

AN ANALYSIS OF THE CAPITAL NEEDS OF SEATTLE'S AFFORDABLE HOUSING PORTFOLIO

By the Housing Development Center
on behalf of
Seattle Office of Housing

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About the authors

This report has been prepared for the City of Seattle's Office of Housing by the Housing Development Center, with sub-consulting services from Kristina Smock. The Housing Development Center is a nonprofit organization, located in Portland, Oregon, whose mission is to create and sustain housing opportunities for low income families and individuals through partnerships with nonprofit owners and governmental agencies.

HDC has provided technical assistance and training to more than 50 nonprofit organizations, and completed the development or rehabilitation of more than 2,300 units of affordable housing in Oregon and Southwest Washington. Since 2001, HDC has emerged as a leader in affordable housing asset management technical assistance and training in Oregon and Washington. HDC's asset management work has preserved over 1,500 existing units in Oregon, California, Colorado and Washington, and improved the asset management capacity of close to 30 organizations.

HDC uses its experience as a practitioner and technical assistance provider to inform public policy and planning through its policy work with public agencies and foundations. HDC has worked with numerous state and local agencies to build industry strength in the areas of development and asset management, including training at conferences in Oregon, Washington and nationally.

Much of the raw data used for this analysis was compiled by Seattle's Office of Housing staff.

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I. EXECUTIVE SUMMARY

Seattle's affordable housing stock is aging, creating a new preservation challenge. By 2016, one-third of the Office of Housing's (OH) current rental portfolio will have been in operation for more than 20 years. The 20-year mark is a critical milestone for rental properties. Properties typically require significant renovations in years 20 to 30 to replace major building systems such as roofs and siding. In addition, properties that received only a selective renovation during their initial development typically need additional rehabilitation between years five and nine. This means that at least 50% of OH's current portfolio of over 10,000 units is expected to need capital improvements during the upcoming seven year Levy period (2010-2016).

A preliminary analysis indicates estimated average capital needs during this seven year period of \$6,000 per unit, assuming that capital needs that arise before this period will have already been addressed. These figures are based on a review of capital needs assessments from a sample group of OH-funded projects. Applied to the entire portfolio, the cost of capital needs, along with design, permitting and other related costs is approximately \$56 million over seven years. An estimated 31% of the total projected costs can be covered by reserves (if annual reserve contributions continue at the current rate adjusted for inflation), leaving a funding gap of an estimated \$38 million.

Seattle's limited experience with recapitalizing aging properties (to date only 9% of the portfolio has been in service for more than 20 years) makes it difficult to determine the portion of the total capital costs that will need to be supported by OH. A preliminary estimate suggests that OH's portion of these recapitalization costs could range between \$11.5 and \$19.2 million over seven years.

Seattle is at the forefront of a national effort to strengthen asset management and underwriting practices in the affordable housing industry, with the goal of supporting the long-term stability of portfolios. This shift will help to ensure that future generations of housing projects will be able to meet their capital needs in a more sustainable manner.

Meeting the capital needs of the current generation of properties will require a combination of strategies including:

- Use of existing reserves,
- Operating changes to increase reserve deposits,
- Refinancing of private debt where feasible,
- Tax credit re-syndication, and
- Additional subsidized gap financing.

Investing in the recapitalization of key properties in OH's portfolio is a strategic policy choice. OH has already invested more than \$286 million to develop its portfolio, with estimated total development costs of \$1.97 billion. Our estimate of additional capital needed to meet the portfolio's capital needs during the 2010 to 2016 period is approximately 4-7% of the City's initial investment, and about 1% of the portfolio's initial development costs.

II. INTRODUCTION

The City of Seattle has actively invested in affordable housing for over 25 years, building an impressive portfolio of 10,098 rental units. These units serve a critical role in the region, providing high quality affordable housing to thousands of residents who would otherwise be unable to afford good quality homes.

Over the next decade, as this affordable housing portfolio ages, Seattle will face a new set of challenges. Seattle was at the forefront of cities providing local support for affordable housing, passing its first voter-approved housing tax measure in 1981. Thousands of units that were funded during the first generation of projects are now reaching the 20-year mark. Currently only 9% of Seattle's portfolio has been in operation for more than 20 years. By 2016, one-third of the portfolio (3,300 units) will have been in operation for over 20 years.

Year 20 is a major milestone for all rental housing in both the private and subsidized markets. Between years 20-30, many of the most expensive major building systems such as boilers and roofs begin to fail. Most properties will need to replace these systems around year 20 in order to ensure these buildings continue to provide good quality housing over the long-term. This means that one-third of OH's portfolio will likely need significant rehabilitation by 2016.

New construction and buildings that receive comprehensive renovations can usually go 15 to 20 years before needing major rehabilitation. Buildings that receive only a selective rehabilitation when they are first placed in service frequently need additional work between years five and nine to continue to provide quality housing. Given the typical lifecycle of rental properties, we can assume that an additional 19% of the units in the current OH-funded portfolio will likely need moderate rehabilitation work over the seven year period from 2010-2106.

The fact that a significant portion of the City's portfolio will need some level of rehabilitation in upcoming years is not surprising, given what we know about the typical lifecycles of rental buildings. By way of comparison, the Seattle Housing Authority (SHA), whose housing portfolio is a bit older than the City-funded inventory, has already encountered the need for rehabilitation of a significant portion of its units. SHA has embarked on four HOPE VI-funded major redevelopment projects, and its *homeWorks* initiative is a three-phase effort that will ultimately renovate 21 high-rise complexes.

