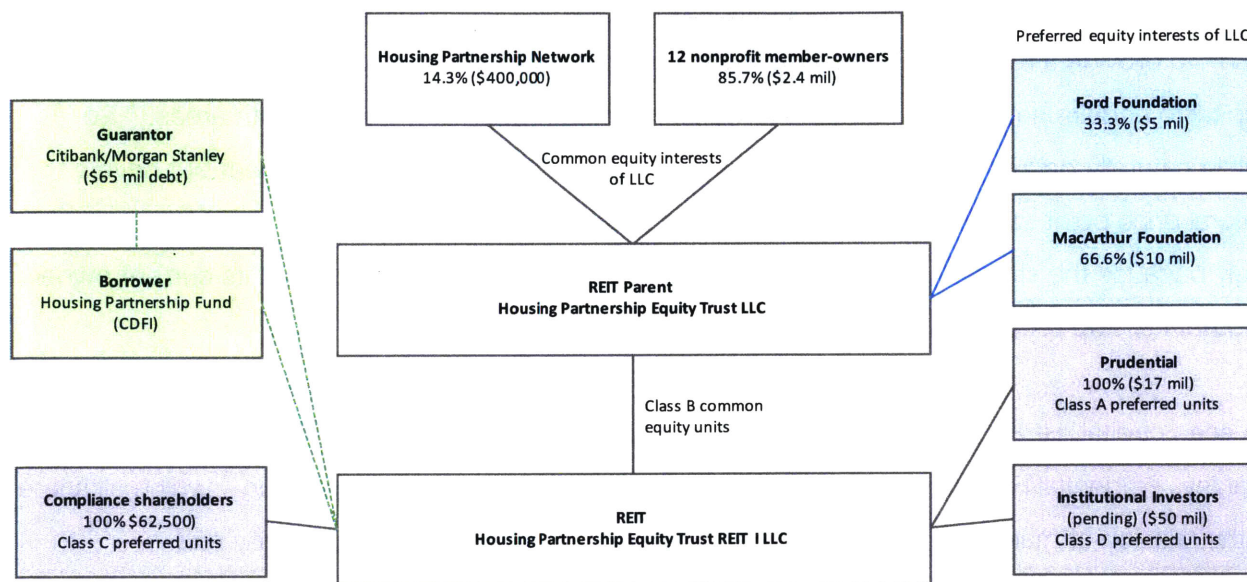
Operationally, HPET investors receive equity units in HPET REIT I in exchange for equity infusions, and are entitled to receive a dividend payout across time. As of July 2016, HPET has not yet declared any dividends paid out to its shareholders. *Exhibit 3.4a* illustrates the relationships between the HPET REIT and its parent trust.

⁷⁵ Housing Partnership Equity Network. (n.d.). Retrieved July 19, 2016, from Welcome to the Housing Partnership Equity Trust: <http://hpequitytrust.com/>

⁷⁶ Housing Partnership Equity Trust. (n.d.). *HPET Investors*. Retrieved July 14, 2016, from <http://hpequitytrust.com/investors-members/investors/>

Exhibit 3.4a: Housing Partnership Equity Trust Organizational Structure

(Source: Williams, S. (2015). *Preserving Multifamily Workforce and Affordable Housing: New Approaches for Investing in a Vital National Asset*. Washington, DC: Urban Land Institute.)



HPET’s strategy lies in being able to provide nimble capital to help General Partners/Operating Partners purchase assets in markets where these GP/OPs would typically have been outbid, because buyers seeking value-add deals would bid highly for these naturally-occurring affordable housing in order to turn them into market-rate entities. In order to reduce the risk of affordable housing being converted to market rate, HPET co-invests with these local partners to keep these units affordable. In a sense, HPET’s REIT structure is purely a result of the desire to avoid taxation, since it operates more as a fund or lender that provides bridge financing rather than as a REIT for the purposes of liquidating assets/raising capital.⁷⁷

Another unique characteristic of HPET is that it is tied to a sponsoring organization, the Housing Partnership Network, which provides a partnership of 12 non-profit housing providers who own and operate 65,000 housing units in markets across the U.S.⁷⁸ This allows it to tap into a ready pool of General Partners (GPs), financial institutions and foundation program-related funding within the Housing Partnership Network who have expert knowledge within their markets and which

⁷⁷ Interview with Ms Elaine Magil, Investment Manager at TCAM, LLC on May 20, 2016.

⁷⁸ Pyati, A. (2016, June 3). Impact Investing Platforms Create New Equity Streams for Affordable Housing. *Urban Land*.

allows HPET to close on deals much quicker than the typical 18-months it takes to seek funding and close a LIHTC deal.

Financially, it is too soon to assess HPET's impact on the affordable housing market, given its short history. In 2015, HPET closed on its second capital raise to bring the total equity raised to \$80 million, a fraction of the amount CDT has invested in nearly two decades. That is not necessarily a negative comparison, given HPET co-founder Drew Ades's conviction that "there is basically an infinite demand right now for affordable housing," an industry in which HPET has infinite room to expand into. It is also too soon to tell if the REIT portion of HPET remains scalable, as it continues to raise equity through different partnerships. Like CDT, HPET clearly seems to operate on a model closer to an investment fund rather than a typical real estate equity REIT, and as such has not been able to enjoy any benefits of going public. The operational set-up of HPET reveals an implied criticism of the current way the government funds affordable housing, which involves a prolonged and complicated process that few small outfits can afford to engage in. Hence, HPET has stepped into a niche market demanding quick and nimble capital, although it remains to be seen if the REIT structure had been necessary to achieve this outcome.

