An Assessment of the Financial Sustainability of King County's Affordable Housing Rental Portfolio

A Report by Impact Capital and the Housing Development Center

FEBRUARY, 2009

Impact Capital
401 Second Avenue South
Suite 301
Seattle, WA 98104
Phone: 206-587-3200
Fax: 206-587-323-
www.impactcapital.org

CTED | Community, Trade and Economic Development

HDC

Impact Capital

Acknowledgements

This study would never have been completed without the assistance of many people. All the data we received came to us from the City of Seattle, King County, Community Trade and Economic Development Department (CTED), and the Washington State Housing Finance Commission (WSHFC). The staff we worked with were, without exception, helpful and generous with their time. Particular thanks go to Cindy Erikson at the City of Seattle, Eileen Bleeker at King County, Heather Matthews at CTED, and Melissa Donahue at the WSHFC. Thanks also to all the staff of the non-profit organizations who took the time to answer the survey information to cull some additional pieces of data. Special thanks go to Charlotte Gamble, a graduate student intern with Impact Capital, who put in endless hours sorting and combining multiple data sources. Her work was invaluable in transforming an overwhelming pile of raw data into a workable format.

Photo Credit

The Pantages Apartments, owned by Capitol Hill Housing. 49 dwellings in a mix of studio, one, two and three bedroom apartments, serving households earning 50%-30% of area median income. (http://www.designadvisor.org/green/Pantages.htm)

An Assessment of the Financial Sustainability of King County's Affordable Housing Rental Portfolio

Table of Contents

Executive Summary

King County's affordable housing community development corporations (CDCs), advocates and funders have created a vibrant community of homes for some of the area's most vulnerable populations in the last decade. A total of 13,643 units of affordable housing create lifelines for people living on fixed incomes, suffering from mental illness, recovering from addiction, moving out of homelessness, or simply struggling to support their families on a low wage job.

With substantial investment made in King County's affordable housing, and the number of people who now depend on this affordable housing as the base from which they can build their lives, the task of CDCs and public funding agencies has shifted. Our task now is to both ensure the quality and viability of King County's existing affordable housing, while we seek to increase the number of quality affordable housing projects.

The primary objective of this study was to assess the performance and long-term sustainability of King County's nonprofit affordable housing portfolio and provide insight into discussions for future policy change. The data for this study is from 2006.

This study, commissioned through the combined efforts of the Washington State Dept. of Community Trade and Economic Development Department, the Washington Housing State Finance Commission, King County and the City of Seattle, evaluated both who is being served by King County's affordable housing, and on the financial performance of that housing. This study looks at the critical balance between fiscal viability and mission, and raised policy level questions related to preserving and sustaining our existing portfolio.

Four main trends emerged from this analysis

- **The King County affordable housing portfolio is extremely successful in providing housing for low income households at rents well below market.**
  - Average one-bedroom rents across the affordable housing portfolio are 29 percent below the Fair Market Rents (FMR). For three plus bedroom units, the affordable housing portfolio provides rents at least 65 percent below FMR.

- **The King County affordable housing portfolio serves a much lower income population than it was designed to house.**
  - While only 29 percent of the units were underwritten to be affordable to serve the extremely low income (30 percent of the Area Median Income and below), over half of the tenants living in the portfolio would qualify for these lowest rent units. Therefore, while the residents in affordable housing pay less rent than what they would in the market, many still pay more than the desired 30 – 35 percent of their income for rent and utilities.

- **42 percent of the properties in this study were not generating enough profit to cover its ongoing operating costs and required debt payments in 2006.**
  - There is a combination of reasons for this lack of cash flow, beginning with the fact that rents are restricted at well below market rates, constraining operating revenues. However, the

study found that owners of affordable project are not charging the maximum allowed rents based on its regulatory restrictions.
  - On the expense side, while the operating expenses of affordable housing mirror those of market rentals for most expense categories, affordable housing projects have some added costs, such as resident services, public funding compliance, as well as added legal and accounting costs such as audit requirements.
  - When higher expenses are matched with lower rents, the costs tend to outstrip income over time.
  - To add to the cost issue, most properties carry debt, which has become unaffordable for many projects.

- **Most properties do not have adequate replacement reserves or a clear plan to address long-term physical improvements.**
  - Rental properties in the open market tend to change hands about every twelve years. At the transfer of ownership, the average purchaser reinvests in the property and raises rents. This model differs considerably from affordable housing, where properties are generally held by the same owner for its entire lifetime, and rent restrictions preclude significant rent increases.
  - Without the opportunity for cash infusions over time, properties struggle to find funds to address major needs. Over half this portfolio is more than ten years old, signaling a time for reinvestment in the near future. The problem of addressing long-term capital needs will grow in the next five to ten years as these properties continue to age.

Best Practices, Strategies, and Policy Implications

The solutions to these challenges will require the collaboration of public agencies, private partners, and owners of affordable housing, lead by public leaders such as the agencies who have commissioned this study. It will require improvements in ownership and property management practices as well as changes in public underwriting of new projects. Most critically, it will require redefining success as an industry; placing the preservation of our existing portfolio on par with new development. The possible strategies to strengthen the existing portfolio outlined in this paper present some challenging policy choices:

- **Maximize rents**
  Rents on King County's current affordable portfolio are well below maximum allowable. However, the housing is also serving tenants with incomes much lower that the projects were intended to serve. Possible strategies to address this include:
  - Increase rents strategically and consistently on all units - consider accelerated increases for higher income tenants.
  - Require minimum rents as well as maximum rents.

- **Revise public underwriting assumptions**
  - Structure financing on new projects with realistic rents, operating expenses and debt payment obligations to ensure projects can financially perform over the term of the private debt.
  - Review public underwriting assumptions of mixed income projects to ensure that rents on the higher income units can be achieved and can cover operating expenses over the long term.
  - Recognize that projects designed to serve populations earning 30% of AMI or below cannot afford to carry debt.

- **Reduce required debt payments**
  Many of the existing projects cannot now, or will not be able to support public loan repayment in the future without operating subsidy or changes in the rental or private debt structure of the project.
  - Structure Housing Trust Fund loans as deferred loans (no debt payment until first mortgages are repaid in full) for lower income targeted properties, recognizing that to do this would reduce trust fund repayment revenues for new projects and revenues that support administrative costs for CTED.
  - Reduce private debt to stabilize existing properties.

- **Create a recapitalization pool of funds to address physical and financial sustainability**
  - Consider dedicating a portion of new housing resources to address long term capital needs and refinancing of the existing portfolio. Estimates indicate costs to address needed capital improvements are a small fraction of the cost to replace units.
  - Consider disposition of properties that are not cost effective buildings or can no longer meet the affordable housing needs.

- **Increase sources of operating subsidies**
  One suggestion would be to create a new fund structured similarly to the Operations & Maintenance Trust Fund, a part of the State Housing Trust Fund and is financed by a state document recording fee. One option for the state is to create a new kind of O&M Fund but to make the eligibility open to a wide variety of affordable housing developments at less restrictive incomes. Other options include new local levies and new legislative appropriations.

- **Increase capacity in asset management**
  Asset management's role in long-term sustainability is evident in terms of a project's financial performance, physical condition, and the quality of housing services provided to residents. Supported by the State and facilitated by Impact Capital, the Housing Development Consortium of Seattle/King Co.'s Asset & Property Management Affinity Group provides a forum for practitioners to increase their knowledge through training and peer learning opportunities.

These strategies require careful consideration and input from all of affordable housing's stakeholders. This study provides the framework in which to begin those discussions, to provide data to inform those discussions, and to provide some initial thoughts on the strategies that policy makers and funders may want to consider.

NOTE: At the time this study was being completed, the financial industry was collapsing. The impact of the changes in available capital and credit, while critical for developing new affordable housing projects, increases the importance of preserving existing affordable housing units. It also provides a new challenge as banks are reluctant to provide refinancing for older properties. This new aspect of asset management will need to be carefully monitored and incorporated into CDC plans for managing their portfolios.

