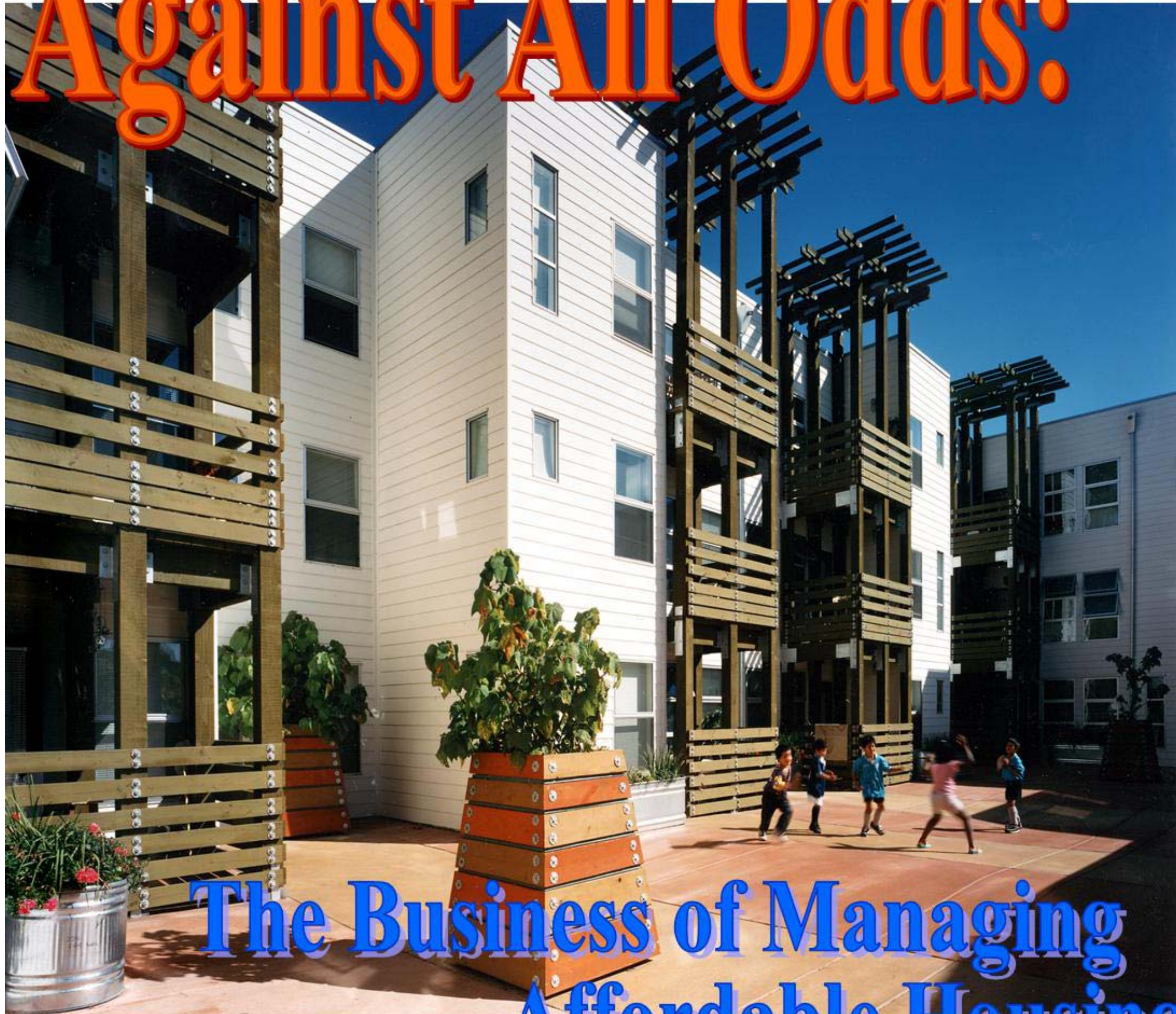
Against All Odds:



The Business of Managing Affordable Housing

A Report to Bay Area LISC

LISC
Bay Area

Against All Odds:
The Business of Managing Affordable Housing

Acknowledgments

In the spring of 2006, the Local Initiatives Support Corporation (LISC) engaged VIVA Consulting to conduct a survey of property managers of affordable housing in California's Bay Area. The survey covered a wide range of topics, including financial issues, reporting and compliance, organizational design, leasing challenges, best practices, and the potential for pooled activities. Fifteen organizations provided significant information through on-line surveys and in subsequent interviews; two additional organizations provided input through interviews alone. Together, the study's 17 participants manage a combined portfolio of over 66,000 units. While a portion of these units are located outside of the Bay Area, the substantial size of the combined portfolio indicates that the study's participants are broadly representative of the organizations managing non-profit-owned affordable housing in the region.

While this study was conducted among 17 CDCs in the San Francisco Bay Area, the experience mirrors anecdotal experiences reported across the country. We therefore strongly believe that these study results will be useful for CDCs throughout the United States as they negotiate funding packages and especially as they pencil out and finalize all line items in their real estate project pre-development, construction and operating pro formas.

In addition to Bay Area LISC, this study was co-sponsored by a number of public and private stakeholders, whose support is gratefully acknowledged:

- California Tax Credit Allocation Committee;
- City of Oakland;
- City of San Jose;
- Gubb & Barshay;
- Merritt Community Capital;
- National Equity Fund; and
- The John Stewart Company.

The work of Judy Weber and Laurie Gould, VIVA Consulting, the principal authors, and Cathy Craig, Senior Program Officer, Bay Area LISC, is what made this study a reality. Many thanks!

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Executive Summary

Community development corporations (CDCs), entered the field of affordable housing development just a few decades ago, and have succeeded beyond the wildest dreams of movement founders, both in the scale of the housing produced, and in the quality of what has been built. Through low income housing tax credits, layered financing, and other creative strategies, nonprofits have made and continue to make efficient and effective use of limited public funds.

Now all the stakeholders in the community development field need to apply that same entrepreneurial, problem-solving spirit to ensure that the housing we have created will provide good places for people to call home for years to come. This study identifies and examines the common challenges managers of these properties encounter, as they struggle to maintain these precious community assets.

It is our hope that this study, which documents what many community development practitioners have long believed, will encourage discussion among the different stakeholders. We seek to ensure the properties' long term sustainability and the enduring revitalization of our communities, and we see the information in this study as the springboard for the legislative, regulatory and policy changes we believe are needed.

The study's key findings, including best practices and policy recommendations, are as follows:

Financial Performance

- ***Few properties generate cash flow for owners.*** Eighty-four percent (84%) of the properties managed by the survey participants put all available funds back into capital repairs or enhanced resident services. Cash flow to owners, whether for asset management fees, deferred developer fees, or any other reason, occurred in only 16% of the properties.

- ***Most management companies in the survey recorded little or no profitability on their fee revenues.*** Of twelve companies responding to the question about profitability, only five recorded profitability at any level; the rest were breaking even or losing money.

- ***Most organizations (81%) find themselves subsidizing the operations and operating losses of at least one or two troubled properties in their portfolios, advancing operating loans or subsidies from their own organizational coffers.*** Thirteen groups reported advancing cash to support their properties' operating expenses "occasionally" or "routinely."

Causes of Financial Strain

- ***Overly optimistic underwriting assumptions*,** for example, unrealistic trending assumptions, where costs increase more steeply than anticipated. The assumptions were often based on operating budgets that were under-estimated to start with.

- ***Revenues are capped*** for affordable properties, according to the regulatory requirements of funding sources. In some cases, Bay Area localities have imposed restrictions on rents beyond the federal programmatic limits. A great source of current financial strain for properties involves changes in HUD's calculation of maximum income levels in some areas, which will preclude rent increases for the next several years.

