Executive Summary

In Austin, TX, an estimated 62,000 unsubsidized residential units are currently affordable to households earning less than 60% of median income. But as the local housing market continues to tighten, all of these homes are vulnerable to redevelopment and loss of affordability. City Council has resolved to preserve 20,000 affordable units over the next 20 years.

In Fall 2014, Dr. Elizabeth Mueller’s Green and Inclusive Corridors Practicum at the University of Texas at Austin provided further research on the current stock of unsubsidized affordable housing, revealing that the majority of these buildings are between 40 and 50 years old and many are in need of building systems upgrades and other capital improvements to increase energy efficiency, decrease utility costs, improve resident comfort, and protect asset value.

Owners may choose to defer such improvements if they do not see a benefit, as energy costs are largely paid by tenants. Others may be undercapitalized and unable to finance the work even if interested. Instead, some may choose to invest in market repositioning, whereby superficial improvements are made in order to increase rents (in one recent case by as much as 53%), displacing low-income tenants to areas with poorer access to transit, jobs, and other opportunities.

This Spring, the Practicum Finance Team considered funding mechanisms to address these issues and enable local owners to perform substantive upgrades to their buildings in exchange for commitments to preserve affordability to low-income tenants. The Team found that a combination of low-interest improvement loans and property tax exemptions could enable preservation of small properties.

Together, these “light touch” tools require less public subsidy per unit than is typically provided for acquisition-rehabilitation in large, traditional affordable housing projects. City agencies and stakeholders are currently developing an affordable housing preservation “strike” fund—a renewable pool of capital designed to be quickly and flexibly deployed as opportunities arise, separate from existing housing bonds and other programs—which could support the use of these tools. Further research may suggest the total scale of funding needed to achieve Austin’s affordable housing preservation objective.
1. Introduction

In its 2014 report Taking Action: Preservation of Affordable Housing in the City of Austin, Housing-Works outlines the case for an affordable housing preservation strategy in the face of Austin’s growing affordability crisis.

An estimated 62,000 unsubsidized units are currently affordable to households earning less than 60% of the area median income, but the implication is that, without intervention, all of these homes are vulnerable to market repositioning or redevelopment.

As the report explains, “preservation… is important because it is cost efficient, environmentally responsible, and it aligns with local planning initiatives” (p. 1).

City Council has recently adopted a resolution to preserve 20,000 affordable units within the next 20 years, but an implementation strategy is still under development.

2. Background

Beginning in Fall 2014, Dr. Elizabeth Mueller’s “Green and Inclusive Corridors” Practicum at the University of Texas at Austin provided further research on the current stock of unsubsidized affordable housing, revealing that:

1) The majority of these buildings are between 40 and 50 years old and many are in need of building systems upgrades and other capital improvements in order to improve energy efficiency, decrease utility costs, improve resident comfort, and protect asset value.

2) Owners may choose to defer these upgrades and improvements because they do not see the benefit, as energy costs are largely paid by tenants. Others may be undercapitalized and unable to finance such improvements even if they were interested in doing so.

3) Instead, owners or developers may choose to invest in market repositioning, whereby superficial improvements are made in order to increase rents (in one recent case by as much as 53%), usually without substantial upgrades to building systems. Low-income tenants are especially sensitive to rent increases and could be displaced to areas with poorer access to transit, jobs, and other opportunities as a result.

3. Premise of Work

The 2012 ImagineAustin comprehensive plan establishes a number of policies that support an integrated intervention strategy, including a policy to “increase the availability of affordable housing, including housing for very low-income persons, through new and innovative funding mechanisms, such as public/private partnerships” (City of Austin, p. 137). Within the Practicum, it was the purpose of the Finance Team to consider such funding mechanisms and, specifically, to assess how they might be used to provide local owners with the resources required to perform substantive upgrades to their buildings in exchange for commitments to preserve affordability to low-income tenants.

In response to the aforementioned City Council resolution, relevant agencies and stakeholders are currently developing an affordable housing preservation “strike” fund—a renewable pool of capital designed to be quickly and flexibly deployed as opportunities arise, separate from existing housing bonds and other programs. Therefore, we also worked to estimate the per-unit public subsidy cost of various options in order to provide a sense of the scale required of the strike fund to achieve the 20,000 unit preservation objective.
1. Research

Last fall, the Practicum developed a typology of unsubsidized affordable rental housing in Austin and produced hypotheses about the typologies and types of owners that may represent the best candidates for partnership for preservation. Our work this semester began with qualitative research aimed at refining our assumptions, uncovering the barriers local owners face to finance capital improvements, and investigating what types of incentives owners may value.