Section 1: Introduction

Background and Context

For over two decades, nonprofit housing providers private partners, and government entities have been working to create and preserve affordable rental housing with the overarching goal of providing quality housing that is affordable and accessible to individuals and families whose housing needs are not met by the open market. Housing nonprofits have been remarkably successful at their work and are well-respected in terms of their commitment to their communities, their resourcefulness, and their ability to serve populations that cannot find other safe, decent housing options.[1]

This housing serves a variety of King County's residents, from low-wage workers and their families, to persons with disabilities, those who have experienced homelessness and our elderly. The King County affordable housing portfolio serves more than 20,000 people at any one time.

Since the establishment of the Low Income Housing Tax Credit (LIHTC) in 1986 and Washington State's Housing Trust Fund in 1987, the nonprofit housing sector has grown from a small niche market to the main vehicle for the provision of affordable housing. Unlike public housing, present day affordable housing is owned by private entities, often carry mortgages from private banks, and retain rent restrictions for between thirty to fifty years. Because of the long term affordability periods, most of the King County properties have been developed by non-profit sponsors and have been held by the same owner since they were developed or redeveloped as affordable housing.

Policy Objectives Shifts to Serving Homeless

Since 2000, funding priorities for affordable housing have shifted to include more service-enriched housing and housing for those experiencing homelessness. The Sound Families Initiative and House Bill 2060, known as the Regional Affordable Housing Program, established funding streams to house households earning 50 percent of the median income, with an emphasis on families, the homeless, or people with special disabilities. The Washington Families Fund (WFF) in 2004 and the King County's 10 Year Plan to End Homelessness in 2005 continued the policy trend towards ending homelessness.

Despite the importance, necessity, and respectability of serving extremely low-income households with service needs, the local funding priorities of the past eight years have driven down project income by restricting rents and promoting specialized services. Since ending homelessness and providing human services are two state and local priorities that are receiving dedicated funding, it is important to ensure that affordable housing nonprofits serving these households adapt its financing assumptions to ensure long-term viability.

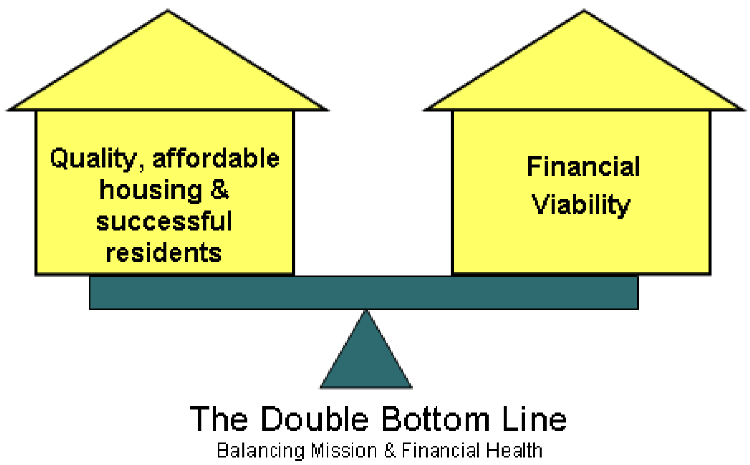
Increased Focus on Asset Management

As the number of affordable housing projects grows, and these properties age, the industry's next challenge is to ensure that this housing will continue to provide, quality, affordable housing through its intended affordability period. Specifically, the properties must be able to cover operating costs, repay debt obligations, and owners must be able to address property capital needs over the long term. At the same time, we must ensure that the projects are serving those most in need within the County.

The Community Development Research Center cites effective asset management as the key to nonprofits' ability to maintain their inventory of affordable housing over the long term.[1] In an asset management-based approach to affordable housing, nonprofit owners look at their housing as a long-term investment, where the payoff is not financial gain but rather the provision of affordable housing over the long term.[2]

Ownership Brings Inherent Conflicts

Ownership and management of affordable housing brings an inherent tension between the double bottom line goals of achieving the mission of serving low-income households and remaining financially viable for the long-term.



In addition to this balancing act, affordable housing providers share many of the same challenges as market rate housing: expenses rising faster than projected, added fees, and market fluctuations. Affordable housing owners face other challenges, such as increased compliance and reporting requirements from public and private partners, and changes in public funding policy to emphasize serving the lowest income households.

Study Design, Scope and Participation

State and local funders commissioned this study to more quantitatively assess the state of asset management in Seattle and King County in order to gauge the current status of the portfolio, inform strategies for strengthening the existing portfolio, and influence funding and underwriting policy in the future. Furthermore, research into Seattle and King County can work as a catalyst for discussion among funders and set the stage for future policy recommendations, including similar data collection exercises for other parts of the state.

---

[1] Bratt, Rachel G., Keyes, Langley C., Schwartz, A., Vidal Avis C. (n.d.) *Confronting the Management Challenge: Affordable Housing in the Nonprofit Sector*. Community Development Research Center.

[2] supra

Impact Capital and the Housing Development Center (HDC) jointly conducted this assessment of King County's financial sustainability. Impact Capital is a regional nonprofit community development financial intermediary that provides capital investments, technical assistance, and training to community development nonprofits. HDC, based in Portland, Oregon, is a technical assistance provider that acts as a development consultant for non-profit affordable housing owners. HDC also provides asset management training and policy analysis related to affordable housing in Oregon and Washington.

The data for this study primarily came from the Washington's Combined Funders Report utilized by Washington State Dept. of CTED, the City of Seattle, King County, and the Washington State Housing Finance Commission. This Combined Funders Report includes project level financial information, tenant demographics, unit characteristics, regulatory set-asides, and replacement reserves. The study team ran numerous analytic comparisons of variables to find patterns that would help inform the status of the King County affordable housing portfolio.

In addition to our agency-collected data, we administered a web-based survey that asked questions related to a project's most recent Capital Needs Assessment (CNA) and the date of the last major rehabilitation to the building.[3] Our CNA survey captured 56 percent of the properties in our project-level database. While the survey sample is not entirely representative of the portfolio, it gives us a snapshot of the needs of the larger affordable housing nonprofits.

Portfolio Overview

The data from the four agencies provided information on a total of 214 projects, which included 13,643 units of housing, ranging from downtown single room occupancy units to mobile home parks. The oldest project was developed in 1981. The average project was placed in service 13 years. The sample from the on-line survey showed that 62 percent of those properties were acquisition/rehabs in comparison to newly constructed buildings.

About a quarter of all units house special needs residents and a similar number house people who were formerly homeless (these two categories overlap). Household sizes tend to be small: sixty two percent of all units housed single person households. This differs considerably from King County as a whole, where only 33 percent of all households were comprised of one person[4].

Universe of Projects in Study

The financial performance section of this study examined 189 projects with 10,853 units and did not include group homes, transitional housing units, shelters, or other forms of supportive housing due to their unique cost structures, including high operating and service expenses along with very little income.

Rent Restrictions

The vast majority of all units in the portfolio are rent restricted, providing affordable rents to households who would be unable to find housing elsewhere.

---

[3] We defined a major rehabilitation as one costing more than $3,000 per unit.
[4] US Census, American Community Survey, King County, WA 2006

TABLE 1.1: Rent Restrictions based on Area Median Income (AMI)		
Affordability Restrictions	**# of Units**	**Percent**
Targeted to 30% and Below	3,922	29%
Targeted to 31-50%	6,096	46%
Targeted to 51- 60%	3,128	23%
Targeted to 60% and Above	180	1%
TOTAL	**13,326**	100%

Seventy five percent of all units are restricted to households with incomes below 50 percent of the area median income (AMI). Twenty-nine percent of all units are further restricted to households with incomes under 30 percent of AMI.

Appendix A provides additional data on the portfolio.