- ***The small size of most of the affordable properties*** is perhaps the greatest cause of financial strain. There are significant economies of scale—and diseconomies of small scale—in property management both at the site and the management company levels. The strong negative correlation between small property size and management company profitability in affordable housing is intensified: the average property size of the profitable management firms was much bigger than that of the unprofitable firms. Overall, the properties in the portfolios are quite small: 52% have 50 units or less.

Compliance and Administrative Staffing Challenges

Compliance seems to be the operating focus of the managers and the main driver of many of the groups' organizational choices. While staffing levels at market-rate and affordable properties seem to be roughly comparable, the managers of market-rate properties can focus on broad-based marketing, i.e., leasing, customer service, and the physical appeal of their properties. The managers of affordable properties, on the other hand, devote significant amounts of time on compliance, with federal, state, and local funder operating regulations and reporting requirements.

- ***Trade-off between regional manager-level supervisory staffing and compliance staffing.*** Groups that staff compliance more heavily assign relatively larger portfolios to their regional managers.

- ***Lack of sufficiently-skilled administrative staff, especially supervisory.*** Groups have devised a range of "best practices" to address this challenge, including diverse approaches to recruiting and training.

- ***Compliance activities for properties with a large number of funding sources, like most affordable projects, are the most demanding and most time-consuming.*** While the average property in the pool surveyed requires 32 FTE hours per year to handle affordability reporting, properties with as many as five funders take 63 FTE hours, nearly *twice* the amount of time.

- ***Funder-required inspections demand even more time.*** Most groups face multiple physical, administrative and compliance inspections annually. Preparation for each inspection can take between 2 and 30 FTE days.

Pooled Services

Given how thin managers of affordable housing are stretched, it is not surprising that they express considerable *interest in pooling services and resources*, especially training in general and compliance training in particular. Also of interest is pooled purchasing of large-ticket items, compliance monitoring, and MIS support (particularly for Yardi, a commonly used property management software).

Policy Recommendations

- ***Develop greater funding agency collaboration on inspections, compliance and reporting standards.*** While California agencies have taken some steps in this direction, much more could be done to ease the compliance burden. Of particular interest as a model is a unified reporting format developed in the state of Washington, accepted both by multiple state agencies and a number of municipalities (including Seattle and Tacoma).

- ***Establish more realistic budgeting for smaller properties.*** Budgets and reserves should reflect the higher per-unit costs and greater financial vulnerability of smaller properties. Management fees for smaller properties should also reflect the relatively greater per-unit cost of managing smaller properties.

- ***Build in predictable rent increases that keep pace with cost inflation.*** Enabling rent increases that are both sufficient and predictable will involve changes in federal and, in some cases, local policies.

- ***Continue discussions about pooled activities.*** Given the high level of interest in pooled resources and activities, particularly training, property management groups should continue to discuss and explore the best options for collaboration.

1. Introduction and Overview

In the spring of 2006, the Local Initiatives Support Corporation (LISC) engaged VIVA Consulting to conduct a survey of property managers of affordable housing in California's Bay Area. The survey covered a wide range of topics:

- financial issues,
- reporting and compliance,
- organizational design,
- leasing challenges,
- best practices, and
- potential for pooled activities.

Fifteen organizations provided significant information through on-line surveys and in subsequent interviews; two additional organizations provided input through interviews alone. Together, the study's participants manage a combined portfolio of more than 66,000 units. While a portion of these units are located outside of the Bay Area, the substantial size of the combined portfolio indicates that the study's participants are broadly representative of organizations managing non-profit-owned affordable housing.

The broad themes that emerged through the survey, the interviews, and a conference held to review the results, are:

- The vast majority of properties do not generate cash flow -- excess after expenses and debt service – for owners. Cash flow, even when it exists, generally remains in the property to support capital or operating needs.
- The majority of property management firms do not clear a profit on managing affordable housing. While a few firms attain profitability, most are either breaking even or losing money from their property management activities.
- Most of the affordable portfolios are dominated by small properties—over half of the properties managed by survey participants have fewer than 50 units. Because there are significant economies of scale in property management, the prevalence of small properties is almost certainly the main obstacle to profitability for these property management enterprises.
- While the management of market-rate properties is organized around the physical condition of the properties, customer service, and other features that contribute to marketing and leasing success, the management of affordable housing is necessarily organized around compliance and reporting.

These findings, described in detail below, have implications for state and local policy and practice, including:

- The need to adjust financing and underwriting standards to compensate for small property size; and
- The beneficial potential for greater collaboration among funders and regulators.

The Context

While there is more anecdotal than factual data on the business of affordable housing management, the current study's results are consistent with the findings of oft-cited reports (see Resources, p. 30) as well as with VIVA Consulting's extensive national experience and research with affordable housing managers. Three major issues emerge from both anecdotes and the limited amount of research available:

- The smaller the average property sizes in a property management company's portfolio, the greater the likelihood that company will not break even financially.
- In many parts of the country, affordable housing project financing is growing more specialized and complex, with more competition for fewer dollars, more layers of funding, and higher percentages of special needs populations. These factors require greater skill levels to operate the properties successfully. In addition, compliance increasingly drains management time and resources.
- The persistent and usually increasing gap between property revenues and operating expenses (including debt service) leaves affordable properties with inadequate resources to meet both current expenses and long-term capital needs.

These issues emerge repeatedly for managers of affordable properties throughout the country. This study documents their existence and impact through analysis of the property management portfolios of 17 Bay Area community development corporations (CDCs). As one participant in the study lamented, "Property management used to be fun, and we used to be able to make a modest amount of money doing it. Now, it's neither fun nor profitable. We need to find a better way." All stakeholders, including funders, lenders, developers, owners, legislators and the property managers themselves share a strong mutual interest in addressing these challenges.

Affordable housing properties that operate in the black and provide stable, decent homes of choice for low-income families are in danger of becoming unsustainable. With a focus on reducing duplication, increasing collaboration, re-evaluating underwriting criteria, and targeted capacity building training, the satisfaction of a job well done will return, and the promise of enduring community revitalization will be realized.

Study Design, Process and Participation

In September 2005, Bay Area LISC convened a focus group of managers of affordable housing, most of whom were non-profits, to discuss issues of mutual interest and concern. The major themes expressed there became the main areas of inquiry for the survey VIVA Consulting drafted for this study. The topics included business organization, best practices, financial performance, approaches to compliance, initial lease-up of new properties, and the potential for pooled functions and other collaborations. The participants in that focus group became the steering committee for the study, and their comments and revisions were incorporated into the final survey.

The final survey was in two parts. The first part addressed organizational issues, including organizational structure, best practices, compliance, financial performance, and interest in

pooled activities. Seventeen participant organizations were asked to complete this survey. The second part looked in depth at the specifics of regulatory compliance and reporting for a single affordable property. Each participant organization was asked to complete this second part for any two properties in its portfolio. The surveys were offered in a web-based format to facilitate completion and data compilation.

In total, fifteen organizations submitted complete or near-complete responses to the organizational part of the survey, and data was submitted on thirty-two properties for part two of the survey. Statistical data in this report is drawn from those electronic survey responses. VIVA Consulting conducted follow-up interviews with staff of each of these fifteen organizations. Two additional organizations provided information via interviews, but did not complete the survey. Of the seventeen participating organizations, all but one are non-profits or wholly-owned subsidiaries of non-profits. In addition, VIVA staff conducted an interview with a senior executive of a large, national for-profit real estate firm that manages a mix of affordable and market-rate properties. Anecdotal information and quotes throughout this report are drawn from both the written surveys and the interviews with all seventeen participating firms, plus the additional for-profit manager.

