

FINANCING PERMANENT SUPPORTIVE HOUSING IN LOS ANGELES

CHALLENGES AND OPPORTUNITIES IN A NEW ERA



FINANCING PERMANENT SUPPORTIVE HOUSING IN LOS ANGELES

ACKNOWLEDGEMENTS

The following research would not be possible without the contribution of numerous individuals. We are indebted to their intellectual and editorial support these past two years as we dove into the multifaceted world of permanent supportive housing financing.

Enterprise Project Team:

Jen Buxtin, Director, Portfolio Administration & Central Region
Reagan Maechling, Senior Underwriter
Ramon Mendez, Director, Solutions and Strategic Priorities, Southern California
Jeff Schaffer, VP & Southern California Market Leader
Lydia Tom, Senior Advisor, Building Sustainable Organizations
Marc Tousignant (lead author), Senior Program Director, Southern California

Additional Enterprise Support from:

Rob Medlock, Director of Portfolio Analysis, Asset Management
Ben Nichols, Vice President, Sustainability
Whit Spencer, Director of Financial Analysis, Asset Management
Mary Bushel, Senior Communications Specialist, Marketing & Communications
Nicole Gudzowsky, Director of Editorial & Design Services, Marketing & Communications

We thank Reagan Maechling for co-authoring the brief on *Targeting Relief Policies Among Housing Finance Agencies* and Ben Nichols and Lydia Tom for co-authoring the brief on *PSH Portfolio and Preservation Analysis*.

PSH Stakeholders:

We also would like to recognize the many representatives from public and private agencies that are on the forefront of financing and delivering PSH across Los Angeles County. Specific thanks are directed to the California Housing Partnership Corporation, especially Diep Do, for preparing a summary of PSH preservation challenges and recommendations. We also appreciate the ongoing partnership of A Community of Friends and Skid Row Housing Trust, two of the premier PSH development organizations in the nation, as they opened up their portfolios to inform our understanding of the physical and financial considerations related to preserving aging PSH properties. A complete list of organizations and contacts that shared their perspectives during roundtables and interviews is included in the appendix.

The Conrad N. Hilton Foundation:

Enterprise could not have undertaken this research without the generous funding support of the Conrad N. Hilton Foundation. The Foundation's commitment to ending chronic homelessness is embodied in its ongoing grantmaking to frontline agencies and intermediaries working tirelessly on this issue. Its leadership extends beyond financial support and into the many public and private initiatives that exemplify the dynamic momentum that is underway in Los Angeles and nationally to eradicate homelessness.

ABOUT ENTERPRISE COMMUNITY PARTNERS

Enterprise works with partners nationwide to build opportunity. We create and advocate for affordable homes in thriving communities linked to jobs, good schools, health care and transportation. We lend funds, finance development and manage and build affordable housing, while shaping new strategies, solutions and policy. Over more than 30 years, Enterprise has created nearly 320,000 homes, invested \$16 billion and touched millions of lives. Join us at www.EnterpriseCommunity.org.

Copyright © 2014, Enterprise Community Partners, Inc. All rights reserved.

CONTENTS

Executive Summary	4
An Analysis of the PSH Financing Landscape in Los Angeles	16
Targeting Relief Policies Among Housing Finance Agencies in California	32
Permanent Supportive Housing Portfolio and Preservation Analysis	42
Appendix: Summary of PSH Stakeholders Engaged in Year 1	58

Cover photo: Lincoln Hotel, sponsored by Skid Row Housing Trust. Photo by Jeffrey Horvath.
Page 7: Renato Apartments, sponsored by Single Room Occupancy Housing Corporation. Photo by Cade Martin.
Page 11: Gateways SRO, sponsored by A Community of Friends. Photo by Harry Connolly.
Page 17: Rivers Hotel, sponsored by Single Room Occupancy Housing Corporation. Photo by Jeffrey Horvath.
Page 23: Rainbow Apartments, sponsored by Skid Row Housing Trust. Photo by Gabor Ekecs.
Page 28: Gateways Apartments, sponsored by Single Room Occupancy Housing Corporation. Photo by Douglas Olson.
Page 31: Willis Avenue Apartments, sponsored by A Community of Friends. Photo courtesy of A Community of Friends.
Page 39: Dewey Hotel, sponsored by Skid Row Housing Trust. Photo courtesy of Enterprise Community Partners.
Page 43: St. George Hotel, sponsored by Skid Row Housing Trust. Photo by Larry Underhill.
Page 48: St. Mark's Hotel, sponsored by Skid Row Housing Trust. Photo courtesy of Skid Row Housing Trust.
Page 49: Crescent Hotel, sponsored by Skid Row Housing Trust. Photo courtesy of Skid Row Housing Trust.
Page 50: Sanborn Hotel, sponsored by Skid Row Housing Trust. Photo courtesy of Skid Row Housing Trust.

EXECUTIVE SUMMARY

BACKGROUND

Enterprise Community Partners received a two-year grant in 2012 from the Conrad N. Hilton Foundation to research challenges and solutions to the financing of permanent supportive housing (PSH) in Los Angeles. At the heart of this research, Enterprise was interested in identifying any possible mechanisms for stretching limited funding to produce a greater number of PSH units, especially in light of recent reductions of key public resources for affordable housing development. The research focused on four main objectives:

- Define and characterize the current financing system for permanent supportive housing production in Los Angeles
- Assess the impact that reduced public subsidies for PSH is placing on the nonprofit PSH housing development community
- Identify obstacles in developing and preserving PSH from a financing perspective
- Identify opportunities or new approaches for state and local government to respond to these changing market conditions

Our research resulted in the preparation of three distinct research briefs on this subject: (1) *An Analysis of the PSH Financing Landscape in Los Angeles*; (2) *Targeting Relief Policies among Housing Finance Agencies in California*; and (3) *Permanent Supportive Housing Portfolio and Preservation Analysis*. This Executive Summary serves to review important findings and recommendations from these briefs.

METHODOLOGY

The content for this research effort was shaped from a variety of sources. Throughout the grant period, Enterprise reviewed numerous studies and planning documents on the subject of affordable housing and permanent supportive housing; where applicable, those citations are provided. Enterprise also held a roundtable in March 2013 with PSH developers in Los Angeles. We later complemented what we heard during the roundtable with a series of individual interviews with each of those PSH development organizations in September 2013. These engagements served to explore developer perspectives on the financing environment for PSH production in Los Angeles.

To inform the analysis on PSH preservation, Enterprise extracted project performance data for 39 PSH developments in the greater Los Angeles area that were assisted through the federal Low-Income Housing Tax Credit (Housing Credit) program and that were still in the 15-year

initial compliance period. In its portfolio, Enterprise defines PSH projects as those with at least one-third of the units designated for households with special needs and where resident services are provided. Only properties with an Enterprise equity interest as of year-end 2012 were included in this research. We also drew upon insights from Enterprise-funded capacity building grants to three high-volume PSH developers in Los Angeles. These grants allowed these developers to conduct assessments of their portfolios and provide recommendations for repositioning aging PSH properties. Lastly, we contracted with an affordable housing development consulting firm, California Housing Partnership Corporation, to provide a separate analysis of barriers and strategies related to PSH preservation.

LOCAL FUNDING AND POLICY LANDSCAPE

Over the past five years, Los Angeles has experienced a decline in public resources for affordable housing development, of which PSH is a component, resulting in a vastly changing funding environment. Reductions have resulted from:

- The statewide dissolution of local redevelopment agencies (RDAs) in 2011, causing the loss of \$50 million in annual tax increment financing for affordable housing development in the city of Los Angeles
- A 51 percent cut in federal HOME funds allocated annually to the city of Los Angeles between 2009 (\$43 million) and 2014 (\$21 million)
- Federal sequestration and its constrictive impact on local public housing authorities that administer rental assistance programs (e.g., Section 8)
- The virtual depletion of bond-funded state housing and community development programs (Propositions 46 and 1C)
- The commitment of nearly all of the \$115 million in funding awarded to Los Angeles County under the California Mental Health Services Act (MHSA) Housing Program
- The lack of homelessness assistance funding for new project requests (e.g., Shelter Plus Care) in the 2012 or 2013 national Continuum of Care competitions

All told, local experts estimate that Los Angeles County has lost essentially \$0.5 billion in financial support for affordable housing in the past five years. At this point, despite aggressive advocacy for new resources, as exemplified in the industry's recent advocacy for a permanent state source for affordable housing development (embodied by SB 391), it does not appear these public sources will be restored. Yet because of the fragmented nature in which Los Angeles invests in PSH, there remains a limited understanding of the level of resources that flow into the PSH delivery system. This makes it difficult to assess the precise degree of PSH resources that were lost with these dramatic shifts in the funding landscape noted above.

In light of these environmental changes, there remains the countervailing pressure on the PSH delivery system to create additional housing to keep pace with unflagging demand. Analysis suggests that PSH production has accelerated in the past two years, and there was little evidence yet of a notable dip in PSH production in this post-CRA environment. Fortunately, there is a healthy PSH pipeline that predated the dramatic resource dip in 2011, fueled significantly by capital funding available through the MHSA Housing Program. Nonetheless, there are legitimate concerns about our ability regionally to sustain that pipeline in the years to come unless new resources are brought to bear to support PSH production efforts.

Fortunately, there have been encouraging signs in the PSH funding landscape for capital and operating support that may begin to offset the reduced investment from historic partners. The creation of the Los Angeles County Department of Health Services (DHS) Flexible Housing Subsidy Pool, a general fund allocation of \$100 million for the state Multifamily Housing Program for 2014-2015, and the passage of Proposition 41, authorizing \$600 million in existing bond authority to fund multifamily housing for veterans statewide, all bode well for the PSH development community.

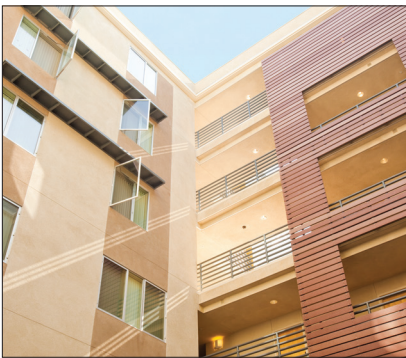
Other highlights from the financing landscape analysis are included below:

- Interviews with public officials responsible for allocating capital funding for PSH suggested that Los Angeles can realistically expect to finance three to five new PSH developments annually, assuming that the current level of Housing Credits do not decline further.
- The establishment of a geographic apportionment of Housing Credits for the city of Los Angeles and an accompanying the Housing and Community Investment Department of the City of Los Angeles (HCIDLA) Managed Pipeline process has been a “game-changer” that impacts the PSH development community in ways that cannot yet be fully assessed.
- Understandably, PSH developers expressed caution about this new process. Concerns centered around limitations on the amount of projects that a developer can have in the pipeline at any given time; selection criteria that they argue disfavors PSH projects; higher thresholds for community engagement; and compatibility with the new civic focus on transit-oriented development, as PSH developers compete for capital funding and project sites adjacent to transit corridors. Developers further warned that they likely will have to look outside of the city of Los Angeles for additional development opportunities.
- PSH stakeholders were also queried about notable trends they have seen in developing or funding PSH development across Los Angeles, all of which pose unique capacity challenges. Here is what they shared:
 - Public policy has shifted to target or limit PSH to chronic and veteran homeless populations, catalyzed by federal housing policy, implementation of the local Home for Good plan and the regional expansion of a coordinated assessment and entry process

(CES). Consideration needs to be given to the financial health of the development organizations that are being asked to deliver PSH in this new environment.

- o PSH developers will inevitably be drawn to focus more on re-investing in their existing portfolio as time progresses and resources shrink. This raises questions with regard to the technical capacity of PSH development organizations to effectively assess their portfolio needs and structure complex repositioning transactions. This trend also impacts the public sector, which has not developed sufficient policy regarding repositioning older PSH properties.
- o Capital funders are encouraging mixed-income, mixed population housing, in which a percentage of overall units in an affordable housing development are dedicated as PSH.
- o There has been an emergence of new players on the PSH marketplace, including both for-profit affordable housing developers and local funders (e.g., Los Angeles County DHS).

PROJECT UNDERWRITING, PERFORMANCE, AND RESERVES



The Enterprise PSH portfolio in Los Angeles is healthy overall and performing comparably to Enterprise's national Housing Credit portfolio. Average PSH occupancy rates were very strong (97.3 percent), the median debt coverage ratio (DCR) of 1.38 for PSH projects is slightly higher than the 1.29 of the general Enterprise investment portfolio, and almost three-quarters (72 percent) of PSH projects showed positive cash flow all three years (2010-2012). Although PSH properties typically have a small margin for operational error – due to deep income targeting, limited rental income, and higher operational expenses – this finding is a testament to a strong ownership ethic among PSH developers, a high, unwavering demand for PSH units and the importance of a stable stream of project-based rental assistance.

Enterprise also sought to better understand the factors behind the sizing of project reserves during underwriting and if in fact reserves in operational PSH projects might be excessive. We found that:

- Projects requiring larger than standard or minimum reserves were driven by the risk of the potential loss of project-based rental assistance, since many of these forms of subsidies (e.g., Section 8) are subject to federal appropriations. In essence, because PSH projects are so often packaged with project-based rental subsidies to ensure financial viability, the reserve sizing is simply a function of the subsidy's contribution to the project and not based on it being supportive housing, per se, or serving homeless households.
- The projected operating deficits resulting from potential loss of rental assistance in supportive housing is impacted by the combination of very deep income targeting that is often required by state and local housing finance agencies and limited up-front assurances that these requirements would be relaxed in the event such subsidies were discontinued or eliminated.

- Providing so-called “targeting relief” for PSH projects, triggered upon the reduction or loss of project-based rental or operating assistance, can make a substantial impact by mitigating capitalized reserve requirements and sizing those reserves closer to minimum or standard levels. Such policies also free up scarce resources to create additional units and promote fiscal integrity for assisted projects. Unfortunately, not all state or local housing finance agencies have incorporated such relief in their capital funding programs or included such “relief language” in their recorded regulatory agreements. See *Targeting Relief Policies Among Housing Finance Agencies in California* for more information about the variation and financial impact of targeting relief on project financing.
- Financial reserves in the Enterprise Los Angeles PSH portfolio are healthy but should not be deemed excessive when considering: (1) public subsidy risk given the deep income targeting of PSH, and (2) the need to maintain this housing resource over the horizon of 55 years of committed affordability (includes 15 years of Housing Credit compliance and 40 years of extended-use) in California. Project reserves are a key resource in addressing those long-term needs since there is no guarantee of an injection of new resources at the end of the initial Housing Credit compliance period.
- Sixteen of the properties in the LA PSH portfolio carry must-pay debt. Of these, eight have 100 percent or nearly 100 percent of total units as PSH, while the other eight have less than 50 percent of units dedicated for that purpose. These latter properties appear to be leveraging the non-PSH units as a way to pay down the must-pay debt. While not all non-homeless populations pay higher rents, it appears the owners are using a leveraging model to their advantage, using less total subsidy to develop a property.