Section 2: Financial Performance

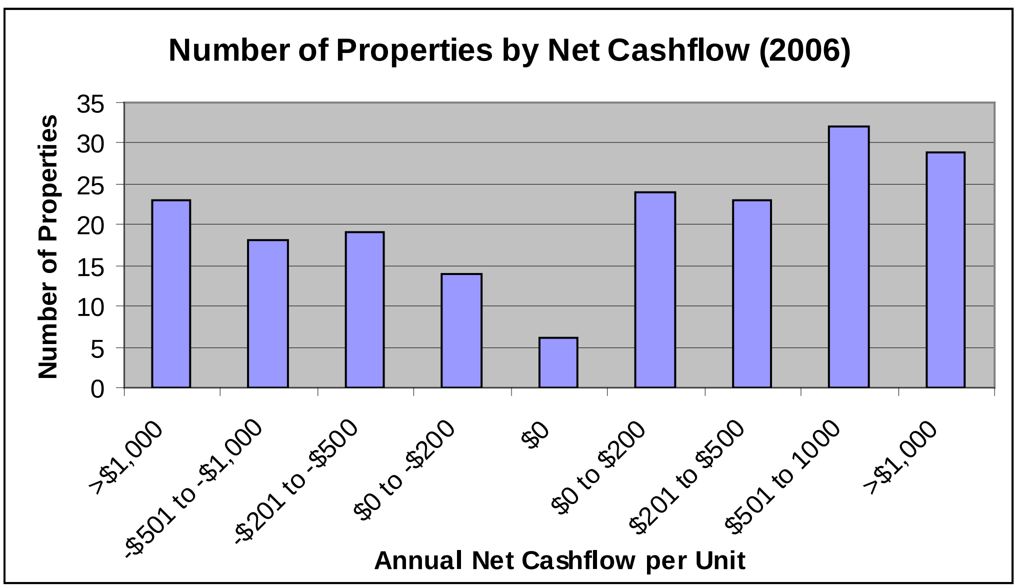
Across the country, affordable housing projects operate with lower than market rents, but typically have higher than market operating expenses. The properties included in this study are no exception. This combination of economic factors means that many projects are operating on thin margins, making them financially vulnerable.

The 2006 LISC study called, "*Against All Odds*: The Business of Managing Affordable Housing", found that of the 66,000 affordable units in the San Francisco area, only 16 percent of these properties produced enough profit to go back to the owners.

Net Cash Flow in 2006

The most meaningful indicator of a property's financial performance is net cash flow, or excess after expenses, which includes replacement reserve contributions and debt payments. Perhaps the most critical finding of this study was that ***42 percent of the affordable housing projects in King County had zero or negative cash flow in 2006***.

The table below shows that less than one-third of the projects had net cashflow above $200 per unit per year, which would be a minimum net cashflow considered to be stable for most projects.



Across the portfolio, the total annual negative cash flow, or funding gap, totals $2,848,770, or an average of $35,170 per non-performing project. Non profit sponsors are filling this gap through tapping into project reserves, or by fund raising or dedicating portions of other operating revenues to cover their property management costs or to make debt payments. These revenues would otherwise be used for additional staffing, resident services, or development of new affordable housing units.

Reasons for Financial Underperformance

When high expenses are matched with low rents, the costs tend to outstrip income over time. This is a simple fact of affordable housing ownership, though there is no simple solution. To add to the cost issue, most properties carry debt, which for many projects has become unaffordable. As a final complication, projects are not charging the maximum rents they are allowed under the restrictions.

- **Regulatory constraints restrict revenues.** Area median income has stayed relatively flat in Seattle for the last five years, meaning that rents on some properties have been constrained by public regulatory requirements.

- **Taken as a whole, the 2006 non-subsidized rents in the affordable housing portfolio were set at about 22 percent below the maximum rents allowed based on the funder required rent restrictions.** There seemed to be no correlation between particular bedroom sizes or levels of affordability and rent maximization, except that 30 percent AMI units tended to be closer to the maximum allowed rent level. Some affordable housing owners likely are not testing the market, and may not be increasing rents when they are able. With a public policy emphasis on ending homelessness, it may be that owners are trying to meet current policy objectives related to serving lower income levels in units not designed to house that population.

- **Affordable housing owners operate within the marketplace.** When the rental market for non-subsidized properties is depressed, owners reduce the rents on their properties in order to maintain occupancy. In some areas, it is possible that the maximum allowable rents based on the projects' rent restrictions may be more than what the surrounding market charges for non-subsidized units.

- **Operating expenses for affordable housing are consistent with market rate units except in four areas: resident services, legal and accounting costs, security and miscellaneous.** Affordable properties in King County cost about a thousand dollars more per unit to run than their market counterparts. The table below compares average per unit operating costs found in this study with costs for market rate units in Seattle, provided by Dupre and Scott, a market research firm in Seattle. Note that line items represent the average cost, for the line item, for all projects that reported any costs on that line item (e.g. many properties had no security costs, but for those that did, the average cost for security was $160 per unit per year).

Operating Cost Categories	Affordable Housing Portfolio Costs per Unit per Year	As percent of Total EGI	Average Market Expenses 2006 per Dupre and Scott	As percent of Total EGI
TOTAL EXPENSES PER UNIT PER YEAR	**$5,506**	**72%**	**$4,307**	**45%**
Property Management	$1,136	**20%**	$1,157	
Service Cost	**$1,452**	**14%**		
Legal and Accounting	**$196**	**3%**	Included in off-site mgt	
Insurance	$353	5%	$235	2%
Real Estate Taxes	$46	1%	$868	8%
Marketing	$38	1%	$166	2%
Security	**$160**	**2%**	Included in Misc.	
Combined Maintenance	$1,160	16%	$1,107	
Repairs and Maint	$880	13%	$675	7%
Decorating/Turnover	$190	2%	$186	2%
Landscaping	$124	2%	$154	1%
Elevator	$132	2%	$92	1%
Utilities	$840	12%	$1,156	11%
Telephone	$83	1%	Included in off-site mgt	
Misc	$422	4%	$410	4%
Misc Costs include:	**bad debt, concessions, lease pmnts, fees**		**cable, pool, rec rm, security & high legal**	

- **Funding for resident services comes from both property revenues and outside funding streams, such as foundations and Health and Human Services.** At $1,452 on average for resident services[5], providing this poses a significant sustainability issue for non-profit owners that typically must fundraise from private sources to cover these costs.

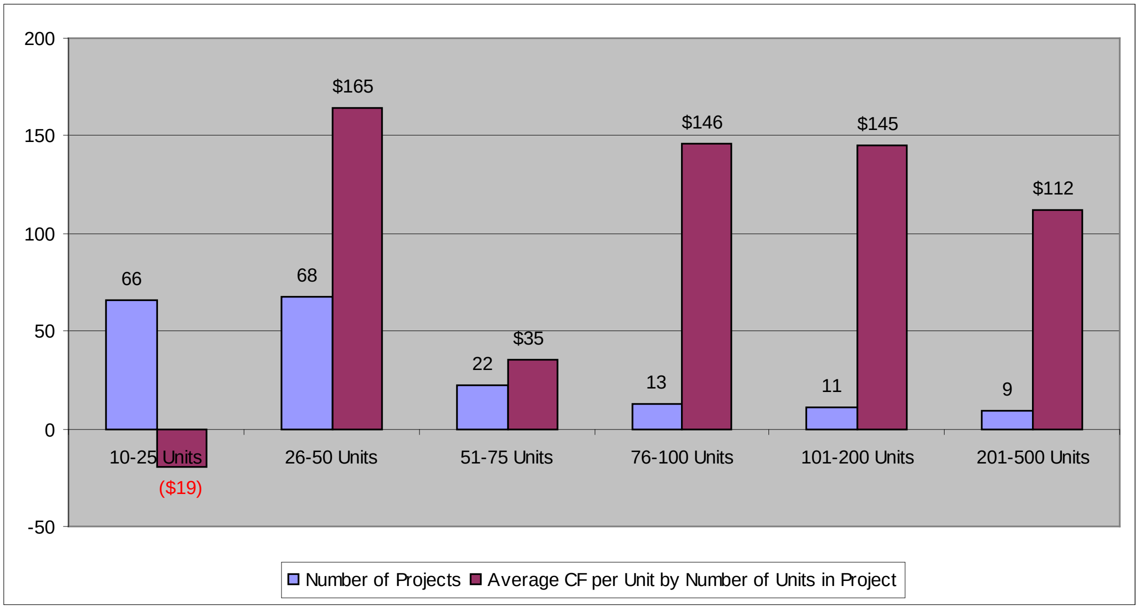
    - **Project size appears to be a clear factor in project financial viability**. This is consistent with finding for the San Francisco area, as reported in the study, "Against All Odds: The Business of Managing Affordable Housing". Generally, with bigger projects, the revenue and expense risks can be spread across more units. When there are fixed costs involved in managing a property, such as compliance, accounting, and audits, it is financially more efficient to manage more units in one project.