The challenge for Seattle is that a portion of the City's portfolio will not be able to meet all of its capital needs on its own. As the portfolio ages, it is clear that for many properties, replacement reserves alone will not provide sufficient cash to cover the properties' upcoming rehabilitation costs. The City will need to begin preparing now in order to develop strategies to meet these capital needs.

Preserving the portfolio over the long term will require an increased emphasis on asset management and long-term sustainability. As the housing stock ages, the role of the affordable housing industry must be redefined to emphasize preservation as much as development. As part of this paradigm shift, the City and its affordable housing providers are moving to put into place tools, personnel and strategies to meet the capital needs of the current generation of projects and to create a more sustainable strategy for subsequent generations. Preserving the portfolio will require recapitalization of a certain portion of the units in order to extend the useful life of key projects that can not cover the full costs of critical capital improvements.

III. OVERVIEW OF THE SEATTLE OFFICE OF HOUSING PORTFOLIO

The Seattle Office of Housing's portfolio includes 260 projects with a total of 10,098 units. About half of OH-funded units are rent restricted to households with incomes of ≤ 30% of area median income; one-third are restricted to households earning 31-50% of median; 5% are restricted to households earning 51-60% of median; and 14% are restricted to households earning 61-80% of median. Many of these units serve households with incomes that are well below the restricted maximums.

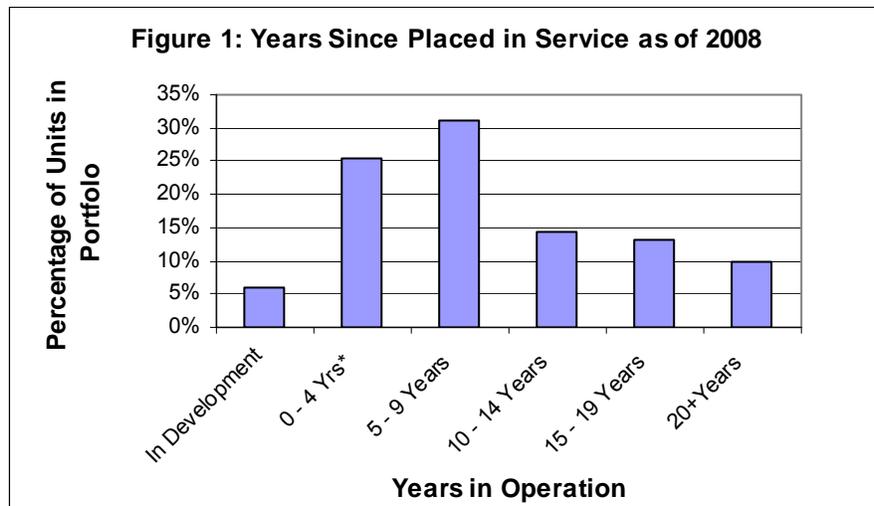
The portfolio's projects include a wide range of building types and sizes, from single family homes to high-rises, and from wood frame to concrete/ masonry construction. The units include congregate group homes, single room occupancy units, and large family units. Projects range from less than ten units (25% of portfolio) to over 100 units (6% of portfolio.) A little under half of the portfolio's projects have between 11 and 50 units and a quarter have 51-100 units.

The portfolio serves a variety of populations, including single adults, families, youth, and those with special needs. Forty-four percent of the units serve special needs populations such as veterans, youth, the elderly, and persons with AIDS/HIV, chronic mental illness, disabilities, and/or substance abuse issues.

Fifty percent of the buildings in the portfolio were constructed over 50 years ago, and 14% of the units are over 100 years old.

Currently only 9% of the units in the portfolio have been in operation as affordable housing for more than 20 years (since finishing construction or the initial City-funded rehabilitation). These projects are in some of the portfolio's oldest buildings, with an average building age of 76 years.

The percentage of projects in operation for more than 20 years will increase to 33% by 2016.



* Excluding those in development

IV. THE PRESERVATION CHALLENGE

The aging of Seattle's affordable housing portfolio creates a new preservation challenge. As one-third of the portfolio begins to reach the 20-year mark, new resources and public policies will be necessary to ensure that the City's investment is protected and continues to meet its public goals. With rising land and housing costs, preserving existing units is a far more achievable and cost-effective goal than replacement housing. It also supports neighborhood stability and avoids the displacement of current residents.

**Figure 2:
Lifecycles for Major Building Systems**

30+ years:

- Gas lines
- Plumbing and sanitation
- Electrical distribution

20-30 years:

- Roof, gutters, chimneys
- Kitchen cabinets, counters, fixtures
- Bath cabinets, counters, fixtures
- Hot water tanks
- Heating systems
- Siding, flashing, sealants
- Windows, doors

15 years:

- Large appliances
- Exterior lighting
- Exterior painting

We know that all building types and uses require periodic capital improvements to maximize their useful life. The specific timelines and cost vary by property, but the need to reinvest in capital replacements over time is a given for all rental properties, whether they are subsidized or in the private market. While some systems are addressed at unit turnover (e.g. interior painting, carpets, etc.), many of the systems that are the most costly to replace have a lifecycle of 20-30 years. Examples of these typical building lifecycles are outlined in Figure 2.¹ Because of these systems' relatively long lifecycles, they are most efficiently addressed through major rehabilitation at key milestones.

