hanley▲wood

MFE

MULTIFAMILY EXECUTIVE

MIXED BAG

Related California's **BILL WITTE** and other top developers reveal how to weave mixed-income deals into seamless communities.

+

Multifamily's Top Enemies, and How to Defeat Them

Introducing the MFE Concept Community, a Deep Dive Into Gen Y

JUNE 2012 VOLUME 17, ISSUE 7

FEATURES Volume 17, Issue 7

06.12

Bill Witte
President,
Related California

40 When Mix Works Magic:

For developers struggling to obtain construction debt, mixed-income projects offer a promising solution. But the approach isn't without its difficulties. BY JERRY ASCIERTO

46 Know Thine Enemy:

Though multifamily is going along swimmingly now, these four people pose a legitimate threat to the industry's future progress. BY LES SHAVER

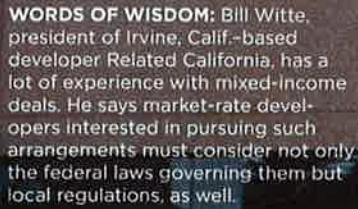
This page and cover: Kyle Monk

Volume 17, number 7. MULTIFAMILY EXECUTIVE (ISSN 1089 4721; USPS 015-907) is published monthly (semi-monthly in March) by Hanley Wood, LLC, One Thomas Circle, NW, Suite 600, Washington, DC 20005 and is printed in the USA. Copyright 2012 by Hanley Wood, LLC. Periodicals postage paid at Washington, DC, and at additional mailing offices.

POSTMASTER: Send address changes to MULTIFAMILY EXECUTIVE, PO Box 3495, Northbrook, IL 60065-9831.

CORRECTIONS: In our Top 50 coverage (May 2012, page 30), we inadvertently mis-cited the name of Archstone's top executive; R. Scot Sellers is the firm's CEO. Additionally, our numbers for general contractor Thompson Thrift Construction require some correction and explanation. The company broke ground on 2,016 multifamily units overall in 2011. However, only 470 of those units were built for clients other than Watermark Residential. According to Thompson Thrift's website, the firm established Watermark to "capitalize on its extensive multifamily development, construction, and management experience." Because of this relationship, we didn't include in Thompson's third-party starts total the units it completed for Watermark. The company disputes this decision. What isn't in dispute is that we committed an error in computing Thompson's multifamily-only revenue numbers, which totaled $57 million in 2011. Lastly, in our March issue ("Under Scrutiny," page 44), we erroneously reported that Behringer Harvard had been sued by an investor. MULTIFAMILY EXECUTIVE regrets these errors.

WHEN MIX WORKS



WORDS OF WISDOM: Bill Witte, president of Irvine, Calif.-based developer Related California, has a lot of experience with mixed-income deals. He says market-rate developers interested in pursuing such arrangements must consider not only the federal laws governing them but local regulations, as well.

MAGIC

MIXED-INCOME DEVELOPMENT OFFERS A POSSIBLE SOLUTION TO THE LACK OF CONSTRUCTION DEBT ON THE MARKET—BUT IT ALSO POSES SOME POTENTIAL PITFALLS TO THE UNWARY.

BY JERRY ASCIERTO

AFTER 18 MONTHS OF WAITING, Patrick McNerney was no closer to getting his construction loan.

In early 2009, the developer submitted an application to the Federal Housing Administration (FHA) for a $50 million loan to build Portrero Launch, a 196-unit development in downtown San Francisco. But a year and a half later, the FHA suddenly stopped processing the application.

McNerney's firm, Martin Building Co., was building another project with FHA funds—a loan that took 20 months to close—and the agency wanted to see how that project performed before approving another deal with him.

Frustrated, and unable to find conventional debt from banks, the developer went back to the drawing board. Though the plan all along was to build a luxury Class A deal, McNerney instead applied for tax-exempt bond financing—which came with low-income housing tax credits (LIHTCs)—and easily won an allocation.

"Within 60 days, I had a loan approval from Citibank, which felt miraculous," McNerney says. "And the reason they moved so swiftly was because it was now a tax-credit project, and the bank wanted Community Reinvestment Act [CRA] credits."

The use of tax-exempt bonds requires the developer to set aside 20 percent of the units for those earning up to 50 percent of the area median income (AMI), while the other 80 percent remain market rate (aka, an "80/20" deal). And while McNerney believes in the social value of mixed-income development, it wasn't as though he was on a social mission.

"I'd love to say it was altruism," he says, "but I was just really struggling to attract financing."

McNerney's mixed-income approach offers a possible solution for the market-rate developers out there struggling to attract construction capital. While borrower scrutiny is at an all-time high, sometimes serving a public purpose—even in just 20 percent of your building—is a more important consideration to a financier than dissecting every last line item on your bank statement and real estate-owned (REO) schedule.

Banks are under regulatory pressure to lend on affordable housing deals and will often fight for the few tax-credit deals in their market to fulfill CRA requirements. Meanwhile, the FHA has refocused on serving the LIHTC market much more than it had in the past. So, why not play to that strength?

