ULI Community Catalyst Report

NUMBER 3

Best Practices in the Production of Affordable Housing

Urban Land Institute

COVER: First Ward Place, Charlotte, North Carolina. Photo courtesy of Urban Design Associates.

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Best Practices in the Production of Affordable Housing

A ULI/Fannie Mae Foundation Policy Forum

March 29–30, 2005

Prepared by Deborah L. Myerson

Urban Land Institute

Fannie Mae Foundation

ABOUT ULI

ULI–the Urban Land Institute is a nonprofit education and research institute that is supported by its members. Its mission is to provide responsible leadership in the use of land to enhance the total environment. ULI sponsors education programs and forums to encourage an open, international exchange of ideas and sharing of experiences; initiates research that anticipates emerging land use trends and issues and documents best practices; proposes creative solutions based on that research; provides advisory services; and publishes a wide variety of materials to disseminate information on land use and development. Established in 1936, ULI has more than 26,000 members in 80 countries representing the entire spectrum of the land use and development disciplines.

Richard M. Rosan
President

ABOUT FANNIE MAE FOUNDATION

The Fannie Mae Foundation creates affordable homeownership and housing opportunities through innovative partnerships and initiatives that build healthy, vibrant communities across the United States. The Foundation is especially committed to improving the quality of life for the people of its hometown, Washington, D.C., and to enhancing the livability of the city's neighborhoods.

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ABOUT ULI COMMUNITY CATALYST REPORTS

ULI is influential in the discussion of and debate on important national land use policy issues. To encourage and enrich that dialogue, the Institute holds frequent land use policy forums that bring together prominent experts to discuss topics of interest to the land use and real estate community. The findings of these forums can guide and enhance ULI's program of work. They also can provide ULI district councils, ULI members, and others addressing land use issues with information they can use to improve quality of life, advance community values, and—in the words of the ULI mission statement—"provide responsible leadership in the use of land to enhance the total environment."

ULI's Community Catalyst Reports are intended to make the findings and recommendations of land use policy forums relevant, accessible, and useful at the community level where land use decisions are made and their consequences felt most directly. Community Catalyst Reports can be downloaded free from ULI's Web site (www.uli.org/policypapers) or ordered in bulk at a nominal cost from ULI's bookstore (800-321-5011).

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Introduction

Best Practices in Producing Affordable Housing, a ULI/Fannie Mae Foundation Policy Forum held in Washington, D.C., on March 29 and 30, 2005, was sponsored by the Fannie Mae Foundation to identify and explore current best practices and learn from companies that are doing an exemplary job of providing affordable housing. In addition, the two-day forum sought to identify the major barriers to the production of such housing. The ultimate goal is a systems change that facilitates the production of affordable housing on a broader scale.

In addition to the initial findings presented in this *Community Catalyst Report*, the highlights of this research will be more fully explored in a ULI/Fannie Mae Foundation Research Report (to be published in January 2006), which will profile the best practices of five for-profit and five nonprofit affordable housing development companies.

Best Practices in the Production of Affordable Housing

As the value of residential real estate in the United States has boomed during the past decade, the affordability of housing has decreased for many households. At the same time, the federal government has steadily reduced housing subsidies. The result is that the private sector, with help from local governments, is increasingly meeting the growing need for more affordable housing. Whether for-profit or nonprofit, affordable housing developers must manage their market carefully. In addition to serving the buyers and renters of the homes they produce, they must navigate among local politics, city planning departments, and the interests of surrounding neighborhoods and other community stakeholders. Nonprofit and for-profit developers alike have produced thousands of below-market-rate housing units by acquiring viable land, assembling complex layers of financing, and negotiating with communities.

The Nonprofit Developer's Perspective

The nonprofit developer of affordable housing has a mission: to provide housing for the needy, the elderly, working households, the disabled, and others that the market does not serve adequately. To carry out this mission, many nonprofit developers find themselves gaining sophistication and drawing more on the techniques of for-profit companies. They combine market-based real estate savvy with a hunt for subsidies to produce homes at below-market-rate prices.