Preliminary results were discussed with representatives of all the participating organizations at a meeting in San Francisco in July 2006. Additional comments and feedback provided at that meeting have also informed the content of this report.

Organizational Characteristics of Study Participants

All of the management firms that completed the written survey were non-profits or wholly-owned subsidiaries of non-profits. Overall, about half of the management companies are departments within a larger non-profit, and about half are subsidiaries. All but one of the subsidiaries are also non-profits.

Most of the groups represented in the survey have obtained significant scale in their management operations. As Marc Diaz reported in a study for the Harvard Joint Center for Housing Studies, the conventional wisdom about property management scale is that organizations need at least 500 units to break even on the marginal costs of their property management operations and at least 1,000 units to cover the fully-loaded costs of property management (see Resources, p. 30). There was only one portfolio that did not meet this 500-unit threshold, and it was close, with 442 units. Two-thirds of the respondents managed 1,000 units or more, and the median portfolio size was 1,280 units. The portfolios also represented a fairly broad geographic scope: ten of the fifteen organizations managed portfolios that spanned multiple counties; four covered all of California or moved beyond state boundaries.

Figure 1 shows the types of properties in the respondent portfolios. There was a fairly even split between family and senior properties, a small number of special needs sites, and an even smaller number of HOPE VI/public housing facilities and single family homes:

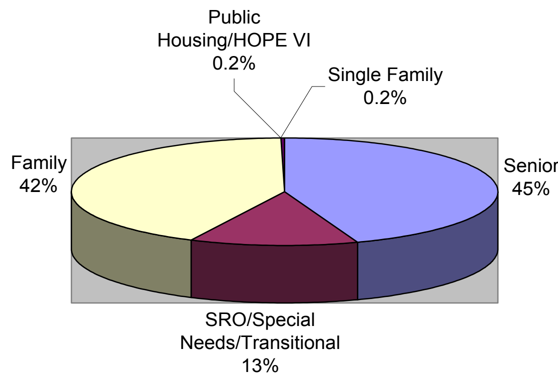

Fig. 1: Property Types in the Collective Portfolio

Because economies of scale are critical factors in successful property management, affordable housing properties begin at a significant disadvantage. Figure 2 shows the distribution: over half of the properties in the groups' collective portfolio have less than 50 units, and only a handful have more than 200:

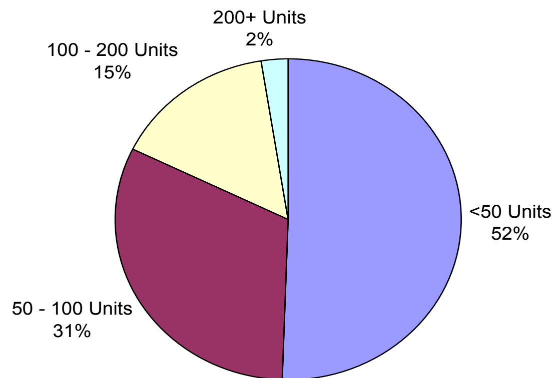

Fig. 2: Property sizes in the collective portfolio

Small properties are much more difficult to operate profitably, on either the property level or the portfolio level, so the small properties these organizations manage contribute to the financial stress on both the properties and the management companies.

2. Financial Performance

Profitability of Properties and Management Companies

Perhaps the most striking finding to emerge from the survey is that the management of affordable housing is not a particularly profitable venture, either on the property level or on the management company level. Few properties generate cash flow for owners, and even when they do, most owners put all available funds back into capital repairs or enhanced resident services. Similarly, most management companies recorded little or no profitability on their fee revenues. If most were breaking even, the system might be sustainable, but in fact most actually find themselves subsidizing at least one or two troubled properties in their portfolios, advancing operating loans or subsidies from their own organizational coffers.

Of twelve participating organizations responding to a survey question about whether or not the property management business cleared a profit (an excess of property management fee revenue over and above the organization's expenses), only five indicated that the operation was profitable. Four firms reported breaking even, and three reported losing money:

Property Management Profitability

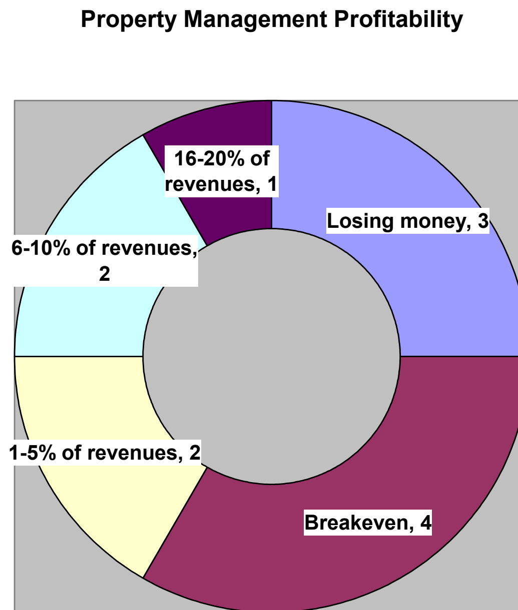

Fig. 3: Management company profits as a percentage of management fee revenue

Further, survey responses clearly indicate that the properties are not, for the most part, generating cash flow that directly benefits owners. In the overwhelming majority of properties, any available cash flow is put back into the property to support capital improvements or expanded resident services, rather than flowing to the owner in one way or another:

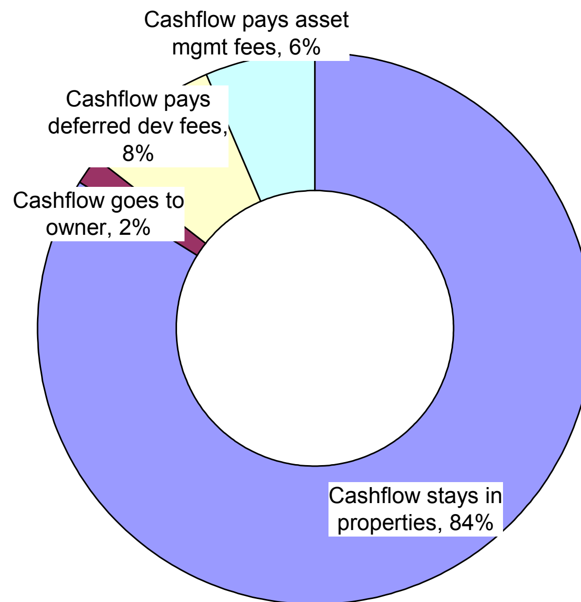

Fig. 4: Use of cash flow in the aggregate portfolio

Finally, most organizations end up providing cash support to at least a few troubled properties in their portfolios. Only three organizations (19%) said that all of their properties cashflow. The rest make cash advances to properties at least occasionally, while six groups (38%) "routinely" advanced cash to properties to fund operations. Even deeper into the scale of financially debilitating activities, three organizations actually include line items in their budgets to cover property operating deficits.

Causes of Financial Strain

When probed about the causes of financial strain in the management of affordable housing properties, survey participants generally agreed on three explanations:

► ***Overly optimistic underwriting assumptions*** set them up for financial struggles down the road. The underwriting missteps identified include:

- *Optimistic trending assumptions.* As one interviewee described the assumptions at the time of closing, "Costs do not trend at 2.5% to 3.5% in affordable housing." In recent years, uncontrollable expenses – for example, insurance and utilities – have increased each year at double-digit rates.
- *Underwriting based on bare-bones operating budgets.* In order to balance sources and uses in development proformas, developers and funders may model low operating expenses to make it look like a project can support a higher level of debt. One interviewee described how this practice leaves properties extremely vulnerable: "To make things

work [in the development proforma], you get down to a bare-bones budget…. You keep your fingers crossed, but things always happen."