PSH PRESERVATION

The assessment of 39 PSH projects in Los Angeles was intended to inform future underwriting, determine whether units might be at risk and develop a preservation strategy for this portfolio. There are both physical and financial challenges related to preservation that must be considered as stakeholders seek strategies to reposition PSH properties.

Physical Challenges

- The first generation of existing PSH units are SRO and efficiency units, which could be challenging to fully reconfigure or expand to meet accessibility needs of persons with disabilities.
- At initial acquisition and/or syndication, many older PSH properties had minimal or moderate rehabilitation work completed. In contrast to current industry standards and current advances in building science for improved energy-efficiency and water conservation, as well as the growing importance of asset management, there was less focus then on long-term financial sustainability. These older properties likely have deferred maintenance and need more expensive building systems upgrades to comply with today’s seismic codes and to allow for accessibility, especially to meet the needs of residents aging in place and/or those with physical disabilities.

- Projects requiring significant rehabilitation may need to relocate tenants temporarily within the building or off-site. Relocating PSH tenants off-site, especially for those with severe mental illness, creates challenges ensuring continuity with site-based supportive services as well as financial burdens if the owner needs to lease market-rate units.
- Programmatic concerns remain an overriding concern for PSH sponsors when it comes to investing in physical needs. On-site supportive services are critical to success in PSH, yet the layouts of many older PSH buildings are obsolete. They neither contain sufficient office space for on-site management and supportive services staff, nor common spaces (e.g., community rooms) that are important for community building activities.

Financial Challenges

At the state and local level, more proactive policy development regarding PSH preservation would be welcomed, accompanied with a plan to use capital and operating funds to support preservation strategies. The California Department of Housing and Community Development (HCD) and HCIDLA are moving toward instituting uniform policies for the restructuring of existing, agency-financed affordable housing projects, yet these efforts are not finalized nor do they apply uniquely to PSH. These efforts need close monitoring and engagement from PSH stakeholders to ensure they address PSH preservation needs.

- The dissolution of redevelopment agencies in California and the overall decline in state and federal funding for affordable housing has led to increasing prioritization of new PSH for people who are chronically homeless. Current PSH projects whose formerly homeless tenants no longer meet (chronic) homeless eligibility criteria are either ineligible or unable to remain competitive for local or state homelessness assistance funding.
- The existing affordability restrictions that cap/limit rental increases on older PSH properties pose a barrier to the ability to leverage new debt. Higher operating expenses and limited rental revenue in PSH already make it difficult to finance conventional debt. Further, limitations on income or population targeting and subordination to new senior debt can all be obstacles for project sponsors seeking to restructure loans with existing soft lenders.
- Current rents and annual rent increases associated with common project-based subsidies in PSH, such as the Shelter Plus Care and SRO Moderate Rehabilitation programs, have been insufficient to cover operating expenses and thus can leave projects with limited financial strength. Among one of the largest PSH developers in Los Angeles, all nine properties with Shelter Plus Care contracts have ongoing net operating deficits, even those that are new construction and built in the 1990's. This same sponsor has had to subsidize building operating deficits with its own financial resources, which is hardly sustainable and places a tremendous financial risk to the organization.

- Moreover, the Los Angeles Continuum of Care now limits rental assistance awards to one year. Investors and lenders are reluctant, if not unwilling, to underwrite such assistance as long-term subsidy contracts.
- The reduction in federal and state resources for affordable housing development has placed pressure on local housing finance agencies to seek repayment (or partial payment) of existing principal debt on PSH loans to generate income. In Los Angeles, housing officials cite this strategy as an important revenue opportunity to support future affordable housing investments.
- PSH projects often have nominal appraised value at Year 15, beyond any remaining debt on the project, resulting in exit tax liability. Currently, HCD and HCIDLA do not permit sales proceeds from a resyndication to pay for exit taxes. A few nonprofit syndicators have agreed to write-off the taxes, but for-profit investors have not agreed to this. If sponsors are unable to pay the tax liability with their own resources, the investor may force the sale of the property.

There is no “one size fits all” strategy for preserving the aging PSH portfolio in Los Angeles. The 55-year affordability period for PSH projects in California is daunting, and all buildings will need some level of capital improvement during that time horizon. The challenge is how to continue to develop and operate quality PSH and meet capital improvement needs across the entire spectrum of properties while preserving these assets as they age.

- Even if rental subsidies are extended beyond the initial 15 year Housing Credit compliance period, only a handful of projects can be expected to operate successfully through the 40-year extended use period in California. Accounting for ordinary repairs and limited capital improvements over this extended use period, we estimate that only six properties in the 39 project sample will finish the 55-year period with positive reserve balances.
- Slightly more than one-half of the Enterprise PSH portfolio consisted of new construction projects. PSH providers reported that nearly all newly constructed PSH developments in their portfolio will have modest capital needs following the initial 15-year Housing Credit compliance period. These physical needs can be met with existing replacement reserves and operating cash flow.
- Based on cash flow analysis, some of the best performing properties could take on extra hard debt. Eleven properties could borrow at least \$500,000, and another five properties could borrow between \$200,000 and \$500,000. Eight of these properties would involve refinancing existing debt.
- Energy and water efficiency upgrades in rental housing are a cost-effective approach to lowering operating expenses, maintaining affordability for low-income households, reducing carbon emissions and creating healthier, more comfortable living environments, especially for people with special needs. With a modest recapitalization, energy and utility savings will prolong the financial viability of this critical housing and stretch the reserves.

Pursuing a fresh infusion of Housing Credits, known as resyndication, is unlikely to be the primary tool to preserve the aging PSH stock but could work for a subset. For PSH properties that are not performing well or barely breaking even, per unit capital improvement costs will exceed \$5-10,000 per unit. For this subset, including projects requiring major rehabilitation (or are tear down/new construction) or for larger buildings (100+ units), the best option is to infuse additional capital by resyndicating the property for another 15-year Housing Credit compliance period. These cases would maximize Housing Credits and allow for developer fees.

- In California, 9 percent Housing Credits are scarce, highly competitive and typically used for producing new affordable housing units. The inability of existing PSH projects to secure local homelessness assistance grants in turn negatively impacts chances for Housing Credit awards since leveraging public funding is essentially required to be competitive under current California Tax Credit Allocation Committee (CTCAC) regulations. Furthermore, not all potential PSH resyndication candidates may meet minimum rehabilitation thresholds, currently at \$40,000 per unit.
- It is therefore critical that 4 percent tax credits/tax exempt bonds be available for PSH rehabilitation projects. They are likely the most viable resyndication option, are non-competitive, appear to be underutilized at the local level and allow the bundling of projects for greater scale and volume to support additional fees and costs. The largest barrier for the 4 percent route is that projects will require higher levels of must-pay debt to cover the development costs unless there is additional public subsidy that can be dedicated.

CONCLUSIONS



Through the utilization of Housing Credits and leveraging additional public and private investment at the state and local levels, Los Angeles has done well to develop a robust inventory of PSH in the absence of a dedicated local funding source. Enterprise observed well-operated properties with healthy reserve balances in the early years, though threats remain during the ensuing extended affordability period. Sustaining PSH rests particularly on the foundation of maintaining project-based rental subsidy commitments that are able to escalate in tandem with increasing operation expenses and a continuum of supportive services to promote residential stability.

Preserving these properties over the full 55-year use period will be a challenge. In a time of flat to shrinking subsidy resources, public stakeholders will need to find a balance between supporting a growing, aging PSH inventory and the need to continue to build new PSH developments. Creativity in financing and policy will be of the utmost importance for success, and solutions will require flexibility from both public and private funders.

NEXT STEPS

Providing solutions to address the many challenges associated with financing PSH in Los Angeles is a complex task with significant variables. As we look ahead, Enterprise and our research partners developed the following recommendations, which fall broadly into six categories:

- (1) Promoting policy and/or regulatory change
- (2) Targeting resources more effectively
- (3) Exploring alternative financing models
- (4) Developing and implementing PSH preservation policies
- (5) Building organizational capacity
- (6) Engaging policymakers to increase PSH investment

We encourage PSH stakeholders to come together to consider these recommendations with the goal of establishing consensus on specific priorities that are both impactful and attainable. Of these, Enterprise looks to play a leadership or collaborative role advancing strategies in the areas of targeting relief reform, the use of publicly-owned parcels for PSH development, the development of PSH preservation policies and catalyzing efforts to assist PSH owners to reposition their portfolios. These strategies are in *italics* below along with the remaining recommendations.

Promote policy and/or regulatory change more favorable for PSH development

- *Incorporate and codify targeting relief provisions in capital funding program regulations as well as recorded regulatory agreements. Model targeting relief policies on promising examples from other state housing finance agencies, such as Washington.*
- Reconsider policy decisions that limit the eligibility of existing PSH projects to receive homelessness assistance grants.
- Advocate for sufficient rental increases in CoC-funded rental assistance programs.
- Convene PSH investors and CoC stakeholders to further understand, if not allay, concerns related to underwriting PSH projects that include project-based CoC-funded rental assistance.
- Ease constraints on below-the-line revenues and limits on cash flow that can be used to fund supportive services in site-based PSH.

Target resources more effectively

- Where feasible, consider converting SRO Mod Rehab subsidies to Section 8 Project-based Vouchers if project sponsors are unable to secure rent increases to accommodate escalations in project operating expenses.
- Utilize CoC reallocation opportunities to repurpose grant funding to convert low-performing transitional housing programs to PSH.

Explore alternative financing models to decrease reliance on traditional development sources

- *Leverage existing, publicly-owned real estate, such as former CRA parcels, for development.*
- Expand the use of master leasing models in existing multifamily properties.
- Continue to utilize and grow investments from the health sector to leverage capital commitments.
- Implement “pay for success” models to expand PSH supply and better outcomes within public systems with high recidivism rates (i.e., health, child welfare and criminal justice).
- Research integrated housing models and the economic impact of mixed-income, mixed population targeting on project-based subsidy needs.

Implement policy and financial solutions for the preservation of existing PSH

- *Ensure that existing PSH lenders adopt recapitalization policies that are sensitive to PSH preservation needs.*
- *Carve out local capital and rental/operating subsidies to preserve existing PSH, in particular those that are expiring Housing Credit projects or have existing local financing commitments.*
- *Prioritize resyndication of the inventory of older SRO buildings that are in need of modernization and are constrained by covenants or regulations restricting rental increases.*
- Protect project reserves and allow for greater flexibility in the use of project reserves, including allowing sponsors to pool reserves across projects.
- Access private financing for the best performing properties; work with public lenders to subordinate to new senior debt and appease lender concern about rental subsidy commitments. If small loans are unattractive to certain conventional lenders, consider a blended public/private loan to allow a re-underwriting of the project/portfolio for the extended use period.
- Obtain rental subsidies for unsubsidized PSH units to improve overall project health.
- Permit asset management fees as a standard above the line expense, separate from partnership management fees to support improved long-term planning for PSH portfolio.
- Maximize assistance through weatherization and utility rebate programs to provide energy-efficiency and water conservation upgrades in multifamily PSH.

Build the capacity of housing development organizations to successfully develop and operate PSH

- *Continue to foster efforts to assist PSH developers to analyze their portfolios, develop and implement repositioning strategies, and communicate preservation needs to public lending partners.*
- Educate PSH developers on opportunities to utilize less traditional development sources, such as Los Angeles County DHS funding, VASH and 4 percent Housing Credits, as well as to develop mixed-income, mixed-population developments.

Continue to engage and educate policymakers and public officials to sustain, if not increase, support and investment in PSH

- *Secure dedicated funds from the city and county for more affordable housing, including PSH.*
- *Work with stakeholders and PHA administrators to advocate for increased project-basing commitments under the existing regulatory ceiling.*
- Develop clearer annual PSH production targets.
- Advocate for additional allocations of capital and operating funding through the MHSA Housing Program.
- Maintain advocacy efforts to renew and expand the Housing Credit program.

AN ANALYSIS OF THE PSH FINANCING LANDSCAPE IN LOS ANGELES

INTRODUCTION

Purpose

In light of a dramatic reduction in public subsidies for affordable housing development (of which PSH is a component) in recent years, this specific financing landscape analysis focuses on the following objectives:

- Define and characterize the current financing system for permanent supportive housing (PSH) production in Los Angeles
- Assess the impact that reduced public subsidies for PSH is placing on the nonprofit PSH housing development community

In many regards, the task of analyzing the funding environment for any type of affordable housing, let alone PSH, is by nature a moving target. The supportive housing industry is constantly evolving since it relies so heavily on public investments, often subject to federal and state appropriations, and leverages countless other public and private resources as stakeholders develop, test and refine approaches to ending homelessness. This snapshot of the PSH financing landscape was developed primarily in 2013, with some limited updates provided in 2014.

Methodology

The information contained in this document comes largely from two sources. First, we engaged key stakeholders over nine months to learn more about their experiences developing and operating PSH and to solicit their opinions about possible refinements to the financing delivery system. Stakeholder engagement occurred through two forums, a roundtable with nonprofit PSH developers in March 2013 and individual follow-up interviews with 12 stakeholders (see Appendix). Second, we sourced materials from public records, community planning documents and outside research to round out our analysis.

Background

What we have learned so far is that the public subsidy picture for affordable housing production and PSH was unquestionably constricted in 2013, and had been in decline prior to that with the lack of a dedicated permanent source at the state or local levels and the well-publicized dissolution of local redevelopment agencies (RDAs) in 2011. Overall, we found inadequate objective information to describe how that trend has negatively impacted the regional PSH pipeline, nor is there enough evidence to suggest a drop in PSH production that parallels the drop in resources.

For the past five years there has been a diminishing trend in public resources for affordable housing development, with a more precipitous decline in the past two. The Southern California Association of Nonprofit Housing (SCANPH) estimates that \$91 million was invested in affordable housing (federal, state and local) in the city of Los Angeles in 2012. This represents an almost 67 percent reduction in funds from the previous year.¹ The drop since 2011 has simply been catastrophic:

- HOME entitlements dropped by more than 50 percent between 2010 and 2013 (\$43M to \$21M); FY 2013-2014 HOME Entitlement was reduced by an additional 11 percent
- Closure of the Community Redevelopment Agency of Los Angeles caused loss of \$50M in annual tax increment for affordable housing in Los Angeles
- Less than 15 percent of California Proposition 1C Housing & Emergency Shelter Trust Fund Act grant funding remains
- The city's Neighborhood Stabilization Program grant has been fully committed
- Federal Section 8 Project-Based Vouchers have been reduced due to sequestration²

Moreover, the Los Angeles Continuum of Care (CoC) did not receive an award for new homelessness assistance projects in the 2012 or 2013 national competitions, which in recent years have represented valuable tools to provide rental assistance for the chronically homeless. At this time, despite aggressive advocacy for new resources, as exemplified in the industry's support for SB 391 in 2013, it does not appear these public sources will be restored in the near future.