Nonprofit housing developers are more entrepreneurial now than in the past, recognizing that they are, in fact, businesses—even if they are tax free and mission driven, with some government support in the mix. As a result, nonprofits (and their boards) are focused more than ever on establishing a capital base to sustain their efforts, and realizing that they need to plan and implement a strategy for sustainability over a 20- to 30-year time span.

The For-Profit Developer's Perspective

For-profit developers of affordable housing often operate on a "double bottom line" philosophy—achieving both a profit and an altruistic outcome: what some call "doing well by doing good."

To produce affordable housing and make a profit, for-profit developers find they need to be able to be creative and spot opportunities. Thoroughness, combined with instinctive judgment on how to make a project work, can yield the desired results. A willingness to form partnerships, whether with local governments, nonprofits, or community groups, is another trait of many successful for-profit developers—as is the ability to say no when a deal will not work.

Comparing Nonprofit and For-Profit Points of View

The forum discussion revealed some distinctions between for-profit and nonprofit affordable housing developers, as well as the many experiences they share. The differences between nonprofit and for-profit approaches to producing affordable housing are important, if sometimes subtle.

Time frame. As mission-driven organizations, nonprofits typically view their work with a longer time horizon than their for-profit counterparts. For-profit developers tend to have a dynamic portfolio, while nonprofit developers often continue to own and manage their rental properties for many years. Nonprofits' consistent presence in a community over time shapes this long-term perspective and makes techniques like land banking more applicable for them.

Capital financing. For-profit developers are more likely to leverage their properties to extract capital, while nonprofit developers traditionally have been less likely to pool their properties' reserves to generate cash flow.

Governance. Nonprofits and incorporated for-profit companies must answer to their board of directors. In a nonprofit corporation, the board reports to stakeholders, particularly the local communities that the nonprofit serves; in a for-profit corporation, the board is responsible to stockholders. As a group legally responsible for the governance of a corporation, a board of directors plays a significant role in a company's long-term sustainability. A strong board can advance an organization with support for new ideas, while a weak board with less capacity may hinder it.

Leadership. Developers of affordable housing, like most businesses, require succession planning —identifying talented employees and preparing them for future broader and higher-level responsibilities. While many large for-profit corporations have established a system for grooming people within their companies to assume leadership when the top position becomes vacant, other organizations—including many nonprofit and smaller for-profit developers—are less likely to prepare themselves for this inevitable circumstance. Nonprofit developers particularly noted that providing room for growth for highly skilled employees and laying the groundwork for eventual turnover in leadership can be a difficult challenge that is more often avoided than addressed.

> *"Opportunity awareness differs between nonprofit and for-profit affordable housing developers. For nonprofits, a deal is driven by the availability of resources. For-profit companies presume that the resources are available and make a decision to go ahead with a project based on their ability to succeed."*
>
> *Helen Dunlap, President, Shorebank Advisors*

The Townhomes on Capitol Hill in Washington, D.C.—a project financed through a HOPE VI grant—blends seamlessly into the existing neighborhood. Corcoran Jennison Companies, a Boston-based for-profit developer, served as development and marketing adviser and general contractor, and is property manager.

Project selection. A for-profit developer, who is often in a position to mix market-rate with affordable units, typically evaluates a prospective project from a market-based point of view. Nonprofit developers, in order to operate in a subsidy-dependent environment, often first identify a municipality that is hospitable to the construction of affordable housing—and may provide some level of support—then pursue a location for construction.

Margin of error. Nonprofit developers are reluctant (and in some cases, limited in their ability) to default on a deal, so they stick with a project even when things turn rocky. For-profit developers are prepared to walk away from a deal if it turns sour. This ability to limit their losses provides for-profits with a larger margin of error.

As familiar themes arose during the forum, it was clear that nonprofit and for-profit developers also share many experiences. For all developers, the ability to build and maintain relationships—whether with lenders, local governments, or community members—is a critical component to building affordable housing. Diversity in housing product and geography often can provide additional advantages for producing affordable housing. As one forum participant commented, "The difference between nonprofit and for profit developers is that nonprofits don't pay taxes."