- *Insufficient scope on rehabilitiation projects.* In an effort to design projects in keeping with available fund sources, developers often shave the scope of rehabilitation projects. Unfortunately, items that are eliminated from the scope may be the ones that have the greatest impact on successful operations, for example, less energy efficient products and materials or shorter life-cycle materials, or features that limit future marketability.
- *Optimistic market assessment.* As markets have slowed in recent years, some parts of the Bay Area have seen market rents slip to levels comparable to tax credit rents. Tax credit properties are thus forced to compete directly with market-rate properties, even though they shoulder the disadvantages of imposing greater limitations and making greater demands on residents.

► ***Overall limitations on revenues*** cause constant financial strain. While costs have increased steeply in many cases, programmatic restrictions in affordable properties always limit rental revenue. Most limits come from federal funding sources, but in some cases municipalities or counties have restricted the owners' ability to increase rents even more sharply then the federal constraints. The federal constraints themselves, and recent developments in HUD policy, are currently the source of the most serious limitation on rents. In 2006, a fall in Fair Market Rent levels in Marin, San Francisco, and San Mateo counties resulted in HUD-calculated lower maximum income levels, income levels that determine the maximum rents for many programs, including the tax credit and HOME programs. While HUD did not actually lower the income limits in response to the new FMR levels, it did freeze the income limits (and thus rents) until the markets catch up with previously-calculated income and rent levels. The end result is that in large portions of the Bay Area, affordable rents already at the maximum programmatic levels will be frozen as many as five or even ten years in some locations. Expenses, of course, will not stand still during the freeze, and many properties face extreme financial stress.

► ***Diseconomies of scale in managing small sites*** places constant strain on companies that manage affordable housing properties. The impact of small site size is discussed in detail below.

The Challenge of Managing Small Sites

Small site size is directly related to a management company's ability to achieve good financial performance. Only five of twelve respondent groups claimed to have profitable property management operations, and those five groups' average property size is between 60 and 94 units. The portfolios of two of these profitable groups each include at least four properties with 200 units or more. By contrast, the three property management groups that are losing money have average property sizes of 32, 37 and 59 units, respectively. The group with the average property size of 59 units may seem to be better positioned financially, but its median property size is much lower: fully 57% of its properties have less than 50 units.

At the site level, small properties are particularly vulnerable to operating challenges. If one or two units is off-line for any period of time, the proportionate bite out of revenues becomes more significant. Since many costs are more or less the same regardless of the size of the property, for example, audit costs, telephone or software updates, per unit costs are necessarily higher. With so few units over which to amortize costs, there is also little to cushion the blow of any unforeseen operating difficulties. As one interviewee commented, "All you need is one problem, and that pretty much blows [the property] out of the water."

At the management company level, small properties represent equal work for less pay. Management roles and responsibilities – handling payables, supervising management staff, compliance oversight and reporting – do not vary much with project size; the amount of work is determined by the number of properties. Unfortunately the amount of compensation paid to a management company is determined by the number of units, because management fees are generally either a percentage of rent revenues or a fee per unit. At $550 per unit per year, for example, a 50-unit building generates $27,500 in management fees, while a 150-unit building generates $82,500 – three times the compensation for roughly the same amount of work at the management company level.

A review of operating costs from the 2005 Operating Cost Database, sponsored by Bay Area LISC and the National Equity Fund (see Resources, p. 30) reveals that property managers may actually be compensated *less* well for the relatively greater burden involved in managing small properties:

Number of units	Median annual management fee/unit
100 or more	**567**
50-99	**518**
16-49	**532**

In 2005, the median annual property management fee, per unit, was $567 for properties with more than 100 units. For properties with between 16 and 49 units, however, the median fee was only $532 annually per unit – 6% *lower* – even though there is wide acceptance of the fact that diseconomies of scale make small property management more difficult. Multiply these low per-unit fees by a much smaller number of units, and the result is severe under-compensation for the managers of the smaller properties. It is no wonder these managers of small-property portfolios are seeing little financial gain for their efforts.

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3. Organizational Design, Staffing Patterns & Best Practices

The property management survey covered a range of organizational topics, with the intent that sharing information on organizational design and best practices will help each group to choose the most efficient structure for its own operations. This section describes organizational practices, staffing patterns, and self-identified best practices of the participating affordable housing management firms.

When asked to name best practices in their operations, every respondent described some aspect of its organizational design: how they had chosen to staff and structure a particular operating function. Because compliance seems to be the central operating focus of affordable housing managers, the main driver of many of the groups' organizational choices, it is not surprising that a majority of best practices revolved around the compliance function.

Administrative Staffing and Organization

Considering the diversity of property types, portfolio size, and geographic scope, there was a remarkable degree of consistency in administrative staffing and organizational choices.

- ► Almost all groups assign to the central office the main role in:
  - preparation of site budgets,
  - investor/lender reporting and site visits,
  - board reporting, and
  - compliance training and monitoring.

- ► Groups draw a clear distinction between staffing of initial lease-up and staffing of subsequent marketing and leasing efforts. Almost all organizations take on initial leasing and review of initial income certifications as a central organizational function, but most delegate subsequent leasing and tenant eligibility review to the sites. Waitlist management is also delegated to the sites in almost all cases.

Figure 5 shows the per/unit staffing patterns for the various types of projects in respondents' portfolios. While the total number of units assigned to each site manager varies, the median and average are quite close. Further, special needs sites are staffed a bit more intensively, but overall the differences in administrative staffing levels between property types is modest:

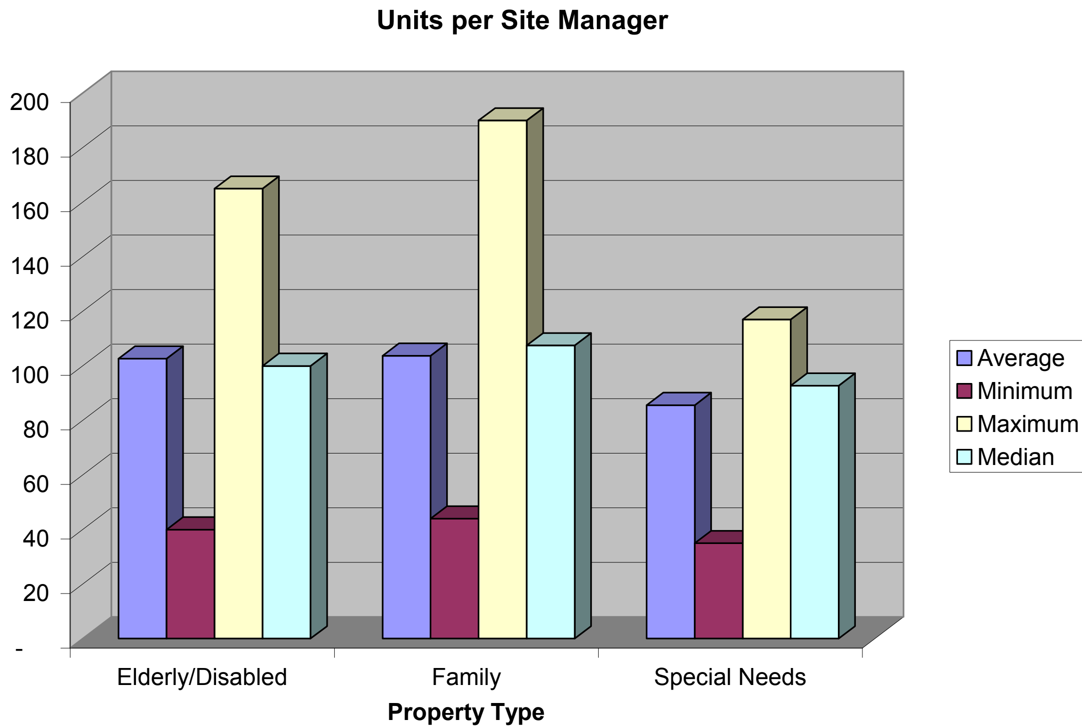

Fig. 5: Units per site manager

Compliance and Supervisory Staffing

There is an apparent trade-off between regional manager-level supervisory staffing and compliance staffing. Anecdotally, most groups describe shifting the assignment of compliance functions between these two job titles. Prior to creating compliance oversight positions, many groups relied on regional managers to perform this function.