      The chart below illustrates that projects with 25 and fewer units are particularly vulnerable to revenue and expense risks. Of the 66 projects that had 25 or fewer units (35 percent of the total universe), the average net cash deficit per unit was $-19. These projects had fewer options to spread its fixed and variable costs across more units and to achieve efficiencies in management. No other project size range had a negative net cash flow.

---

[5] This was the average for those projects that included resident services in the operating statement.

Average Net Cash Flow per Unit by the Number of Units in Projects



- **A higher percentage of the projects with no cash flow were acquisition/rehab rather than new construction.** Because the Combined Funder Report does not indicate this delineation, this information was taken from a smaller sample of projects that responded to the on-line survey. However, it is clear that acquisition rehab projects are less competitive in the market, and more likely to have rents constrained by market rather than regulatory constraints. In addition, acquisition rehab projects that did not have full rehabilitation when they were placed in service as affordable housing frequently have higher maintenance costs.

  Half of the properties with private debt had debt coverage ratios[6] below 1.1, the level at which a project could be in technical default. Public funders, looking to maximize the number of units produced with their dollars, often evaluate projects based on leveraged funding from other sources. The downside of this leverage emerges when revenues or operating expenses do not hold true to the initial financial assumptions. In 2006, there were 52 projects (35% of the total) with must pay debt that had negative net cash flow. Another 22 projects had debt coverage ratios of below 1.10, a typical private lender standard for technical default.
- **If the current portfolio's debt payments were reduced or eliminated, all but nine properties would show a positive cash flow.**

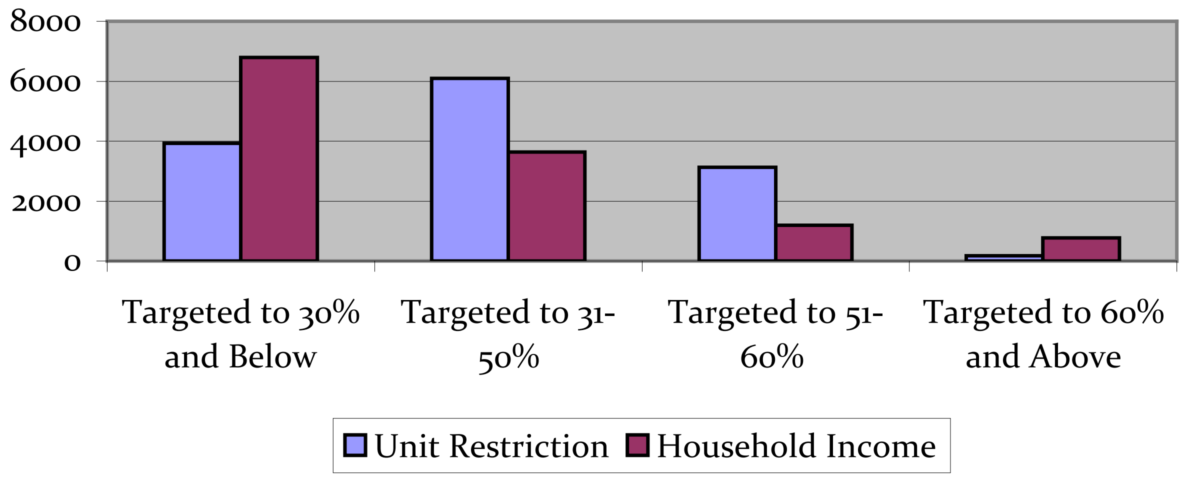
- **Many characteristics did not correlate.** This study found no correlation between low cash flow and affordability target, unit mix, prevalence of homeless or special needs population, or age of properties. Another factor should correlate highly with financial performance is how closely the revenues and expenses track with the financial projections used to underwrite the project. However, that information was not available for this study.

APPENDIX B discusses financial performance in more detail.

[6] Debt coverage ratio (DCR) is net operating income divided by must-pay debt service. A 1.10 DCR means that for every dollar of debt there is $1.10 of income to cover that debt.

Section 3: The Affordable Housing Mission

The affordable housing providers in King County are doing an excellent job of ensuring that the public investment in affordable housing is benefiting King County's low income residents. In fact, the populations being served are much lower than the projects were intended to serve. While 29 percent of the units are restricted to be affordable to the lowest income category (30 percent AMI), over half of the tenants in the entire portfolio have incomes below 30 percent AMI. The graph below compares rent restrictions to tenant incomes, showing that almost 7,000 households qualify for about 4,000 units that were designed to be affordable to them. In essence, Seattle-King County's affordable housing residents are overwhelmingly low to very-low income.



Total Units: 10,853, Total HH: 10,800

- **The average income of households in 2006 was $12,452, well below 30 percent AMI.** In comparison, the 2006 King County AMI for all households was $42,600. An affordable rent for someone living on this income would be $311, substantially less than any of the restricted rents as set by the federal guidelines. Those that are living in units designed to serve people at their income level are still paying more than 30% of their income which is referred to as the ideal "affordability" standard.

- **The Population served by affordable housing is at a lower AMI than originally planned for.** Some tenants who qualify for the most deeply restricted units are living in units restricted to tenants with incomes at or below 50 percent of area median, as evidenced by the higher number of units compared to tenants in the higher range of income restricted units. Because rents are set based on the unit rather than the household, these households are paying housing costs above the goal of 30 percent of their income. The average non-subsidized household pays 52 percent of their income towards rent. Over 80 percent of these families have incomes below 35 percent AMI.

Without affordable housing, many of these very low income households would likely be homeless. Per census data, within the general population of King County residents, 47 percent of renter households pay more than 30 percent of their income for rent. This figure increased from 39% to 47% between 1990 and 2005.

- **Affordable housing provides rents that are affordable to households with incomes well below the level needed to rent in the open market and provides housing for tenants typically rejected in the market.** As shown on the chart below, affordable housing units in King County provide rents that are affordable to households with incomes well below levels needed to rent comfortably in the open market. Additionally, owners of affordable units tend to accept residents that market property management would reject, such as tenants with previous evictions, unappealing credit reports, criminal records, or limited income. Residents may be paying more than the ideal rent amount, but they have a quality home for less than they could afford anywhere else.

Unit Size	FMR*	AMI at which rent is affordable
Studio	$612	48%
1 Bedroom	$698	51%
2 Bedroom	$840	53%
3 Bedroom	$1,187	65%
4 Bedroom	$1,450	71%
	Average rent in affordable housing**	**AMI at which rent is affordable**
Studio	$481	38%
1 Bedroom	$565	42%
2 Bedroom	$685	44%
3 Bedroom	$777	44%
4 Bedroom	$925	48%

*FMR and median income information from 2006

**Affordability calculation includes an estimated utility allowance

- **Use of rent subsidies**
  Affordable housing funders, such as CTED and the Housing Authorities, have addressed the rent burden issue by providing rent subsidies when possible. Thirty percent of tenants in this study receive some level of rent subsidy, sixty-six percent of which are through the Section 8 program. Rent subsidies generally cover the difference the total rent charges and 30 percent of tenants' income. Rent subsidies are most frequently tied to special needs and transitional properties, appropriately skewing the availability of subsidy to those most in need.