Best Practices: Predevelopment

Predevelopment efforts, such as assembling and acquiring land, forming partnerships, performing due diligence, and gaining entitlements, are the important first steps that developers undertake before launching a project. Forum participants discussed a variety of long- and short-term predevelopment activities that lay the groundwork for successful projects. The best predevelopment practices include the following:

1. Market the organization and the idea of affordable housing.

Widely promoting the concept of affordable housing is an important part of cultivating a hospitable environment for projects. Nonprofit housing developers, as mission-based organizations, are particularly aware of the need to generate wider acceptance in the larger community. Successful promotion techniques include demonstrating to a community the economic as well as social benefits of providing affordable housing, educating the public on the need for workforce housing, spreading the word about affordable housing success stories through local media coverage and opinion pieces, and building a local constituency to serve as an advocate for affordable housing.


URBAN DESIGN ASSOCIATES

To create a sense of community, traditional town planning principles associated with new urbanism were employed at First Ward Place in Charlotte, North Carolina. The site was developed by the Bank of America Community Development Corporation and the Charlotte Housing Authority.

In addition, nonprofits find it useful to pursue public relations efforts that help them to be widely recognized and respected as organiza-tions that add value to the community.

2. Be strategic with land use issues.

Developers note that addressing land use matters, such as zoning or land acquisition, is a key predevelopment task. Some developers, especially nonprofits, suggest land banking as a strategy for buying land cheaply for later development. The longer time frame considered by nonprofits for development often translates into these organizations holding land longer, waiting for the right opportunity to arise. In addition, nonprofits' concern for the public interest can be persuasive as a means to obtain support from local governments in rezoning hearings or for land purchases.

3. Politics matters.

A receptive political environment is critical to predevelopment. Every project must take into account considerations such as the political will of local leaders, the potential for resistance from NIMBY neighbors, and the willingness of the local government to provide support, allocate resources, or implement tax advantages that can be leveraged for a particular project.

4. Build mixed-income housing.

Housing developments with a mix of market-rate and subsidized units are often better received by local governments and neighbors than projects with all below-market-rate housing, developers say.

5. Create compatible design.

Ensuring that a new development blends aesthetically into the neighborhood helps surrounding communities to accept affordable housing more readily, developers note.

> *"The nonprofit time frame is much different than the for-profit developer's: it's much longer term."*
>
> *Adam Weinstein, President, The Phipps Houses Group*

6. Recognize the role of the public sector.

The public sector, especially the local government, plays an influential role in successful affordable housing projects. Local governments can "set the table" with assistance for land acquisition or tax deals, or with other supportive measures that help underwrite the development. However, local governments can be a hindrance later in the process with time-consuming, inconsistent, duplicative, or unwarranted review, developers say. Streamlined local government review is crucial, both nonprofit and for-profit developers say.

7. Have a nose for opportunity.

Developers should be attuned to identifying promising locations for new affordable housing developments. While experience in a particular market is valuable, so is networking with local leaders and scouting out undervalued markets in "not hot" and "one-off" neighborhoods. The willingness to take risks and the ability to evaluate a site's potential are what provide the edge to make a project successful. Above all, developers note, it is important to know your competitive advantage—what your firm can bring to the market that others cannot.

8. Know your market and your resources, and find a match between them.

To make a project feasible, it is critical to assess what product will meet the local market's affordable housing needs and what resources are available for financing, then match them up.

Valley Square Commons in Golden Valley, Minnesota, offers affordable two- and three-bedroom rental townhouses. The homes, developed by St. Paul–based affordable housing developer CommonBond Communities, were quickly rented and currently have a waiting list for prospective tenants.

COMMONBOND COMMUNITIES, INC.

Best Practices: Financing

An organization's financing strategies are critical to help it assess prospective deals and determine the nature of its relationships with financial partners. Best practices in financing include the following:

1. Apply creativity and flexibility to a full spectrum of finance.

Affordable housing typically requires multiple layers of financing from a variety of sources. As such, successful projects demand savvy and ingenuity from a financing perspective, developers say, with methods that vary according to the housing product and other particulars of the market.

Examples of creativity include the following:

■ A nonprofit made a bulk purchase of 120 units in a for-profit developer's condominium project to resell with income restrictions. The nonprofit got a reduced price on the deal from the bulk purchase, and the for-profit developer met its lender's presale requirements for financing.

■ A for-profit developer gave the local government a half share in an affordable housing development, which cemented local acceptance and a local stake in the outcome of the project.