The number of units per compliance manager varies, but both the average and the median hover around 1,200 (the average is 1,139, and the median is 1,230):

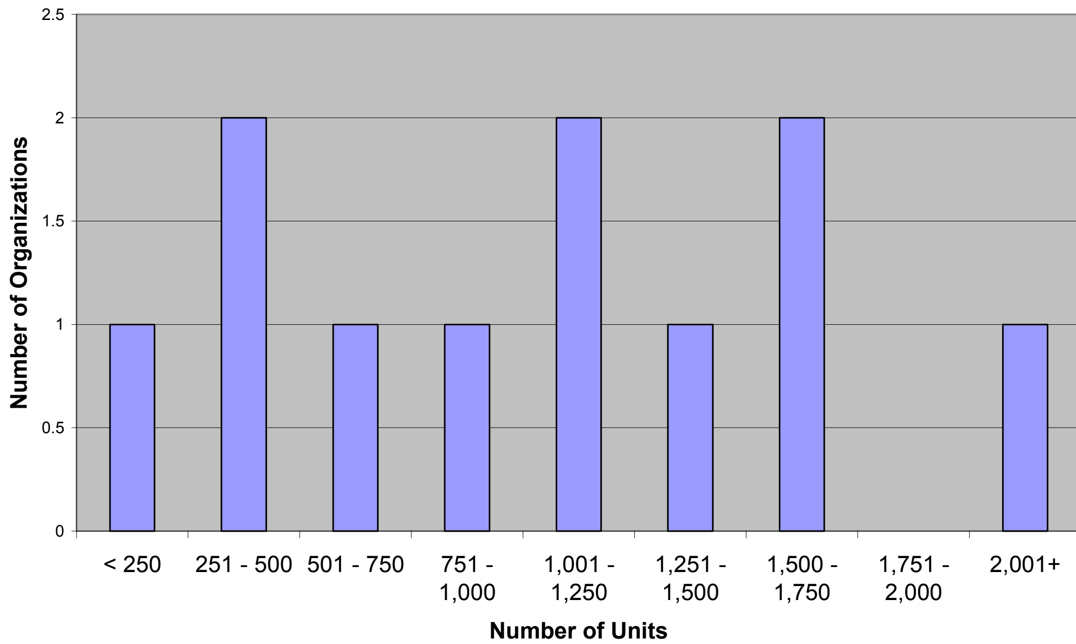

Fig. 6: Units per compliance manager

There is also variation in the assignment of properties to regional portfolio managers. The median number of properties assigned to each portfolio manager is seven, and the average is eight, but the range runs from five to fourteen:

Fig. 7: Properties per regional manager

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While it is difficult to rely on findings from such a small data set, there does appear to be an inverse relationship between regional manager staffing and compliance manager staffing: with only two exceptions, the more heavily organizations staff one position, the more lightly they staff the other:

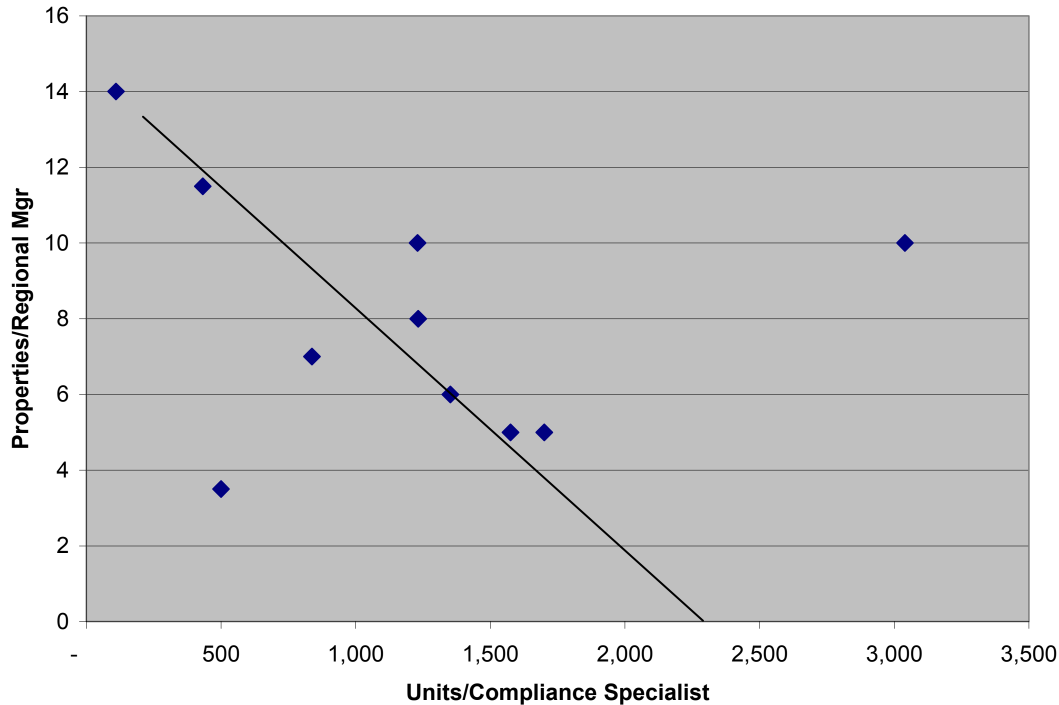

Fig. 8: Relationship between compliance and regional manager staffing.
Please note***: the line is illustrative only, not mathematically derived.***

In interviews, participants agreed that compliance was often the dominant driver of their organizational and operational choices, and they all stated they spent less time on the physical management of the property than they would with a market-rate portfolio.

Accounting

As the matrix below shows, most accounting functions, with the exception of rent collections and associated activities (including deposits and subsidy vouchering), are centralized. Please note: some organizations listed multiple ways of handling each function, presumably using different practices at different properties, so some rows total more than 100%:

	Central Office	Sites	Outsourced
AP: data entry	73%	27%	7%
AP: invoice approvals	87%	33%	0%
AP: check processing	93%	0%	7%
AR: check receipt and data entry	53%	47%	7%
AR: deposits	27%	80%	0%
AR: subsidy vouchering	53%	67%	0%

A majority of the organizations (nine out of fifteen, or 60%) use Yardi as their property management software, and most of these (seven of nine) also use Yardi for their general ledger.