We interviewed a number of local housing experts in Austin who specialize in multifamily development both for and not-for-profit. We worked with other Practicum teams to develop interviews with local owners of small multifamily properties in Austin. Perhaps the greatest challenge to our previous assumptions resulting from this research concerned the notion of undercapitalization. While we had previously assumed that local owners of small properties had insufficient access to capital to make substantive improvements, our interviewees consistently asserted that this was not a major barrier.

In fact, our cash flow analysis, discussed below, confirmed that even affordable properties are likely generating sufficient income to sustain additional debt. Instead, the primary barrier is a lack of incentive, especially with vacancy so low in Austin. This issue must be seriously considered in the design of any viable intervention relying on voluntary owner participation and tolerance for the associated bureaucratic processes.

In an effort to identify potential financing tools to address the issues at hand, we reviewed a wide range of programs in Austin and best practices around the United States, categorizing them according to whether they are currently utilized, underutilized, under consideration, or unavailable for use in Austin.

For each, we noted the administering agency, sources of funds, and eligible uses. This information was derived from government websites, preservation literature such as Minnesota Preservation Plus Initiative’s report on light-touch preservation The Space Between (2013) and Harvard Joint Center for Housing Studies’ Profiles in Preservation (2015), and interviews with local housing experts.

Our final selection of finance tools to model depended on four characteristics: (1) legality—the tool is available for use in Austin without necessitating major legislative change; (2) responsiveness—the tool can be deployed relatively quickly as fleeting preservation opportunities arise; (3) scalability—the tool is feasible and economical for use on the necessary scale to achieve the full preservation objective resolved by City Council; and (4) the tool provides an incentive for voluntary participation by multifamily housing owners and other partners in a market where low vacancy means that business as usual is often the most profitable option.

With these criteria in mind, we selected the following tools for assessment:

- Energy efficiency rebate and savings
- Property tax exemption
- Low-interest improvement loan
- Land sale

2. Baseline Cash Flow Models

In order to model the costs and impacts of the potential preservation tools, we first developed a baseline cash flow model for property typologies common in each corridor. We sought to understand the cash flow these properties generate as well as the range of profits the owners expect. To conduct this analysis, we used a standard multifamily 10-year pro forma template. We controlled the rent rates, capital reserves, operating expenses, property tax rate, and mortgage terms across both scenarios. Key assumptions were derived from conversations with developers, property owners, and affordable housing experts, as well as Austin-based case studies and national property management survey results.

We controlled income generation by using the set base rent rates for efficiencies, one-, two-, and three-bedroom units as established by HUD’s income limits for residents earning 60% of the area median income (AMI) (2015). As the goal of this work is to preserve units for this income bracket of the population, we decided it was important to base our assumptions and results on the premise that these properties are currently affordable. In this way, we were able to analyze what level of subsidy is necessary to maintain these rent rates and protect these rates from rent growth which would result in displacement.

Rents grew across all multifamily property types in Austin about 6% between 2013-2014, which we used as the baseline market growth rate (Marcus & Milli-chap, 2014). It is likely that growth rates for Class C properties is higher, though that data was unavailable at the time of modeling. Austin is also experiencing cap rate compression (CBRE Cap Rate Survey, 2014).
Even for Class C apartment complexes, we used a relatively low cap rate of 7%. This compression is reflected in sales prices for comparable properties which exceed the capped income for these properties, suggesting investors are confident in the ability to generate value in these underperforming assets. Similarly, vacancy in Austin is low. We used an occupancy rate of 96%, which was confirmed by several interviewees who elaborated on the point that tenant retention is critical to their business model.

Both models assume the current owner purchased the property five years ago with 25% equity and 75% debt. The mortgage calculations use an interest rate of 3.75% based on 2010 rates (Federal Reserve), amortizing payments over 25 years, and maturing in 15 years. We used standard capital gains tax rates, deducted interest annual, and used the appropriate income tax bracket depending on the amount of cash flow.

We developed operating expense assumptions using a combination of general industry practices and official operating expense surveys of garden apartment complexes (NAAHQ, 2014). A general rule among amateur property managers is that operating expenses should average about 25 to 30% of gross rent. In our models, the per unit operating expenses taken from surveys averaged out to roughly 30 to 33% of gross rent. This slightly higher expense rate reflects the age and condition of the older properties we examined. This was later confirmed by another small property interviewee who budgets upward of 45% of gross rent towards operations.

Tables of our assumptions and snapshots of the 10-year operating pro formas are available in the appendix.

