How Private Equity Can Help Low-Income Communities

"NEF’s Multifamily Affordable Rental Housing Private Equity Fund goes far beyond financing….It brought the Baseball Hall of Fame from Cooperstown to San Diego’s South Bay, via broadband programing, to provide an incredible after school program that uses baseball to teach cultural diversity, science, statistics, geometry and healthy living to the kids living in these communities."

– Linda Mandolini, President of Eden Housing

Our nation is in the midst of a severe affordable housing crisis. A significant amount of capital is needed to address it. Investment efforts must focus not only on building new affordable housing supply but, importantly, on preserving existing affordable housing assets.

Morgan Stanley, through the firm’s Global Sustainable Finance group (“GSF”), has joined with mission-oriented partners to bring much needed capital to help address the affordable housing problem, in the form of private equity.

The private equity investment strategy, implemented in partnership with the National Equity Fund (“NEF”), a nonprofit general partner, provides bridge financing to mission-oriented affordable housing sponsors that allows them to acquire and secure multifamily affordable rental housing properties that are approaching the expiration of their government subsidy programs. By securing and maintaining control of such properties, the sponsor gains the time required to reposition the buildings and obtain permanent financing to preserve affordability, which eliminates the risk that the affordable properties will be lost to market-rate ownership.

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An Attractive Impact Strategy

This article provides high level background on the affordable housing crisis and why a private equity strategy to preserve existing affordable housing supply has much to recommend it. To borrow a popular communications tool, we have developed a “Top Ten” summary:

Top Ten Reasons Why a Mission-Oriented Affordable Rental Housing Private Equity Fund is an Attractive Way to Help Low-Income Communities

10. Investors can participate in an emerging new impact asset class.

9. Investors can both help low-income communities and enhance government efficiency because affordable rental housing preservation requires less government subsidy per door than new construction, making the preservation strategy a taxpayer-friendly way to generate positive social returns.

8. An investment helps address a dire need for flexible mission-oriented bridge financing that can cover up to 100% of project acquisition costs.

7. An investment generates high impact with low relative risk given the characteristics of affordable rental housing (supply shortage, high demand during strong economic cycles, higher demand during weak economic cycles).

6. An affordable rental housing preservation private equity fund can be structured to provide current income and short duration, which facilitates earlier return of capital to investors relative to traditional private equity funds (e.g., the NEF preservation funds described below had five-year terms compared with traditional ten-year terms of traditional private equity funds).

5. An affordable rental housing preservation private equity fund is not correlated with market-rate housing private equity because demand for affordable rental housing units increases during weak economic cycles.

4. For bank investors, an affordable rental housing preservation private equity fund qualifies for CRA credit.

3. Investors have an opportunity to partner with highly experienced, mission-oriented fund managers like NEF.

2. Mission-oriented private equity funds can construct intentional-impact mechanisms like a set-aside from fund fees to pay for resident and neighborhood social services.

1. Mission-oriented private equity funds could potentially provide compelling, double-bottom line, attractive risk-adjusted total financial returns and social returns.

Risks

There are risks associated with mission-oriented affordable rental housing private equity that invests in government subsidized multifamily rental housing.

There is take-out risk associated with the public sector subsidies needed at exit to ensure a property’s long term affordability. Should government entities lose the ability or desire to continue subsidies, it would likely be difficult to maintain affordability and could result in a sale at exit that ultimately converts rents to market-rate. The resulting decrease in affordable housing supply generates a negative social return.

There is also interest rate risk. Should interest rates increase, property values may decrease.

The Preservation Challenge

Community Development Financial Institutions (“CDFIs”) were created to lead community revitalization and economic development in the nation’s most underserved communities. The nation’s largest CDFIs invest heavily in affordable rental housing because it is the pillar of any healthy community, and housing investments are often the basis upon which additional economic

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development capital flows.

However, as a result of many forces, the supply of affordable rental housing in the U.S. has been diminishing. The number of apartments deemed affordable for very low-income families across the U.S. fell by more than 60 percent between 2010 and 2016, according to a recent Freddie Mac report².