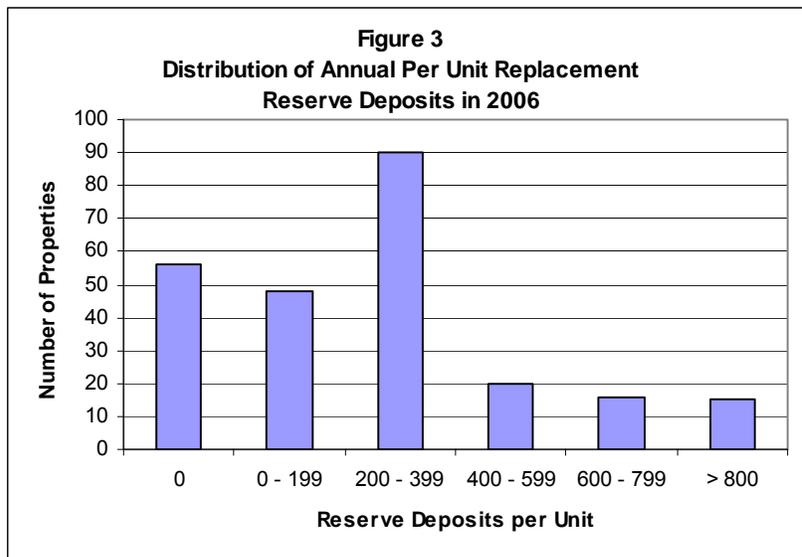
Replacement reserves for Seattle's portfolio

Affordable housing owners plan for these major system replacements by setting aside annual

contributions to replacement reserves to pay for projected capital improvement costs over time. Public and private funders typically require a minimum per unit deposit to replacement reserves as part of their funding agreements. A 2004 study by the Office of Housing found that funder requirements averaged \$200-\$300 per unit per year. The Office of Housing's requirements were comparable to, and in many cases exceeded, other funders' minimum requirements. Since 2007, OH has increased its minimum reserve requirement to \$350 per unit per year for newly-funded projects and has sought to increase reserves for projects going through transfers of ownership or refinancing. OH requires capital needs assessments as part of every transaction and monitors reserve contributions and balances annually.

In 2006, the average minimum required deposit for OH's portfolio was \$297 per unit per year, with a median of \$250. The majority of the projects in the portfolio met or exceeded these requirements.

While projects are performing well in terms of putting reserves aside, they are simultaneously spending those reserves to cover periodic upgrades. This means that reserves have limited growth over time. Current reserve balances averaged \$2,814 per unit as of 2006. More than one-half of the properties in operation reported 2006 replacement reserve balances of



¹ The examples in Figure 2 are based on the useful life estimates provided in OH's capital needs assessment form.

of less than \$1,000 per unit. It is notable that of the properties that have been in service for more than 20 years reported significantly lower reserve balances than those in operation for between 15-19 years. Half of properties in service for more than 20 years made no reserve deposits in 2006. This means that unless there is a corresponding reduction in capital needs (which there does not appear to be), most of these older buildings will not be able to meet their expected capital needs with existing reserves.

Figure 4: Cumulative Replacement Reserve Balances Tiered by Amount					
	< 1,000 per unit	\$1,000 to \$2,000 per unit	\$2,000 to \$3,000 per unit	\$3,000+ per unit	Total Projects/ Units in Operation
# projects	65	64	35	81	245
# units	5,016	1,709	1,231	1,533	9,454

Are the portfolio’s replacement reserves adequate?

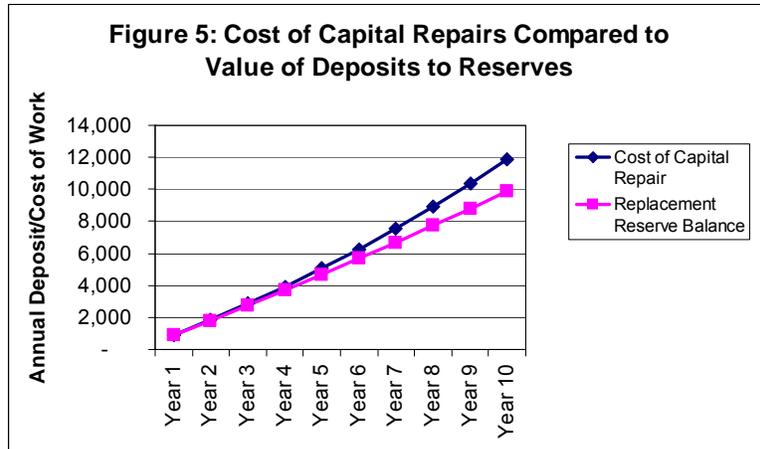
It is difficult to assess the adequacy of the portfolio’s reserve balances without knowing the capital needs of each individual project and comparing those needs to each project’s available reserves. This would require up-to-date capital needs assessments (CNA) for each property, which are not yet available for the full portfolio. To date, borrowers have completed updated CNAs for just under half of the projects in the OH-funded portfolio. (More data will be available in the future - OH has incorporated a requirement in its current Notice of Funding Availability for newly-funded projects to prepare a CNA within six months of completion.)

In an effort to create a ballpark assessment of the adequacy of the portfolio’s reserves, HDC and OH analyzed the capital needs and reserve balances for a sample of 33 properties that have been in operation for more than five years (see Section V). Our initial review shows average projected capital needs for these properties of \$6,000 per unit over the seven year period of 2010-2016, assuming that capital needs that arise before this period will have already been addressed. To fully cover these capital costs, properties would have needed net increases in reserves of \$450-\$600 per unit per year starting in year one of operations.