2. Develop a long-term plan for capital.

It is important to establish a long-term plan for managing capital, on top of a day-to-day strategy, nonprofit developers say. Because many nonprofit developers continue to own and manage

Heritage Crossing in Baltimore, Maryland, is a mixed-income, mixed-use community containing 75 affordable units and 185 that are market rate. Developed by Baltimore-based Enterprise Homes, Inc.,the community replaced a distressed public housing project.

their rental properties, over the years their growing portfolios offer the opportunity for refinancing; pooling of collateral is a way for nonprofits to free up equity income to use for their mission.

3. Take out soft debt.

Low-interest loans from state or local government lenders, as well as from federal funding sources, can be a key to many affordable housing deals. These loans are called soft debt because these sources often offer deferred repayment or forgivable debt terms.

4. Use cross-subsidy.

Applying the cash flow generated by market-rate projects is one way to subsidize below-market-rate housing. This cross-subsidy may occur within a single project, such as a development that is subject to inclusionary zoning, or between projects, such as a nonprofit developer who pursues a market-rate deal to generate income to serve its mission with other properties.

New Pennley Place in Pittsburgh, which replaced an existing apartment complex that had fallen into disrepair, is a vibrant, mixed-income rental community that has sparked revitalization of the area. The project, developed by the Community Builders, Inc., a nonprofit affordable housing developer based in Pittsburgh, combined building renovation with new construction.


COMMUNITY BUILDERS, INC.

5. Drive down costs.

Keeping out-of-pocket costs down is an important strategy for the production of affordable housing. Some developers seek soft debt for a deal, negotiating with the local government to comply with certain regulations in exchange for debt forgiveness. In other cases, developers may seek to keep down costs per unit by increasing density and building additional units. Other techniques to keep down development costs include seeking access to publicly or institutionally owned land that may be available for development, thus lowering the cost of land acquisition.

> *"For-profit developers need to be patient, pushy, and persistent."*
>
> *John McIlwain, Senior Resident Fellow, ULI/J. Ronald Terwilliger Chair for Housing, Urban Land Institute*

6. Employ rigorous business principles.

To manage the risk in their real estate deals, it is important for developers to apply business principles consciously and with discipline, they say. These principles include the willingness to make difficult decisions, such as walking away from a deal if it proves impossible to close a gap in financing. For a nonprofit, adherence to the mission is an additional "business principle" that can help it evaluate the merit of prospective projects.

7. Be tenacious.

The attributes of persistence and patience—in activities ranging from negotiating with local governments to assembling multiple layers of financing—pay off in the development of affordable housing.

8. Develop long-term relationships with lenders and investors.

People are an important component of any real estate development project. Because time is a critical factor in many real estate deals, it is important for a developer to have a good working relationship with a loan officer in order to act quickly when necessary. A longstanding relationship with a lender is part of a solid track record that helps developers manage risk and support future efforts.

Best Practices: Sustainability and Growth

Long-term sustainability and growth strategies provide companies with an opportunity to plan for the future. The sustainability of the organization's evolving structure and board governance is a priority for many nonprofit developers. The best practices to promote sustainability and growth are the following:

1. Reinvent the organization regularly.

As an organization grows, matures, takes on new roles, and adapts to changing times, it must find ways to reinvent itself. Nonprofits especially find that they need to plan for an evolution of management that reflects the growth of the organization. For example, an organization that starts as a community service provider may acquire development expertise and then expand to provide property management services. With each change, the nonprofit must reorient the organization and ensure that management practices are appropriate for its continued growth.

2. Develop proactive strategies for growth.

Planning for growth, rather than simply letting it happen, allows developers to be more deliberate in their decision making.

3. Seek geographic diversity.

For many developers, geographic growth is important in order to find a mix of markets that have potential for the development of affordable housing. In addition, the path of expansion is often determined by the location of communities that have a need for and the resources to support affordable housing. "Meeting the market"—and building the organization to meet local needs—is a useful strategy for continued growth. The hiring of local workers can help a developer to get established more quickly in a new location.