"A mixed-income deal offers a better story," says McNerney. "HUD loves it, and banks love it too."

Local-Issuer Issues

Sometimes, it's only a stone's throw to get to that 20 percent affordable set-aside. Many municipalities already have inclusionary zoning laws, which mandate that a percentage of all apartment buildings be set aside for affordable housing. In San Francisco, that requirement is already 15 percent, which developers can satisfy either within the building itself or off site in a separate structure.

"If the public policy is pushing you in that direction in any event, you're going to have to deal with it one way or another," says Bill Witte, president of Irvine, Calif.-based developer Related California. "Manhattan, for instance, gives a 10-year property-tax exemption if 20 percent of the units are affordable. So oftentimes, communities will provide incentives, and developers will then look to the bond program."

Arranging a capital stack that includes LIHTCs and tax-exempt bond credit enhancements adds complexity—and time—to the process. But other factors can expedite things. Municipalities are often more inclined to give the green light more quickly—and offer additional incentives—to a deal that serves a public purpose.

But there is no such thing as a free lunch, and that old cliché certainly applies to tax-exempt bond financing. The Related Cos., parent firm of Related California, has developed nearly two dozen 80/20 deals and worked with many municipalities in its 40-year history. Before a market-rate developer takes the plunge on an 80/20 deal, there are several factors to consider, says Witte.

First, federal laws governing the use of tax-exempt bonds require all the units, not just the affordable ones, to remain rentals for at least 15 years. So, any developers looking to turn some units into condos in a few years need not apply. And some states impose a longer time frame, such as California, where the affordable units must stay affordable rentals for 55 years, Witte says.

In fact, while the federal laws are fairly straightforward, there are many variables at the ground level that can really trip you up. Developers would do best to first study what their state requires as a condition of the financing.

"There are often requirements of the local issuer of the bonds governing the location of the affordable units, how spread out in the building they are, and the sizes of the affordable units," says Witte. "Those issues completely depend on the local issuer of the bonds."

Verification Initiation

Related has done 80/20 deals in which the LIHTCs were sold to generate additional equity, and the company has also held on to the credits and used them to offset its own tax liability.

But whether you keep or sell the credits, developers need to be aware that LIHTCs come with stringent compliance issues, Witte says.

And it's a much different process from renting to a garden-variety market-rate tenant, where income verifications are done just once, at initial leasing. In contrast, the affordable units have to be rented to those making up to 50 percent AMI. And once a year—for a 15-year compliance period—the property manager has to make sure the tenants meet this income requirement.

"It's best to bring in a management company with experience in tax-credit compliance, or third-party consultants like Novogradac or Reznick," says Phil Melton, who leads the affordable housing debt arm of New York-based Centerline Capital. "Or, you're going to have to train your staff to ask questions of a more personal nature than they're used to doing."

Those questions include a deeper dive into a household's finances. The owner must verify all income sources of all adult household members over 18, as well as benefits paid on behalf of minors in the household. Income from assets must also be included in that tally.

Another tip regards file retention. Those first-year tenant files have to be retained for the entire 15-year compliance period, in case the IRS and HUD want to make sure you qualified those residents correctly from day one, advises Witte. Failure to do so may result in some stiff financial penalties.

Partnering for Profits and Purpose

An 80/20 deal is often handled by a single developer. But deeper levels of income mixing require deep rosters, a gathering of different skill sets.

In February, Related California broke ground on

HIGH-PROFILE: The 196-unit Portrero Launch in San Francisco, opening in September, was bought by Henry Cisneros' CityView for $90 million in January.

Courtesy Martin Building Co.

the $350 million Village at Santa Monica, a 318-unit mixed-income development that utilizes 4 percent LIHTCs and tax-exempt bonds. When the developer won the request for proposal in 2006, it was given affordability parameters by the city of Santa Monica: Roughly half the 318 units had to be affordable. To make the deal work, the company decided to develop the other half as high-end condominiums.

"At the time, for-sale housing was literally riding into the boom, so the residual land value for condominiums was much greater than for apartments," says Witte. "The way to make this project work financially was to pay the city for the land in a sufficiently large number that it could take the proceeds and use them to subsidize the affordable units."

That decision set the developer back. Scoring the tax-exempt bonds and related LIHTCs was the easy part; finding construction debt for a condo project remains a wild goose chase. Yet, the company finally found a 65 percent leverage loan from Wells Fargo and HSBC over the winter, with 35 percent equity coming from the development team—a capital stack that was impossible two years ago, when Related was raring to break ground.

The overwhelming majority of that equity came from the Resmark Cos., which partnered with Related on the condos. "The recession probably cost us a couple of years," says Witte. "But that's a very good deal in today's world for condominiums, if you can finance them at all."

Related and Resmark hope to sell the condos for upward of $800,000 when they come on line in 2014, and are confident that such a price can be achieved in a high-cost seaside area like Santa Monica.