Clearly, for many properties in OH’s portfolio, current replacement reserve levels will not be adequate to meet the properties’ capital needs over time. Making up the current shortfall with reserves would require that those properties deposit an average of \$1,050 per unit per year into reserves through 2016, which is not financially feasible. The gap between reserves and long-term capital needs can be explained by several factors:

- Until recently, most funders’ annual minimum reserve deposit requirements did not include a factor for inflation, so the dollar value of these deposits has diminished over time. The average replacement reserve requirement for OH’s portfolio was \$206 in 1985 (OH, 2004) compared to \$297 in 2006 – an increase of about 2% per year, compared to an annual inflation rate of 4%. The value of \$206 in 1985 dollars is equal to \$395 in 2006 dollars, meaning that current reserve requirements are worth 25% less than they were 20 years ago. [Note: OH began including an inflation factor in its minimum reserve requirements in 2007.]

- Existing replacement reserve balances are also not keeping up with the increasing cost of capital improvements. Reserves typically earn 2-4% interest per year, while capital improvement costs rose more than 6% compounded annually over the past 10 years (Dupre and Scott, 2008).



- Most reserve deposits are based on a 20-year capital needs assessment, which is reasonable considering the uncertainties associated with projecting far into the future. However, since many building systems have useful life expectancies of between 20-30 years, it is critical that capital needs assessments incorporate building reserves towards these longer term life cycle costs. A review of useful life charts from OH indicates that the average cost to replace items with a useful life of less than 20 years is \$21,000, while the average cost for items with 20 or more years of useful life is \$31,000, reflecting such big ticket items as elevators, heating systems, and renovation of plumbing or electrical systems.

As housing portfolios around the country have started to reach the 20-year mark, the affordable housing industry has developed a more complete understanding of building lifecycles and effective asset management strategies. What we have learned suggests that it does not make sense to try to meet the long-term capital needs of most properties with reserves alone. Several factors underlie this conclusion:

- Accumulating a net increase of \$450-\$600 in reserves each year isn't feasible for many projects because operating expenses would exceed income. Most properties can meet the current average reserve deposit amount of \$297 and maintain a positive cash flow. To achieve a *net* annual increase of \$450-\$600 in reserves, properties would need to deposit more than \$600 each year, assuming some portion of accumulated reserves will need to be spent prior to the point of needing a major rehabilitation. If reserve deposits were raised to \$600, however, properties serving the lowest income households (30% AMI) would have a negative cash flow. Almost half of the units in OH's portfolio (49%) serve households at this income level. Projects serving higher income households could still have positive cash flow at the \$600 reserve deposit level, but only by reducing the amount of amortized debt they can carry.
- OH lending policies have increasingly prioritized projects that serve extremely low income, special needs populations. Although approximately 40% of these have Section 8 or other rent subsidies which provide higher revenue, those units without operating subsidies bring in very limited rental incomes. At the same time, their maintenance and repair costs tend to be higher than average, making it particularly difficult to build reserves. In general, these projects have smaller reserve requirements and still have difficulty building reserves without operating subsidies (OH, 2004). Increasing the minimum reserve deposits for the portfolio would require either a fundamental shift in OH policies and priorities away from this high need population, or the availability of additional rent subsidies.

Clearly, there will not be a single solution to the challenge of addressing long term capital needs. Instead we will need to assume that capital improvements will be covered by a combination of reserves and additional capital infusions after 15 to 20 years of service (and potentially more frequently for selective rehabilitation projects). This approach is consistent with typical reinvestment strategies in the private rental market. According to Dupre + Scott, the typical owner of a private market rental invested \$513 in capital improvements² per unit in 2007 (Dupre and Scott, 2008). The average holding period for Seattle private-market apartment properties since 2000 has been 10 to 12 years (Dupre and Scott, 2004). When buildings change ownership, the new owners typically make substantial investments in capital improvements. For example, buyers invested an average of \$12,000 per unit in 2007 following a building's change of ownership (Dupre and Scott, 2008). These capital investments are often partially paid for through additional private debt supported by substantial rent increases. In a sample of buildings purchased from 1995-2005, average rent increased 15.5% within one year following a building's change in ownership (Dupre and Scott cited in OH, 2007).

Since most nonprofit affordable housing providers have a mission of long-term ownership and their properties are subject to 50+ year regulatory agreements, recapitalization at transfer is not a viable option for affordable housing. Likewise, given the mission of retaining long-term affordability and the provisions of public funder regulatory agreements, substantial rent increases are not a solution. But the need to recapitalize at key intervals still holds true.

The source of recapitalization dollars for affordable housing will likely come from a combination of owner equity, equity from refinancing private debt, re-syndication and additional public funds. Best practices in asset management will also be critical to containing capital needs and positioning projects to be able to contribute to periodic reinvestment. These best practices include consistent annual rent increases, effective project planning that incorporates design features that reduce maintenance costs over time, investment in adequate rehabilitation at the front end of projects, good quality capital needs assessments and capital planning, and strengthening of project sponsors' oversight of property maintenance. These practices, which are discussed further in Section VI, are all critical components of the effort to address the capital needs of Seattle's portfolio.

V. CAPITAL NEEDS OF THE SEATTLE OFFICE OF HOUSING PORTFOLIO

This section provides an estimate of the capital needs of Seattle's affordable housing portfolio based on our analysis of a targeted sample of 33 properties. Potential sources to fund these capital needs are discussed in Section VI.

Methodology for capital needs estimates

Providing an exact comprehensive analysis of the capital needs of Seattle's portfolio is not possible since less than half of the projects in the portfolio (47%) have a capital needs assessment (CNA) on file to date and fewer than half of the CNAs were completed within the past two years. The scope and reliability of the available CNAs vary widely, with some conducted in-house and others conducted by third party professionals. In-house CNAs for older buildings may

² This figure reflects replacement costs that do not fall under regular maintenance or turnover. Private market investors generally do not set aside reserves, but they invest in capital improvements as needed.

under-represent total costs because accurate estimates for major systems replacements often require more costly engineering studies that are not typically part of an in-house review.

