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REITs take on affordable housing problem

BY ANNA ROBATON

Housing Partnership Equity Trust (HPET) made its first acquisition in 2013, partnering with nonprofit Mercy Housing Inc. to acquire a low-rise 1970s-era apartment community that had become a neighborhood eyesore after years of neglect. After closing on the 128-unit property, located in a leafy, close-in Chicago suburb, HPET and Mercy Housing spent some $2 million to tackle a wide array of problems, from outdated energy and mechanical systems to peeling paint and mold.

The property's fate could have been much different. In other hands its long decline might have continued, making it increasingly harder for young families, seniors and other types of tenants to stay put. Such older apartment communities near public transit, shops and other amenities have also become prime targets for investors who aim to fix them up, attract higher-paying tenants and find new buyers in relatively short order.

For its part, HPET, a social-purpose real estate investment trust (REIT), has very different aims. It's among a handful of REITs that are tackling one of the biggest problems facing many U.S. cities – a shortage of affordable housing for working families – while delivering returns to investors.

CASTING A WIDE NET

HPET's $280 million portfolio, which stretches from coast to coast, mostly serves households earning 50 percent to 80 percent of the area median income in their respective markets. In the Chicago area, for instance, its properties are home to delivery truck drivers making about $42,000 a year, nursing aides earning some $32,000 annually and other hard-working Americans who might otherwise have to spend as much as half their salaries on rent.

The federal government defines "cost burdened" families as those spending more than 30 percent of their incomes on housing, which can make it difficult to also afford groceries, medical care and other essentials.

"There is a housing crisis affecting almost every community in the country," says Anne Segrest McCullouch, president and CEO of HPET, whose investors include big institutions, affluent individuals and family offices.

"The reality," she adds, "is that many working families, particularly renters, are paying 50 percent or more of their income for housing."

DOING WELL AND DOING GOOD

According to McCullouch, HPET's investors share a common goal: to make a return and a difference. The private REIT's target return is 8 percent to 10 percent (including dividends) over a long-term period for the common stock it's currently offering. Since 2015, HPET has paid a preferred dividend of 4.5 percent annually.

"Whoever the investor is, whether a large institution or a family office, the common theme is that they absolutely want a fair, risk-adjusted return, and they absolutely want to make an impact," says McCullouch.

THE MAKING OF A CRISIS

Why are so many cities facing an acute shortage of affordable housing? For starters, rents in many parts have risen faster than incomes throughout much of the current economic boom. Meanwhile, developers have tended to focus on high-end apartments, largely because of construction costs. In recent years, publicly traded apartment REITs have mostly exited the middle of the country and concentrated on fast-growing coastal markets, where construction costs are especially high.

"Big developers need to make their math pencil and to do that you need to charge higher rents," explains John Pawlowski, a senior analyst covering residential REITs at Green Street Advisors.

As asset prices have climbed, many private investors have moved farther up the risk spectrum, searching for higher returns in value-add properties that have long served low- and moderate-income renters. According to a 2019 report by the Joint Center for Housing Studies at Harvard University, low-rent housing stock (or apartments renting for less than $800) declined by more than 4 million units between 2011 and 2017.

"There's almost no new building of modest-income rental housing and, as a result, the stock we have is the stock we have. When one of these properties gets torn down or repurposed to serve much higher-income tenants, then it's gone," says McCullouch.

TO PRESERVE AND PROTECT

HPET was founded in 2012 by mission-driven nonprofits to stanch the bleeding. It invests long-term equity alongside leading nonprofit owners and operators of affordable housing, like Mercy Housing. Its financial muscle – and deep expertise in the nuances of affordable housing – helps nonprofits compete against commercial developers for acquisitions of properties that get little or no public subsidies.

Since its founding, HPET, based in Washington, D.C., has preserved some 3,105 units for long-term affordability. Average rents for properties in its portfolio are affordable at 57.4 percent of area median income on average.

RINSE AND REPEAT

To preserve affordable housing and generate steady returns, HPET and its counterpart, The Community Development Trust (CDT), must be highly selective about what they buy. Among other things, that means having a smart ground game.

Like HPET, CDT works closely with experienced local, regional and national partners to identify investment opportunities, conduct due diligence and make targeted bids for properties. At times, its partners help the company identify acquisition opportunities before they are widely marketed to other investors.

"We work with experienced, high-quality general partners, both for-profit and not-for-profit, who have extensive experience in owning and managing affordable housing. We try to do repeat business with those we have a positive experience with, and they with us," says Joseph Reilly, president and CEO of CDT, a private REIT whose investors are mostly big banks and insurers.

CDT invests equity, alongside its partners, in affordable apartment communities, but it's also a national direct lender and secondary-market buyer of permanent mortgages that support the preservation and development of such communities.