Maintenance Staffing

As Figure 9 demonstrates, maintenance staffing was fairly consistent across organizations: about 100 units per maintenance staff member if custodial work is outsourced, and about 50 if it is done in-house:

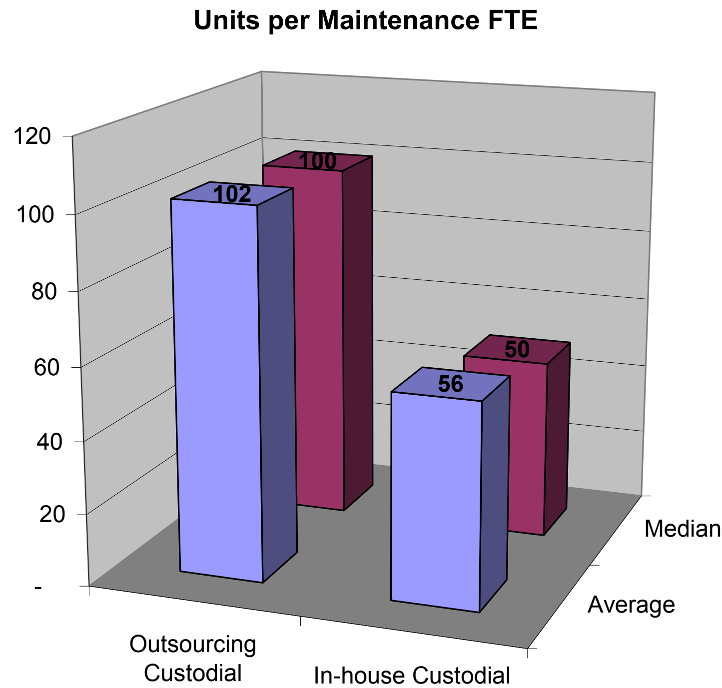

Fig. 9: Units per maintenance FTE

This matrix demonstrates groups tend to push day-to-day maintenance activities out to the sites and to centralize maintenance planning activities, including preventive maintenance programming, and especially capital project planning:

	Central Office	Sites
Receiving tenant requests	**0%**	**100%**
Issuing work orders	**15%**	**85%**
Maintenance staff supervision	**36%**	**64%**
Establishing preventive maintenance programs	**62%**	**38%**
Capital projects < $15,000	**85%**	**15%**
Capital projects > $25,000	**93%**	**7%**

Most groups (93%, or all but one) outsource landscaping. Roughly one quarter (27%) outsource custodial work. Nearly half (47%) outsource painting. A number of groups outsource painting or turnover preparation only on an as-needed basis, when in-house staff are not available to get the work done in a timely way.

Challenges and Best Practices

A number of groups named maintenance staffing strategies as best practices. These strategies involved deploying in-house staff as needed among multiple properties, either general maintenance staff or a "roving team of specialists," in either case charged to properties on an hourly basis.

Many groups spoke of administrative staffing as their greatest challenge, particularly at the supervisory level. The growing complexity of property financing sources, in particular the layering of resident eligibility requirements, income tiering, reporting, and other related tasks, has raised the bar on administrative staff skill requirements. Concludes one executive: "We used to be able to hire 'C' thinkers. Now we need 'B' level abstract and forensic thinkers."

Participants described a number of strategies they have adopted to solve the challenge of finding skilled staff for administrative positions:

- "We are focusing on hiring responsiveness, professionalism, dependability and administrative/customer service skills rather than property management/tax credit skills as we have in the past. We can train those skills. As a result, we're getting better candidates than we have before."
- "We have eliminated the traditional regional property supervisor position. Instead, we have strong managers acting as supervisors for clustered properties."
- "We consciously groom site managers so we can promote from within."

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4. Reporting & Compliance

Compliance is the central administrative focus of affordable housing managers. A senior executive at a large national firm that handles both affordable and market rate properties summarized the differences between managing affordable and market-rate properties as follows: "While staffing levels at market and affordable properties are roughly comparable, the managers of affordable properties focus on compliance, while the managers of market-rate properties focus on leasing, i.e. marketing, customer service, and the physical appeal of their properties."

As Figure 10 shows, the reporting burden for affordable properties is greatest for tax credit properties:

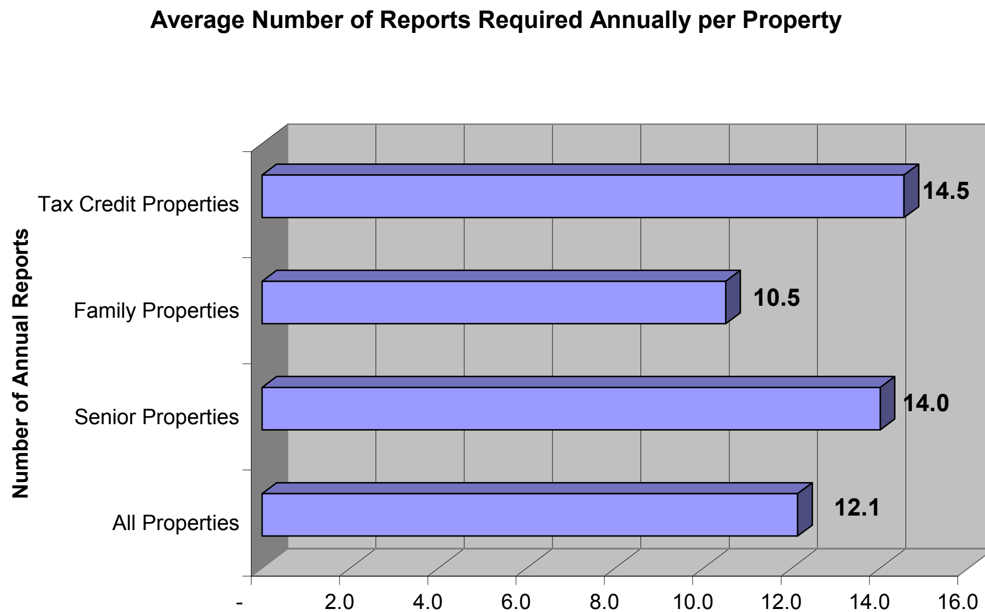

Fig. 10: Number of reports by property type

Not surprisingly, the amount of time spent reporting increases with the number of funding sources involved in a property's financial structure, and Figure 11 demonstrates that finding:

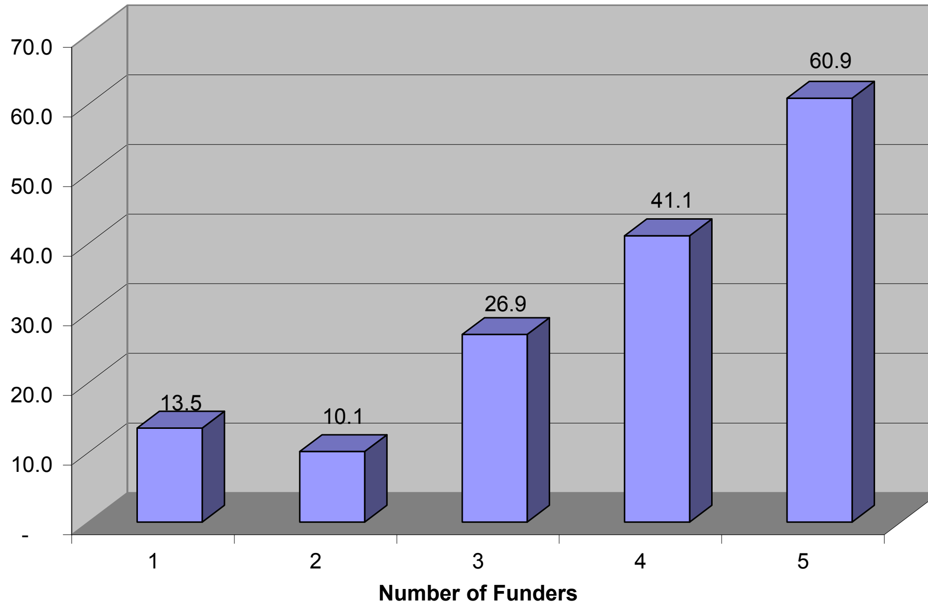

Fig. 11: Report preparation hours by number of funders

For the pool of sample properties, on the average, 32 hours annually are spent on report preparation. The diagram above shows that the number of hours is nearly twice as high for properties with as many as five funders.