Given these data limitations, OH staff and HDC analyzed CNAs from a sample of 33 properties in an effort to develop general estimates that could be applied to the portfolio as a whole. We selected the sample from projects which had been in operation over 5 years and had CNAs completed within the last two years, with priority given to CNAs that were conducted by third parties. Specific projects were selected for the sample according to a set of risk factors that typically correlate with a project's capital needs. We then tested the sample to determine whether these risk factors were indeed predictive of capital needs.

Through this process we identified two key variables that most closely correlate with levels of capital need. We grouped projects based on these variables and then calculated average capital costs for the sample properties in each of these groups. Finally we applied these calculations to the portfolio as a whole by sorting each of the properties in the portfolio into these groups.

Key variables affecting capital needs

Our analysis of CNAs from the sample of 33 properties revealed two key variables that correlate with capital needs:

- **Years in operation:** number of years since placed in service
- **Level of initial rehabilitation:** new construction/ substantial rehab vs. selective rehab

Other variables were tested, but showed no correlation with capital needs for our sample. These variables included the age of the buildings and properties' operating expense to revenue ratios, which can indicate constrained dollars for maintenance expenditures. We did not test correlations with every potential variable given the limited scope of the study. Most notably, the study did not evaluate potential correlations with type of construction or population served.

As noted earlier, the typical lifecycle of many of the major building systems in rental properties is 20-30 years. Given this fact, it is not surprising that we found that the projected capital needs over the study period for properties in operation more than 20 years were higher than for those in operation 5-9 years by several thousand dollars per unit. However, the correlation between years in service and projected capital needs was not completely consistent. This may be due to the limited sample size. In addition, because typical milestones in affordable housing financing strategies (such as year 15 for Low Income Housing Tax Credits) encourage addressing rehabilitation needs between years 13-18, it may be that some projects have already completed some major system replacements, explaining a dip in average projected costs per unit for projects that have been in operation for 15-19 years.

The second variable that affects the capital needs costs of different properties is the level of initial rehabilitation that a property received when placed in service. While new construction or substantial rehabilitation projects can typically make it to year 20 without needing a major rehabilitation, projects that received only selective rehabilitation when they are first placed into service typically need rehabilitation work after only five to nine years.³ Because of this dynamic, we found that the capital needs costs for properties that received only selective rehabilitation

³ Projects will occasionally need rehabilitation before the five to nine year mark. This is typically the case if there are construction defects or structural issues that were not adequately addressed in the initial rehabilitation. Our review of OH's portfolio suggests that there are a number of projects that may meet these criteria, but they make up a very small percentage of the portfolio as a whole.

when placed in service tended to be higher than for properties that were new construction for each range of years in service, beginning in year five.

Clearly, the cost and timing of properties’ rehabilitation needs will depend not only on the quality of initial rehabilitation, but on levels of ongoing maintenance, age and quality of the building, and level of wear and tear (which is often a function of the population served). If necessary rehabilitation work is deferred, the costs for ongoing maintenance and long-term replacements are likely to escalate. Delaying critical improvements can also create costly deterioration problems and add to operating challenges.

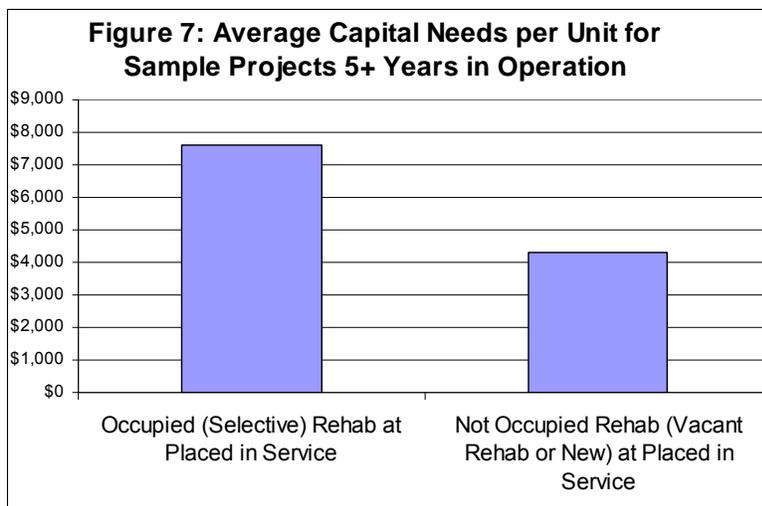
Capital needs of sample properties by years in operation and level of initial rehabilitation

In an effort to quantify the capital needs of the properties in OH’s portfolio, we analyzed the average capital needs of properties in the sample based on their years in operation and level of initial rehabilitation, and then we applied these averages to the portfolio as a whole. We did not include in our analysis those properties currently in development or new construction/ substantial rehabs placed in service less than 5 years ago, since those properties are not anticipated to need rehabilitation before 2016. Comprehensive data on the level of initial rehabilitation was not available, so we used the distinction between “occupied rehab” and “vacant rehab” as a proxy for categorizing properties as selective or substantial rehabs with the assumption that properties that are rehabilitated while occupied receive only a partial renovation. In contrast, properties that are vacated prior to rehabilitation typically receive a more complete renovation that addresses major systems such as heating, plumbing and electrical and replacement of bathrooms and kitchens.