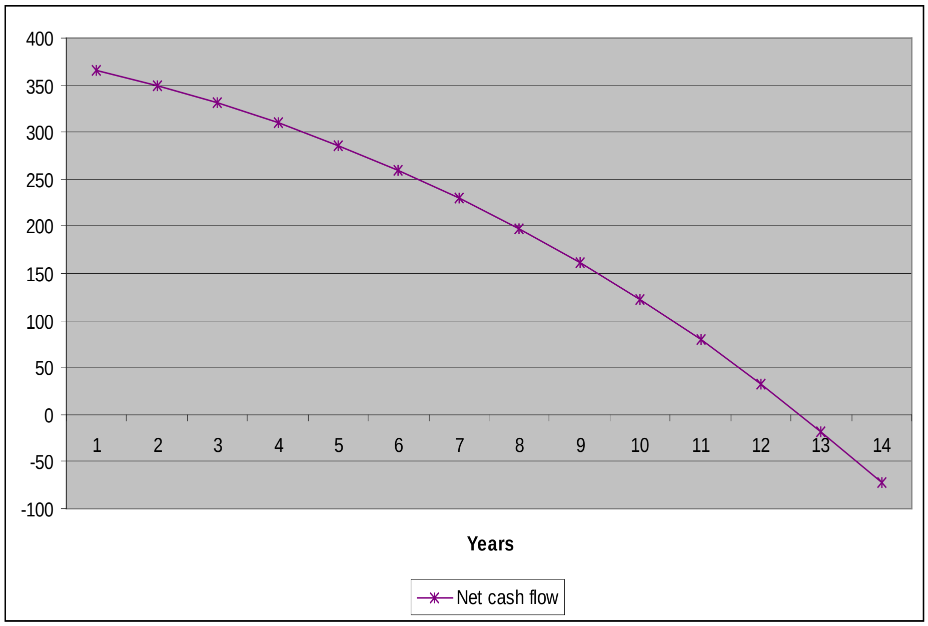
Appendix C contains additional information of rent levels for affordable housing renters.

Projecting Financial Viability

Standard financial projections for affordable housing real estate assume that revenue will increase by 2-3% per year while expenses increase by 3-4% per year. This lopsided equation means that expenses will overtake revenues at some point in time. To anticipate when these lines will cross is best determined by the proportion of revenues that are used to cover the expenses. As expenses become a greater proportion of revenue, less cash remains left over and projects may begin operating in the red.

- **The average King County affordable housing project needed 72 percent of its revenues to cover its operating expenses.** The high expense ratios in the King County portfolio raise concerns about how well they will cash flow over time. Out of 189 projects in this study, 47% of them had an expense ratio over 75%.

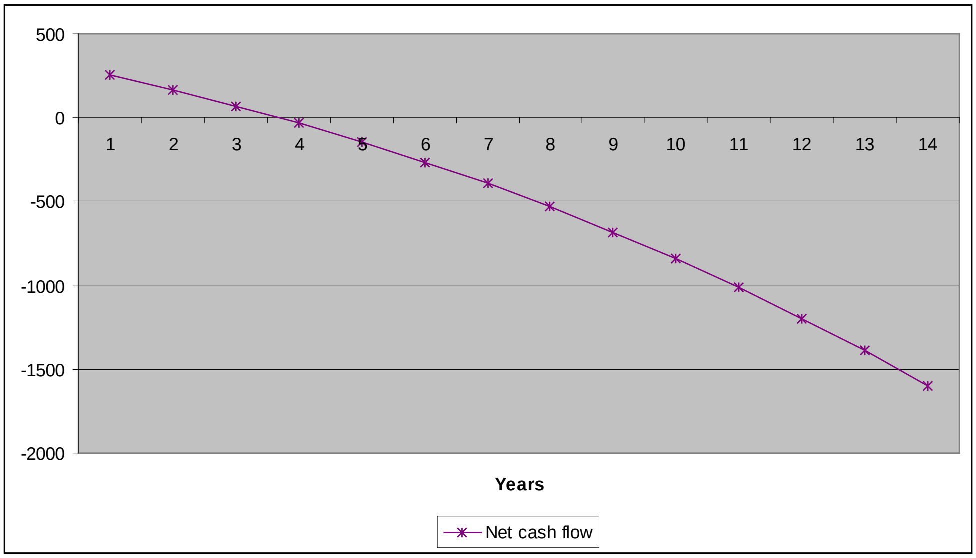
  In projecting forward when the income and expense lines would cross, based on the standard financial real estate assumptions for affordable housing, we could expect a property to go negative in thirteen years, even if there was not any debt. The chart below illustrates when a project would go “in the red” if the following assumptions held true:
  - Revenues increased by 2% each year
  - Expenses increased by 3% each year
  - Debt coverage ratio was 1.15 in year 1
  - The expense to revenue ratio was 72 percent



In actuality, most projects do not follow the standard real estate financial projections. In the past five years, projects have been experiencing more than three percent annual increases in operating expenses, especially in insurance and utilities. In addition, half of the King County portfolio has a 1.1 DCR or less, which means that these projects will probably go negative sooner than the chart above indicates.

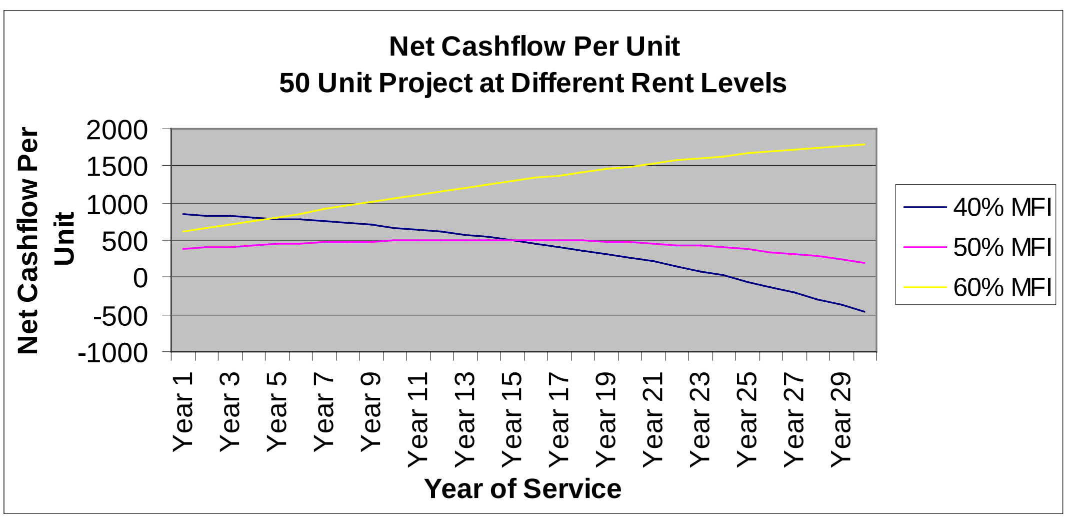
The chart below illustrates when a project would go “in the red” if the following assumptions held true:

- Revenues increased by 2% each year
- Expenses increased by 4% each year
- Debt coverage ratio was 1.1 in year 1
- The expense to revenue ratio was 72 percent



Projecting Financial Viability by Using AMI Rent Levels

Another way of projecting net cash flow is by looking at which income levels a household would be able to affordably cover their rent. In general, the lower the AMI rent restriction is on a project, the less revenue it could generate and the sooner it will go negative.