Chapter Three concludes by observing that nearly 15 years stand between the creation of CDT and HPET, the only two affordable housing REITs operating in the market today. As demonstrated in the earlier overview of the development of REITs in the U.S., there has been substantial evidence that REITs function as an important tool to generate equity, capitalize balance sheets and spur acquisitions and development in the real estate industry. As the market has become more specialized and sophisticated, federal regulations and the tax code have evolved to reflect the growing appetite for investment into real estate over the last 60 years. The REIT market is mature, entrenched and familiar. Why, then, has its benefits not yet been enjoyed by the affordable housing industry? Why have the two affordable housing REITs in the U.S. remained private, and in truth, operate more like investment funds than traditional equity REITs? Chapter Four will discuss the rationale, structure and strategy of a publicly listed affordable housing development REIT and articulate the argument behind why this form of REIT can play an influential role in making affordable housing production more efficient.

CHAPTER FOUR

Why Affordable Housing Developers Should Go Public

Chapter Four will put forth the argument that an affordable housing REIT should go public to raise capital because the Initial Public Offering (IPO) process allows it to be nimble in choosing when to raise capital, flexible in deploying it and allows it to tap into a wider capital market to exploit investor appetite for portfolio diversification. From the macro perspective, affordable housing development REITs can provide an additional source of equity into a mature industry and help to create more variations in affordable housing products than public subsidies already do, such as middle-income workforce housing.

As the previous chapter has demonstrated, the public REIT has a long history of being the investment vehicle of choice for developers and property owners who find that the benefits of tax exemption and access to capital outweigh the costs and constraints of REIT regulations and living in the public fishbowl.⁷⁹ Given the fragmented nature of capital sources available to affordable housing developers, where the search for financing is often dependent on the depth of business networks, I argue that the public REIT can serve as the organizing platform to raise capital across different pools of institutional equity, private wealth and public funding, and in this way help to demystify affordable housing as an asset class.

4.1 Developer Compliance with REIT Regulations

Before I elaborate on how affordable housing development REITs can play an important role in blending the benefits of serving the public good with the agility of privately raised capital, we need to first understand whether the REIT structure itself can serve this purpose. This section attempts to show that even though there are currently no development REITs that specialize in affordable housing, this is not due to any inherent quality of the REIT set-up being unsuited for the affordable housing asset class.

Long Term Owner-Operators

Most affordable housing developers are owner-operators, building or acquiring affordable housing units to hold for the long term. They are permanent, patient investors who enter the business not

⁷⁹ Geltner, D. M., Clayton, J., Miller, N. G., & Eichholtz, P. (2014). *Commercial Real Estate: Analysis and Investments*. Mason, Ohio: OnCourse Learning.

expecting to exit in the medium to long term. Many of them have also taken on an operator role to exploit the economies of scale they enjoy from building a very specialized product. Being owner-operators thus ensures that they have a continuous stake in the performance of the asset and the health of the investment, so they are naturally incentivized to ensure that their properties are well-managed and maintain their value. As such, affordable housing REITs would have no problems in meeting the stipulation that the bulk of REIT income must come from passive rental income.

Few, if not no, affordable housing developers make their money by employing the typical value-add strategy utilized by commercial developers and real estate funds – buying underpriced properties, making capital improvements and then flipping them – because affordable housing properties rarely appreciate in value over the short term. This makes them natural fits for the REIT structure, since the business is structured on long-term rent receivables rather than on sales proceeds or capital gains. That said, while affordable housing as an asset class rarely has a significant up-side, it is fair to say that with near-infinite demand and a rigidly tight supply, there is no down-side either. This could explain why the affordable housing development business is still one where it is difficult for developers to raise enough retained earnings to finance the next acquisition transaction or development project. In addition, not flipping properties also helps an affordable housing REIT to qualify its income as passive, and does not trigger the “dealer property” clause where sale proceeds are taxed at 100%.

Incomes and Fees

Today, on top of the rental income they earn from stabilized properties, many affordable housing developers also earn income through development fees, which can range from 3% to 10% of total development costs, depending on the structure of the partnership and the size and complexity of the project. This is why some developers who specialize in acquisition-rehabilitation projects for very old buildings focus on volume deals, because each individual asset does not throw off much net cash flow after debt service. For such developers, fees form the bulk of their earnings. Larger developers who can take on greater risk, either through new construction projects or by undertaking mixed-income housing, earn a ‘promote’⁸⁰ on top of their fee to compensate them for

⁸⁰ A ‘promote’ allows a developer to receive an outside or disproportionate share of the project’s profits as compared to the share of equity that the developer (as the GP) has put in, usually 1% as compared to the LP’s 99%. The promote is usually distributed after the junior tiers in the waterfall, which breaks down the distribution of earnings to a project’s respective partners whenever the project’s returns hits certain thresholds.

the sweat equity and operational expertise they pour into a project. The largest developers who have grown and scaled over time can often afford to create or purchase an asset management subsidiary in order to provide in-house property management services to the portfolio of assets they have accumulated. Thus, these developers also earn an annual asset management fee during the life of the property. Although REIT regulations are intended to only allow passive incomes to flow through the REIT entity, the advent of the Taxable REIT Subsidiary (TRS) has allowed many developers to convert themselves into operating partnerships that own TRSes, in order to allow the TRS to collect (taxable) fees at the subsidiary level as well as (non-taxable) rental income from stabilized assets at the partnership level.