Figures 6 and 7 demonstrate how the level of initial rehab and years in operation affect the capital needs costs of the sample properties. The average capital needs cost ranges from \$3,710 to \$8,486

Figure 6: Average Capital Needs by Level of Rehab and Years in Operation		
Project Type	Occupied rehab (i.e. selective rehab)	Not occupied rehab (i.e. new construction or complete rehab)
<15 years since placed in service	\$7,099	\$5,658
15+ years since placed in service	\$8,486	\$3,710

depending on years in operation and level of initial rehabilitation. The average capital needs costs over the study period were almost 1.8 times higher for occupied rehabs (i.e. selective rehab) than



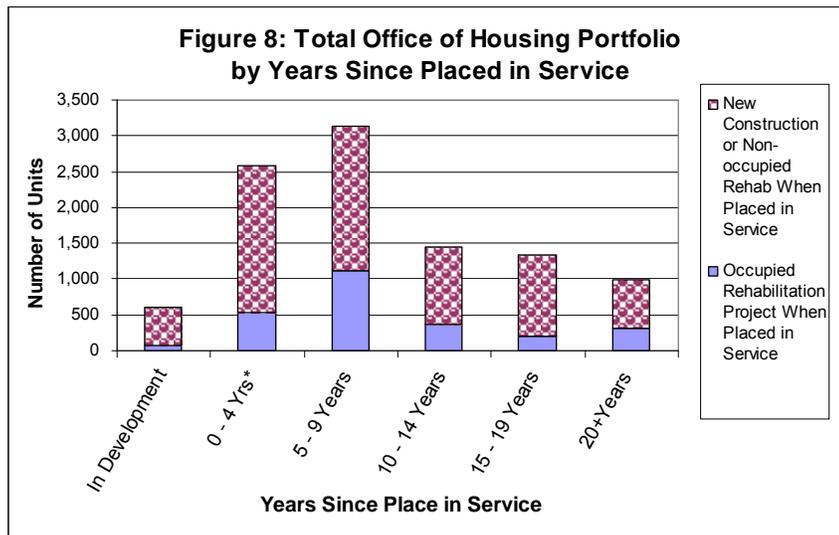
for not occupied rehabs (i.e. substantial rehabilitation or new construction). Not surprisingly, average capital needs costs were the highest for occupied rehabs that have been in service for over 15 years.

Every portfolio will have a few projects with exceptional capital costs that may fall significantly above the averages that we found in our sample. This includes newer properties with construction defects or unaddressed major building

system defects. In order to prevent these properties from skewing our averages, we removed two such outliers from our sample. Strategies to contain the percentage of such outliers in a portfolio include improved oversight at initial development and adequate initial funding. However, whenever new building materials are introduced (e.g. LP siding), the affordable housing industry will experience the same level of risk as the construction industry as a whole.

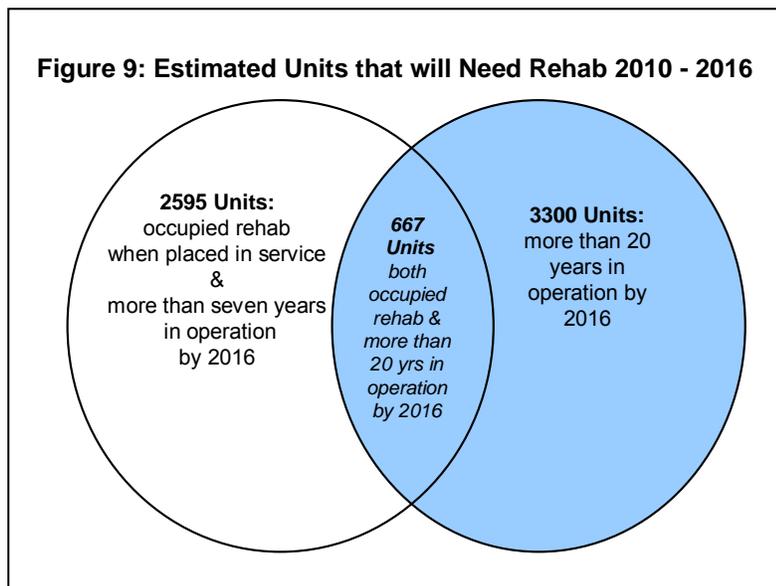
Capital needs estimates for entire portfolio

To estimate the capital needs of the entire portfolio, we applied the averages in Figure 6 to all the properties in the portfolio. Figure 8 shows the number of units in each age range that were occupied vs. not occupied rehabs when they were placed in service.



* Excluding those counted under the "in development" category

Figure 9 shows that a total of 5119 units are expected to need rehabilitation between 2010 and 2016, or approximately 51% of the OH portfolio. This estimate is calculated by adding the total of



the units that were occupied rehab when placed in service and will have been in operation for more than seven years by 2016 (2,595 units) plus all of the units that will have been in operation for more than 20 years by 2016 (3,300 units) less 667 units that fit both categories to avoid duplication.

By applying the average capital costs from our sample to all of the units in the portfolio expected to need rehab during the seven year study period, we estimate that between 2010 and 2016, the portfolio will have \$56 million in total rehab needs. Given the

limitations of our data, this is an estimate intended to provide an order of magnitude, not an exact cost. The figure includes hard rehab costs as well as an additional 20% in associated soft costs - e.g. architects, loan fees, building permits, appraisers, etc.

Figure 10: Estimate of Total Costs 2010-2016	
Capital Costs	\$46,480,284
Soft Costs	\$9,296,057
Total Capital Costs	\$55,776,341
Use of Reserves (w/ interest)	(\$17,391,073)
Net New Dollars Needed	\$38,385,268

A projected \$17.4 million in reserves will be available to pay for capital costs over the seven year period, assuming that projects continue to set aside

annual reserves at the current rate adjusted for inflation. This means an estimated 31% of the total projected capital costs will be covered by reserves. (See Section VI for an analysis of the portion of the remaining costs that will be covered by private and public funding sources.)