Since its founding in 1999, CDT has invested $1.9 billion in equity and debt capital, helping to preserve and create 49,000 affordable apartment units, or homes for 125,000 people. It invests in properties that are affordable to people earning no more than 80 percent of area median income. Rents typically represent about 30 percent of income for people in that bracket.

"There isn't a city we visit these days that isn't struggling with the notion of providing sufficient affordable housing," says Reilly.

The Costs of Prosperity

That's because some cities have become victims of their own success. Take Austin, Texas, where CDT recently acquired its fourth apartment property with the Austin Affordable Housing Corp., an affiliate of the city's housing authority. Through the deal, CDT and Austin Affordable Housing have been able to create, rather than preserve, affordable housing by setting aside half of the property's 452 units for households earning less than 80 percent of area median income. The property previously had no such restrictions in place. CDT has also budgeted more than $750,000 for apartment upgrades and capital reserves.

In recent years, Austin has seen a huge influx of businesses and residents, many of them relocating from California because of the city's relatively affordable cost of living, deep talent pool and quality of life. The population and job market have surged, as have rents and development activity targeting higher-income residents. As a result, teachers, firefighters and other workers of modest means have found it increasingly difficult to afford apartments near jobs, public transit, schools, grocery stores and more.

"The affordability challenges have always been around for low-income renters, but in many markets, they're moving up the income stream," says Benson "Buzz" Roberts, president and CEO of the National Association of Affordable Housing Lenders.

BEYOND APARTMENTS

As social-purpose REITs specializing in affordable apartment communities, CDT and HPET occupy a rare space. But they are not the only REITs to make workforce housing a priority. Some publicly traded REITs create and preserve affordable housing simply by virtue of the property types in which they invest, whether manufactured-home communities or modest, single-family rental homes. Sun Communities Inc., for instance, is a publicly traded REIT that owns and operates 420 manufactured-home and recreational-vehicle communities across the United States and in Canada. Such communities offer a low-cost path to ownership for many blue-collar families that can't afford a down payment on a traditional home.

"Workforce housing is a pretty broad universe. It's bigger than just apartments," notes Pawlowski of Green Street Advisors.

A NEW MODEL EMERGES IN D.C.

In the Washington, D.C., market, JBG SMITH, a publicly traded REIT that owns mixed-use properties, has set out to address the growing shortage of affordable apartments in its own backyard. In 2018, the company joined with the nonprofit Federal City Council to launch the Washington Housing Initiative, which consists of an impact fund that raises money from private and philanthropic organizations for the acquisition of properties by nonprofit and for-profit groups that share its commitment to keeping them affordable. So far, the fund has raised about $100 million, including capital contributed by Bethesda, Md.-based JBG SMITH.

The Washington Housing Initiative also includes an independently managed nonprofit, the Washington Housing Conservancy, that acquires, develops and manages apartment communities in fast-growing neighborhoods that are still affordable to working families, but expected to become less so over the next decade.

"In the D.C. area, there is a significant stock of naturally affordable housing because of its age and location. But there has been virtually no capital organized to preserve that affordability," explains Brian Allan Jackson, an executive vice president at JBG SMITH, who is leading the company's participation in the Washington Housing Initiative.

THE 'MISSING MIDDLE'

Over the next decade, the initiative aims to preserve thousands of affordable units serving what Jackson calls the "missing middle," households earning too much to qualify for Section 8 vouchers or other forms of rental assistance yet struggling to pay for housing and other basic expenses.

Since 2000, Arlington County, Va., located across the Potomac River from Washington, D.C., has lost a whopping 90 percent of its "naturally affordable" multifamily housing stock to redevelopment and/or repositioning activity, notes Jackson.

JBG SMITH manages the Washington Housing Initiative's impact fund. The firm also shares its expertise with the Washington Housing Conservancy, an arrangement that helps it function like a large real estate organization — rather than a nonprofit startup — and thus gives it certain competitive advantages as it pursues deals.

"This is a way to take the skills we have as a firm and use them for the betterment of community. There's a lot of appeal to being able to do more than just write a check," says Jackson, who hopes the Washington Housing

Initiative will serve as a model for other real estate companies that want to address housing affordability.

BACK TO THE FUTURE

As the initiative pursues its first acquisitions, HPET is looking back on some of its initial deals. The REIT recently sold its first-ever acquisition (the low-rise apartment community near Chicago) to a local private investor committed to affordable housing. The property was sold with use restrictions in place, ensuring that a significant number of units there will remain affordable for years to come.

"We took a neglected property that should have been a great community asset and turned it into one. We also made a return on the property, which we can now invest in a new one," says McCullouch. "To me, that deal was a real success."

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