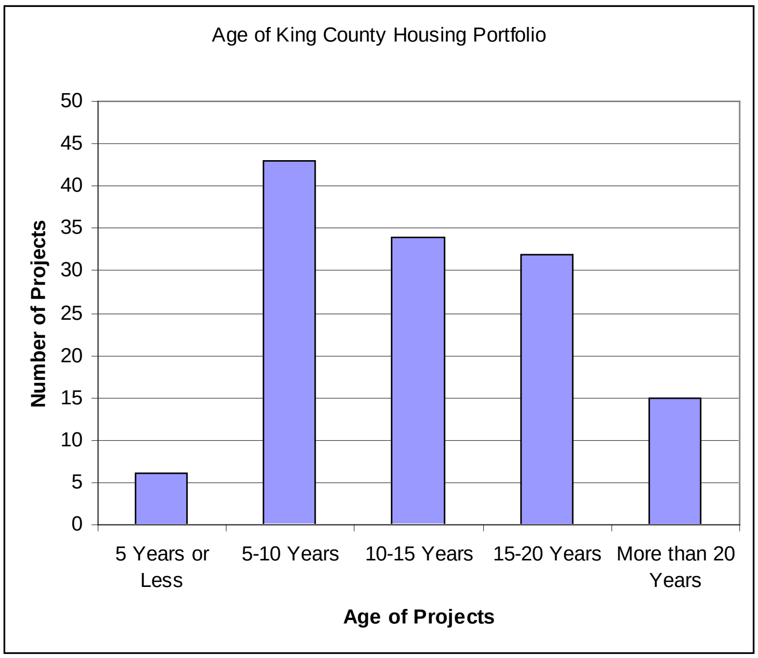
In looking ahead, it is likely that more than 42 percent of the King County affordable housing projects will be experiencing a negative net cash flow in the next five to ten years. Facing financial viability challenges, many projects may defer maintenance, forego setting aside reserves, and/or be unable to pay off their must pay debt.

Maintaining Physical Condition

Most properties in this study did not have adequate reserves or a clear plan for addressing the long-term physical improvements that will be needed to maintain the property.

Based upon the 130 projects with data on year funded, the average project has been operating as affordable housing for 13 years. For acquisition and rehabilitation projects, the buildings themselves are significantly older than this.

Although forty-seven projects have been in service for more than 15 years, twenty-seven percent of properties have completed a major rehabilitation within the last 10 years, while an equal number of properties have not completed a major rehabilitation in more than 10 years.[7]



Note: Chart does not include any projects placed in service since 2006.

In the open market, rental properties typically "flip" every 7-10 years, at which time owners often invest in upgrades that can be recouped from the sale or by raising rents. In an affordable portfolio with long term restrictions, owners typically retain the properties over much longer periods of time. Most funders do require owners to put aside annual deposits to replacement reserves, but those amounts are not sufficient to cover large scale remodels or upgrades, which are critical to keeping an apartment complex appealing to both prospective residents and neighbors.

The average per unit replacement reserve balance for projects included in this study was $2,300. HDC, in 2008, conducted a more in-depth capital needs study for the City of Seattle.

In the capital needs evaluation, HDC found that the average projected cost of capital improvements over a seven period was $6,000 per unit, representing a $3,700 gap per unit for those properties that will capital improvements in the next seven year. This included capital costs for only those buildings that had been in service for more than 5 years.

Bound by affordability and other restrictions, affordable housing owners do not have the same options as market developers in terms of selling outdated or non-performing properties. If an affordable housing owners did not fully invest in repairs and upgrades additional issues contributing to questionable viability arise: tenants no longer want to live there so the applicant pool becomes less appealing, increased

[7] Major rehabilitation is defined in our survey as spending more than $3,000 per unit.

vacancy creates financial problems and further limits an owner's ability to address capital needs, neighbors complain about unsightly properties, and large funder investments become at risk. Recapitalizing, while sometimes expensive, still costs significantly less than developing new units.

Section 5: Best Practices, Policy Implications and Strategies

The solutions to these challenges will require the collaboration of public agencies, private partners, and owner/managers of affordable housing, lead by public leaders such as the agencies who have commissioned this study. It will require improvements in ownership and property management practices, as well as changes in public underwriting of new projects. Most critically, it will require redefining success as an industry; placing the preservation of our existing portfolio on par with new development. The findings of this study indicate that we need to give equal weight to this existing asset, while we also work to increase housing opportunities for the community.

Work is already underway to improve asset management practices, including efforts of the Housing Development Consortium of Seattle/King County's Asset and Property Management Affinity Group, a consortium of owners of affordable housing and public funding partners facilitated by Impact Capital. The City of Seattle and CTED are both working to address non-performing properties in their portfolios and building their own asset management capacity. Possible strategies to strengthen existing portfolios present challenging policy choices:

- **Maximize rents**
  Rents on King County's current affordable portfolio are well below maximum allowable. However, the housing is also serving tenants with incomes much lower that the projects were intended to serve. Possible strategies to address this include:
  - Increase rents strategically and consistently on all units - consider accelerated increases for higher income tenants.
  - Require minimum rents as well as maximum rents.

- **Revise public underwriting assumptions**
  - Change public underwriting to ensure a mix of income levels in projects so that revenues can cover operating expenses over the long term.
  - Structure financing on new projects with realistic rents, operating expenses and debt payment obligations to ensure projects can financially perform over the term of the private debt.
  - Recognize that projects designed to serve populations earning 30% of AMI or below cannot afford to carry debt.

- **Reduce required debt payments**
  Many of the existing projects cannot now, or will not be able to support public loan repayment in the future without operating subsidy or changes in the rental or private debt structure of the project.
  - Structure Housing Trust Fund loans as deferred loans (no debt payment until first mortgages are repaid in full) for lower income targeted properties, recognizing that to do this would reduce trust fund repayment revenues for new projects and revenues that support administrative costs for CTED.
  - Reduce private debt to stabilize existing properties.

- **Create a recapitalization pool of funds to address physical and financial sustainability**
  - Consider dedicating a portion of new housing resources to address long term capital needs and refinancing of the existing portfolio. Estimates indicate costs to address needed capital improvements are a small fraction of the cost to replace units.
  - Consider disposition of properties that are not cost effective buildings or can no longer meet the affordable housing needs.

- **Increase sources of operating subsidies**

  One suggestion would be to create a new fund structured similarly to the Operations & Maintenance Fund, a part of the State Housing Trust Fund and is financed by a state document recording fee. The O&M Fund helps projects to bridge the gap between incomes and expenses when projects serve very low income or high-need populations. Since it is currently only available to projects who receive Housing Trust Fund money, a large portion of the portfolio is cut off from this potential source of subsidy. Therefore, options for the state include:
  - create a new kind of O&M Fund but to make the eligibility open to a wide variety of affordable housing developments at less restrictive incomes.
  - Advocate for the creation of new local levies and new legislative appropriations.

- **Increase capacity in asset management**

  Most properties do not generate enough cashflow to pay for asset management directly and most property management fees do not cover asset management costs. Asset management's role in long-term sustainability is evident in terms of a project's financial performance, physical condition, and the quality of housing services provided to residents.

  CTED has partnered with the Housing Development Consortium of Seattle/King County to support the Consortium's Asset & Property Management Affinity Group. The Group, facilitated by Impact Capital, provides a forum for practitioners to increase their knowledge of asset and property management through training and peer learning. The Group is working on best practices and other tools to increase the effectiveness of asset management in the County.

The following chart tries to capture some of the complexity of the interrelated issues involved in addressing the challenges of an affordable housing portfolio.

STRATEGY	ADVANTAGES	DOWNSIDES
Raise average rents	Increase project cash flow Higher debt potential lower expense ratios increase long term viability More savings potential for long term needs	Serve less needy population Displacement of lowest income tenants
Reduce rents	Increase affordability for residents Serve lower income population	Reduce cash flow Reduce ability to carry debt
Add additional rental subsidy	Maintains or increases deep affordability Potentially allows for higher rent collection	Have to balance providing a deeper subsidy for some or some subsidy for many
Deeper capital subsidy during development	Less risk of default and either increase in project cash flow or more affordability More savings potential for long term needs Increased affordability for residents Secure units at less cost than new development Maintain community relationships	Fewer units produced
Recapitalize aging projects	Preserve existing investment	Less funds available for new projects

These strategies require careful consideration and input from all of affordable housing's stakeholders. This study provides the framework in which to begin those discussions, to provide data to inform those discussions, and to provide some initial thoughts on the strategies that policy makers and funders may want to consider. Additional evaluation of each strategy is needed to evaluate costs and explore the short and long-term effects on affordable housing portfolios and the industry in Washington State.