Implications for the OH portfolio

The gap between the portfolio’s reserve balances and capital needs puts Seattle’s affordable housing stock at risk. This situation will require a strategic response in order to ensure that the portfolio remains viable in future years.

Without implementation of portfolio wide asset management strategies and without identifying additional sources of capital beyond reserves, this problem will likely escalate over time. Unmet capital needs eventually lead properties into a downward spiral: As the quality of the building deteriorates, the property’s occupancy rate decreases. Rents become constrained as the property becomes less competitive in the market. The continuing deterioration of the property increases turnover costs as well as costs for overall maintenance. Without the resources to meet these costs, the property continues to deteriorate, and a self-reinforcing cycle sets in.

Underperforming properties can also drain the resources of their nonprofit owners, divert owners’ attention and resources away from other projects, and place properties at risk for penalties from private investors and lenders.

VI. STRATEGIES TO ADDRESS CAPITAL NEEDS

To ensure that OH’s portfolio remains stable, public funders and nonprofit owners must work together to address the capital needs of the existing units, while ensuring that future generations of housing are well positioned to meet their capital needs over time. Over the past few years OH has started to implement a range of asset management strategies that will help to achieve these goals. These strategies, along with the resource and policy tools listed below, will enable Seattle to preserve its affordable housing for the next 20+ years.

This section begins by outlining the steps the City will need to take in order to improve the portfolio's sustainability over the long term. Then it lays out potential strategies to stabilize the portfolio's current at-risk properties in the short term.

Strategies to improve portfolio sustainability over the long term

Ensuring that future generations of housing are better able to meet their capital needs will require strong asset management and underwriting practices. Seattle is at the forefront of a national trend within the affordable housing industry that is redefining success to emphasize the long-term stability and sustainability of portfolios. To support this shift, the Washington State Department of Community Trade and Economic Development (CTED), Impact Capital and the Seattle Office of Housing have submitted a joint application which is a finalist for significant funding from the MacArthur Foundation's *Window of Opportunity* housing preservation initiative to support asset management and preservation work. The Housing Development Consortium of King County, with financial support from CTED and active participation of OH, has also established an asset management affinity group to set benchmarks for asset management practices and property performance, to provide tools and training resources, and to foster networking opportunities for professionals in the field to share strategies and expertise.

OH's emphasis on strong asset management and improved underwriting practices will help to support the future capital needs of the portfolio in the following ways:

- ✧ **Asset Management:** Asset management that includes professional staffing and systems to oversee an owner's portfolio can achieve a number of critical outcomes that can extend the useful life of buildings, create additional resources for rehabilitation, and make more effective use of available resources:
 - ✓ **Increase revenue through regular rent increases and keep vacancy rates low:** Because expenses increase every year, annual rent increases, where achievable in the market and within regulatory constraints, are necessary to enable projects to adequately fund routine maintenance and repairs, and to set aside budgeted reserve contributions. In addition, regular rent increases are critical to assuring that properties are in a position to support new private debt, an important source for recapitalizing a project. A study of King County's affordable housing portfolio found that projects are only collecting 78% of maximum potential rent allowed under project regulatory agreements (Impact Capital/HDC, 2008). The vacancy rates for the OH portfolio (93.9%) are only slightly below industry norms (95%), but greater emphasis will need to be placed on achieving good collection rates, shorter unit turnover times and maximum rent potential. With that in mind, the ability to raise rents needs to be evaluated in the context of market constraints and the impact on affordability for residents. Currently the portfolio serves a much lower income population than projected in the original financing applications.
 - ✓ **Active oversight of maintenance costs and activities:** Quality asset management can reduce maintenance costs through scheduled preventive maintenance, quickly addressing problems before they escalate, and assuring value for dollar spent on repairs. Effective maintenance and planning can reduce properties' long-term capital costs and lengthen the intervals between rehabs. Seattle's nonprofits have made use of water and energy-saving retrofits in a number of buildings. "Green building" efforts for projects going forward will incorporate built-in durability, energy conservation and other

strategies to lower ongoing operating costs and free up dollars for maintenance and repairs.

- ✓ **Capital planning:** Preparation and monitoring of annual capital budgets, periodic capital needs assessments, and replacement reserve modeling can help prioritize capital improvements and allow adequate lead time to address capital needs in a cost effective manner and to gather resources to address those needs. Improved capital planning can also be supported by strategic changes in the way that capital needs are analyzed, such as the shift to a 30-year rather than 20-year timeline for CNAs.
- ✧ **Underwriting:** Long-term sustainability begins with realistic initial underwriting. Modifications to traditional underwriting practices can help to support the long term sustainability of new and existing affordable housing properties. Such changes include:
 - ✓ **Underwriting:** Adjust rent and operating expense assumptions used for loan underwriting to use more conservative assumptions about increases in income. This will help ensure that more projects will be financially viable for the long term. Eligible costs can also include support for designs that include cost effective operating measures (e.g. conservation, low-maintenance materials, durable products, improved data management, etc.).
 - ✓ **Support for adequate reserves:** It may be strategic to use less conventional debt and more deferred or low-interest public funding up front in order to increase net cash flow so that properties have adequate revenues to put into reserves. An option for properties that cannot cover the cost of regular reserve deposits may be to capitalize replacement reserves up front, particularly for rehabilitation projects.
 - ✓ **Level of initial rehabilitation:** Eliminate selective rehabilitation as a development strategy unless a clear rehabilitation plan and reserve strategy are in place at year one to address capital needs for the next five to ten years. Assure that acquisition/ rehabilitation projects are adequately rehabilitated at the front end, or that upfront reserves can meet capital needs until the project can support additional capital improvements.