Public Scrutiny

Affordable housing developers are no stranger to the public scrutiny REITs live under. REITs are beholden to their shareholders, every quarter of every year. In order to do that, REITs undertake a huge reporting burden and have to be adept at tracking regulatory changes and IRS notices. Similarly, affordable housing developers have historically been subject to scrutiny from the public, the housing agencies, underwriters, syndicators and the like. Any affordable housing property that has received subsidies is subject to yearly inspections to ensure that the property in service meets the Qualified Allocation Plan. If it does not, the developer risks losing its allocation of tax credits and has to answer to the tax credit investor depending on this stream of credits. If said developer has built on municipally-owned land purchased for nominal sums but has not delivered the agreed-upon affordable units, the bad optics of negative press can ruin its business reputation and wreck lenders' confidence. It is not so far fetched to state that affordable housing developers wouldn't find the scrutiny of going public out of their comfort zone.

4.2 Rationale for a Development REIT

As mentioned earlier, there are currently no development REITs that specialize in affordable housing. Consequently, there is no quantitative market data available for analysis. As such, this chapter relies on a body of knowledge gathered from interviews conducted with professionals working at affordable housing and market-rate multifamily developers, CDFIs, lenders, housing agencies and NAREIT. Where needed, I have relied on REIT literature and regulation to put together the possible set-up of an affordable housing REIT and have employed publicly available data from proxy cases in order to make an assertion. Still, it is timely to acknowledge again that the

focus of this thesis is the question of why development REITs should be tapped as an investment vehicle for affordable housing rather than to delve into the mechanics of how such a REIT might function. For the latter, further research and an army of tax lawyers might more expertly take up this investigation.

Nimble Capital

In Chapter Two, we discussed the complexity and inflexibility of the use of LIHTC and public grants, as well as the looser, more start-up nature of private debt and equity funds that invest in affordable housing deals. In the former, the time it takes to make it through the competitive process for tax credit or grant allocations can put a developer at the risk of mistiming project delivery, whereas the latter does not yet have the scale and reach of the LIHTC and Section 8 programs. Trying to create a mechanism that can raise equity nimbly and flexibly to make it easy to develop many affordable housing developments is the goal of the affordable housing development REIT in mind.

I will immediately acknowledge that the IPO process is expensive, potentially costing more than the estimated \$1 million required to set up a private debt or equity fund. Estimates show that the typical IPO process can cost 15% to 25% of the initial capital raised, with Pricewaterhouse Coopers quoting that 87% of companies spent more than \$1 million in one-time costs.⁸¹ The legal, accounting and printing costs associated with Sarbanes-Oxley disclosure obligations can often be out of reach for the typical affordable housing developer. In addition, REITs operating as public companies often incur higher operational costs due to the significant compliance requirements, with PwC estimating that public companies spend an average of \$1.5 million in recurring costs as a result of going public.⁸² However, such costs can potentially be mitigated at the corporate level by having the developer (operating partnership) and the REIT entity share the same management and prevent the doubling up of costs. In addition, developers can claim qualification as an “emerging growth company”⁸³ under the 2012 Jumpstart our Business Startups Act that allows smaller firms to take advantage of more lenient REIT set-up requirements.

⁸¹ PricewaterhouseCoopers LLP. (2012). Considering an IPO? The costs of going and being public may surprise you.

⁸² Pinedo, A. T., & Tanenbaum, J. R. (2016). Frequently Asked Questions About Initial Public Offerings.

⁸³ Defined as companies with total annual gross revenues of less than \$1 billion.

Cost issues aside, the IPO process is familiar and the obligations and legal strictures surrounding it known. Taking an affordable housing developer through the IPO process would be a pain pill to swallow at the beginning in exchange for the ability to raise substantial equity to deploy later. With careful planning, a large developer (or several mid-scale developers joining forces) can go through the process efficiently. Going public will, for the first time, create a public market for affordable housing securities, allow the company greater access to capital in the future (through secondary equity offerings), and facilitate its use of equity in lieu of cash or debt financing. Because the developer is in control of when it raises financing, it can determine how much it wants to raise, when to raise and on what terms the capital is raised. If there is no development in the pipeline, REITs can invest a certain amount of their assets in Treasuries until the right project comes along. The developer can time when it hits the market and swiftly respond to market movements. All in all, the development REIT can immediately capture any value created when a new building is completed, leased up, and transitions from a construction project to a cash flow generator, by selling its shares during a period when company growth is reflected in higher share prices.

Flexible Capital

As a development REIT, there is no restriction to whom the shares can be offered and how many securities can be sold. Capital raised from the IPO process can be used for many different purposes, as working capital, for research and development, for paying down debt, making acquisitions or to embark on construction projects.⁸⁴ There is no limit in how the REIT can deploy its funds, and the REIT retains the flexibility on all business decisions. Essentially, going public creates liquidity for a developer in an industry that is considered highly illiquid.

Contrasting with developers who work on projects funded with equity raised through LIHTC or public grants, affordable housing REITs face no restrictions at the project level and can determine what, where and how they want to develop. The developer can assess the market and determine where the market gap lies, instead of having to comply with a housing agency's stipulation for a specific product type. That said, being a public REIT does not disqualify a developer from receiving public funding should it choose to compete in agency RFPs, as long as it is willing to meet project-level requirements.

⁸⁴ Pinedo, A. T., & Tanenbaum, J. R. (2016). *Frequently Asked Questions About Initial Public Offerings*. Morrison & Foerster LLP.