Inspections are another time-consuming aspect of compliance activities. As Figure 12 shows, most properties face multiple inspections over the course of a typical year:

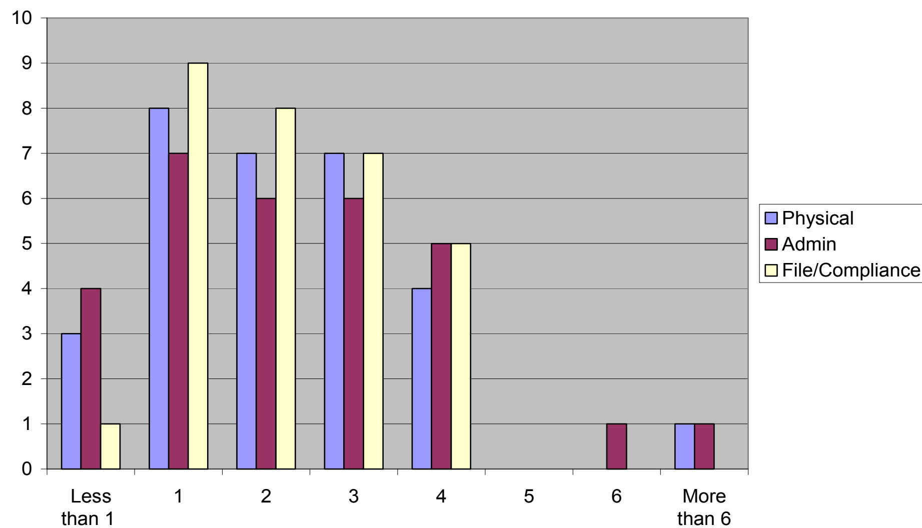

Fig. 12: Inspections per property

Interviewees gave widely disparate accounts of the amount of time it took to prepare for each of these inspections: from 2 to 30 FTE days for a physical (REAC) inspection; from 2 to 20 days for an administrative (MOR) inspection; and from 1.5 to 20 days for a compliance inspection.

Harder to quantify are the demands of the most time-consuming part of the compliance process: managing the application and income certification process.

Because compliance is of such central concern to affordable housing managers, they have developed a number of best practices:

- "We have a binder prepared with copies of all requested materials for the inspectors. They love it."
- "We conduct quarterly in-house audits of problem properties and address issues immediately."
- "Compliance manager reviews site files two months in advance of inspection."
- "We purposely decentralized compliance to property supervisors. We hire from the market/for-profit industry and train in affordable housing. We need their financial skills."

5. Tightened Lease-up Requirements

The initial session with participating organizations in the fall of 2005 surfaced concern over the growing challenge of initial lease-up of affordable properties. Indeed, the survey and follow-up interviews found that lease-ups have grown increasingly difficult, time-consuming and expensive.

Participants noted that the trend in affordable housing projects is toward greater complexity. In order to be competitive for a very tight pool of subsidy resources, projects are including more units for extremely low-income families (earning 30% of AMI or less), and are including more units for special needs households with intense social service requirements. With more income tiers, more occupancy requirements, and a more complex set of requirements to determine occupancy eligibility, it has become much more challenging to locate households who are eligible residents for a given property.

An additional layer of complexity comes from the frequent need to provide translators and to address other unique cultural issues that would make properties accessible and attractive to diverse immigrant populations.

To further complicate matters, housing authorities, who often have the task of referring either Section 8-eligible families or eligible families from their general public housing waiting lists, are not always prompt in their referrals and have not always kept their lists up-to-date.

Participating groups report a wide range of experience in how long it takes to rent-up properties when they first come on line. While rent-ups of modestly-sized properties can be achieved in as little as 2-3 months in very strong markets, other lease-ups have taken as long as 17 months. Tax credit regulations require that household income certification must be dated within 90 days of lease-signing, and thus may become stale if construction completion and occupancy are delayed. Twenty-five percent (25%) of the respondents to the survey have had to conduct the income certification process at least twice during the course of initial lease-ups.

All respondents were asked to provide data on their most recent property rent-up. Twelve organizations provided this data, and all of the examples offered were for tax credit properties. The average actual per unit cost for lease-up of a new property was $1,026, although the range of cost was great: from $136/unit to over $3,000/unit). There was, however, consistency in the fact that most lease-ups turned out to be more expensive than budgeted: eight of the twelve projects (67%) reported going over-budget on their lease-ups.

Follow-up interviews revealed most groups attribute the increasing difficulties to the increased complexity of the task. Compliance and eligibility requirements have indeed become more exacting and layered.

6. Pooled Activities

Given the common challenges, many of them overlapping and repetitive, it is not surprising that respondents were quite intrigued by the prospect of pooling activities. Pooled training, on compliance, administration and maintenance, excited the most interest, followed by MIS Support, but other pooled functions were of interest as well:

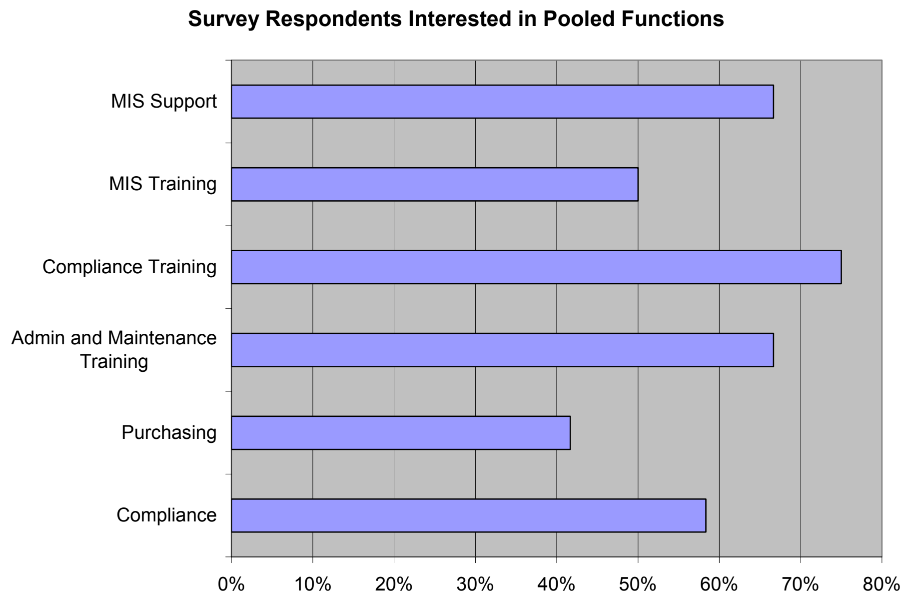

Fig 13: Interest in pooled activities

Training

Respondents expressed the greatest interest in pooling compliance training, particularly compliance training approved by the California Tax Credit Allocation Committee (TCAC). Other areas of interest included general property management skills, maintenance, fair housing, and human resources. LISC and Merritt Community Capital currently co-sponsor a well-regarded property management training, but respondents cited the need for additional training resources. Here are some other comments and observations:

- Cost savings were the most frequently-mentioned reason for pooling training. Pooled place-based compliance trainings within commuting distance were preferred, because they would save on training fees as well as travel expense and time.
- One respondent pointed to greater performance consistency among organizations as another desirable outcome of pooled training.
- Groups varied a great deal in their other preferences and opinions about training that could work for the group.
- There was general consensus that the preferred cost was from $75 - $149 per day per participant.