The impact of RDA dissolution on the PSH delivery system was an obvious impetus for this landscape assessment, yet the relationship between RDAs and PSH was a particularly difficult one to assess in Los Angeles. We know that the now defunct Community Redevelopment Agency of Los Angeles had been investing in PSH for some time. Redevelopment funding was often used as front-end capital to leverage other capital commitments from the state and federal government, yet there were not any reliable statistics, even estimates from local experts, on the amount of RDA investments in PSH. Estimates point to approximately 300 units of affordable housing built annually through the RDA in the city of Los Angeles, accounting for nearly 20 percent of total affordable housing delivered in the city. Some 827 RDA units were planned for completion in the city in the next two years, which now are expected not to receive funding.³

This reduction in public resources couldn't have come at a more challenging time, as the city and county of Los Angeles seek aggressively to show marked improvements in reducing homelessness in the region. Accordingly, there remains increased pressure on the PSH delivery system to create additional housing to keep pace with unflagging demand. A key goal of the Home for Good plan,

1 Email correspondence from SCANPH Executive Director Alan Greenlee (in response to an informational query from California Assembly member Adrin Nazarian, CA-46), August 26, 2013.

2 Los Angeles Housing Department 2013 Round 1 AHTF and Call for Projects Recommendations to City Council, June 20, 2013, p.8.

3 U.S. Department of Housing and Urban Development, Office of Policy Development and Research. *Redevelopment Agencies in California: History, Benefits, Excesses, and Closure*. January 2014.



widely regarded as the strategic plan to end homelessness in Los Angeles, is to create 12,000 permanent supportive housing units for chronically homeless by 2016, including 500 units per year through new construction or rehabilitation.⁴ That production target appears to have been subsequently reduced to 400 units per year with an expectation that local capital commitments for PSH will amount to \$20 million annually supported by approximately \$2.4 million in project-based rental assistance (representing 300 units through Section 8, Shelter Plus Care, VASH programs) to meet that goal.

Analysis suggests that PSH production has accelerated in the past two years. In 2011, according to Home for Good, we only created 211 PSH units through new development (little over 40 percent of the original annual target).⁵ But in 2012, that figure almost doubled, up to 394, essentially meeting the revised annual production target.⁶ At this time, we appear relatively close to keeping pace with that production level through existing 2013 funding commitments. Fortunately, there is a healthy PSH pipeline that predated the dramatic resource decline for affordable housing production in 2011, and that was fueled significantly by the state's MHSA Housing Program. Nonetheless, there are legitimate concerns about our ability regionally to sustain that pipeline in the years to come, as the following discussion elucidates.

OVERVIEW OF THE PSH PRODUCTION FINANCING SYSTEM IN LOS ANGELES

Our first objective in this landscape assessment is to provide some overview of the financing system for PSH in Los Angeles. This is hard to circumscribe, but we start with a disclaimer that our focus here is only upon the primary public agency production vehicles available for PSH development. Further still, we concentrate most on the city of Los Angeles and with notably less attention to the variety of other public funding programs that share a piece of the broader constellation of financing resources.

City of Los Angeles

The city of Los Angeles has historically played a major role in providing capital financing for PSH through the establishment of its Affordable Housing Trust Fund (AHTF) and specifically its subset, the Permanent Supportive Housing Program (PSHP). Though the AHTF was originally proposed at \$100 million, since its creation it has rarely approached that level despite pledges to do so from previous mayoral administrations. Instead, the city has been challenged to do anything more than cobble together its federal block grant resources (HOME, CDBG, HOPWA, etc.,) and package them

⁴ *Home for Good: The Action Plan to End Chronic and Veteran Homelessness by 2016*, pp.12-13. The 12,000 unit target includes housing created through turnover of existing PSH units, new construction/rehabilitation, and scattered-site leasing.

⁵ Home for Good, 2012 Update, p.18.

⁶ Home for Good, Year 2 Progress Report, p.6.

for release under this production tool. Nevertheless, the program has remained an important cog in the financing system with a strong leveraging characteristic (over 4:1). Since its inception (not including 2013 commitments), the city’s PSHP has provided financial support for 36 projects representing 2,288 units of permanent supportive housing. Approximately 68 percent (1,558 of 2,288) of those units receive Section 8 Project-Based (PBV) assistance (see below).

City of Los Angeles Permanent Supportive Housing Program Production (Since 2003)⁷

Number of Projects	36
Total Units	2,288
PBV Units	1,588
PBV Value	\$242,551,690
Capital Committed	\$136,569,099
Total Commitment (Capital & PBV)	\$379,120,789
Total Development Cost	\$754,721,439
Amount Leveraged	\$618,152,340
Leverage Ratio	4.53

In early 2013, the Los Angeles Housing Department (since renamed the Housing and Community Investment Department or HCIDLA) released \$18 million in General Fund allocation through the AHTF to provide capital support for permanent supportive housing to serve the chronically homeless. A total of eight applications were received, totaling \$15.6 million in funding requests. The city since approved \$12.6 million (includes approximately \$500,000 in HOME funds) in funding for four projects that represent 316 new PSH units, including 206 units for the chronically homeless.⁸ This investment, representing a final gesture for Mayor Villaraigosa’s supportive housing legacy, was driven primarily by housing production goals associated with the Jones Act settlement.⁹ Together with the General Fund allocation and the Housing Authority of the City of Los Angeles’s (HACLA)’s pledge of 300 Project-Based Section 8 vouchers for 2013 AHTF projects, the city says that these investments will allow them to exceed the Jones Settlement Agreement production targets expect. The Round 1 projects provide 206 additional units for the chronically homeless individuals outside of Skid Row and/or greater downtown. Overall, the total number of units dedicated to this population is estimated at 1,320 citywide.

⁷ June 20, 2013 LAHD Round 1 2013 AHTF Transmittal to City Council, CF# 13-0303

⁸ The city received eight project requests under this NOFA but ultimately recommended five projects. Two needed little or no subsidy from the City General Fund, resulting in over \$5 million from the original allocation. As a result, HCIDLA recommended that: (1) \$4 million be used for the acquisition and recapitalization of the Alexandria Hotel, to preserve the affordability of 463 units of low-income housing; and (2) the remaining \$1.9 million be transferred to the AHTF to create additional affordable housing.

⁹ This 2007 agreement between the city and fair housing advocates (ACLU and the National Lawyers Guild) mandated that, prior to re-enforcing a public sleeping prohibition ordinance, the city would create 1,250 new PSH units citywide, with at least 50 percent (625) of the units to be located in Skid Row and/or greater downtown Los Angeles. According to the city, by the end of 2012, 656 units were in various stages of development in the Skid Row area and/or downtown Los Angeles areas, surpassing the 50 percent goal. However, the city was 136 units short of meeting the overall goal of 1,250 units prior to release of Round 1.

The city attests that, despite cuts to affordable housing production resources and the various political transitions at the mayoral and council levels the overall commitment to permanent supportive housing production will remain steadfast. Conversations with leadership at HCIDLA revealed an affinity for PSH projects overall but sensitivity nonetheless to a few mitigating factors:

- The presence of other pressing affordable housing needs citywide
- A desire to not “flood” the California Tax Credit Allocation Committee (CTCAC) with PSH requests at the expense of advancing other affordable housing (e.g., families, seniors)
- The need to size their commitments with the availability of tax credits as well as local operating subsidies

Affordable Housing Managed Pipeline

There are two significant, interrelated shifts in the city’s approach to PSH that can be considered “game changers” and will inevitably define the local financing landscape in the foreseeable future:

- (1) The establishment of a unique geographic Low-Income Housing Tax Credit Program (Housing Credit) apportionment for the city of Los Angeles
- (2) The accompanying roll-out of a “Managed Pipeline” process to better control the application of scarce public resources for affordable housing projects.

As part of this new approach to affordable housing in Los Angeles, the HCIDLA expects to issue a semi-annual “Call for Projects” within its AHTF program to identify multifamily rental housing projects (for low- and very low-income households) that intend to apply for 9 percent Housing Credits in the upcoming round. In terms of advancing projects in the managed pipeline, the city’s aspiration is to ensure that there is a sufficient mix of project types, including PSH, so that projects are ready to compete as soon as possible in the next available CTCAC round. Additional program guidance issued by HCIDLA in May 2014 establishes additional tiebreakers for PSH projects looking to compete in the same CTCAC round: developments that have committed operating subsidies (Section 8, VASH), then those with committed financing and placed in service deadlines.

The efforts underway to better align the city’s managed pipeline process with the Community Development Commission of the County of Los Angeles (CDC) affordable housing bid process, including the timing of funding commitments, are certainly encouraging. HCIDLA staff expressed interest in improving coordination with their county counterparts, such as project selection for mutually attractive projects, site identification, how to define and meet transit-oriented development (TOD) policy objectives and project underwriting. The current partnership with the county service departments to evaluate supportive services plans (related to capital requests to HCIDLA) will continue and was cited as a successful partnership from the HCIDLA’s perspective.

PSH Developer Perspectives on the Affordable Housing Managed Pipeline

The HCIDLA considers the managed pipeline a work in progress that will continue to be refined, though the process is intended to provide more investment certainty to the affordable housing development community. There are obvious tradeoffs for project sponsors that may value the added transparency but know that not all of their projects can meet these elevated readiness thresholds. Perhaps unsurprising since the process is so new, our conversations with PSH stakeholders during 2013 revealed several key concerns about this new managed pipeline process, which are described in greater detail below:

- **Emphasis on Transit-Oriented Development (TOD)** – Nearly all the developers we spoke with were appreciative of the city’s increasing emphasis, as outlined in the new Five Year Consolidated Plan, on building affordable housing near transit centers. Yet, questions remain around how this new investment strategy will work for and impact PSH developers. The feedback we collected revolved around a few key themes:
 - (1) The lingering confusion around the TOD definition, including identification of specific transit corridors that are priorities for the city
 - (2) The scarcity of TOD sites in specific communities (e.g., San Fernando Valley) and thus the anticipated, heightened competition for those sites among developers
 - (3) Related to the preceding point, a concern that nonprofit PSH developers are thinly capitalized and not able to compete (or secure private debt) as well as the many for-profit developers that are entering the PSH marketplace
- **Selection Criteria** – Clearly the scoring criteria associated with HCIDLA’s initial Call for Projects offered large incentives for project leveraging, TOD/Con Plan alignment, and advancing former CRA assets. Alternatively, PSH developers were frustrated to learn that serving special needs populations (at least 10 percent of all units) appeared to be a minimal policy priority, worth only five points (out of 100).
- **Council Office Support and Project Readiness** – The PSH developers we spoke with all reiterated the concern that PSH project sponsors must face an even stiffer test of possible community opposition. At application submittal, they must now include a letter of support for commitment of city funds to the project from the applicable council office(s) to meet the Project Readiness threshold. While council support has always been a critical aspect of securing city approval for an affordable housing project, this appears to now be a milestone to be met much earlier in the development cycle. As council offices in turn seek neighborhood council engagement/sanction for the project, developers report experiences in which these community bodies overreach their purview, stepping outside of zoning alignment to even question population targeting. Securing favor can significantly impact the project, particularly its design, at quite an expense or delay to the project. Since developers simply have no choice but to win local council approval for the project to advance, they are in a compromised position to negotiate additional demands.

Housing Authority of the City of Los Angeles (HACLA)

For several years, HACLA has partnered with the HCIDLA to offer both capital financing and project-based vouchers (PBVs) for permanent supportive housing developments through the AHTF program. The combination of these resources has been a driving force for PSH production as well as a shining example, locally and nationally, of interdepartmental coordination. After committing in past years to an average of 300 vouchers annually in line with AHTF capital allocations, HACLA cautioned that 2014 would likely fall short of that level. The summary below of PBV allocations for the past four year demonstrates the importance of PBVs in creating PSH units and an increasing focus on using this resource to assist housing partners in targeting units for the chronically homeless.

Summary of HACLA PSH Project-based Voucher Commitments, 2010-2013

Year	Total Units	PBVs Requested	Chronic Homeless PBV Units
2010	287	221	48
2011	521	397	218
2012	715	384	119
2013	316	215	176
Total	1,839	1,217	561

Source: HACLA PBV Activity Summary, accessed 9/26/13

Looking ahead, HACLA’s ability to sustain this level of PBV commitment is unlikely, at least in the short-term due to the funding cuts wrought by federal sequestration, estimated at 8 percent in 2013 and a possible 3-5 percent cut in 2014. As a result, it was very challenging for HACLA staff when we met in 2013 to forecast (and HACLA refused to do so) any PBV commitments as 2014 approached. While they still see strong demand for PBVs among developers, HACLA understands that these environmental forces will compel these agencies to look outside the city for development opportunities.

Despite this glum news, HACLA staff reported in our interview that their commitment to PSH is “strong but threatened.” They are encouraged by the nascent efforts among county service departments (i.e., Health Services and Community Development Commission) to offer up their own versions of operating subsidy programs. They feel that they can be informative as these programs take shape, in terms of program design to compliance. They also remain open to additional VASH project-based vouchers, though they are concerned with recent experiences indicating low demand from developers. Further assessing developer appetite for VASH PBVs is worth pursuing, including better understanding the program’s timeliness requirements and overall compatibility in deal structuring.

STATE PROGRAMS

California Low-Income Housing Tax Credit Program

The federal Low-Income Housing Tax Credit (Housing Credit) program remains the most popular financing tool in the affordable housing industry. Based on the amount of capital needed to make PSH projects feasible, nearly all capital funders in Los Angeles have aligned their process and regulations to be compatible with the program. In just a quick review of the five PSH projects approved through the city's Affordable Housing Trust Fund in 2013, on average this source represented 52 percent of overall development costs (and in some individual project cases as much as two-thirds).

As the California Tax Credit Allocation Committee (CTCAC) Executive Director Bill Pavao described, PSH developers typically have “three bites at the apple” to receive an award for tax credits. Most PSH projects come in for 9 percent credits, whereas the 4 percent deals are typically matched up with State Housing and Community Development (HCD) funding (though recent changes to HCD programs makes them compatible with 9 percent deals). There is a 10 percent set-aside for nonprofit sponsored projects, with a preemptive priority for homeless deals, which makes this the main category under which PSH deals are funded. Beyond that, the second “bite” occurs in the special needs/SRO set-aside category (4 percent of overall credits available). If not successful there, PSH projects “cascade” to the geographic apportionment section, typically reserved for deals that serve families or seniors. This section is usually over-subscribed and very competitive.

While the amount of PSH projects approved by CTCAC has varied over the past two years, Los Angeles PSH projects have been well-represented. In 2014, for example, of the 11 projects approved statewide for funding under the nonprofit or special needs categories during Rounds 1 (March) and 2 (July), five developments were located in Los Angeles County.¹⁰ In turn, the respective geographic regional allocations for the city of Los Angeles and the balance of Los Angeles County, now that they are bifurcated, are clearly being used to advance large family and senior projects, leaving PSH projects to compete with similar PSH projects across the state. This dynamic is sensible, as Los Angeles continues to produce well-leveraged PSH developments that are competitive on their own merits and do not need the security of being recommended in the geographic allocations.