But, the choice to go public should naturally lead an affordable housing developer to pursue more creative projects, such as mixed-use and mixed-income projects that cater to a wide spectrum of affordability, or developments that are in neighborhoods in danger of losing their historical character. These are the kinds of developments that LIHTC and CDBG/HOME cannot fund. Indeed, as lofty as public policy objectives are, it is undeniable that many publicly-subsidized Big 'A' affordable housing 'projects' have inevitably 'ghettoized' the disadvantaged. Perhaps, small 'a' affordable housing developments that include residents across the income spectrum could be the types of projects that challenge affordable housing developers to push the envelope on their product offerings, beyond the narrow scope of public housing. With a good equity cushion, such REITs could embark on larger developments and experiment with mixing market-rate, workforce and low-income housing in a proportion that is sufficiently profitable. Affordable housing REITs can blend the development capabilities and specialized knowledge of a developer with the nimbleness and flexibility of private equity.

Wider Capital Markets

Being a REIT would also allow long term owner-operators to turn to the wider capital markets to raise equity, in addition to the sources already discussed in Chapter Two. Funding for affordable housing would no longer just tap on government budgets or foundation money, which can either come with strings attached or require a lot of negotiation to come up with specialized deals. Going public would allow any philanthropic individual, pension system, lending institution or private equity fund to go on to the exchanges and invest in the affordable housing developer, immediately. Individual, socially-conscious retail investors can also get in on the game. No individualized contracts will need to be negotiated, as they had been for the setting up of CDT and HPET, since the prevailing share price and dividend indicate the yield an investor gets.

Often, being able to turn to wider capital markets takes the pressure off a developer to conform to a lender or investor's strict underwriting rules. Long term operators of affordable housing tend to spend more during the construction stage to build a better quality product. While some private lenders are starting to understand the correlation between product sustainability and property value, few developers can expect private lenders to fund the portion of development costs for high-end building systems, which are often significant investments. To be able to turn to the public

markets to fund such decisions for the long term horizon without compromising on product quality is perhaps something that might lean a developer towards conversion into a REIT.⁸⁵

Furthermore, REITs with sufficient capitalization can also raise debt to support development projects, often on the basis of the REIT's overall performance rather than off the expected cash flow of a specific project.⁸⁶ Hence, all the typical sources of debt and equity available to a non-REIT developer are also available to the development REIT. Going public can only expand the capital horizons for an affordable housing developer.

4.3 Structure of a Development REIT

REIT literature reveals that there are many types of REIT structures in use in the market today, many of which do not meet the long term horizons of affordable housing (finite life REIT) or do not meet the operational requirements of affordable housing (stapled REIT, paperclip REIT). This section proposes that a potentially useful REIT structure for taking a traditional affordable housing partnership public is the Umbrella Partnership REIT (UPREIT) with a Taxable REIT Subsidiary.

The UPREIT is the most common operating structure for publicly-traded equity REITs. A typical UPREIT would hold all of its assets through an operating partnership (OP) in which it owns a majority share of. The UPREIT can be wholly owned, as is envisioned in this proposal, or it can have minority limited partners, OP Unit Holders, which can open up REIT ownership to private equity or philanthropic funds interested in affordable housing.⁸⁷ As part of the roll-up process, the original partners who own the development firm will contribute their existing assets to the OP in exchange for OP Units, while the newly public REIT contributes cash raised from the IPO process in exchange for interests in the OP. Once this UPREIT structure is in place, a taxable REIT subsidiary can be set up in order to carry out development work and non-customary asset management services. *Exhibit 4.3a* summarizes what this UPREIT and TRS structure might look like, using a hypothetical development company called CRE DUSP LLC, a partnership with two owners.⁸⁸

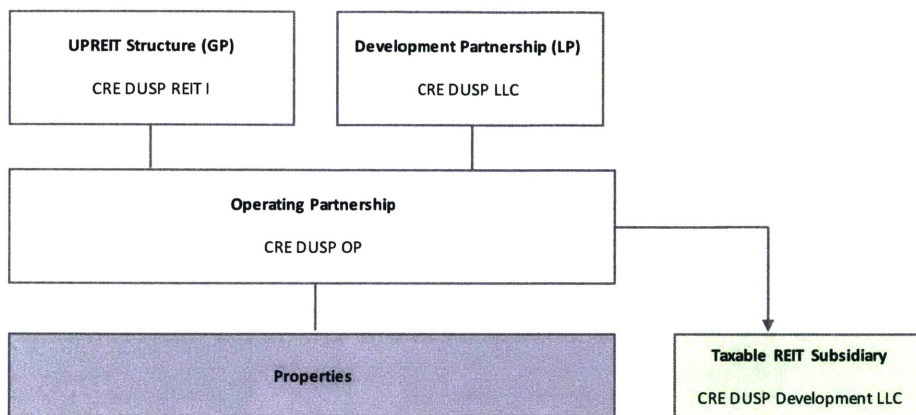
⁸⁵ Interview with Mr Kenan Bigby, Managing Director at Trinity Financial on April 27, 2016.

⁸⁶ That said, studies show that REITs do best when they keep their leverage ratio below 50%, above that, every 1% increase in leverage ratio has reduced annual returns by 0.4% between 1995 and 2009. Source: Kirby, M. (2009). *Capital Structure in the REIT Sector*. Green Street Advisors.

⁸⁷ Pinedo, A. T., Hirshberg, B. D., Humphreys, T. A., & Goett, D. J. (2016). *Frequently Asked Questions about Real Estate Investment Trusts*. Morrison & Foerster LLP.

⁸⁸ CRE stands for the Center for Real Estate and DUSP stands for the Department of Urban Studies and Planning, the two MIT affiliations this author claims at the time of this writing.