The Burnet Road model is based on a small property of 10 units including a mix of efficiencies, one-, and two-bedroom units with set base rental rates at 60% AMI levels. Under our assumptions, we found that these owners are receiving strong returns, even with rents stabilized at 60% AMI and a modest 3% annual growth rate. Our analysis suggests that these owners are receiving approximately 40% returns on their equity in these properties. However we posit that because yields are high and vacancy is low, there is little reason for small property owners along the Burnet Road corridor to rehabilitate their units, or to sell to an operator that would acquire, rehabilitate, and hold as an affordable property. These properties appear to be strong investments.

Here, the key challenge is that, while we identified viable tools that would allow owners to perform necessary upgrades to their building without displacing residents, the incentive for them to do so is minimal. We hypothesize that when the Austin rental market begins to cool down, vacancy begins to rise, and rent growth slows, there may be a greater incentive for landlords to perform upgrades in order to attract qualified tenants. As we ran our analyses of the potential tools, we held constant or slightly increased the expected return on equity rates that the property owners would expect under the baseline scenario with no interventions.

The Riverside Drive model is based on a medium-large sized property of 110 units including a mix of efficiencies, one-, two-, and three-bedroom units with set base rental rates at 60% AMI levels. Our original hypothesis was that these larger properties would be better capitalized and able to perform rehabilitation using some existing cash flow. Based on similar if not higher operating assumptions as the Burnet property model, we found the large Riverside property to be underperforming by market conditions. Return on equity figures were low, around 15%, especially compared to Burnet. In Austin’s current market conditions, this is simply not a viable project. From these results, we hypothesize that these properties cannot be charging base rents as low as 60% AMI levels, and in some cases many of these properties may already not be affordable to the target population.

In reality, many of these property owners carry little to no debt and their cash flows greatly exceed our expectations. For the purposes of this analysis, however, we chose to place debt on these properties in order to understand the possibilities for preservation for the most cost-burdened property owners. For both typology models, we assumed that the baseline market-based scenario would include rent growth of up to 6%, the average rate of growth in the Austin market. At this rate, residents earning 60% of AMI would be displaced within 1-2 years if there were no intervention to preserve these units.
Part II

1. Light Touch Tools

Energy efficiency rebate and savings

The first tool we assessed is a voluntary performance-based utility rebate program. Austin is among a relatively small number of major US cities that have a public electrical utility provider. This enables the City to work closely with Austin Energy to align its social, environmental, and economic goals. It is now a citywide objective to reduce peak energy consumption by 800MW by 2020 from the 2007 baseline figure. To this end, Austin Energy recently implemented a rebate program with funding from the American Recovery and Reinvestment Act to promote energy efficiency upgrades in multifamily housing (Kennedy, Grahn, & Knop-Narbutis, n.d.).

Considering this program’s success, the rebate amounts offered were assumed to be sufficient to attract participation from owners, but rental data for their properties were not available. Per-unit improvement costs for the model were derived from a report on the HUD Green Retrofit Program (Braman, Kolberg, & Perlman, 2014). Additionally, common area utility expenses were reduced in the cash flow. We then reduced common area utility expenses by 15% for years 2-10 in the pro forma.

In 2015 dollars, the utility savings over nine years for the landlord is approximately $18,000. However the net present value of the initial investment of $25,000 and nine years of savings is negative. This will not payback within the 10 year period and by itself is not a good investment. If our model represents the average case, the average rebate would have to be increased from $750 to $1,100 in order for the utility savings to pay back the initial investment. It is important to note that these utility savings are calculated in 2015 USD and not discounted to the present value.

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For the Burnet property, we modeled full weatherization and energy-efficiency improvements in the first year, with these costs offset by credits by 38%. This program would expect the landlord to provide the remaining cash to pay for improvements, which is feasible between their budgeted reserves and project cash flow. We then reduced common area utility expenses by 15% for years 2-10 in the pro forma.

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Alone, weatherization and energy-efficiency accounts for only about 10% of the total amount needed to fully rehabilitate aging rental units. While these improvements increase tenant comfort and reduce tenant energy costs, many of these investments do not necessarily allow landlords to increase rents the same way that upgrades to finishes, appliances, exterior materials, and landscaping do. As such, we suggest that the improvements be bundled in with total building rehabilitation in order for this tool to be attractive to landlords.

Combined with a property tax exemption, discussed below, completing energy efficient upgrades would allow tenants to remain in more efficient and comfortable homes. Because studies suggest that tenants receive 85% of the energy savings, the landlord could increase rents by 3% instead of 2% and tenants would still be paying the same amount of rent as a proportion of their income.