Generally speaking, affordable rental housing in the U.S. is built with both private capital and government incentives, including the essential federal Low-Income Housing Tax Credit ("LIHTC") program and other programs funded by local entities such as New York City’s Department of Housing Preservation and Development. Often, these programs support new rental housing production, for which there is great demand.

However, new construction is significantly more expensive than preservation of existing properties; taking into account the entire lifecycle of a property, new construction still costs 25-45% more per unit than preservation according to the Center for Housing Policy³. Thus, preserving the existing affordable rental housing stock, through both the physical rehabilitation of existing properties and extension of the affordability period as per their government contracts, is an economically efficient and taxpayer-friendly strategy.

The Growing Opportunity

Private equity is an effective tool to help preserve affordable rental housing because it is a flexible form of capital that can be rapidly deployed in custom-tailored structures designed to meet the needs of local and mission-oriented sponsors.

Several years ago, Morgan Stanley GSF joined forces with NEF to respond to the critical need for capital to assist South Bronx-based multifamily affordable rental properties suffering from severe physical and financial distress. GSF and NEF eventually formed two private equity funds to finance the complex rescue transactions. That initiative provided over $100 million to rescue 819 affordable apartment units, home to more than 2,500 New Yorkers.

Following on their New York City success story, NEF and GSF applied the private equity model nationally to another aspect of the housing crisis: the desperate need to preserve multifamily affordable rental housing at risk of loss due to expiring government subsidies (e.g., federal LIHTC and/or local programs). Without the government rent-restrictions accompanying those subsidies, properties can be converted to market-rate units, especially in hot real estate markets, and low-income residents could be displaced.

Since inception, the Morgan Stanley and NEF affordable rental housing preservation private equity funds have provided more than $186 million for the acquisition and preservation of 4,353 affordable housing units in 22 developments.

The Business Model

With NEF as general partner and Morgan Stanley GSF as sole limited partner, the private equity strategy provides flexible capital to help mission-oriented sponsors acquire at-risk properties and preserve affordable rental housing. Under this scenario, affordable rental housing is preserved when mission-oriented sponsors negotiate with government officials to extend rent-restrictions and provide additional subsidy.

One such sponsor is Eden Housing, a non-profit affordable housing developer and owner in California. “Our partnership with the NEF private equity fund, sponsored by Morgan Stanley, and access to their private equity capital has allowed us to move quickly and effectively to take on some very complex preservation projects, so that we are able to protect both the properties and the residents,” said Linda Mandolini, President of Eden Housing.

As part of its mission-oriented activity, NEF sets aside a portion of the fees it receives for managing the fund to pay for support services such as after school education, college readiness, job preparedness, and community garden programs. Those support services add value to

² Freddie Mac Multifamily in Focus, Rental Affordability is Worsening (November 2017).
³ Working Paper for the Center for Housing Policy, Comparing the Costs of New Construction and Acquisition-Rehab In Affordable Multifamily Rental Housing: Applying a New Methodology for Estimating Lifecycle Costs (February 2013).
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the quality of life for building residents and the surrounding community.

“Thanks to the NEF private equity fund we were able to bring our expertise to nearly 600 affordable apartments in two communities in San Ysidro in southern California,” noted Eden Housing’s Mandolini.

The partnership between NEF and GSF works well because of the partners’ shared mission and complimentary assets:

Both NEF and GSF are focused on generating significant positive community impact. Both are financially savvy investors focused on employing efficient strategies to ensure sustainable affordable housing solutions.

GSF is a private sector partner that seeks to form public/private partnerships and collaborations with mission-oriented entities. NEF’s position as a top Low-Income Housing Tax Credit syndicator makes it a sophisticated general partner and private equity fund manager that can deliver world-class transaction origination, execution, portfolio management, servicing, and dedication to providing quality resident services.

NEF and Morgan Stanley GSF are exploring ways to expand the array of mission-oriented private equity funds and broaden the network of impact-focused partners.

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