There was less consensus on a range of other training issues:

- Some groups were very receptive to on-line training, and others were not.
- Some groups valued testing; others opposed it.
- Some groups valued off-site, multi-day trainings, where staff could focus wholly on the new material; others preferred shorter, more local trainings which would not distract staff from their general responsibilities.

Other Pooled Functions

While less than half of the groups expressed interest in pooled purchasing, some indicated that pooled purchasing might be of value to get bulk purchase discounts on big-ticket items like carpeting and appliances.

Many groups indicated a willingness to discuss sharing compliance staff. Two groups indicated that they have excess capacity in this area; interestingly, only one of these two groups indicated that they would be willing to pool this capacity for potential cost savings.

MIS support is of interest to many groups. A number suggested sharing technical support for Yardi, given the significant number of groups using that software.

7. Policy Implications

This study confirmed a widely-held anecdotal belief: property management of affordable housing in the Bay Area is not a profitable venture for most of its practitioners. Moreover, many aspects of property management – lease-up of new properties, staffing, managing compliance of properties with increasingly complex resident eligibility standards – are becoming more challenging. If the ownership and management of affordable housing is truly a money-losing proposition for many groups, affordable housing will not be sustainable. Ultimately, financial and operational challenges could force some groups out of the business, reducing the pool of operators willing and able to provide high-quality affordable housing. Consolidation among managers is probably not a solution, since virtually all of the managers are already operating at a scale that should be sufficient to allow profitability. The issue is foundational: small properties largely underwritten with unrealistic assumptions will always be challenged to perform successfully.

The findings of this report strongly suggest policy review and change in the following areas:

► Agency Collaboration on Inspections, Reporting & Compliance Standards

Compliance adds enormously to the overall cost of operating affordable housing:

- analysis and documentation of overlapping sets of affordability restrictions,
- initial and on-going documentation of compliance with affordability restrictions,
- completion of numerous funder reports, and
- preparation for multiple inspections by multiple parties throughout the year.

In recent years, the various regulatory agencies working in California have, indeed, made efforts to streamline the process and content of affordable housing regulation and compliance. In 2003, for example, the California Department of Housing and Community Development (HCD) adopted the Uniform Multifamily Regulations, followed by the Multifamily Housing Program and Supportive Housing Regulations in 2003 and 2005; these regulations established a higher level of consistency and coordination among HCD, the California Tax Credit Allocation Committee (TCAC) and California Housing Finance Agency for newly-funded projects. These same agencies are also attempting to coordinate site inspections on all properties they mutually regulate.

Specific recommendations are:

- Further streamlining of compliance and reporting is still appropriate and could provide even greater relief without sacrificing the quality of the oversight. In Washington state, for example, all of the state agencies have collaborated with several municipalities (including Seattle and Tacoma) to create a single, unified annual reporting form that all of the funders have agreed to accept. A unified reporting format would reduce the reporting burden on managers while using tax payer funds more efficiently.
- Re-evaluation of income eligibility requirements and standards could provide even greater assistance, since eligibility review and income certification generally take even more time than reporting.

- Federal and state agencies should also re-evaluate the process of turning contract administration over to third-party contractors. These third-party agents represent an inherent conflict, because they are motivated to find fault with managers in order to justify continuation or expansion of their role or to demonstrate that they are acting in a thorough manner. Managers of affordable housing have found many of the contract administrators to be inconsistent and/or capricious.

► Realistic Budgeting for Smaller Properties

Smaller properties enjoy many fewer economies of scale than larger ones, and consistently cost more to operate on a per-unit basis. LISC's most recent study of operating costs shows costs that are between 7% and 13% higher per unit for properties with 16 – 49 units than for properties with 100 or more units. Yet initial underwriting seldom incorporates this fact. Per-unit costs to the property management firm, too, are greater in smaller properties. Even so, the LISC study shows that median property management fees for buildings with 16 to 49 units are actually 7% lower than the per-unit fees for properties with 100 or more units.

Specific recommendations are:

- Budgets for smaller properties should reflect the greater per-unit costs of operating those properties.
- Property management fees for smaller properties should reflect the relatively greater per-unit costs to the management company of overseeing those properties.
- Reserves for smaller properties should reflect the financial and operational vulnerability of small properties and should provide greater per-unit cushioning.
- Properties with more complex financing structures or more elaborate rent tiering are also more expensive to manage; and budgets should reflect the additional time requirements.

Community development goals may continue to drive the development of small-scale rental housing developments, for example, crucial urban in-fill sites or in relatively small communities. It is important for policy makers and affordable housing developers to adopt realistic operating assumptions for these beneficial projects in order to ensure their long-term viability.

► Realistic underwriting standards

Property operations are frequently hampered by unrealistic underwriting assumptions at the development stage. In recent years, for example, expenses have increased much more steeply than revenues, and many managers face continuous difficulties operating properties that were not sufficiently or appropriately renovated at the time of redevelopment.

- Underwriters should assume that negative trending will continue to be fairly steep and therefore size loans to keep properties in the black over the long term. This may require Year 1 debt service coverage ratios of more than 1.15 in some cases. It

would definitely require an increase of tax credit equity and/or soft loan funding in order to keep projects financially feasible.
- Property rehab scope should be sufficient in all cases so that the properties will be able to complete future improvements for 15 years by drawing only on replacement reserves.

► Predictable Rent Increases That Keep Pace with Cost Escalation

In the past some municipalities and counties have limited owners' abilities to increase rents annually, even beyond the limits already imposed by federal program regulations. These restrictions have prevented rents from keeping pace with expense inflation and put many properties under substantial financial strain. Currently, restrictions on the federal side have effectively frozen income limits – and thus tax credit rents – in much of California, including Marin, San Francisco, and San Mateo Counties. Given HUD's methodology for calculating income limits, it could be 5 or even 10 years before some of these areas can resume annual rent increases, keeping many existing properties under long-term financial strain.

Specific recommendations are:

- Owners, managers and regulators in this area should join in pressing the federal government for regulatory relief in the determination of income limits and rent caps, to acknowledge the reality that few enterprises can financially weather multiple years of rising costs and flat revenues.
- TCAC and HCD should adjust their underwriting guidelines to reflect the projected restrictions on rent increases in some areas.
- Local governments should refrain from imposing stricter regulations on rent increases than those already incorporated in the provisions of federal funding programs.

► Continued Discussion of Pooled Functions

Many participants were very responsive to the potential for pooled services – training in particular, but also compliance, MIS and purchasing – as a way to achieve greater consistency and save money. The property management community and area intermediaries should convene a group to further explore the options for pooling functions, to determine whether it would, indeed, be possible to reap financial and operating benefits.

8. Resources

Bratt, Rachel G., *et al.* *Confronting the Management Challenge*. 1994.

Diaz, Marc. "Assessing Property Management for Affordable Housing." Joint Center for Housing Studies, Harvard University: 2004.

Ernst & Young. *The State of the LIHTC Portfolio*. 2002; updated 2006.

LISC. "Investing Where It Matters," Report on Community Development Activity in the Bay Area. 2006. Estimates non-profits have developed a total of 60,307 affordable units, both rental and ownership, through the end of 2005.

Millennial Housing Commission. *Meeting Our Nation's Housing Challenges*. 2002.

www.cdexchange.org. The 2005 Operating Cost Database includes operating expense data from 289 affordable housing developments in the greater Bay Area.

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October 2006

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