Exhibit 4.3a: Hypothetical UPREIT and TRS Organizational Structure

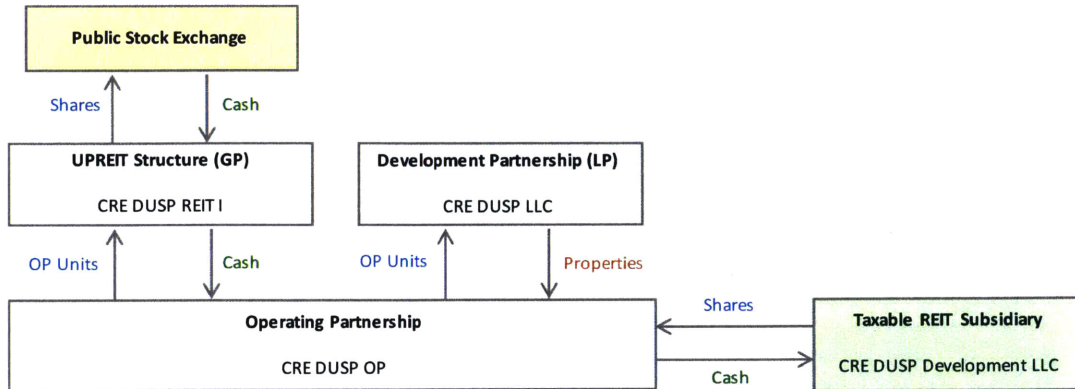


As part of this IPO process, the OP will own all of the development partnership’s former assets and will from here on conduct all future REIT business. All rental income from existing stabilized properties flows through the OP and up to the REIT, which will then have to distribute a minimum of 90% of its income as dividends to avoid corporate tax. When it comes to acquisitions, the REIT can acquire additional assets by having the OP purchase the properties using cash it has raised from the IPO (which will trigger a tax event for the sellers) or with the issuance of OP Units (which defers the tax event for the sellers). All development and asset management activity must take place at the TRS level, in order not to endanger the REIT’s qualification for its tax-exempt status. Any new buildings completed by the TRS development arm can then be transferred to the OP in exchange for OP units, which does not become taxable income until the TRS redeems the OP Units for REIT shares which are then sold on a public exchange at the prevailing fair market value.⁸⁹

How do OP Units compare to REIT shares? OP Units are equivalent to REIT shares on a one-to-one basis, usually after an initial holding period. It is typical for UPREITs to view OP Units and REIT shares as the same since they represent identical percentage rights to an essentially identical pool of assets. This makes all holders of OP Units eligible to redeem REIT shares, which can then be liquidated on the open market. *Exhibit 4.3b* illustrates how cash is raised through OP Units and REIT shares during the IPO process.

⁸⁹ Brody, M., & Kleindorfer, J. (2013). *REIT Roll-Up and M&A Transactions*. Latham and Watkins LLP.

Exhibit 4.3b: Hypothetical IPO Process to Raise Cash for UPREIT and TRS



Although I will go on to discuss suitable strategies an affordable housing development REIT might undertake in the next section, I will lightly touch on the strategy of the above set-up and discuss the main benefit of adopting the UPREIT-TRS structure here. Essentially, the whole point of adopting a REIT structure centers on the desire to be tax-efficient (or, to be more forward about it, to be tax avoidant), hence it is important to note that the UPREIT-TRS structure ensures that none of the internal exchanges of property triggers a tax event for the development partnership, and still allows the OP to raise cash for business.

Not shown in *Exhibit 4.3b* is the relationship between how equity raised in the public exchanges benefits the development arm, the TRS. Basically, the OP can buy up to 100% of the stock in the TRS, as long as the TRS's asset base is no larger than 20% of the REIT's total assets, which should not be an issue if the TRS is only intended to run any asset management business, and to channel stabilized properties into the REIT's asset pool. Additionally, the parent REIT can lend to the TRS to finance development activities, as long as the interest payments made by the TRS to the parent REIT meets the income tests.

4.4 Strategy

As with every business decision, the sum total of the advantages and disadvantages of affordable housing developers going public is positive only under certain circumstances. This section will highlight those circumstances and suggest the necessary business strategy that might best leverage on the REIT as a perpetual platform to access public capital.

First, not all affordable housing developers should go public. The most likely candidates to succeed are the ones who have been in business long enough to have developed sizable portfolios, with asset bases larger than 1,000 units, scattered across various geographical locations in order to diversify away what little risk that is present in affordable housing. These developers should have strong development and acquisitions teams, having formed the necessary deep connections within the real estate world to get buildings out of the ground, while also having thrown their business far and wide enough to own and operate properties in many different jurisdictions. In all likelihood such affordable housing developers are for-profit and have specialized in government subsidized projects, but have hit a plateau in growth and have found it difficult to continue expanding without greater access to capital.

Second, the type of affordable housing developers who should go public are those who are temperamentally ready to shoulder greater risk by attempting more creative and experimental affordable housing projects, while its day-to-day business is secured by a large, stabilized asset base. In a sense, the existing portfolio to be liquidated is every bit as important as the success of its new projects, since it is this portfolio that is throwing off the necessary income to fund quarterly dividends. This is not to say that this public REIT should throw out the bread-and-butter work of building 'traditional, tried-and-tested' affordable housing projects, instead, such work should be accompanied by more adventurous projects that can serve as proofs of concepts that could not otherwise have been built under the LIHTC regime, nor secure financing (since it can't comply with typical debt underwriting to qualify for debt that isn't priced exorbitantly to account for the corresponding risk). One potential challenge is the construction of workforce housing, which till date has still not been proven to be financially viable, mainly due to the fact that rent growth naturally has to be suppressed to remain affordable and that few public policies support the building of units built for those earning between 100% and 150% AMI.