"From a financing point of view, mixed-income works best in very strong markets—the higher the rent, the easier it is to [get it to] work financially," says

5 TIPS FOR MARKETING AND MANAGING A MIXED-INCOME COMMUNITY

1. Move the market-rate residents in first: Mixed-income properties require a careful approach to the timing of moving in the range of residents that will occupy the units. Moving in market-rate occupants first tends to be the most successful strategy, because it helps establish the property's tone.

2. Make design a management matter, too: Buildings should be designed for or above the market. Ideally, the design finishes for market-rate and affordable units should be the same. An advantage to a single design finish across units is that it allows market-rate and affordable tenants alike to occupy any unit as units turn over.

3. Link with local schools: Creating linkages with a nearby school has multiple benefits. It stands out as an amenity for market-rate residents while offering a valuable resource for low-income households with children.

4. Be prepared with strong public relations: It's important to present the property as a market-rate community with a seamless affordable component. Ensuring that the property is perceived as market rate creates a competitive edge for attracting and retaining tenants.

5. Establish resident involvement: Properties often have a tenant-based group that can be an important resource for communication between management and residents. Fostering participation from all residents encourages interaction about common interests and strengthens community ties.

Source: *Marketing, Managing and Maintaining Mixed-Income Communities*, Urban Land Institute

BOUND TO BONDS: Seven years after it was proposed, the $160 million One Santa Fe (left) broke ground in L.A., thanks to an 80/20 tax-exempt bond execution.

THE RIGHT MIX: Half the 318 units at the $350 million Village at Santa Monica (right) will be high-end luxury condos; the other half, affordable housing.

Renderings, L to R: Courtesy Michael Maltzen and KTGY; Courtesy Koning Eizenberg Architecture and Moore Ruble Yudell

Witte. "By contrast, a working-class neighborhood—where the tax-credit rent and market rent are relatively close—doesn't work very well."

Related also teamed with the nonprofit Community Corp. of Santa Monica on the 160 affordable apartments. Related has been working on this deal for years, but sometimes developers can find opportunities by being brought in late in the game.

Such was the case with the 116-unit vPoint, a tax-credit project in Arlington, Va., that opened its doors in April. Bozzuto Development Co. was brought in as a fee developer, partnering with nonprofits the First Baptist Church of Clarendon and the Virginia Housing Development Authority, as well as Chesapeake Community Advisors.

The Class A vPoint sits on land that once housed the Church at Clarendon, which had its steeple—a local landmark—incorporated into the design. Forty-six units are market rate and 70 are affordable, of which 12 will be supportive housing for very low-income households. But the general partnership structure isn't unusual on the mixed-income developments Bozzuto has done—in fact, it's par for the course.

"They'll come to us for the wherewithal—you have to guarantee the construction loan, and the cost to get any project going before it even breaks ground is probably about $1 million," says Toby Bozzuto, president of Greenbelt, Md.-based Bozzuto Development Co. "And they help us in many cases with the political relationships and the tax-credit application work. When you compete for tax credits, the scoring system gives disproportionately more points to people that partner with nonprofits, and it's almost undoable without that."

On an 80/20 deal, one of the main goals is a sort of invisible integration—the units should provide all the finishes and features that market-rate renters expect. And the development should include all the same amenities that renters would expect. The goal is to make the affordable units invisible to the naked eye.

"Generally speaking, the idea is seamlessness," says Witte. "Nobody knows which units are the affordable ones, except, perhaps, the manager." [M]

BRIDGING THE GAP

Not only can affordability help attract construction capital and municipal support, it's also useful in finding gap financing.

The Martin Building Co.'s $80.4 million Portrero Launch is set to open in San Francisco in September, but when it does, the affordable units will serve even lower-income tenants than the 80/20 program requires. The developer applied for a $1.4 million Infill Infrastructure Grant through California's Proposition 1C program, and that money only goes to affordable housing deals—the more affordable, the more likely to win a grant.

"I volunteered to set units at 30 percent AMI so that there was a higher likelihood of getting the award," says Patrick McNerney, Martin's president.

Meanwhile, the McGregor Cos. recently broke ground on the $160 million One Santa Fe, a 438-unit mixed-use development in downtown Los Angeles. The project was conceived seven years ago, but the recession derailed it and led the developer to use tax-exempt bonds for the first time in his firm's 25-year history.

"Securing a construction loan was proving to be somewhere between extremely difficult and impossible," says firm founder Bill McGregor. "As we progressed, it became clear the best financing package we could put together would have affordability inherent in it."

The developer received funds through the New Issue Bond Program, and the bonds were credit-enhanced through an $86.2 million FHA-backed loan. McGregor also received LIHTCs, which provided roughly $8 million in equity.

One Santa Fe also found some gap financing by virtue of its affordability. The developer scored a $4 million loan from the L.A. Housing Department that required two-thirds of the affordable units to be targeted at those earning up to 40 percent of AMI.

"That $4 million was one more piece of a complex puzzle. ... each piece in the capital stack was critical," says McGregor. "If you pulled any out, the whole thing doesn't work."