¹⁰ This does not account for affordable housing developments that may be setting aside a lower percentage (e.g., 35 percent) for homeless households, or for special needs projects that were approved under the geographic allocation categories.



During the research period, we also learned of two announcements related to the California Housing Credit program that appear favorable for PSH developers. In 2013, California passed AB 952, permitting CTCAC to award state credits to special needs projects within federally-designated Difficult Development Areas (DDAs) and Qualified Census Tracts (QCTs). Second, as part of the proposed 2015 recommendations, CTCAC is recommending an increase in the special needs housing type goal from 15 percent to 25 percent. Such a proposal clearly affirms that special needs housing is a high public policy priority; it also is a practical response to what CTCAC says is an increasing amount of project requests to develop supportive housing.¹¹

California Department of Housing and Community Development (HCD)

This past decade offered a tremendous infusion of voter-approved resources (Propositions 46 and 1C) for the state of California's HCD affordable housing programs, which for PSH developers is embodied mostly in the Multifamily Housing Program's Supportive Housing component (MHP-SH). During the last 10 years, HCD programs have been highly utilized within the Los Angeles PSH portfolio, though we are seeing less of that lately, as unfortunately those bond-funded initiatives are nearing expiration. In 2013, HCD announced the availability of nearly \$60 million in capital financing for permanent affordable and supportive housing development, which included nearly \$7 million in MHP-SH funding (no less than 35 percent of units must qualify as PSH) and \$3 million in Governor's Homeless Initiative funding.¹² With the lingering absence of a permanent source for affordable housing development in the state, as illustrated in the failure of SB 391 (The California Homes and Jobs Act) to advance in the State Assembly in 2013, at least HCD can look forward to the passage of a new veterans housing bond (Proposition 41) and a new MHP allocation of \$100 million in the 2014-2015 state budget. The latter represented the first general fund allocation for the program in more than a decade.

COUNTY PROGRAMS

CDC Affordable Housing Loan Program

Under its Affordable Housing Loan Program, the Community Development Commission of the County of Los Angeles (CDC) provides capital funding and operating subsidies for the creation of permanent rental housing units serving special needs populations, including homeless people. Historically, the CDC has made available approximately \$15-20 million in redevelopment funding available for such developments, with 50 percent of those funds dedicated to special needs housing.

¹¹ For the first time in the history of the California Housing Credit program, CTCAC reached the 15 percent housing type goal for special needs projects in 2014.

¹² Established by Governor Schwarzenegger in 2005, this funding is a collaboration between HCD, California Housing Finance Agency (CalHFA) and the Department of Health Care Services (DHCS) to provide an integrated PSH model for persons with severe mental illness who are chronically homeless. Typically, these funds are coupled with State Mental Health Services Act funding. Priorities are given for projects serving homeless veterans and/or people with developmental disabilities.

By all respects, the CDC was ahead of the curve in offering specific capital funds to assist developers to target a wide range of defined special needs populations, well before their county counterparts (Mental Health, Health Services, Public Social Services, etc.) figured out a way to dedicate their own resources to housing activities. Permanent supportive housing providers and advocates were enthused with the decision by the county in 2013 to continue to support PSH production through the re-release of a portion of approximately \$60 million in recaptured redevelopment funds (received subsequently to the County General Fund).

In October 2013, the CDC made available \$15 million through Round 19 of their Affordable Housing Loan Program, with some important distinctions to note from past NOFAs:

- **Exclusive Focus on Special Needs** – For the first time, the NOFA was dedicated entirely to special needs housing, including a strong focus on projects serving homeless populations. Homeless projects are defined as those in which at least 50 percent of total units are set-aside for homeless households. Tie breakers for project selection prioritized homeless projects first (over special needs or mixed-population projects); the second tie breaker favored projects that serve a higher percentage of homeless units (compared to that same ratio in special needs or mixed-population projects).
- **Availability of Operating Subsidies** – For the first time, the CDC offered a Capitalized Operating Subsidy (COS) of \$6.3 million in conjunction with requests for capital funds, a clear recognition of the significant operational and revenue barriers endemic to PSH developments. The COS will pay the difference between the projected rental revenue from a homeless unit and its proportionate share of operating costs for a period between 17 and 20 years. The COS must target homeless households with income at or below 30 percent AMI.
- **Coupling with County Supervisorial District Discretionary Funds** – The Round 19 NOFA included nearly \$2.3 million in “Homeless Bonus Funds,” representing commitments from three Supervisorial Districts (Districts 1, 2, and 5) to assist with capital, COS and serving funding support. This is significant because previously each board office would allocate up to \$5 million annually to a range of pet projects in their districts, mostly to assist with direct homeless services, with little strategic rationale behind those investments.

Our interview with the CDC underscored staff’s excitement around the new COS program, especially since HACLA had been unable to issue PBV commitments for two years. The decision to dedicate all the resources to special needs and homeless projects reflects, in their opinion, the best chance to stretch limited resources. They cited increasing partnerships with county service agencies as an encouraging trend, one that allows them to feel more comfortable as they more deeply invest in PSH projects. They also noted a departure from previous NOFAs in that they will be requiring a more stringent threshold for developer capacity, in line with CTCAC requirements, to discourage “wannabe” developers that are only chasing resources.

As for their relationship with HCIDLA and the new city managed pipeline process, CDC staff surprisingly described an active level of involvement in its conceptualization, though it is early still to see how it will affect their ability to advance mutually attractive PSH deals. They also noted the alignment of funding decisions so that HCIDLA letters of support will be in place in time for CDC Round 19 NOFA applications.

Mental Health Services Act Housing Program

With the passage of the Mental Health Services Act (MHSA, also Proposition 63) in 2006, Los Angeles County received a one-time allocation of \$115 million for capital financing (\$75 million) and capitalized operating subsidies (\$40 million) to provide permanent supportive housing for people with mental illness and who are homeless or at-risk of homelessness. The MHSA housing program, in many respects, could not have emerged on the development financing scene at a better time. In 2008, as the economy plunged with the deterioration of the housing market, this program brought significant relief to the PSH development community and the added value of partnerships for supportive services with the administering agency, the Los Angeles County Department of Mental Health (DMH). All told, in the years since, the program served a vital role in sustaining the PSH pipeline, though there is legitimate concern about the future of this program as nearly 96 percent of its funding has been committed.

Staff at DMH shared in our interview that the program has financed 36 projects to date, representing a significant portion of the PSH pipeline countywide. As the program evolved, it was particularly adept at attracting higher capacity traditional affordable housing developers that offered set-aside units for MHSA households as part of a larger tenant mix. Though they are concerned that their role in the financing system will diminish, and what that means for a seemingly healthy PSH pipeline, they are committed to offering enough capital resources to assist with three to five developments annually.

They are also advising the county CDC on the roll-out of their new COS program and have committed funds to the DHS flexible housing subsidy pool that will be available this year. Finally, DMH noted that they have existing MHSA resources (such as Full Service Partnerships) that allow for housing activities and that could potentially be targeted more strategically to assist with PSH development or operations.

IMPACT OF FUNDING REDUCTIONS ON PSH DEVELOPMENT COMMUNITY

Understanding the impact of this new financing environment for PSH production was a central research question. Regrettably it was been a difficult one to assess, at least quantitatively. This question requires both more exploration and more time, since the PSH development pipeline is only beginning to adapt to this new environment.

In the absence of greater time to assess this environmental impact, we turned to those PSH stakeholders on the frontline of financing, developing and operating PSH. During our March 2013 roundtable and stakeholder interviews, we asked all our stakeholders: have you seen any changes in the deals you are developing or, if a public agency, for which you are seeing requests for funding? Specifically, we were curious about any evident shifts in volume, housing types (rehabilitation or new construction), focal populations, geographic priorities or financing sources that might indicate notable trends resulting from this new funding environment.

In terms of volume, we cannot at this time offer any decisive conclusions that suggest a sizable drop in the number of PSH units that are being produced annually. Nearly all the PSH developers shared an understanding that the city was committing to producing 300 units of PSH per year, slightly below the 400 units that advocates had sought. That target was not directly confirmed by HCIDLA in our interview, though the initial Call for Projects (Section 5.6.2) issued in 2013 states that “in order to maximize utilization of the 9 percent Housing Credit resource and to support production of PSH in accordance with the Consolidated Plan, the city will prioritize the goal of always having at least 300 units of PSH in the managed pipeline.” More candidly, HCIDLA staff noted their interest in funding three to five PSH developments per year, but that was dependent on outside factors, including the availability of Housing Credits and Section 8 PBVs. As for the latter resource, we noted earlier that there simply is no confidence on HACLA’s part that they can commit to that level of PBVs in 2014.

The county of Los Angeles, on the other hand, felt slightly less constrained in the short-term. The CDC’s release of the Round 20 NOFA in September 2014 offered more than \$22 million in capital funds (including \$17 million in county general funds) and 200 PBVs; CDC staff said they must revisit the 2015 allocation next year. That said, with MHSA Housing Program funding nearly depleted, DMH’s ambition of financing three to five PSH deals per year will not be realistic without additional MHSA resources.

We received even less clarity on possible variations in housing types (construction, rehab, project sizing, etc.), outside of CTCAC staff claiming they are seeing new construction projects fall from 90 percent of approved deals at the peak to now 60 percent. In contrast, based on the published managed pipeline self-scores, only one development (SRO’s Panama Apartments) was a rehab project. The county CDC saw little change in recent years, still at 90 percent new construction. During our conversation, the CDC pointed out that they approach rehab very seriously, requiring

that hard costs represent at least \$80K/unit, double the city's minimum. They did note that they are now requiring a minimum number of units/project size for Round 19; deals can be no less than 15 units.

Developers relayed the likelihood that as time progresses and resources shrink, they will inevitably be drawn to focus more on re-investing in their existing portfolio. One is left to wonder what will happen to the aging SRO stock, since those buildings are not of interest at this time to HCIDLA and lack appeal to agencies like the Los Angeles County Department of Health Services, which have resources but are looking for on-site services space and larger unit sizes, two characteristics that are often lacking among older PSH buildings in Los Angeles.

More insight was offered on the types of tenants that are being targeted in this emerging PSH landscape. Stakeholders all cited the various community-led efforts to prioritize the most vulnerable, engage in a coordinated entry system and serve chronically homeless people as substantial factors in whom they are being asked to house. Relatedly, these initiatives are fostering an increased level of partnerships with county health and human service departments. In turn, these agencies are offering up their own resources (e.g., Department of Health Services Frequent Users Initiative) to advance housing development. Stakeholders also observed a trend, evident for several years among capital funders, to incentivize mixed-income, mixed-population housing developments. More capacity building and research should accompany those initiatives to help maximize the understanding and efficacy of those models.

Aside from targeting chronically homeless people, we heard that there is a rise in developments targeting homeless veterans, likely a reflection of federal policy and an infusion of VASH resources, which were not affected by sequestration. To a lesser extent, developments targeting transition-age youth were cited, undoubtedly related to their focus under MHSA. Interestingly, all but one of the five developers we interviewed noted little operational concern with serving chronically homeless populations since they were already well-experienced providing PSH and/or had capacity as a short-term housing provider. All the PSH developers though cautioned against "over-targeting" buildings to the chronically homeless, as was exemplified by the 75 percent threshold for Round 1 of the AHTF in 2013.

The dual trends of an increasing focus on the hardest-to-serve homeless populations and diminishing capital resources, however, present some concerns from a supportive services standpoint. The pressure among PSH developers to offer deeper targeting raised one poignant philosophical question in our developer interviews: has the PSH industry become a de facto "asylum" substitute? How this shift affects the capacity of these providers to deal with the various mental and physical health challenges that come with these tenants remains an ongoing query. Certainly providers are struggling to keep pace with the need to secure more service funding and hire more clinically trained staff. Fortunately the ever-increasing role that DHS and DMH are playing in the industry could be a source of relief to alleviate the stress on these providers.

It was little surprise to hear the developers worry that the city's new managed pipeline would result in a limited number of projects that they could site and advance within the city. As a consequence, developers could not submit everything they had in their pipelines. Therefore, there is a real possibility of PSH development opportunities moving outside of the city. Such a trend, which is just starting to become apparent, could significantly favor developers with a regional presence, those that have fostered relationships with other jurisdictions, have a successful track record securing community input and approval and have developed partnerships with regional service providers. That is a scenario to monitor, since three, arguably four, of the largest PSH developers currently operate exclusively or close to 90 percent within Los Angeles city limits.

OTHER NOTABLE DEVELOPMENT & FINANCING TRENDS



Aside from observing areas of current or potential impact on the PSH development community as we enter a new funding environment, we listened to stakeholders as they described other development and financing trends. We choose to discuss a few of the more notable examples below.

Emergence of New Players in the PSH Marketplace

As Los Angeles has moved aggressively to target scarce PSH resources to the chronically and most vulnerable homeless populations, there has been an accompanying shift in the type of public and private players that are entering the marketplace. On the public agency side, the focus and partnership between HUD and the Veterans Administration on addressing veterans homelessness is an obvious difference, represented most notably through the HUD-VA Supportive Housing (VASH) program and the Supportive Services for Veterans Families (SSVF) programs.

Locally, there has been an impressive, though fragmented, investment from the County Board of Supervisors (BOS) through the legacy of the \$100 million Homeless Prevention Initiative (HPI), as evidenced recently in the CDC's Affordable Housing Loan Program. Aside from BOS-level investment, funding through the County Department of Health Services and First 5 LA represent a promising contribution of new production resources from public partners that historically had not been involved. Developers welcomed these new players and, though very new on the financing scene, consider their investments a positive outcome for leveraging existing resources. Also, the creation of the Home for Good Funders Collaborative, and the annual grants they are providing to PSH providers, is another new investment source, especially helpful for activities that are traditionally more difficult to fund publically (e.g., move-in, housing retention services).

Finally, we heard from nearly every interviewee that they are seeing more for-profit developers stepping into the PSH field. They are partnering with nonprofit affordable housing developers or other supportive service providers to produce PSH. This trend is very evident even in the MHSA pipeline, as well as sponsor responses to the city's Call for Projects. The nonprofit PSH developers

related concern that these for-profit developers are able to secure big conventional permanent loans on deals that their nonprofit peers cannot. From a systems level, partnerships to develop and operate PSH have capacity gaps. Traditional affordable housing developers often have little to no experience in providing housing for challenging populations. Service providers who partner with experienced developers to develop and operate PSH frequently do not understand long-term operational and financial liabilities when partnering in development.

Need for Community Engagement Earlier in Project Development

We noted this in the Managed Pipeline section, but overall, PSH developers were quick to point out the increasing pressure to engage the community much earlier in the development process. The city's policy of requiring council support to meet Project Readiness criteria could have a dramatic impact. It has resulted in developers facing awkward negotiations with neighborhood councils on aspects of the project (targeting for instance) that are not germane to their advisory role. And even as developers are forced to look outside the city for deal opportunities, how will that shift affect siting issues and requirements on development opportunities? The interviews alerted us as well to various Community Plan updates that are occurring at different stages throughout the city, with the potential to shape subregional development priorities.