Property tax abatement

The next tool we assessed is a tax abatement program on multifamily properties that commit to certain limitations on rent growth. Rather than offering a tax credit, the taxing authority would abate some or all of the property taxes owed and forego the associated revenue. The justification is that the market value of the property is at least in part a product of the rental income it is able to generate, which would be reduced through participation in such a program.

Typically, individuals must negotiate with the Travis Central Appraisal District on a case-by-case basis if they believe their property has been over-valued. Tax abatement is currently available for non-profit-owned low-income housing in designated municipal zones, but no comparable program exists for for-profit owners. Property in Austin is subject to a number of different taxing authorities, and it may be difficult to coordinate compliance from each one. Rather than a partial abatement of assessed value from multiple taxing authorities, a full abatement from the City of Austin was modeled, with unabated taxes paid to the other authorities. The objective of this assessment was to determine whether the tax abatement was sufficient to compensate owners for foregone income due to limitations on rent growth.
A full abatement of City of Austin property taxes provides property owners relief of approximately 20% of their annual property tax bill. The property owner would continue to pay property taxes based on a rate for the Austin Independent School District, Travis County, Travis County Healthcare District, and Austin Community College. We modeled this exemption for the 10 year period, not including the first year. We held the rent growth rate constant at 2% per year, controlling against market pressure to grow rents between 5 to 6%, which would displace current residents at 60% AMI. This exemption appears in our model to allow the property owner to maintain their expected annual yield on equity while holding rents at only 2% growth.

Currently this tool is available to properties within tax increment financing districts (TIF), enabled by Homestead Preservation Districts within the City of Austin. In 2015 dollars, the 10-year public subsidy to exempt these units from City of Austin property taxes is approximately $4,000 per unit. Using a 7% discount rate subsidies. For example, an interest rate of 2.50% on a rate for the Austin Independent School District, Travis County, Travis County Healthcare District, and Austin Community College. We modeled this exemption for the 10 year period, not including the first year. We held the rent growth rate constant at 2% per year, controlling against market pressure to grow rents between 5 to 6%, which would displace current residents at 60% AMI. This exemption appears in our model to allow the property owner to maintain their expected annual yield on equity while holding rents at only 2% growth.

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**Land sale**

The final tool we assessed is a land purchase and leaseback in order to simultaneously provide equity for substantive improvements and produce a long-term affordability commitment on the property.

In this model, an entity such as the Austin Housing Finance Corporation purchases the land from beneath the structure and leases it back to the owner. The building owner makes lease payments to the financing entity over time, but proceeds from the land sale are immediately available to finance rehabilitation.

The agreement caps rent growth and grants the financing entity right of first refusal if the owner sells the building in order to maintain affordability. The objective of this assessment was to determine whether the land sale was sufficient to enable owners to perform and benefit from the improvements without accelerating rent growth.

The model assumes a $10,000 annual lease, based on precedents reported by Austin Housing Finance Corporation. While the owners would owe an initial capital gains tax, the property would be exempted from property taxes as a result of relinquishing ownership of the land. Taking into account the sale proceeds, lease payment, capital gains tax, property tax savings, a $500,000 complete rehabilitation of the property, and a rent growth cap, the owner would yield a net profit just less of $100,000.

While this may seem like the ideal option for the owner, the tenants, and the City, it is most appropriate for non-profit ownership. As many small property owners likely hold their assets as long term investments in which they plan to sell in order to retire or fund a child’s higher education, removing the property’s greatest value - land - is not attractive.

While the property owner will receive profit today, they will likely receive below market value for their building in future years, as the land is no longer part of their investment. In this way, the land sale option is not an attractive real estate investment.

We recommend this option for non-profit operators or as a tool to finance acquisition-rehabilitation over a period of years.
2. Acquisition - Rehabilitation

The cost for a government agency or developer to acquire, rehabilitate, and hold a property at affordable levels is one third to half the cost than if the same agency were to construct new units (cite?, year). In Austin, this method is particularly attractive as (1) construction costs for new projects have increased between 12-15% annually for the past five years (cite?, year); (2) regulations such as residential compatibility render many infill properties undevelopable for multifamily uses (cite?, year); and (3) as neighborhood groups continue to react negatively to new affordable housing projects located in high opportunity areas (cite?, year). Acquiring and rehabilitating affordable homes allows government agencies or developers to avoid the regulatory risk associated with any kind of new development in Austin, posed both by exclusionary neighborhood groups and slow and complex regulatory processes that make any kind of infill, particularly affordable infill housing, difficult.