> *"Economic forces govern land use choices . . . [and] housing is seen as a loser. Thus, there is a lack of housing by policy. We need more successful models for better land use decisions."*
>
> *Fran Wagstaff, Executive Director, Mid-Peninsula Housing Coalition*

4. Invest in human capital.

The sustainability of any company or organization depends on the continuity of leadership. For nonprofit developers, where decades-long tenures for established management figures are common, planning for the succession of leadership is important for long-term survival. The recruitment of young and midcareer professionals, along with leadership development, is critical for growth.

Arbor Lakes Commons is a CommonBond community for seniors in Maple Grove, Minnesota, a suburb of Minneapolis. CommonBond Communities, Inc., is Minnesota's largest nonprofit provider of affordable housing.

5. Know your competitive advantage.

Understanding what a firm's strengths are compared with other companies and capitalizing on them are important components of sustainability, developers agree.

6. Focus on capital structure.

Capital structure—the blend of interest-bearing debt and long-term equity funding that companies require to finance the capital needs of the business—is a vital consideration for any business, whether nonprofit or for-profit. Each organization needs to identify the balance of debt and equity that is the most cost-effective for the company while providing adequate financial flexibility to manage risk and growth. One forum participant described managing three pools of capital: for operating reserves, existing deals, and future deals. However, it is important that the capital structure not be static, but rather grow with the organization.

7. Maintain product diversity.

Developers that produce several types of affordable housing can broaden their expertise, penetrate different markets, and serve a range of communities. For companies with a property management office, construction of rental housing offers an additional long-term revenue source.

8. Develop a strong and well-informed board.

Nonprofit developers also have a board of directors that helps with governance of the organization. Making the most of the board members' strengths —typically one or more of the oft-cited attributes "wealth, wisdom, or work"—and recruiting able board members as turnover occurs are important components of a nonprofit's success.

9. Pursue vertical integration.

For many developers, scaled development requires vertical integration—the incorporation of different components of development, such as construction, land development, property management, and social services, within a single company. For-profit developers often grow this way, finding that this type of structure adds to capacity and produces revenue that makes it self-supporting. The diversity of revenue sources is also an advantage for long-term growth.

10. Manage assets effectively.

Because rental properties can be part of a development company's portfolio for a long time, strong asset management supports a good public reputation and ongoing cash flow.

Wheeler Creek is a new mixed-income, affordable housing development in Washington, D.C., that includes for-sale units. The community was developed as a joint venture between Enterprise Homes, Inc., A&R Development, and Wheeler Creek Estates Community Development Corporation.

CHALLENGES AND OPPORTUNITIES OF PARTNERING

Some developers establish partnerships to produce affordable housing, often between a for-profit and a nonprofit company. Jim Grauley, senior vice president for the Bank of America Community Development Corporation, led forum participants in a discussion of the pros and cons of partnering to develop affordable housing.

Place-based partnerships, with a geographic focus on a particular city, region, or neighborhood, are common, Grauley notes. Partnerships are most successful, he suggests, when each party brings a unique ability to the endeavor, such as a mixed-use project where a nonprofit contributes experience in building affordable housing and a for-profit developer offers a track record in commercial development. Of prime importance for any partnership is an exit strategy that details next steps when the partners have completed the project.

Priorities for Prospective Partners

- Establish trust and understanding between parties.
- Align the mission and objectives.
- Examine the alignment of cultures: figure out how to work together to run project management.
- Decide how to structure the deal.
- Determine how long the partnership will exist, and formulate an exit strategy.
- Designate management of day-to-day operations, control, and decision-making responsibilities, as well as each partner's share in the project equity.
- Determine an equitable split of the benefits.

11. Seek limited guarantees.

Developers prefer financing with limited guarantees as a way to minimize risk.

12. Think long term and build it to last.

A high-quality product produces a return for the community, as well as for the developer. It is important to view affordable housing development as an investment, and to build a high-quality product that will last for the long term, both nonprofit and for-profit developers say. Construction of a high-quality product offers multiple benefits: in the short term, a good for-sale housing product will withstand market changes; in the long term, property management is easier for durable and attractive units. Rental properties encourage a long-term perspective because in many cases, property management offices affiliated with the development companies manage the units.

13. Build and maintain a good reputation.

A good public reputation for a high-quality product will go a long way toward advancing the success of for-profit and nonprofit housing developers. Achieving and maintaining favorable visibility streamlines the path for future projects.

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