CONCLUSIONS

Our review of the PSH financing system in Los Angeles portrays an environment very much in flux. Traditional funding sources, notably longstanding HUD programs and local RDA funds, are either shrinking or have been lost. At the same time, we are heartened to hear of the arrival of new financing models and a series of coordinated initiatives to help offset the reduced investments from historic partners. The assessment also illustrated that the impact of funding cuts on the PSH delivery system is evident but may be too soon to quantify objectively. Nonetheless, there are significant shifts underway, such as the city's managed pipeline and the emergence of new funding partners, that will inevitably shape the financing and policy landscape for years to come. Our analysis also validated three assumptions related to the local PSH financing picture that we close with below.

For one, there is unanimity among all stakeholders of how indispensable project-based rental or operating assistance is to project feasibility. Not a single stakeholder in our latest round of interviews suggested anything less than the need for such subsidies in PSH developments, though there were varying perspectives on the type of model (COSR or project-based voucher) that suited them best. Under our current financing models, it is safe to suggest that our future level of PSH production will be indexed essentially to the amount of project-based operating subsidies attached to these deals. Specific comparisons or analyses should be done on these models to understand their strengths or weaknesses, underwriting concerns and possible areas for

expansion. We also learned that mixed-income, mixed-population deals are on the rise. Particularly in an era of constrained public housing authority (PHA) resources, more work could be done to model different scenarios to see if a small number of PSH units in a traditional affordable housing project can subsidize the higher rents of the non-PSH units without additional rental or operating subsidies.

Our research also underscored the essential role of the Housing Credit program in overall project financing. As noted earlier in the Housing Credit program overview, tax credit equity typically represents a significant portion (i.e., more than one-half) of the development budget. Moving into a new era with a city of Los Angeles-specific geographic apportionment suggests the importance of paying close attention to how credits will be distributed throughout Los Angeles County and what that means for PSH deals supported by the county CDC. The sustainability of the industry at present essentially depends on the continued vitality of this resource, which highlights the ongoing need for federal advocacy in light of any advancement in federal tax policy reform. But as we seek to sustain the Housing Credit program for the long term, Los Angeles needs to look concurrently at alternative financing models that do not depend on the conventional resources we have come to rely upon. Alternatives could involve attracting new partners from non-housing sectors (e.g., health) that could create favorable outcomes, such as reducing the length of time associated with housing development, ease the public subsidy burden and promote greater flexibility in how resources can be used to advance supportive housing.

Finally, the need for flexibility and consistency among project funders remains a paramount concern and recommendation. We understand that certain funders, but not all, have the ability to waive targeting requirements in the event of a loss of subsidy. Such flexibility can result in a sizable difference in how the deal is structured and what reserves need to be capitalized. Also, certain funders should revisit their allowance of supportive services above the line or from cash flow. HCIDLA's recent decision to allow a residual receipts allowance for housing case management is bold and could be a possible model. The CDC in turn has added case management as an allowable expense (in addition to historically allowing service coordination above the line), even recently removing the salary maximum for such staff. Finally, PSH developers questioned why they should be subject to the same deadlines for certain project milestones as regular affordable housing developers. They argue that these deals are far more complex and some accompanying discretion and flexibility on the part of funders could be more responsive to the unique challenges they face in building and operating this housing.

TARGETING RELIEF POLICIES AMONG HOUSING FINANCE AGENCIES IN CALIFORNIA

INTRODUCTION

This specific brief addresses the issue of targeting relief and how state and local housing finance agencies accommodate modifications to income and population targeting in permanent supportive housing (PSH) projects when there is a loss of project-based rental assistance or operating support. The purpose of this document is to inform how PSH is financed and underwritten in Los Angeles.

OVERVIEW OF TARGETING RELIEF IN THE CONTEXT OF UNDERWRITING PSH DEVELOPMENTS



A key distinction of PSH is that, in connection with serving homeless and other vulnerable populations, deep income targeting is often stipulated in recorded regulatory agreements and can remain in effect even if project-based rental subsidies are reduced or eliminated. Moreover, it is common that the underwriting of these projects includes a stress test (also referred to as a loss run analysis by some funders). The stress test analyzes how a project would operate if rental subsidies were no longer available to the project. Typically, these stress tests take into account all applicable tenant and rent restrictions, so-called targeting restrictions. The results are used to determine and size additional reserves that would be used to support operations in the event that project-based rental or operating subsidies were to become unavailable during the 15-year tax credit compliance period.

While in some cases state and local housing finance agencies (HFAs) and other funders indicate that they would consider relaxing the income or population targeting if the subsidy was no longer available, there are limited examples of HFAs agreeing upfront to provide such relief to project sponsors in such a circumstance. Despite varied forms of targeting relief taken by capital funders servicing PSH developers in the Los Angeles area, the financial implications for a PSH development can be substantial if this relief is available upfront: reserves are able to be sized much closer to standard or minimum levels. An upfront commitment from capital funders to allow specified relief targeting can save a project hundreds of thousands of dollars in reserves, precious resources that could be redirected to create additional PSH units.

TARGETING RELIEF POLICIES AMONG KEY PSH CAPITAL FUNDERS IN CALIFORNIA & LOS ANGELES

Enterprise reviewed the policies of several of the key HFAs providing capital funding for PSH developments in Los Angeles. This review revealed that targeting relief provisions vary among HFAs, though five of the six funding programs included some form of targeting relief. In each of the cases we reviewed, the project sponsor must evidence this hardship and describe how adjusting its targeting requirements will offset the loss of subsidy and enable the project to remain financially viable. In the best examples, the language is not only delineated in the program regulations but included directly in the Extended Use Agreement or recorded regulatory agreement. It is important to note that in these examples affecting PSH development in Los Angeles, targeting relief is only considered when a project-based rental or operating subsidy is attached to the project (not other forms of subsidies such as capital or supportive services) and subsequently lost or diminished, depending on the program.

In addition to evaluating the degree to which relief exists and, moreover, where it is formalized within program materials, our analysis also reviewed other characteristics. These included: if the relief could be triggered by subsidy reduction and/or elimination, the type of subsidy considered eligible and whether relief allowed for changes in the income level and/or population targeted in the project. The table below provides a summary of targeting relief provisions among key PSH capital funders in California and Los Angeles.

Summary of Targeting Relief Provisions among Key PSH Capital Funders in California and Los Angeles

Relief Criteria	Funding Source					
	CTCAC	HCD/MHP	HCIDLA	CDC	MHSA	AHP
Allows Targeting Relief	Yes	Yes	Yes	Yes	Yes	No
Type of Subsidy Considered: Project-based Operating (O) and/or Rental Assistance (RA)	O, RA	RA	RA	O	O, RA	
Relief Codified in Program Regulations	Yes	Yes	No	Yes	Yes	
Relief Captured in Loan or Regulatory Agreement	No	Yes	Yes	Yes	Yes	
Relief Triggered By:						
Subsidy Elimination	Yes	Yes	Yes	Yes	Yes	
Subsidy Reduction	No	No	No	Yes	No	
Nature of Targeting Relief						
Maximum Income Allowed (up to)	60% AMI	50% AMI	60% AMI	50% AMI	50% AMI	
Funder Allows Modifications to Target Population (if needed)	Yes	No	Yes	Yes	No	

California Tax Credit Allocation Committee

The California Tax Credit Allocation Committee (CTCAC), responsible for the administration of the federal Low-Income Housing Tax Credit (Housing Credit) program in California, recently revisited and clarified its position to reflect a more balanced approach to relief targeting, rooted in the overall goal of minimizing disruption to existing residents while acknowledging the financial realities associated with subsidy loss.¹ The new standard, per Section 10337(a) of the 2014 regulations, is the first time that CTCAC has codified a position on this topic in the program regulations. In addition to now calling out operating and project-based rental assistance subsidies, CTCAC sought an appropriate compromise between maintaining the financial feasibility of the project and protecting the income targeting approved at the application stage.

Under the new standard, sponsors are first expected to apply for and accept all subsidy renewals. Then, if at no fault for the subsidy's termination, sponsors are secondarily required to notify CTCAC immediately in writing and find alternatives. If such alternatives cannot be secured, with sufficient documentation provided to evidence the unsuccessful search for a replacement source, then the sponsor is allowed to raise rents above those recorded in the regulatory agreement so long as they are done as gradually as possible. CTCAC can still determine the appropriateness of those new rents, consistent with federal maximums. The new standard further suggests that sponsors explore the rental mix in their buildings, perhaps raising rents on non-special needs units (while maintaining deep income targeting for other units), to facilitate project viability. Lastly, CTCAC now allows a special needs sponsor to transition to non-special needs households as necessary and upon vacancy whenever possible.

California Department of Housing and Community Development: Multifamily Housing Program

The California Department of Housing and Community Development (HCD) Multifamily Housing Program (MHP), another significant source of capital investment in PSH in California, also imposes limitations on targeting relief. Section 7312 of the program regulations concerning rent standards for MHP-assisted units states that, for projects that receive renewable project-based rental assistance, sponsors shall in good faith apply for and accept all renewals available. Further, if the project-based rental assistance is terminated, rents that were previously covered by this assistance may be increased but only to the minimum extent required for fiscal integrity as determined by the state HCD. And, rents are still limited to no more than 30 percent of 50 percent of area median income (AMI).

It is important to note that state HCD requires sponsors of MHP-assisted projects with project-based rental assistance to fund a transition reserve in the event the rental assistance contract is terminated. That particular reserve must be sized in an amount sufficient to prevent, for two years, rental increases for units previously covered by the project-based rental assistance. The transition reserve may be capitalized or funded from annual project cash flow, subject to HCD's review and approval.

¹ Prior to adopting a new standard in 2014, CTCAC expected project sponsors to "make every effort to find alternative subsidies or financing structures" that would enable the deep targeting that was memorialized in the regulatory agreement. If that proved unsuccessful, and no alternative operating subsidy was available, then CTCAC would work in good faith with the sponsor to raise income targets and the resulting rent stream. CTCAC would offer this assurance in the form of a side letter upon request.

City of Los Angeles Housing and Community Investment Department

Compared to the other HFAs, the city of Los Angeles Housing and Community Investment Department (HCIDLA) incorporates similar targeting relief criteria for projects it identifies as receiving rental assistance. One key distinction, though, is that these criteria were not found in its Affordable Housing Trust Fund NOFA or program regulations. Rather, the example we reviewed came from a loan agreement for a recent PSH development. It specifically highlighted rental assistance programs from the Housing Authority of the City of Los Angeles (HACLA) or county of Los Angeles Department of Health Services (DHS), which are common (or soon to be) HCIDLA leveraging sources.

Under this policy, borrowers that have seen their rental assistance commitments withdrawn or terminated for no fault of their own can petition HCIDLA to modify the affordability restrictions and maximum rental charges under the following circumstances:

- (1) Alternative funding is unavailable
- (2) The project is otherwise in full compliance with all the terms of the current HCIDLA loan
- (3) More restrictive funding requirements do not apply to the project

If these criteria are met to HCIDLA's satisfaction, it will proceed with such modifications. Further, HCIDLA will allow changes in the target population to the minimum extent necessary to accommodate the new rent levels. In that situation, sponsors may be required to modify the supportive services plan responsive to changes in the target population.

Community Development Commission of the County of Los Angeles

For information about targeting relief provisions for the Community Development Commission (CDC) of the county of Los Angeles, we reviewed the Round 19 Affordable Multifamily Rental Housing NOFA, released in October 2013, as well as specific loan document language for a PSH project that was approved for funding during the competition. Round 19 was the first to include a capitalized operating subsidy (COS), a clear recognition on the CDC's part of both the scarcity of rental assistance subsidies and the difficulty operating PSH with limited rents.² The COS program guidelines state that, assuming no fault of the borrower, in the event of a decrease or termination of the COS, the maximum household income and the rents charged for the COS units may be increased by an amount necessary to replace the reduction in the COS. Sponsors would not be permitted to exceed 30 percent of 50 percent AMI for maximum annual rents. The CDC further would allow for changes in the target population if necessary to accommodate the new rent levels.

2 The COS is available to subsidize the cost of operating homeless units in special needs and mixed-population projects, paying the difference between the projected rental revenue for a homeless unit and its proportionate share of operating costs for a period between 17 and 20 years. The COS program units must target homeless households with incomes at or below 30 percent of AMI.

California Mental Health Services Act Housing Program

The Mental Health Services Act Housing Program (MHSA Housing Program) is a statewide program that offers permanent financing and capitalized operating subsidy reserves (COSRs) for the development of PSH serving persons with serious mental illness who are homeless or at-risk of homelessness. The program is jointly administered by the California Housing Finance Agency (CalHFA), responsible for project underwriting and loan servicing, and the Department of Health Care Services, who in partnership with local county mental health departments oversees the supportive services component.³ Per the general rent and occupancy requirements outlined in the program term sheet (which are included in project loan agreements as well), the project sponsor has several obligations should it experience a change in its non-MHSA funded rental or operating subsidy commitments and wish to seek relief in modifying the income targeting on the assisted project.

While the program acknowledges that projects funded with MHSA may have operating and/or rental subsidies from other sources, sponsors are expected to notify the CalHFA at least two years prior to the expected depletion of these subsidies and to submit a plan to transition the use of these units to non-MHSA units. The transition plan must include at a minimum the following components:

- (1) Steps taken by the borrower to secure rental subsidies necessary to sustain the MHSA units, such as Shelter Plus Care and Section 8
- (2) An explanation of the fiscal necessity of adjusting the number or use of the designated MHSA units
- (3) A process for increasing the rent and continuing to market and rent the MHSA units to members of the MHSA target population who do not require subsidies
- (4) The plan for continuing, throughout the term of the MHSA permanent loan, to apply for other subsidies, renewal of subsidies and/or applications to the county for additional funds to subsidize the rental of MHSA units to members of the target population

Upon receipt of that information, CalHFA conducts a review of the transition plan and the overall financial feasibility of the MHSA-assisted housing development. Approval of targeting relief is further conditioned on rent levels not exceeding 30 percent of 50 percent of AMI and agreement that the sponsor will continue to seek other subsidies and a commitment to continue to market to the MHSA target population.

³ From an underwriting perspective, a project with reserve funds such as a COSR does not have the same risk as a project with rent or operating subsidy that is subject to annual appropriations, like Project Based Section 8. Some funders may not need to conduct a stress test, because all of the operating funds needed to carry the project through the term of the contract are set aside for the project up front. Additionally, the MHSA Program takes into account the fact that not all projects that have capital funds from MHSA have a COSR, or the COSR may only cover a portion of the units.