Strategies to stabilize current at-risk properties

Meeting the capital needs of the portfolio's current at-risk properties in the short term will require a combination of existing reserves, refinancing of private debt where feasible, potential disposition of a small number of non-strategic properties to strengthen the balance of the portfolio, re-syndication, and additional public gap financing.

- ✧ **Reserves:** As noted earlier, an estimated 31% of the projected capital costs over the seven year period from 2010-2016 will be covered by reserves. For the majority of properties, reserves will play an important role, but they will need to be combined with other funding sources.
- ✧ **Private refinancing:** A portion of the projects in the portfolio will be able to meet the remainder of their capital needs through private refinancing. The ability to refinance is primarily determined by whether a property can bear additional loan payments or if the current interest rate is more favorable than an existing debt. An assessment of the Debt

Coverage Ratio (DCR)⁴ of the portfolio suggests that the majority of properties would not be able to take on additional debt. Most lenders require a DCR of at least 1.15 in order to take on debt. Only 37% of the portfolio has a DCR above 1.15, and the median DCR is 1.0. However, in some circumstances properties with DCRs under 1.15 may still be able to refinance:

- In some cases properties have paid down enough of their initial loans that refinancing for a longer term will not require higher debt payments. This is particularly likely to be the case for older properties that are nearing the end of their initial loan term. In other cases, if existing loans carry an interest rate above the current market, it may be advantageous, depending on prepayment penalties, to refinance.
- Some properties may be able to improve their net cash flow, thereby increasing their ability to take on additional debt, by increasing their rents and/or improving collections. In situations where market and regulatory constraints allow increased rents, the additional revenue can allow the property to meet higher debt payments. However, significant rent increases will increase the housing costs for residents and may require a shift in the population served – a trade-off that will have to be considered on a case by case basis.

✧ **Property disposition:** Disposition of non-performing properties or obsolete housing types should be considered as a potential strategy when appropriate. Nationally, preservation strategies are increasingly being addressed at a portfolio level rather than just a property-by-property basis. The increased emphasis on asset management has opened up the discussion about the role of property disposition as an important tool for stabilizing portfolios. Some properties may not warrant reinvestment for physical, financial, or strategic reasons. Most notably, housing authorities are disposing of single family properties which typically have significantly higher operating costs. From this perspective, selling off key problem properties can free up capital to improve the financial and physical health of the rest of the portfolio and refocus critical asset management capacity toward the balance of the portfolio.

✧ **Public recapitalization:** Seattle projects that are not able to cover all of their capital needs through reserves and private refinancing are likely to need some combination of public recapitalization funding from OH, CTED, and the State Housing Trust Fund.

- Some projects will be able to use additional Low-Income Housing Tax Credits (LIHTC) after the initial 15-year compliance period has expired. Tax credit eligible projects may be able to cover 60-90% of major capital replacement costs through LIHTC equity, if they can secure an allocation. In order to be eligible for tax credits, projects must have a minimum of \$6,000 per unit in rehabilitation costs, and re-syndication is generally not cost effective unless the total rehabilitation costs are \$500,000 or more. LIHTC allocation is a competitive resource and use for preservation would impact new development.
- Projects that are not able to re-syndicate with additional tax credits would need a combination of gap financing from OH, CTED, or other governmental or philanthropic sources.

⁴ The Debt Coverage Ratio is calculated by dividing Net Operating Income by hard debt. Data is from Impact Capital/ HDC (2008).

What will public recapitalization cost?

OH's share of development financing has paid for an average of 30% of the costs for acquisition/rehabilitation projects over the past few years. To estimate OH's portion of the recapitalization costs, we estimated that OH would need to cover an average of 30-50% of the total rehabilitation costs for the portfolio after reserves. This range assumes that projects will achieve less leverage of City dollars than at the initial financing stage, primarily because LIHTC will not be as common a financing source. Because the industry does not have much experience with recapitalization of aging affordable properties, we do not have enough data to develop more precise estimates.

The total estimated rehabilitation cost for the portfolio over the seven year period of 2010-2016 is \$56 million. The gap left after we factor in project reserves is \$38.4 million. If we assume OH will need to cover 30-50% of this gap, we get a ballpark figure of \$11.5 - \$19.2 million. The actual number may be lower depending on how much effect improved asset management strategies (e.g. rent increases) are able to have on addressing the needs of current at-risk properties. The cost will also be shaped by how the State responds to requests for additional tax credits and Housing Trust money for recapitalization.

Reinvestment in Seattle OH's portfolio will maintain the quality of the city's affordable housing stock. Preserving existing affordable units safeguards millions of public dollars that have already been invested in these units, and it sustains the housing for many years of additional service. Over the past 20+ years, the City of Seattle has invested more than \$286 million to develop its portfolio, with estimated total development costs of \$1.97 billion. For 4-7% of the City's initial investment or 1% of the estimated total development costs, the City can ensure that these units will continue to provide high quality, stable housing for another 20 years.

The magnitude of the current gap between capital needs and resources can be mitigated in future generations of housing by placing greater emphasis on asset management and long-term sustainability. Over the past few years, the affordable housing industry has honed its understanding of what it takes to create a stable and sustainable portfolio. Seattle is at the forefront of this movement, and its work toward best practices in property management, asset management and other pro-active stabilization strategies will help to ensure that future generations of housing will be able to meet their capital needs in a more sustainable manner.

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