Conclusions

Funders and project owners face difficult trade-offs while balancing financial viability with achieving its mission. With 42 percent of the King County affordable housing projects not generating positive net cash flow, it appears that the portfolio has been leaning heavily towards the mission end of the spectrum.

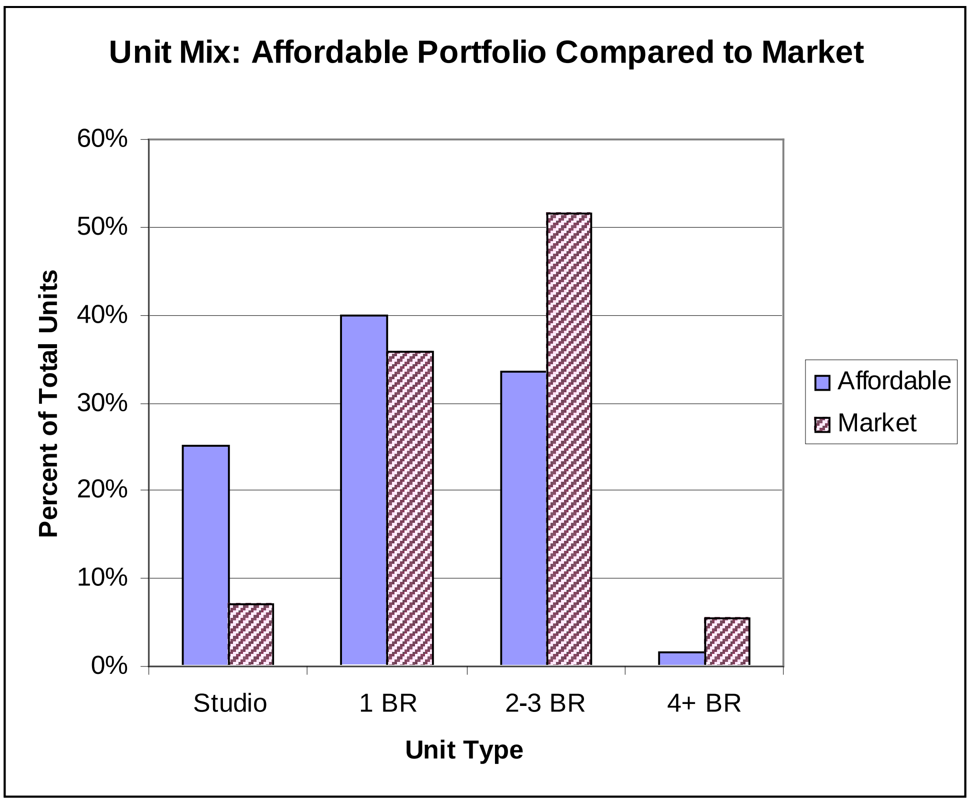
There are several ways that owners and funders can work to correct this. One is to look at the market and determine if the underwritten rents are not supportable. Another is to go back to the underwritten operating assumptions and determine if the current operating costs exceed those initial estimates and make any necessary adjustments. Individual properties can also defer maintenance, defer property management fees, reduce operating reserve contributions, obtain operating deficit guarantees, or restructure debt – strategies that reduce the long term sustainability of the housing.

Focusing only on the expense side of the problem will not fix the structural issues related to project risk. Properties can also look towards increasing revenues by raising rents and acquiring more subsidies from the state, city, and county. In light of the recent policy shift towards very-low income populations requiring specialized services, raising rents is unlikely to be a viable option. We conclude that if the state, city, and county want to continue dedicating funding towards high-cost populations while also maintaining maximum affordability, they will need to explore the necessary funding to keep affordable housing developments operable and in decent capital condition.

APPENDIX A: Additional Data on Portfolio Characteristics

The units in the King County Affordable Housing Portfolio tend to be small. Sixty-five percent of all units in the affordable portfolio are studios or 1-BR units. Within the open rental market in King County, 52% of all units have 2-3 bedrooms.[8]

The preponderance of smaller units makes sense when serving a population that includes many special needs individuals and people leaving homelessness. The portfolio does provide larger units as well, some with up to 5-bedrooms, to serve families. The pie chart below shows a complete breakdown of all unit sizes in the affordable portfolio. The properties have a high occupancy rate, only about 5% of all units were vacant at the time the data was collected.



30 At the time the survey data was collected, 23,408 people were living in the portfolio's units. About a quarter of all units house special needs residents and a similar number house people who were formerly homeless (these two categories overlap). As would be expected given the smaller unit configurations noted above, household sizes tend to be small: sixty two percent of all units housed single person households. Within King County as a whole, only 33% of all households were comprised of one person.[9]

[8] US Census, American Community Survey, King County, WA 2006
[9] US Census, American Community Survey, King County, WA 2006

APPENDIX B: Additional Data on Financial Performance

Characteristics of Projects with Negative Cashflow

To evaluate the causes of fiscal non-performance for any specific property, it is necessary to evaluate their revenues, expenses and debt structure, along with the capital needs of the property and impact of any upcoming milestone events, such as balloon payments. However, in looking at the portfolio as a whole, it may be helpful to look at some of the characteristics of projects with cashflow and those with zero or negative cashflow.

Characteristics of Projects with and without Cash Flow		
	No Cash Flow	**Positive Cash Flow**
Total Projects in sample	81	108
Total Units in sample	3,793	6,513
Average Units/Project	47	60
Information from limited sample in survey*:		
% New Construction	25%	48%
% Acquisition Rehab	75%	52%
Average age of Building (not funding)	1949	1966

***Note**: The sample size for determining new construction vs. rehab and ages of buildings included only the 55 properties that responded to the on-line survey.*

Operating Expenses

The differences in operating costs between market and affordable housing reflect the difference of intent between the owners. A market apartment owner takes on properties as a financial investment; non-profit owners of affordable housing own properties will the goal of providing the opportunity for low income residents to build better lives. Each of the cost categories that differentiate affordable from market housing make sense within that context.

1) Resident Services: Most owners and funders of affordable housing expect more from their properties than solely affordable housing. Affordable housing projects generally offer some level of services, from services directed primarily at eviction prevention or increasing housing stability, to case management and treatment services that help residents address significant barriers to housing such as drug and alcohol abuse or chronic mental illness. Service costs are supposed to be reported separately on the Combined Funders Report, but in the data collected for this study, that division was not always clear. This may be simply a reporting error, or it may be that costs for services that are integrated with property management are hard to delineate.

2) Accounting: Funding for affordable housing comes with a number of “strings”. One of the big ones is compliance. LIHTCs provide large amounts of equity to many of the subsidized projects in the King County portfolio. Ongoing program requirements for those awarded the credits include annual third-party audits, as well as monthly financial and occupancy reports. Other funders have

their own requirements, and while Washington's public funders are leaders in the using a single, common report, submitting all the required documentation to all parties is still a significant task, and cost, that properties must bear.

3) Security: Unlike market rate apartments, affordable complexes are often purposely situated in areas of town profit motivated developers want to avoid. Some properties specific target populations that are excluded from market rate housing, such as those with criminal histories or are in recovery from drug or alcohol abuse. While many affordable housing properties have no more security issues than market rate housing, for those that have issues, security is a very expensive budget item.

Debt Service

The funding for affordable housing projects comes from a combination of public and private sources, including private mortgages and repayable public loans. Seventy-seven percent of the affordable housing in the King County portfolio were financed with private or public debt that requires loan payments. The chart below details some of the characteristics of properties with and without debt payments.