Of all the programs that we reviewed that offered some form of targeting relief, the MHSA Housing Program appeared the most restrictive due to the requirement that project sponsors continue to serve the target population in the event of a subsidy loss. Such a prohibition appears unlikely to change since the focus population is outlined in the MHSA statute, central to the program's purpose, and applies to all MHSA-funded activities, not only housing. The program's regulations were also the most explicit in terms of the steps associated with seeking targeting relief. In certain cases, finding higher income households that qualify under MHSA guidelines is a significant feasibility test and may not be viable, thereby rendering the targeting relief in effect out of reach.

Affordable Housing Program

Though an important and competitive source of gap financing in affordable housing, including PSH, the Federal Home Loan Bank's Affordable Housing Program (AHP) does not appear, based on our review, to offer any specific regulatory relief to ease income or population targeting requirements in assisted projects. It is a challenge therefore to understand how exactly AHP program staff address this need if it arises based on the lack of formal attention to the issue in the program literature. Our staff recalled at least one project sponsor that recently unsuccessfully requested such relief. That AHP is essentially silent on targeting relief is rather significant because projects must defer to the most restrictive rental restrictions associated with that development, even if other capital sources differ and offer relief.

THE IMPACT OF TARGETING RELIEF ON PROJECT FINANCING

To illustrate the financial impact of targeting relief on project financing, we analyzed a hypothetical PSH project based upon the following typical characteristics: a 30-unit development with 100 percent of its units (all one-bedroom) set-aside for homeless households with special needs. Further, the CTCAC Extended Use Agreement requires that half of units have rent/income limits at 30 percent AMI and half at 40 percent AMI. The project's rental subsidy will include a new 15-year Project Based Section 8 contract for all the units, so residents will pay 30 percent of their income for rent, and the Section 8 rental assistance will cover the difference between what the tenant can pay and fair market rent (currently \$1,083/month for a one-bedroom apartment). In addition to the Housing Credit, the project also has soft financing from HCIDLA, MHSA and AHP. The project has an operating reserve that is equal to six months of operating expenses, replacement reserve deposits and debt service (OERDS), which is standard for any project, regardless of whether or not it is PSH.

Scenario 1

In the first scenario, we look at what happens when the project based rental assistance is eliminated through no fault of the sponsor in the fourth year of operations. Without rental assistance, rental income transitions from \$1083/unit/month, to the maximum allowable tax credit rents: \$428/month for the units at 30 percent AMI and \$571/month for the units at 40 percent AMI. This is consistent with the recorded regulatory restrictions for CTCAC and HCIDLA. The sponsor could seek targeting relief from CTCAC and HCIDLA, but in the AHP application, the sponsor agreed to set aside half of the units for homeless (or at risk) households at 30 percent AMI.

Based on this requirement, the sponsor acknowledges that it will be difficult to find residents that are able to afford rents of \$428 and \$571, but that can meet the AHP definition of homeless or at-risk. For example, an individual whose only income is SSI or SSDI (\$877/month based on current payments in California) could afford a maximum of \$261/month in rent (30 percent of \$877). Thus, assuming that the rents will need to be \$261/month for the AHP-restricted homeless households (retaining the existing residents), and \$571/month for the remainder of the units (which would likely have to be re-tenanted), our standard analysis reveals that the project would need additional reserves (beyond the 6-month reserve noted above) to cover its operational expenses over the remainder of the 15-year tax credit compliance period. This is equal to more than 40 months of operating expenses, reserves and debt service (OERDS), which in this case is slightly more than \$875,000.

Scenario 2

In the second scenario, we assume that the project does not have an AHP award, but rather a soft loan from the CDC. The sponsor needs to seek relief from CTCAC, HCIDLA and CDC for both rent and occupancy targeting. While CTCAC and HCIDLA indicate a willingness to allow rents to increase to 60 percent AMI if the need is demonstrated, CDC caps rents at 50 percent AMI, or in this case, \$713/month. At \$713/month, our analysis shows that the additional reserves required would drop substantially, from 40 months (as indicated in Scenario 1) to seven more months of OERDS (equivalent to about \$150,000 for this project). Also, the new occupancy targeting would allow the sponsor to rent to residents that meet the higher income requirements.

Scenario 3

In the final scenario, the sponsor has substantial cost savings during construction and is able to pay off its loan from CDC, so the CDC restrictions no longer apply. When the rental subsidy is lost, the sponsor seeks targeting relief from CTCAC and HCIDLA. Both agencies allow rents to increase to 60 percent AMI, or \$856/month. At this level, project revenue would be sufficient to cover expenses, and the project would not need any additional reserves. Also, the new occupancy targeting would allow the sponsor to rent to residents that meet the higher income requirements.

Though hypothetical, these scenarios illustrate the real and inherent value that relief targeting provides. An upfront commitment from funders to allow specified relief targeting (assuming the need can be appropriately demonstrated and no other alternatives are available) can save a project hundreds of thousands of dollars in reserves that have to be carved out from limited dollars available to build affordable housing.

CONCLUSIONS

Upon assessing the leading HFAs that provide capital support for PSH development in Los Angeles, there are some important commonalities and differences regarding their various approaches to targeting relief. For one, capital funders demonstrate with their targeting relief policies a near unanimous recognition of the integral relationship between project-based rental assistance and project viability. While the financial risk to the project still has to be illustrated by the project sponsor to request relief in the event of an elimination or reduction of subsidy, such recognition shows an important awareness and commitment to the fiscal integrity of the PSH investment. The fact that there are even targeting relief provisions at all in five of the six funding programs we reviewed is encouraging, regardless of how formal or expansive that relief is. Targeting relief provisions also assume a protective role to ensure that project sponsors do not walk away from their commitment to serve vulnerable populations even when the project-based subsidies remain in place.

Beyond this philosophical commitment, there is also general consistency among capital funders regarding the maximum rent levels they allow under relief circumstances; while none of the programs allowed assisted households to exceed 60 percent AMI, consistent with Housing Credit guidelines, three programs (State MHP, MHSA, and the CDC Affordable Multifamily Rental Housing) established a rental ceiling of 50 percent of AMI. However, capital funders also align on some policies less desirable for developers: they do not provide relief for project sponsors that have lost (by their own fault) their subsidy for compliance reasons, and they require sponsors to make and evidence concerted if unsuccessful attempts to secure replacement sources.

For those HFAs where relief is provided, the differences are notable but not dramatic. Some funders call out operating subsidies distinct from rental assistance commitments, but no agency goes so far as to allow relief for projects that lose other types of non-rental assistance based subsidy sources.⁴ Certain agencies outlined a more regimented process for seeking relief and the due diligence associated with those steps, including steps to seek alternate resources and show sufficient merit for relief being warranted. Only one funder, the county CDC, would consider targeting relief for projects that face a reduction in subsidy and not just a complete loss of that

⁴ We found an example in Washington state where a permanent supportive housing project was provided relief (under a requirement to serve homeless households) if either rental subsidy or services dollars were deemed insufficient; in addition to covering service subsidies, relief covers both funding reductions as well as elimination of the contract.



resource. Clearly the largest distinction was whether relief would include modifications to the target population in addition to the income levels of assisted households. Only MHSA was clear about the sustained need for project sponsors seeking relief to continue to market and rent those units to the program's focus population. Others, such as CTCAC and HCDLA, noted a desire to continue serving the target population to the extent possible and allow for transitions in target population if necessary.

There are several other concerns about targeting relief that are worth noting. Since all funders require the project sponsor to seek and accept all possible renewals for project-based rental assistance, the question can be raised as to how realistic the expectation of success is in an environment of diminishing, if not limited, public subsidies. Similarly, projects are faced with a challenging feasibility test as to whether they can secure higher-income tenants that fit the target population that was approved at the application stage. On a related note, depending on the rental and targeting mix in the building, as well as vacancy levels, certain projects may not possess the flexibility to retain tenants who cannot meet these elevated relief thresholds.

Finally, echoing a concern we heard during our interviews with PSH developers in Los Angeles, there is an obvious but inherent tension in advancing targeting relief at the expense of public policy goals around ending homelessness. While developers all acknowledged the importance of project feasibility, they were less unanimous in recommending flexibility if it meant taking precious PSH units off the market.

RECOMMENDATIONS

While we are encouraged by the relative availability of targeting relief offered by the state and local HFAs, there are still refinements that can be made to these practices that can further facilitate the development and operation of PSH in Los Angeles. We offer a few suggestions below.

- Advocate for the incorporation of targeting relief provisions into the Federal Home Loan Bank's Affordable Housing Program; where feasible, align provisions consistent with approaches from other HFAs.
- Ensure that targeting relief provisions are codified in program regulations as well as recorded regulatory agreements (look to other states, such as Washington, Illinois, Minnesota and Maryland for relief language that is established in recorded extended use agreements).
- Include all forms of project-based rental and/or operating assistance as subsidy sources eligible for consideration under targeting relief policies.
- Where possible, broaden relief to include modifications to the target population in addition to elevating income targeting.

- Expand relief criteria to allow project sponsors to access relief when experiencing subsidy reductions. Reductions would still have to be evidenced as substantial enough to jeopardize project feasibility.
- Explore the feasibility of broadening subsidy types to include the reduction or loss of supportive services funding. Engage other HFAs across the country that include such subsidies in their underwriting guidelines to better understand the impact of this approach.

REFERENCES

California Tax Credit Allocation Committee

2014 Program Regulations

<http://treasurer.ca.gov/ctcac/index.asp>

California Department of Housing and Community Development

Multifamily Program Regulations

<http://www.hcd.ca.gov/fa/multifamilyregs.html>

California Mental Health Services Act

MHSA Housing Program Term Sheet

<http://calhfa.ca.gov/multifamily/mhsa/termsheets/index.htm>

County of Los Angeles Community Development Commission

Affordable Multifamily Rental Program

<http://www3.lacdc.org/CDCWebsite/EHD/Programs.aspx?id=5287>

PERMANENT SUPPORTIVE HOUSING PORTFOLIO AND PRESERVATION ANALYSIS

BACKGROUND

Given that permanent supportive housing (PSH) has been such an instrumental tool in communities like Los Angeles to end homelessness, the need to accelerate production of PSH has never been more urgent. A parallel pressure is emerging to ensure that the growing portfolio of PSH created in the past two decades can be sustained sufficiently for the long term. Within this context, Enterprise researched the challenges and opportunities associated with PSH preservation, with the broader goal of developing strategies for preserving and reforming current PSH financing.

This brief focuses on addressing four key questions:

- Do PSH developers and owners use resources efficiently to maximize production while mitigating risk and keeping portfolios healthy and investor confidence high?
- Are there opportunities to reduce reserve requirements associated with loss of project-based rental assistance and the deep income targeting of PSH developments?
- Do older PSH properties maintain surplus reserves, and could they be utilized to assist existing properties and allow for consideration of portfolio approaches for capable owners with sizeable housing assets?
- What strategies are there to preserve affordability of PSH projects with extended use restrictions?

Enterprise analyzed its investments in Los Angeles PSH projects that were assisted through the Low-Income Housing Tax Credit (Housing Credit) program. In short, we found the following:

- (1) The PSH portfolio throughout Los Angeles is healthy overall and performing comparably to Enterprise's national Housing Credit portfolio. Industry stakeholders from all sectors – housing and service providers, lenders, investors and philanthropic funders – have created a strong and effective delivery system for new PSH development.
- (2) Financial reserves in the Enterprise Los Angeles PSH portfolio are healthy but should not be considered excessive when considering: (1) public subsidy risk given the deep income targeting of PSH over the Housing Credit compliance period, and (2) the need to maintain this housing resource over the horizon of 55 years of committed affordability (includes 15 years of Low-Income Housing Tax Credit compliance and 40 years of extended use in California). We make recommendations for addressing the underwriting challenge inherent in accounting for the subsidy needed to house the city's most vulnerable. Over the long term, PSH project sponsors will need additional resources to fund capital needs from modest improvements to more substantial renovations in the case of older Single-Room Occupancy developments (SRO) with obsolete layouts and projects that don't meet current codes for accessibility and resiliency. Project reserves are a key resource in addressing those long-term needs.

- (3) There remains a significant challenge to sustain vital PSH production efforts while addressing the physical and financial needs of preserving the aging existing PSH portfolio. As the existing portfolio ages, these properties could compete with new PSH units for funding unless smarter ways are found to leverage resources through policy and other tools.

The Critical Relationship between PSH and Public Subsidy

Understanding the relationship between a successful PSH property and public assistance – capital, operating and services – is vital to knowing how new PSH units may be built and existing units preserved. Overall, the success of the current PSH delivery system is built upon the following subsidy arrangement:

- (1) The use of private equity investment through syndicating Housing Credits, which provides the majority of the capital funding for PSH developments¹
- (2) Public capital from federal, state and local housing finance agencies (HFAs)
- (3) Public rental assistance to subsidize deeply targeted units
- (4) Funding for a continuum of supportive services available to residents to stabilize their transition to permanent housing and to promote their recovery and well-being

Project-based rental subsidy, for instance, is indispensable to the financial viability of PSH projects as it allows rents to be charged at reasonable levels to extremely low-income residents (typically Section 8 or Shelter Plus Care for PSH). However, federal project-based subsidy is subject to annual congressional appropriations, which make future funding levels less certain. To continue to attract private capital, it is critical to demonstrate that projects have the ability to withstand potential loss of rental subsidies or service funding, fluctuating operating expenses or physical repair needs. While funding for services is another critical aspect of this equation, it is not a focus of this paper.

Analysis of PSH in Los Angeles

Enterprise's initial goal for this analysis was to review current underwriting assumptions and performance data for a sample of the existing PSH inventory in Los Angeles. The aim was to assess the state of existing PSH to inform future underwriting, determine whether units might be at risk and develop a preservation strategy for this portfolio. Challenges with access to and availability of detailed operational data precluded a comprehensive review of the entire Los Angeles PSH portfolio financed by the city and other housing finance agencies (i.e., beyond those projects syndicated by Enterprise).

¹ The Housing Credit provides critical capital funding for PSH development and serves as today's engine for affordable housing production nationwide. Federal law mandates compliance with income targeting and rental affordability for a minimum of 30 years (the initial 15-year compliance period and the minimum extended-use period of 15 years) and PSH developers are awarded Housing Credits based on their commitment to comply over this mandatory period.



Instead of the broader sample, Enterprise reviewed three years of performance of its PSH investments throughout Los Angeles County. In its portfolio, Enterprise defines PSH projects as those with at least one-third of the units designated for households with special needs where resident services are provided. Regrettably, the data that was accessed did not account for the exact percentage of formerly homeless households residing in each PSH building.

The sample of the Los Angeles PSH portfolio reviewed represented a total of 39 properties and over 1,900 units, of which 85 percent (or 1,622 PSH units) are designated for residents with special needs, including formerly homeless people. Those 39 PSH developments were developed by seven organizations, four of which each developed six or more PSH properties in the sample. By analyzing project performance data of the 39 Los Angeles PSH projects, Enterprise was able to assess actual operational performance versus underwriting, actual reserve balances versus projections and reserve levels based on reliance of rental assistance to support the extremely low-income, special needs populations housed.