Third, an affordable housing development REIT shouldn't go it alone, undertaking projects with just conventional debt and public equity. It should layer the capital stack and experiment not only with product type, but with the kinds of below-market debt that the Community Development Trust can provide and the kind of private equity that the Housing Partnership Equity Trust can tap from its institutional and foundation investors. The development REIT can illustrate the market gap faced by the housing sector and find ways to respond that are not only financially viable but also fulfill the

goals of social-purpose entities. By collaborating with these established entities, affordable housing development REITs can utilize such partnerships to signal to the market the viability of its business plan.

Ultimately, the best developer candidate to be taken public would be a for-profit, private affordable housing developer which has reached its limits in terms of scale and growth, but who has also developed a good track record and incubated the necessary expertise to understand the full scope of affordable housing work. A good reputation and deep linkages into the industry would lead this developer to the next step of expanding its partnership to allow some private placements of stock in order to demonstrate success with institutional funds, especially of the kind that can pass on a good word and have ripple effects with the decision makers at CalPERS and NYSERS. Then, when the market is judged to be responsive, this developer should go public and qualify for REIT status to raise public equity, hopefully having previously whetted the appetite of its target investment audience. In summary, financing affordable housing need not be a zero sum game – affordable housing development REITs can and should expose themselves to the widest sources of capital, blending public monies, private and public equity in order to create a financially viable business out of attractive and much-needed workforce housing.

4.5 Potential Pitfalls

As with all new business ventures, there are major uncertainties and unresolved issues that could hinder the success of an affordable housing development REIT. Most major of these issues is the question of how to value affordable housing. As raised in Chapter One, from the point of view of market economics, affordable housing as an asset class is simply not the highest and best use of property. This is due to the fact that its subsidized rent is leaving uncaptured value on the table, the curbing of its rent growth prevents it from profit-maximizing and all these deed restrictions can last for as long as 10 to 20 years. Would there be any point in taking an affordable housing developer public if the market significantly discounts the value of the REIT's underlying properties? How will shareholders react to this? Or will the market be ready to price affordable housing as a government bond instrument, risk-free, with low but assured dividends?

What class of investment is affordable housing?

The best case scenario is obviously to steer the market into viewing affordable housing as the real estate version of a government bond, which means that the linchpin of a successful REIT IPO hinges on the affordable housing developer pitching its stocks as core investments, backed by stabilized, fully-leased real estate with long term leases. While affordable housing may not fall into the category of assets with high credit tenants and Class A buildings (and in reality, often has the opposite), it shares many of the other characteristics that do make it a core asset. While affordable housing does not experience significant appreciation in value, it provides a stable, predictable cash flow with correspondingly low risk. Properties with Section 8 HAP contracts practically guarantee perpetual cash flow. Debt taken on for LIHTC properties is guaranteed by the housing authorities and the GSEs. There is no danger of oversupply, nor is there any danger that the asset class will become obsolete. As long as there are economic inequalities, the demand for affordable housing will never go away. Can this be said of any other asset class?

Next, if we agree that affordable housing REIT stocks should be viewed as core investments, then the types of investors who could be interested could be anyone seeking capital preservation and long hold periods. Hence, it is important to point out that affordable housing can be attractive and marketable to the right type of investor. Institutional investors, social-impact investors and anyone looking to diversify their portfolio will fall into this category. Chapter Two had earlier identified the list of investors who might fit this profile.

How would we value core affordable housing REITs?

Without any empirical data, it is difficult to predict how the market would respond to valuing an affordable housing development REIT and to appropriately determine the highest initial share price. By taking some guidance in classifying affordable housing REITs as core investments, we know that cash-on-cash returns for such investments are in the mid-to-high single digits. 6% to 8% is often quoted as a decent range of returns for affordable housing-related investments,⁹⁰ which gels with the 7% to 9% returns that the Community Development Trust has made in recent years. Anyone seriously attempting to value the stocks of such a REIT might investigate further into

⁹⁰ Interview with Mr Mark Dunne, Managing Director at Boston Capital on Chief Credit Officer at Community Preservation Corporation on April 19, 2016.

proxies already listed on the stock market that would share many similarities with the operations of an affordable housing REIT.

Say, for example, that our hypothetical CRE DUSP REIT did employ the strategy of investing in workforce housing catering to the middle income market. One viable method of valuing such a REIT could be to look for a developer or asset manager specializing in Class B or Class C multi-family market rate properties and to apply an appropriate discount to reflect the lack of value appreciation for affordable housing properties.

Exhibit 4.5a: Stuyvesant Town-Peter Cooper Village, Manhattan’s Last Major Bastion of the Middle Class



Another way could be to employ anecdotal data published for middle-income, workforce housing, such as the widely-reported transaction of Stuyvesant Town-Peter Cooper Village in New York City, which traded hands at \$5.45 billion in December 2015, the largest single-asset real estate deal in the history of the U.S. since the same complex was sold for \$5.4 billion at the peak of the market in 2006.⁹¹ Completed in 1947 and located in the heart of Manhattan on the Lower East Side, ‘Stuy Town’ has 11,232 units spread over 110 buildings, and has traditionally housed families of teachers, construction workers, firefighters among others, due to the rent stabilized restrictions have have been in effect.