Characteristics of Projects With and Without Debt Payments		
	With Debt Payments	**No Debt Payments**
Projects in Sample	146	42
Average:		
No of units per project	57	41
Year Placed in Service	1995	1996
Expenses	5,485	6,838
Cash Flow per Unit	139	305
Percentage:		
Percent with zero or negative Cash Flow	38%	55%
Special Needs Residents	14%	88%
Formerly Homeless Residents	16%	69%
Income Distribution of Tenants		
30% AMI Households (HH)	43%	85%
31-50% AMI	37%	9%
51-80% AMI	17%	5%
Over 80% AMI	3%	1%

Total projects reviewed for debt was 188.

Projects without Debt Payments

Most units that do not have required debt payments serve special needs populations and/or very low income tenants, and have related higher operating costs. While a majority of the "no debt payment" projects have negative or zero cash flow, these projects also are more likely to house populations that receive rent subsidies or operating subsidies. Because many subsidy programs adjust the subsidy amount annually based on operating expenses, some of the 23 projects with no debt payments and zero or negative net cashflow may not be at risk. However, for those projects without rent subsidies and serving special needs populations with very low incomes, rent subsidies may be one of the only options for addressing long term financial health.

Debt Coverage Ratio versus Net Cash Flow per Unit

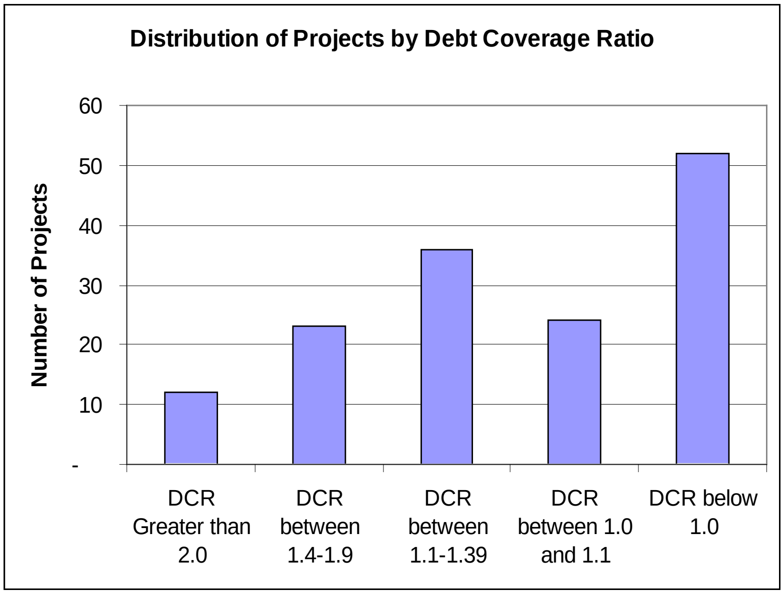
Although debt coverage ratios are a standard industry measure for market rate housing, this ratio alone does not fully illustrate the challenges of financial viability for affordable housing projects. Debt cover only looks at the ratio of debt to income and does not portray real dollars to cover asset management costs and other functions nor does it cushion a project against variances in its budget.

With constrained rents and additional expense categories, many affordable housing projects carry little or no debt. The lower the debt payments, the less cushion a debt coverage ratio of 1.15 equals in net cashflow. The following table illustrates this concept. Note the difference in net cashflow.

Cash Flow with Rents Set at Different Affordability Levels, Assuming a 1.15 DCR

	30% AMI	40% AMI	50% AMI	60% AMI
Maximum Monthly Rent for 1 BR Unit	388	534	680	826
Annual Rent	4,656	6,408	8,160	9,912
Operating Expenses	(4,500)	(4,500)	(4,500)	(4,500)
NOI year 1	156	1,908	3,660	5,412
Debt Payment (1.15 DCR)	136	1,659	3,183	4,706
Cash Flow per Unit	***20***	***249***	***477***	***706***

Most funders would consider a project in default if the debt coverage ratio falls below a certain level. Typically lenders do not foreclose on a loan as long as the borrower continues to make the payments, but being in technical default does put the project, including all the public funding, at risk. Maintaining debt payments when the property does not produce enough income to pay for it, also puts stress on the sponsoring organization.



In 2006, there were 52 projects (35% of the total) with must pay debt that had negative net cashflow. Another 22 projects had debt coverage ratios of below 1.10, a typical private lender standard for technical default.

APPENDIX C: Additional Data on the Affordable Housing Mission

A central goal of all affordable housing is to provide housing to low income households with rents below the market rate. The mechanics of how rent restrictions are set in the development stage and how they work in operations do not always work as neatly as the ideal vision. The study compared who actually lives in the restricted units in the County to how well those residents matched with the population the projects were designed to serve. This required an analysis of how the affordability levels are set for most projects to better understand the complexity of affordability as it relates to restrictions.

Explanation of How Affordable Housing Rents are Set

The question of how affordable units set their rents is a complicated one. There are two main ways that rents can be made affordable, and each of these strategies has a slightly different method for setting rents.

1. ***Operating Subsidies:*** Operating or rent subsidies, the best known of which is Section 8, reduces rent by making a monthly payment to the property owner of the difference between the market rent and the portion of the rent paid by the tenant. Typically, housing authorities manage these programs and require that the tenant pay 30% of their adjusted income for housing costs, including rent and tenant paid utilities. Thus, tenant rents under this program are set based on an individual tenant's household income.

2. ***Affordable housing within the King County portfolio*** relies primarily on a second method of making rents affordable. Under these programs, the rents are kept affordable primarily by reducing the amount of operating expenses and mortgage payments that the owner must pay in exchange for the owner agreeing (through deed restrictions) to keep unit rents below a specific rent, and to house only households with incomes below a certain level. Various low interest loan and grant programs used to develop the property, as well as property tax exemptions ensure that the rents can be set at below market rates and still keep the projects operating in the black. Because the rents are set at the time that these projects are developed, the rents are not set based on a specific household's income, but are set based on a federal formula described below. Note that some of the affordable housing in this portfolio uses both models.

The rents at most properties described in this study are calculated through a federal formula based on the area median income and a presumed household size for each bedroom type. For example, in 2006, the year this data was collected, affordable rents were set per the following table.

BR Size	Presumed HH Size	Median Income	Max Monthly Gross Rent 50% AMI	Max Monthly Gross Rent 30% AMI
Studio	1	54,500	681	408
1 Bedroom	1.5	58,400	730	438
2 Bedroom	3	70,100	876	526
3 Bedroom	4.5	81,000	1,012	607
4 Bedroom	6	90,400	1,130	677

2006 Rent Maximum

The combined rent and utility payment (or gross rent) for the unit could not exceed the 2006 ceiling housing costs listed on the chart. These restricted are set by Housing and Urban Development (HUD) each year. Rents are set by owners, but cannot exceed the HUD maximums, regardless of who rents the unit. Owners also cannot set rents too far below these maximums, since the loan payments are set based upon these rent levels, and there are generally no operating subsidies to allow owners to reduce rents, even if the household living in the unit has an income well below the targeted rent.

Paying half of your income for rent when that income is $3,000 per month is a very different story than paying half your income when you make $1,200 per month. In absolute dollars, $1,500 after rent each month will buy a lot more food and other essentials than $600. The less money low income families and individuals need to devote to rent, the more they can spend on other essentials such as food and medicine, and the more they can devote to education or other activities that may improve their long term financial situation. Additionally, tenants who have an affordable rent payment are more likely to make that payment every month, avoiding costly collections or eviction procedures for property owners and giving the residents more stability and security in their daily lives.

Average Rent by Unit Size Compared to Market

Average 2006 rents compared to HUD figures for average 2006 market rate rents, called Fair Market Rents (FMR) were as follows:

Average Rent by Unit Size Compared to Market				
	Affordable Housing Portfolio Average Rent	Seattle Metro Area FMR	Amount Below Market	Percent Below Market
Studio	$481	$612	$131	30%
1 Bedroom	$565	$698	$133	29%
2 Bedroom	$685	$840	$155	29%
3 Bedroom	$777	$1,187	$410	74%
4 Bedroom	$925	$1,450	$525	65%