For national context, at the end of 2012, Enterprise had Housing Credit investments in 273 supportive housing projects across the country, concentrated primarily in New York and Los Angeles. This represents approximately 17 percent of the total number of Housing Credit projects in which Enterprise has an investment (over 11,300 PSH units). The Los Angeles PSH portfolio represents 14 percent of the total national Enterprise PSH portfolio. For this research, only properties with an Enterprise equity interest as of year-end 2012 were reviewed.

Nationally, Enterprise's PSH projects perform very well compared to the overall Enterprise portfolio, as indicated by the following key project performance metrics:

- The average occupancy rate for PSH projects was 95.7 percent, slightly less than the strong 96.2 percent of the overall Housing Credit portfolio.
- The median debt coverage ratio (DCR) of 1.38 for PSH projects is slightly higher than the 1.29 of the general Enterprise investment portfolio. The DCR measures a property's ability to pay its debt. DCR is calculated as a property's net operating income divided by the debt payment.

PORTFOLIO ANALYSIS

Characteristics of the Enterprise PSH Portfolio in Los Angeles

Enterprise reviewed a variety of characteristics associated with the 39 PSH projects in Los Angeles, with some highlights offered below:

- The average project size was 49 total units.²
- Seventy percent of the PSH properties dedicated 100 percent of their units as PSH. Of those with less than full targeting, PSH units represented 61 percent of the total units. Only three projects contained less than 50 percent of units targeted to homeless or special needs populations.³
- Forty-six percent were less than 10 years old; 44 percent will be approaching Year 15 in the next five years; and 15 percent of the sample is at Year 15 of its Housing Credit compliance period or will reach that milestone this year.
- Construction types were predominately new construction (51 percent) or substantial rehabilitation (44 percent), with moderate rehabilitation representing only 5 percent.
- The vast majority of projects included project-based rental assistance through two federal sources: Shelter Plus Care (46 percent) and Section 8 (36 percent) programs. Two projects were supported with SRO Moderate Rehabilitation grants.

Project Performance within the Los Angeles PSH Portfolio

Occupancy Rates

Consistent with Enterprise's national PSH portfolio, supportive housing projects in Los Angeles demonstrated very strong occupancy rates. The PSH projects out-performed Enterprise's national Housing Credit portfolio, averaging 97.3 percent occupancy (compared to 96.2 percent). The two moderate rehab deals had even higher occupancy at 98.4 percent. This finding is perhaps unsurprising in that the California market is typically among the strongest markets in the country, and there is a tremendous demand for PSH.

Operating Expenses

Total operating expenses include administrative costs, bad debt, real estate taxes, utilities, repairs and maintenance, insurance, management fees, professional fees and miscellaneous other expenses. The average total expense across the 39 projects was \$7,372 per unit per year, which is

2 The average size of the Enterprise supportive housing portfolio in LA may not be representative of PSH in metro LA, as two leading local supportive housing nonprofits report having larger than average project sizes, with one having an average size of 79 units.

3 Across the country, two-thirds of the supportive housing projects dedicate 100 percent of their units to assisting those with special needs, and nearly 90 percent have at least 50 percent of their units as PSH units. In addition, 2,500 PSH units are scattered among another 250 properties in the portfolio. This PSH integration helps special needs residents become members of a broader society. More choices for living environments reduce the political and neighborhood issues that may arise from housing for homeless people. This integrated approach appears to be on the rise as more state housing finance agencies prioritize integration of PSH for funding and should be a consideration for future PSH units in Los Angeles.

eight percent higher than the median operating expense (\$6,883) for Enterprise’s Housing Credit portfolio in California (includes PSH and non-PSH properties). The range of expenses was wide, from \$5,000 to \$12,000 per unit per year, suggesting that more study is needed in consultation with PSH developers to better understand the wide variation in per unit expenses in PSH.

Enterprise collaborated with the Corporation for Supportive Housing in 2011 to explore the costs of operating PSH across the country. We found that operating expenses are higher on average (about 11 percent) than for affordable housing, with security (e.g., 24-hour front desk coverage) accounting for a large part of that difference. Legal, administration, security/payroll, and property management expenses were, on average, 53 percent higher in PSH as compared with affordable housing. Moreover, it is increasingly common for PSH properties to include supportive services personnel (e.g., service coordinator or case manager) in the operating budget, as allowable by capital funders.⁴

Operating Cash Flow

Operating cash flow is one of the key measures of a property’s performance. Positive operating cash flow means the property’s collected rents and rent subsidies allow it to pay all its operating expenses, must-pay debt service and required reserve payments. Beyond these, the property may utilize cash flow to pay its secondary debt (normally from a government source), save cash for the future, make capital improvements or provide cash to the property owner who can use those funds to operate other properties or provide supportive services to its residents. Negative operating cash flow means a property’s rents and subsidies cannot cover all expenses, must-pay debt and reserve payments. In these cases, either existing reserves or the owner’s own resources must be used to cover the payments. If the only source is the nonprofit owner’s cash, then the organization may be put at financial risk or forced to limit its services in order to subsidize its properties.

Of the 39 properties, almost three-quarters (72 percent) showed positive cash flow all three years reviewed, while 28 percent (11 properties) had a negative operating cash flow at least once over the three-year period (see below).

Percentage of Enterprise PSH Projects in Los Angeles with Negative Cash Flow (2010-2012)

Number of Years of Negative Cash Flow	Percentage of Projects
0 Years (i.e., Positive Cash Flow)	72 percent (28 projects)
1 Year	15 percent (6 projects)
2 Years	10 percent (4 projects)
All 3 Years	3 percent (1 project)

Note: A few of the projects with “positive cash flow only” listed above began operations within the last three years so they have had only positive cash flow but not yet for three years.

4 See *Permanent Supportive Housing: An Operating Cost Analysis*, <http://www.enterprisecommunity.com/resources/ResourceDetails?ID=67590.pdf>.

As shown in the chart on page 45, one property had negative cash flow all three years, and four more had negative cash flow for two of the three years. Affordable housing properties, especially those that serve residents with extremely low incomes, may have a small margin for operating error and fluctuating revenues and expenses. The finding that PSH properties have experienced such limited negative cash flow over the last three years is a testament to strong ownership and operations as well as high demand for the PSH units. It also highlights the importance of a stable subsidy income stream.

Must-Pay Debt

PSH developers use two types of debt to finance their properties: must-pay debt and secondary debt. Must-pay debt is a traditional first mortgage product that requires monthly principal and interest payments to the lender. If these payments are not made, then the lender could foreclose on the property to recover its loan. Secondary debt, sometimes referred to as “subordinate” or “soft debt,” is usually from a government entity or even from the project sponsor. These funds are necessary to cover the development costs that are above the total of the must-pay debt and Housing Credit equity. Typically, secondary debt payments are cash flow contingent, which means they are only made if the property generates positive operating cash flow.

Sixteen of the properties in the LA PSH portfolio carry must-pay debt. Of these, eight have 100 percent or nearly 100 percent units for special need residents, while the other eight have less than 50 percent non-special needs units. These latter properties appear to be leveraging the non-special needs units as a way to pay down the must-pay debt. For the entire portfolio, only 12 properties have non-special needs units of 25 percent or more. While not all non-special needs populations pay higher rents, it appears the owners are using a leveraging model to their advantage, using less total subsidy to develop a property.

This integrated housing solution not only offers a financial solution but also provides a social benefit as formerly homeless individuals and families live within a traditional apartment property instead of in one which may be associated with a stigma of homelessness. These reasons, both financial and social, may be why more state housing finance agencies are pursuing integrated housing solutions for PSH units. The industry needs a better understanding of the extent and impact of this growing dynamic. Outside of the Enterprise project sample, to what extent do PSH properties include units for general occupancy? Are these properties financially viable, and what are the challenges to operating them successfully? What are the social returns for low-income families living in these mixed-income settings?

Reserve Analysis

The portfolio analysis also studied the financial reserves associated with the Enterprise Los Angeles PSH project sample. Specifically, we wanted to know if PSH project underwriting treated reserve requirements differently than other forms of affordable housing. Then, we wanted to assess the health of project reserves in operational PSH developments, to see if these reserves were in fact excessive.

Operating and replacement reserves are standard in any affordable housing investment. To a lesser degree, PSH projects have other reserves, which could include a rental subsidy reserve (or transition reserve in the event subsidy is lost), an outside reserve (held by the owner instead of the partnership, although sometimes the source is developer fee funded by equity) and/or a tenant services reserve (though none of the LA PSH projects had such a reserve). Housing Credit projects generally capitalize, at minimum, an operating reserve in an amount equal to six months of operating expenses, replacement reserves contributions and must-pay debt service (OERDS).

The issue of project reserves is a source of ongoing debate in the PSH development community, and among those public and private agencies that provide permanent financing. While reserves are standard in affordable housing projects, PSH developers often see their properties' capitalized reserves at levels higher than in typical affordable housing projects, while they have limited authority to access those precious resources for the benefit of the project or organization. Investors counter that the reserve requirements are necessary to mitigate the risk associated with the potential reduction or loss of project-based rental subsidies and/or tenant services funding, all of which are subject to annual budget appropriations from Congress and other levels of government.

In early 2013, an across-the-board cut in federal funding known as sequestration went into effect. While experience with rental subsidy has been very strong, with no real losses, these recent sequestration cuts gave stakeholders a view into potential outcomes. Approximately 43 percent of the projects in Enterprise's stabilized Housing Credit portfolio have material revenue from federal rental or operating subsidies, including Section 8 project-based contracts (PBRA) and Shelter Plus Care rental assistance. Fortunately, in projects with Section 8 PBRA, there were no reductions in contract payments, though HUD has renewed some PBRA contracts for periods of less than 12 months in order to avoid making cuts.⁵

⁵ The short-term effect of the limited sequestration on performance of the Enterprise portfolio was negligible; however, Enterprise will continue its longstanding underwriting practice of carefully evaluating the relationship of rental assistance contract rents to market and Housing Credit maximum rents, as well as the ability of projects to withstand a reduction or elimination of rental subsidy.

Skid Row Housing Trust (the Trust) is one of the premiere permanent supportive housing developers in Los Angeles and across the country. The Trust's PSH portfolio includes 25 properties, 14 of those are 15-25 years old and considered part of their aging portfolio.

All properties are SROs, except for one. Eight properties were originally built between 1908 and 1924 and were renovated in the mid-1990s. The remaining six properties were new construction projects built between 1992 and 1999. All properties, except for one, were previously syndicated with Low-Income Housing Tax Credits, and the limited partners (LPs) have exited.

All properties require accessibility upgrades to adequately house special needs tenants with physical disabilities. Some properties are restricted to homeless and chronically homeless as the target population and are either partially or fully subsidized by Shelter Plus Care or Section 8 project-based rental subsidies. Others are restricted as low-income buildings and are housing homeless and chronically homeless residents using Shelter Plus Care rental subsidies.

Operating Reserves

Even prior to engaging in this research on PSH financing in Los Angeles, Enterprise had begun to explore the sizing of project reserves in supportive housing. In an internal review of 19 PSH projects from across the country considered by Enterprise's credit committee from 2009 to 2011, projects requiring larger than standard or minimum reserves were determined to be driven by the potential loss of project-based rental subsidy. The underwriting analysis which calculates this reserve requirement is referred to as a subsidy loss run. In essence, because supportive housing projects are so often packaged with project-based rental subsidy to ensure financial viability, the reserve sizing is simply a function of the subsidy's contribution to the project and not based on it being supportive housing, per se, or serving homeless households.

The severity of projected loss run deficits in supportive housing is impacted by the combination of very deep income targeting that is often required by state housing finance agencies (HFAs) in supportive housing projects and the limited up-front assurances that these requirements would be relaxed in the event rental subsidy were discontinued or eliminated. As a result of this deep targeting to households at 30 and 40 percent of area median income (AMI), and in a few cases even lowered to Supplemental Security Income (SSI), the reserves required to cover loss run deficits was more significant than would be the case if loss run rents were subject only to federal Housing Credit requirements (50 or 60 percent of AMI). While in some cases state HFAs and other funders are willing to indicate that they might consider relaxing the income targeting or adjusting the target population if subsidy were no longer available, there are limited examples of an agreement upfront to relax these restrictions in a loss run scenario. One such state is Washington. The result of Washington's policy is that the three local projects in Enterprise's internal analysis had modest reserves relative to the populations being served. Please see the accompanying brief, *Targeting Relief Policies among Housing Finance Agencies in California*, for a more thorough discussion of relaxing rent restrictions and project reserves.

With the Los Angeles portfolio, Enterprise assessed the level of operating reserves by comparing the year-end operating reserve balance to what was projected during underwriting. For the 36 PSH properties for which there was reserve data (three properties were still in their first year of operations), operating reserve balances appeared healthy overall. There were only six projects that appeared to have under-funded operating reserves; of those, only one was dramatically short of its target (by 38 percent), while the remaining five projects averaged 94 percent of projections.

Illustrating Physical Challenges

Three properties in the Trust's portfolio require accessibility upgrades, have obsolete layouts and need substantial renovations, which would be cost prohibitive or challenging to reconfigure. One building has one on-site services office for 91 homeless/chronically homeless units, while another property does not have an on-site management office. The Trust is considering demolishing these properties and building new construction. Two properties are adjacent sites that could be combined into one new project.

Replacement Reserves

Replacement reserves, which are intended to be used for future capital improvements, were also compared to projections. These reserve balances were on average equal to 87 percent of their projected levels. This is not necessarily a negative, as it could demonstrate that PSH project sponsors are being responsive to a project's physical needs before Year 15. What could not be determined through the data available was whether a portion of these replacement reserves were capitalized at the beginning of the Housing Credit compliance period or from annual required reserve payments.

Capitalized replacement reserves are often necessary in moderate rehabilitation deals when it is determined through initial projections that ongoing replacement reserve deposits may not be feasible from ongoing property operations.



While reserve data indicate the operating and replacement reserves are generally healthy, we do not believe that PSH projects in general are sitting on surplus reserves. In many cases, the reserves will be needed for each project's long-term needs. Presuming rental subsidies could be extended beyond the first fifteen years, only a handful of projects can be expected to operate successfully through the 40-year extended-use period. Enterprise analyzed the 39 Los Angeles PSH operating properties and used industry standard trending assumptions to project operations forward through the additional 40-year extended-use period. The analysis takes into account ordinary repairs and limited capital improvements over the extended-use period. Only six properties will finish the 55-year period with positive reserve balances. More discussion of the level and adequacy of reserve balances follows in the next section of this paper.