⁹¹ Bagli, C. V. (2015, December 18). \$5.45 Billion Deal for Stuyvesant Town Completed After Threatened Lawsuit. *New York Times*.

As part of the latest transaction, the Blackstone Group, the new owners of Stuy Town have agreed to keep a bloc of 5,000 apartments affordable over the next 20 years, with 4,500 units kept for families earning 160% AMI or below (\$3,205 monthly rent for a 2-bedroom unit) and an additional 500 apartments set aside for families earning 80% AMI or below (\$1,553 monthly rent for a 2-bedroom unit).⁹² In order to push this through, city government officials agreed to provide \$221 million in subsidies to help Blackstone maintain this affordability. If we assume that these government subsidies were sufficient in getting Blackstone a NPV = 0 deal for the first 20 years and that all 5,000 units are identical, then we can use some back-of-the-envelope calculations to derive the terminal Year 20 rent roll, net operating income and derive its present property value. If we run a 20-year discounted cash flow assuming that the property has a 35% operating margin, with a terminal cap rate of 5%,⁹³ then each of the 5,000 units is worth around \$1.28 million today.⁹⁴ If CRE DUSP REIT decided to build workforce housing on the Lower East Side too, adjacent to Stuy Town, such anecdotal evidence could help advisors run their valuations. At the end of the day, a REIT's valuation is only as good as its acceptance in the market, and one of the persistent pitfalls in setting up an affordable housing development REIT might be the need to resolve the valuation issue.

Will shareholders' interests align with the REIT's operating philosophy?

There is a reason why non-profit social enterprises or community development corporations rarely carry out their work under the scrutiny of the public eye, let alone under the pressure of the stock exchange ticker. Non-profit work is sometimes difficult to measure and assess in the same way financial returns are not, and naturally an affordable housing development REIT must find a way to articulate its impact (both socially and financially) in a way that satisfies its shareholders. Going public exposes the affordable housing developer to the daily judgments of the market, and opens up the risk of misaligned interests between its operating philosophy and its shareholders. A simple answer to this issue is for the developer to state its operating mission clearly and assume that any shareholders interested in its stock understand that they are forgoing high risk and high returns for long term low volatility returns. Affordable housing development is not a business to go into for

⁹² Bagli, C. V. (2015, October 19). Stuyvesant Town Said to Be Near Sale That Will Preserve Middle-Class Housing. *New York Times*.

⁹³ A present value derived using an assumed 5% cap rate, a slightly high cap-rate than the current going cap-rate of 3% for Manhattan multifamily assets to account for cap rate creep upon exiting the deal.

⁹⁴ Total Year 20 Rent Roll (including subsidies) = $(\$3,205 \times 12 \times 4,500) \times (1+2\%)^{20} + (\$1,553 \times 12 \times 500) \times (1+2\%)^{20} + \221 million = \$492 million. NOI = 65% x \$492 million = \$320 million. Per unit value = $\$320 \text{ million} \div 5\% \div 5,000 \text{ units} = \1.28 million .

quick gains, and whichever share price the investor buys into the REIT at should be a price he/she is willing to pay, after including the opportunity cost of higher returns.

Conclusion

Chapter Four has argued that an affordable housing development REIT is best placed to exploit current market gaps by blending the strengths of equity raised in the public market and the availability of public subsidies to nimbly deploy capital into constructing mixed-income market rate and workforce housing. The REIT structure is well positioned to allow the developer to deploy nimble and flexible equity raised from the widest capital market available to the affordable housing asset class. I have also demonstrated that it is possible to take reference from existing development UPREITs in order to create a structure suitable to such needs, and that an UPREIT-TRS structure best allows internal transfers of properties to occur without triggering tax events. At the end of this chapter, I hope to emphasize the fact that it is timely that affordable housing developers look more closely at the REIT vehicle as a way to resolve the difficulty in raising equity to build public goods, and to view the REIT platform as an organized way to consolidate fragmented sources of capital and to finally launch into the wider consciousness the value of affordable housing as an asset class.

CHAPTER FIVE

Conclusion

5.1 Final Thoughts

This thesis was written out of a desire to demonstrate how market dynamics can be used to produce an asset that is indisputably a public good, especially one that has had a long history of being subsidized by the government in the face of the market's failure to produce it. As dissonant as the concepts of 'free market' and 'public good' are, this dissonance is fading away even as the assumption that all investors are profit maximizers is dimming. Profit is no longer simply only that which is tangible and measurable. In the vein of philanthropic giving that used to mark Wall Street's sharing of the fruits of its wealth with Main Street, today there is social-impact investment, a class of investors who measure profit-maximizing both in financial returns as well as community benefits. It is this investor appetite the previous chapters have explored and exploited in order to test the viability of an affordable housing development REIT, a business that was not viable until recently.

In this thesis, I have sought to demonstrate how the affordable housing REIT vehicle can leverage on the strengths of nimble and flexible capital found in the public markets as well as on the non-profit maximizing actions of social-impact and institutional investors to address some of the significant failures in how the government funds affordable housing today. Where there is fragmentation of capital sources, the affordable housing development REIT can pose as a single platform to raise funds, at one share price, without prolonged contract negotiations. With the REIT mechanism, affordable housing developers can scale and expand, reaching into heretofore untapped capital sources without relying on networking or government ties. They can complement the bread-and-butter work of building LIHTC and Section 8-subsidized housing with the challenge of building the type of interesting and much-needed mixed-income workforce housing that neither public subsidies nor commercial lenders are willing to fund. Affordable housing development REITs are, in essence, an alternative response to the free market's failure to produce affordable housing in high-density urban areas in the U.S.