Given proximity to transit and access to jobs, services, and schools, we hypothesize that the best properties for the acquisition-rehab strategy include:

- a) medium sized properties (20-60 units);
- b) properties controlled by absentee owners or unso-
  phisticated property managers;
- c) properties in poor condition but not in urgent need of redevelopment;
- d) distressed assets such as bank-owned properties;
- e) properties where sale to an investor would result in total tenant displacement; and
- f) properties whose tax credits are nearing expiration.

Predevelopment costs for acquisition-rehab are minimal. As we learned in interviews, developers conduct standard feasibility analyses, and pay for environmental and property condition reports, which are especially important for older properties that may contain hazardous materials and require substantial rehabilitation work. As the financing for rehabilitation tends to roll into permanent financing for the long-term mortgage of these assets, there is little need for public subsidy in these stages of the process.

It is neither common practice nor a recommendation that the “strike” fund be used to subsidize ongoing operations of these properties.

For government agencies or developers, the best po-
  tential use of intervention funds in the acquisition-re-
  hab process is for the acquisition itself. Quickly deployable funds provided by the “strike” fund would allow developers to compete with investors. Investors are able to pay more for properties because their business model is to increase rents upon acquisition, which increases their cash flows and valuation of the property, thereby increasing the amount they can pay for land.

Quickly deployable funds are also beneficial to developers who must compete for low-income housing tax credits to make their projects viable. As the tax credit allocation process only occurs once per year, “strike” funds would enable these developers to bid for prime properties when they otherwise could not due to lengthy capital sourcing timelines.

Five case studies from the Austin Neighborhood Housing and Community Development Department suggest that, historically, the City of Austin’s general obligation bonds have subsidized five acquisition-re-
  hab developers between $18,000 and 34,000 per unit (NHCD, 2015). Median per-unit subsidies for these five studies is $23,000. These forgivable loans provided by the City to de-
  velopers are but one slice of a large stack of capital sources. As such, this $23,000 figure is only the subsidy provided by the City of Austin—all projects received other public subsidies, such as low-income housing tax credits. It is important to consider that this may not be the full amount of subsidy necessary to incentivize more developers to acquire and rehabili-
  tate properties and maintain affordability over time.
Affordable Housing Preservation Finance Strategies

**Programs**

- **Energy Rebate**
  - Rebate program for energy efficiency upgrades, resulting in reduced utility bills
  - **Subsidy**: $750/unit
  - **Impact**: Tenant affordability, building performance

- **Tax Abatement**
  - Partial abatement of property taxes based on affordability preservation within TIF districts
  - **Subsidy**: $4,000/unit over 10 yrs

- **Improvement Loan**
  - Low-interest, long term loan to finance capital improvements
  - **Subsidy**: $2,700/unit over 10 yrs

- **Land Sale**
  - Land purchased from and leased back to owner; owner retains building
  - **Subsidy**: $24,000/unit

- **Acquisition Assistance**
  - Quickly deployable gap financing for third party developers
  - **Subsidy**: $23,000/unit

*Explanation of model assumptions, mechanics, and results available in full: https://soa.utexas.edu/work/green-inclusive-corridors.*
1. Recommendations

In order to achieve the three goals of tenant affordability, property rehabilitation, and landlord incentive, our findings suggest that two “light-touch” preservation strategies will work best in combination with each other.

First, exempting properties from City of Austin property taxes potentially offsets the loss of rental income a landlord would receive due to a commitment to cap rent growth at only 2% per year in order to prevent tenant displacement.

Second, to rehabilitate the property, it is feasible for a small property owner to take on a mortgage for an improvement loan with favorable terms and subsidized interest rates. The combination of these two strategies may make it possible for small property owners to improve and hold their assets and allow tenants who earn 60% of the area median income to remain in place.

However, the success of light-touch preservation strategies are dependent on market conditions, as property owners require an incentive to take on additional debt to make the improvements.

Our findings suggest that these strategies would be more successful in slower market conditions with higher vacancy and cap rates than have been witnessed in Austin in recent years.

The amount of public subsidy necessary to make these two light-touch strategies possible for small property owners is approximately one third of the subsidy that the City of Austin has contributed to recent affordable acquisition-rehab projects.

Light-touch preservation allows small owners to improve their properties, provide affordable units, and maintain a fairly stable yield on their equity.

This strategy is important for the City of Austin to consider as these small properties which provide affordable housing in high opportunity areas are likely too small for the acquisition-rehabilitation strategy to make financial sense.

2. For Further Research

The predictive power of the analyses discussed above is highly contingent on the accuracy of the underlying assumptions used. Further research may be necessary to validate these assumptions, including further qualitative inquiry of local multifamily housing owners.

However, we believe that, having held the assumptions constant through the modeling of each tool, the comparative assessment leading to our final recommendations is sound.
References