Preserving PSH Units for the Long-Term

The Housing Credit compliance period is 15 years, but federal law mandates another 15-year extended-use period during which the property must remain affordable. California projects are typically committed to 40 years of extended use, making the affordability period 55 years for each property. The extended-use period for affordable housing projects in California is daunting, and all buildings will need significant capital improvements during that time. The challenge is how to continue to develop and operate quality PSH and meet modest

Illustrating Physical and Financial Challenges

Four properties in the Trust's portfolio are in deteriorated physical and financial health. These are SROs that were built in the 1990's with minor or moderate rehab work completed at that time. These properties require accessibility upgrades and building systems upgrades and have experienced deferred maintenance, negative operating deficits and insufficient funding of reserves.

capital improvement needs across the entire spectrum of properties while preserving these assets as they age during the extended-use period. On the current trajectory and with fixed or shrinking public subsidy programs, a growing percentage of the subsidy dollars will be needed to simply preserve existing PSH and affordable housing units instead of creating new units. How can the amount of subsidy be best limited?

Enterprise's "Preserving Housing Credit"⁵⁶ paper, released in 2013, spoke to the continued affordability and strong physical condition of the Housing Credit portfolio at Year 15 as a testament to the success of the program. Enterprise learned that most properties are in good physical condition after the initial 15-year period, and 84 percent are able to achieve breakeven operations or better. However, 16 percent report insufficient revenues to fund expenses, reserves and/or required debt service. While the properties are performing, 15 years of normal wear and tear do take a toll, and most properties could use \$5,000 to \$20,000 per unit in capital improvements. These dollar amounts are not overwhelming, but currently the only source to cover these costs would be extra public capital subsidy.

The Enterprise PSH portfolio in Los Angeles that was reviewed for this paper echoes these findings, although there are notable physical and financial issues that threaten the long-term viability of PSH. On the physical side, a primary challenge is that the first generation of aging PSH properties are old-style SRO buildings with shared kitchens and/or bathrooms, and often lack office (for case management) or community spaces that are integral to community building and on-site service provision. Such designs are obsolete by today's standards and pose both accessibility and programmatic concerns compared to newly developed PSH buildings, which stress the availability of on-site supportive services space and accommodating the needs of residents that are aging in place as well as those with physical disabilities. Another unsettling reality is that a significant portion of older PSH properties had minimal or moderate rehabilitation work completed at the outset, likely have deferred maintenance needs, and require upgrades to key building systems.



⁵ <http://www.enterprisecommunity.com/resources/ResourceDetails?ID=0083269>

Illustrating Rental/Operating Subsidy Challenges

All nine of the Trust's properties with Shelter Plus Care contracts have ongoing net operating deficits. Current rents and annual rent increases have been insufficient to cover operating expenses.

The Shelter Plus Care properties include five new construction properties (from the 1990's). Although these properties are in average or good physical condition and require minor rehab, they are in poor financial health with net operating deficits and insufficient reserves.

Out of the six properties with Section 8 subsidies, four properties breakeven or have positive cash flow. In particular, the two properties that have supplemental income from commercial tenants have the healthiest cash flow.

Public stakeholders and owners will need to assess the size and scale of this portfolio and determine what resources will be allocated to renovate and upgrade these with a likely reduction in density and people served. During the 40-year extended-use period, most projects will need more than \$5,000 to \$10,000 a unit of capital improvements. However, further research and analysis can more specifically identify the current and future capital needs of the PSH portfolio. Slightly more than half of the Enterprise PSH portfolio studied consisted of new construction projects. Newly constructed PSH should have modest capital needs following the initial 15-year Housing Credit compliance period. These physical needs can be met with existing replacement reserves and operating cash flow.

In terms of financial barriers for preserving PSH, developers raised a common concern associated with older buildings: current rents and annual rent increases associated with certain project-based rental assistance subsidies, such as Shelter Plus Care and SRO Mod Rehab, have been insufficient to cover operating expenses. These types of subsidies can leave projects with limited long-term financial strength and refinancing options, even new construction projects, unless they can be adjusted to levels that compare with escalating operating expenses. At worst, sponsors will have to continue to subsidize building operating deficits with their own financial resources, which is hardly sustainable and represents a tremendous risk to the long-term health of these sponsors. With these considerations in mind, Enterprise offers four preservation strategies that could help make needed improvements, improve operations and optimize the least amount of public subsidy.



1. Use of Project Reserves

Reserves and the Extended-Use Period

As mentioned above, several properties in the Enterprise sample have healthy reserve balances, as illustrated below on a per unit basis.

Total Reserve Balances in Enterprise PSH Projects in Los Angeles (Per Unit)

Amount of Reserves Per Unit	Percentage of Properties
More than \$10,000	21 percent (8 properties)
\$5,000 to \$10,000	51 percent (19 properties)
Less than \$5,000	28 percent (9 properties)

Six of the properties with more than \$10,000 per unit in reserves are in Year 12 of the compliance period or higher. This makes sense as the older properties have made more annual replacement reserve contributions, and all reserves have generated interest income for longer periods of time (though interest income has been less since 2008). Since many properties face capital improvements in the \$5,000 to \$10,000 range after the 15-year compliance period, using a portion of operating and replacement reserves may be a solution. Utilizing reserves in this way could complement any hard debt and provide a way to pay for the needed improvements without over-leveraging the property.

To maximize the resources to support these operating properties while minimizing the need to seek new resources, it will be critical for industry stakeholders to protect project reserves for preservation of this portfolio. Otherwise, even mission-driven owners will be increasingly unable to subsidize the housing portfolio and will give up this inventory. Further, the public sector will be faced with challenged projects housing very low-income and vulnerable populations without capable owners.

Still, despite the relative health of project reserves evident in the Los Angeles portfolio (at least in the initial 15-year compliance period), reserves balances should not be considered excessive as the vast majority of PSH nonprofit property owners cannot meet their 55-year affordability term without receiving more public subsidy or putting their organizations at financial risk. There are notable reasons, therefore, for caution in over-stretching the use of reserves during the extended-use period.

First, reserves are in place to protect an owner in case something goes wrong at a property. They keep the owner from coming out of pocket for a deficit or capital need. Using too much of the reserves after Year 15 could jeopardize the financial health of the property since it is critical for mission-driven owners to sustain a sufficient reserve, especially with 40 years of extended-use commitment in California.

Second, rents rise at a slower pace than property expenses. Typical underwriting assumes a 2 percent annual increase for rents and 3 percent for expenses. Given the rate differences, rents and expenses will eventually cross and expenses will be higher than rents. Therefore the property will have negative cash flow requiring the use of reserves to breakeven. Unless rental assistance subsidy can grow at the same pace as operating expenses, reserves will eventually be needed.

Also, this analysis does not take into consideration that a building will need significant capital improvements during 55 years of operations. Most building systems have a useful life of 20 to 40 years, meaning that most buildings can expect to replace all major systems during the extended-use period. These expenditures will run at least \$10,000 to \$20,000 per unit and could be substantially more expensive.

Reserve Pooling

After the Housing Credit compliance period, a potential portfolio approach could maximize options but will require lender flexibility and owner capacity. A mission-minded owner with a portfolio of projects with varied performance could benefit from stronger properties cross-subsidizing more challenged ones. By pooling the reserves across multiple projects, there is a greater likelihood that they will be self-sustaining or require more modest re-investment. This will require cooperation among lenders and negotiation on existing debt and treatment of conflicting terms and conditions. Local and state governments have been the primary source of significant and critical public debt for PSH when pressed to close their own operating deficits. Policy choices will have to be evaluated to balance programmatic priorities with how to best preserve this housing.

2. Energy and Water Retrofit

Rising energy and utility costs can pose a significant threat to maintaining affordable rental housing. During the 2013-2014 winter season, many parts of California experienced the lowest rainfall within the last 100 years. Water rates are projected to increase due to supply constraints, which reflect trends across the country. Energy and water efficiency upgrades in rental housing is a cost effective approach to lowering operating expenses, maintaining affordability for low-income households, reducing carbon emissions and creating healthier, more comfortable living environments, especially for people with special needs. With a modest recapitalization, energy and utility savings will prolong the financial viability of this critical housing and stretch the reserves.

Increased funding for the Weatherization Assistance Program through federal stimulus efforts provided an unprecedented opportunity to expand benefits to more multifamily rentals than ever before. In Kansas, Florida, Massachusetts, New Jersey, New York, Oregon, Rhode Island, Vermont and Wisconsin, state Weatherization agencies provided set asides or partnered with the HFA to target multifamily rentals, including retrofitting older Housing Credit projects. A majority of states implement utility-funded energy efficiency programs, often paid for through charges included in customer utility rates. These programs are a significant and growing source of resources for residential energy retrofits that remain largely untapped by the multifamily sector. Enterprise and National Housing Trust will be issuing a report of survey responses from state HFAs of how they have been preserving and improving the affordable housing portfolio, including strategies such as additional Housing Credits (known as “resyndication”) and other resources and policies.

3. Additional Hard Debt

Another limited option is to allow some of the best performing PSH projects to take on extra hard debt. This is a very limited and qualified option available only to some properties with strong cash flow and modest physical needs.

Based on the lowest operating cash flow over the three year period analyzed, Enterprise calculated a property’s ability to carry 30-year 6 percent debt based on a debt coverage ratio of 1.15. According to those calculations, 11 properties could borrow at least \$500,000, and another five properties could borrow between \$200,000 and \$500,000. Of those 16 properties, eight currently have must-pay debt, so adding debt would involve refinancing. The other eight would be required to take on new debt for the first time.

There are two caveats to making this approach possible. First, any public debt currently on the property would need to allow new debt to be placed on the property, and the existing public debt would need to be subordinate to new debt. Second, since the operations of a PSH property are dependent on a rental subsidy such as Section 8 or Shelter Plus Care, the lender would need to feel comfortable that the subsidy would be in place for years to come as a source to repay the debt. Without this assurance, the lender could require large reserves to protect its investment in the property.

This model is similar to HUD’s Rental Assistance Demonstration (RAD) for public housing authorities (PHAs). For RAD⁷, HUD saw the billions of dollars in capital improvements needed in PHA portfolios across the country and opted to make the properties operate more like Section 8 contracts instead of PHA units with breakeven operations. This allows the properties to generate cash flow that may be used to leverage must-pay debt to make the capital improvements instead of funding one lump sum for capital improvements.

⁷ See <http://portal.hud.gov/hudportal/HUD?src=/RAD>.

As mentioned above, the hard debt strategy only works for 16 of the 39 properties as they are currently structured. Changes in operating subsidy could allow more of the PSH units to fall into this category. Alternatively since small loans are less appealing to lenders – modest loans of \$200,000 to \$500,000 are not attractive to private lenders because of fixed costs for origination and servicing – public stakeholders could consider a blended public/private loan that allowed a re-underwriting of the project/portfolio for the extended-use period. This would take into account physical repairs needed to extend the useful life of the project/portfolio and operating assumptions during the extended-use period. A restructured public loan blended with private debt for any project that could carry it would minimize new public resources while attracting private capital that would be interested if they could service the public debt along with the additional small private loans.

4. Fresh Infusion of Housing Credits (Resyndication)

Inevitably, there will be properties that are not performing well or are barely breaking even, and some of these properties may need more capital improvements than the average \$5,000 to \$10,000 per unit. For this subset, the best future is to resyndicate the property for another 15-year Housing Credit compliance period. The goal of the resyndication will be to rectify any capital needs or financial feasibility issues that will allow the property to perform better in the next 15 years.

Given the scarcity of Housing Credits and public subsidies and the growing volume of aging properties (increasing to 100,000 units maturing nationally this year), resyndication is unlikely to be the primary tool to preserve aging affordable housing stock. However, resyndication could be prioritized for the inventory of older SRO buildings that could benefit from modernization and energy efficiency upgrades. Projects that target very low-income residents and are constrained by covenants or regulations restricting rents and increases may have to look at this option to address long-term physical and financial needs as well as capitalize depleted reserves. In the survey of state HFAs, more than 30 states report allocating 9 percent Housing Credits for resyndication, including California, which has allocated 9 percent Housing Credits to 20 projects for resyndication over the past five years.⁸ Many of the PSH projects may not be eligible for 9 percent resyndication because they cannot demonstrate enough leverage to be competitive and may not meet minimum rehab thresholds (\$40,000 per unit).

⁸ Enterprise and National Housing Trust will be issuing a report of survey responses from state HFAs to how they have been preserving and improving this portfolio from allowing resyndication to other resources and policies like QAP incentives or priorities.

More states and localities are encouraging owners to utilize tax-exempt bond financing, which comes with 4 percent Housing Credits. This model appears underutilized at the local level, and importantly supports the bundling of projects for greater scale and volume to support additional fees and costs. The greatest barrier inherent in this type of resyndication is that the property must be able to support enough debt to be eligible to use bond financing, unless additional soft subsidy sources that can be dedicated. The role of HFAs in providing soft debt therefore is vital to ensuring the success of a 4 percent transaction. HFAs will need to review and use their policy levers to make these preservation deals feasible.

CONCLUSION

Despite the lack of a dedicated funding source for PSH development, Los Angeles has developed a strong PSH delivery system that leverages prized Housing Credits with other federal and local resources. This system produces well operated properties with healthy reserve balances in the early years diminishing over the extended use period. Preserving these properties over the full 55-year use period will be a challenge. Sustaining project-based rental subsidy commitments that are able to escalate with increasing operational expenses will be ever important to solidifying these earlier PSH developments for the long-term. In a time of flat to shrinking subsidy resources, public stakeholders will need to find a balance between a growing, aging PSH inventory with the need to continue to build new PSH developments. Creativity in financing and policy will be of the utmost importance for success, and these ideas will require flexibility from both public and private funders.

APPENDIX: SUMMARY OF PSH STAKEHOLDERS ENGAGED IN YEAR 1**Los Angeles PSH Developers Roundtable**

March 26, 2013

CSH Los Angeles Office

Roundtable Participants

Agency	Participant(s)
A Community of Friends	Tara Barauskas
SRO Housing Corporation	Anita Nelson, Joseph Corcoran
Clifford Beers	Cristian Ahumada
LTSC CDC	Thomas Yee
Hollywood Community Housing Corporation	Bill Harris, Malen Rodriguez, Maura Johnson
LA Family Housing	Keon Montgomery
PATH Ventures	John Molloy
Corporation for Supportive Housing	Molly Rysman, David Howden
Enterprise Community Partners	Jeff Schaffer, Ramon Mendez, Marc Tousignant, Victoria Shire (national office)

Stakeholder Interviews

Agency	Interviewee(s)
LA Family Housing	Keon Montgomery
A Community of Friends	Tara Barauskas
PATH Ventures	John Molloy, Jesus Hernandez
Skid Row Housing Trust	Mike Alvidrez, Gigi Szabo
California Housing Partnership Corporation	Paul Beesemyer, Amy Anderson, Zorica Stancevic
California Tax Credit Allocation Committee (CTCAC)	Bill Pavao
Corporation for Supportive Housing	Molly Rysman
United Way	Michael Nailat, Zahirah Mann
Los Angeles Housing and Community Investment Department (HCIDLA)	Manuel Bernal
Los Angeles County Department of Mental Health	Reina Turner
Housing Authority of the City of Los Angeles (HACLA)	Peter Lynn, Carlos Van Natter
Los Angeles County Community Development Commission (CDC)	Pansy Yee, Blanca de la Cruz, Lynn Katano