Given the growing maturity of below market debt and equity funds as well as well-established private REITs already investing in affordable housing, perhaps the next natural step for the affordable housing industry is the affordable housing development REIT, taking on the role of bond

instruments in a notoriously illiquid industry, unlocking equity from a stable, low-yield asset in order to plough it back into producing more affordable housing.

5.2 Further Research

Chapter Four highlighted some of the potential pitfalls that an affordable housing REIT might face, given the newness of such an investment vehicle. Before ending off this thesis, this section highlights three interesting topics for further investigation that will be useful for anyone seeking to combine affordable housing with the REIT vehicle.

Valuation

As referenced in the previous chapter, affordable housing properties rarely change hands and there is insufficient data available to anyone trying to put a value on the underlying property, and henceforth on the initial share offering for an affordable housing REIT. It also doesn't help that the biggest owner of affordable housing in most municipalities is a public housing authority or community development agency which is tax-exempt. Hence, a large volume of affordable housing is supposedly 'off the market' and whose assessed values don't tell us much. The other significant chunk of affordable housing is trading at a discount due to age and poor maintenance. Ironically, a far better-studied subject has actually been the recording of how proximity to affordable housing has depressed the values of surrounding homes, resulting in vocal neighborhood opposition. However, affordable housing's ability to discount the value of surrounding properties is irrelevant to our topic at hand.

As the sketchiness of the back-of-envelope calculation for the Stuyvesant Town case mentioned in Chapter Four illustrates, affordable housing has no known cap rate or discount rate, unlike other asset classes within the real estate sector. To make a quick point, I have valued Stuy Town's affordable units using a 5% cap rate to account for a theoretical 200 basis point cap rate creep above the prevailing 3% cap rate that many Manhattan multi-family properties have been trading at recently. However, this methodology is neither rigorous nor would it stand up to market scrutiny.

Some mixed-income housing properties have been successfully valued, but the methodology has been to value the market-rate component of the property and then to apply a discount to take into account the affordable component. Workforce housing could potentially be valued by treating it as

equivalent to Class B or C multi-family properties, which are receiving below market rate revenue streams. That said, any affordable housing development REIT with a mixed-bag of housing typologies on its books will need to find a way to blend all these values across the board and to reach a final value. One useful suggestion is that since the discount rate is made up of two components – the risk-free rate and the risk premium – affordable housing developers could easily apply a discount rate equal to the risk-free rate since its status as a deed-restricted asset means that affordable housing is not exposed to any systematic risk. After all, affordable housing has a perfectly elastic demand and inelastic supply. Would the market respond to the risk-less nature of affordable housing by potentially pricing it higher than market rate housing? Or would the market apply a significant discount to affordable housing, in the same way affordable housing has discounted the values of nearby private properties?

Counter-cyclical of Affordable Housing

Another interesting way to view affordable housing development REITs is to treat them as the source of a typical bond or security instrument that fluctuates up and down accordingly with market movements. One good proxy is the LIHTC funds, as discussed in Chapter Two, which have exhibited the counter-cyclical of investment demand into affordable housing. Based on such data, investment into affordable housing goes up when market volatility makes market rate investment risky in recession years and vice versa. Might this be due to the fact that affordable housing shares so many of the characteristics of bond instruments – low yield, low volatility, long term, stable? In trying to understand how to value affordable housing, not only would you need to put a static price tag at the point of the transaction, but you would also need to understand how affordable housing-based securities fluctuate with market dynamics. If we assume that the number of social-impact non-profit maximizing actors in any market is fixed and no one invests in affordable housing unless they want to, then, will a heretofore stable asset be unnecessarily exposed to market volatility when money flees towards stability during down times? Do we then treat U.S. Treasuries and bonds as a proxy of how to value affordable housing securities?

Tax Credits In Lieu of Stock

During my research into the feasibility of an affordable housing development REIT, an intriguing idea that kept cropping up was the possibility that an affordable housing REIT could distribute tax credits in lieu of stock to its investors. Hence, the development REIT would be able to syndicate

tax credits on its own platform, without turning to multiple levels of syndicators and lenders to raise equity. This would make valuation of the affordable housing REIT fairly simple – investors are simply bidding for tax credit, and whatever price they pay is the price at which the tax credit is valuable to them. It is a remarkably elegant concept that would simplify the process of raising equity through tax credits and which would also put many of the financial infrastructure around LIHTC out of business.

Operationally, though, this tax credit REIT would run up against many of the issues discussed earlier in Chapter Two that made LIHTC a cumbersome way to raise equity. A tax credit REIT would no longer be in the business of producing affordable housing, since its need to distribute tax credit would divert resources towards competing for tax credits and arbitraging by looking for low-cost tax credits and selling them at a higher price. Furthermore, only undertaking government-sanctioned projects that qualified for LIHTC would go against the desire to be flexible and nimble, the whole point of setting up a REIT in the first place. And, as previously mentioned, it takes on average 18 months just to get a LIHTC project approved. Lastly, retail investors who hope to invest in affordable housing tax credits to lower their tax burden will run into the Alternative Minimum Tax, a 1979 tax regulation that prohibits anyone from reducing their tax liability to zero.

Conclusion

It is my hope that the above research has provided a good foundation on which the idea of affordable housing development REITs can be further developed and eventually materialized. All indicators point to the fact that increasing private-sector participation in affordable housing production is at an all-time high and perhaps an affordable housing develop REIT is well-poised to harness the willingness of social-impact investors to raise capital for affordable housing and to inject a much-needed variation of this asset class into communities in need of investment and revitalization.

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