FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 11, Issue 1 Financing Special Needs Housing

Author(s): Daniel M. Leibsohn, Community Development Consultant
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Many people believe that there is "too much money chasing too few deals." Certainly, tax credit or other heavily-subsidized deals could be accurately characterized this way. However, I believe the reverse is true for many other types of community development projects . . . there are too many deals chasing too few dollars. Projects like community facilities, day care centers, health care facilities and non-profit buildings may be economically viable, but financing for these deals is still very difficult to obtain.

Special needs housing[1] also suffers from lack of available financing--especially permanent financing. Certainly, the risks and layered financing structures of these deals can be a lender's worst nightmare. But remember how complicated we thought tax-credit projects were just a few years ago? Today, the use of tax-credits is commonplace, and developers have come to rely on them as a primary source of multi-family finance.

If history repeats itself, there is some hope that special needs finance will become routine. But for now, concerns related to the financial structure and costs of operation in special needs projects are legitimate. Later in this article, several underwriting options will be presented that could mitigate a number of these concerns.

Most special needs developers support their operating budgets solely through grants, fundraising, and if available, Section 8 financing. But there is growing experience in special needs housing lending. As we review the unique characteristics and challenges inherent in these developments, keep in mind the tremendous lending opportunities that exist for financial institutions seeking qualified community development loans. Acquisition, construction, rehabilitation, bridge and permanent financing are all in demand. There is also a need for operating lines of credit which help provide working capital when public agency or foundation payments are behind.

The Unique Attributes of Special Needs Housing

Effective participation in a special needs project requires an understanding of the key differences between these developments and other single or multi-family developments. Let us consider the most obvious differences:

In special needs housing, the income streams for development and operations are different (sometimes idiosyncratic), and funding requirements can vary greatly. For example, many of the sources that support AIDS housing differ from those that support housing for the mentally ill, emancipated youth or victims of domestic violence. These sources can vary geographically within a state or among states; they may offer annual or multi-year support; and, they will likely include a combination of federal, state and local funding coupled with some level of private support. Examples of these sources include: county marriage license taxes (for victims of domestic violence), HUD funding, school system foster care funds and public health monies. Regardless of the mix, each source comes with unique requirements. The challenge is learning how to juggle, blend and balance the use-restrictions, timing and reporting requirements of all potential sources.

Operating capital can also vary from project to project, depending on the targeted population to be housed. For example, residents in some developments pay rent from SSI, welfare payments or earnings from part-time jobs. Other developments may be fully supported by subsidies and fundraising, so tenants pay no rent at all. Foundations, corporations and individuals, therefore, are also major sources of operations and capital revenue.

The result is an extensive and varied financing framework for both development and operations, each with its own, sometimes byzantine, set of guidelines and requirements. For lenders, these conditions require a commitment of time and patience to learn a new set of complex funding arrangements.

There are three different stages of housing, each with unique development and operating conditions. For example, victims of domestic violence often begin with a short-term stay in an emergency shelter, usually from two-to-four weeks. They may then move to transitional housing, for as long as two years. Afterwards, some form of permanent housing becomes the final stage. Some of the key differences among these housing stages include physical configuration and income stream.

If the physical layout is not easily reconfigured to appeal to a large market, added risk and potential costs are created for lenders. This can occur when a dormitory-style building is used as a shelter; when a mixed-use property includes offices, clinics, and meeting rooms for services; or when a five- or six-bedroom group home is located in a neighborhood of smaller homes. The wide continuum of housing types--residential hotels, single-family group homes, congregate housing, apartments, condominiums, dormitories, etc., each comes with its own set of issues and risks.

The risk associated with special configurations has little to do with the construction or operational phase of a project. Configuration becomes an issue in the unfortunate event of a default or property foreclosure. In addition, the location of the facility may cause problems for lenders. Quasi-residential properties are sometimes located in non-residential neighborhoods, largely due to neighborhood opposition from other, more favorable locations.

Lenders and other investors must understand how the physical configuration and location will affect the future marketability of a property. Furthermore, they must have some idea of the costs associated with a reconversion, which could become necessary for the successful sale of a property.

Low Income Housing Fund

Low Income Housing Fund (LIHF) was created in 1984 in the face of a serious crisis in low-income housing. LIHF's goal is to increase access to capital for low-income communities, with a focus on low-income housing, at affordable rates and terms. LIHF's community lending philosophy incorporates four principles:

- Projects should target the poorest and most vulnerable people;
- Work should be done in a very strong community development context;
- LIHF should help to build a nonprofit housing industry; and,
- Projects should be undertaken with a high degree of technical rigor.

LIHF also assists various homeless and special needs populations and, more recently, has been lending extensively for community facilities and other community development activities.

LIHF operates within the private financial community and the nonprofit community, and serves as a critical link between these two sectors. LIHF's capacity is demonstrated by a 13-year track record, using very limited operating and capital resources to assist in the financing of over 13,490 units, of which the large majority house very low-income people.

The Low Income Housing Fund
74 New Montgomery St. #250, San Francisco, CA 94105
(415) 777-9804/www.LIHF.org

The developers of special needs projects may differ from the affordable housing developers to which lenders have grown accustomed. While some may be experienced and savvy developers, others may be new housing developers or social service providers with little experience in housing development. This inexperience can be manifested in any number of ways. For example, an inexperienced developer may create a project budget that mixes all operating expenses together--with administrative costs listed right after maintenance, followed by van costs and counselor's salaries. Other issues associated with property management or long-term repayment strategies could also raise red flags. This is not to say that inexperienced developers shouldn't participate in special needs developments. There are, however, a number of steps that investors and lenders can take to strengthen a proposed deal, which can result in a "win-win" for all concerned.

Underwriting Strategies

There are several ways to address the issues associated with special needs housing. The first is a commitment to learn the field and its unfamiliar requirements. The others that follow are examples of flexible underwriting techniques that can be used when reviewing a special needs proposal.

1. **Separate income and operating expenses into housing, administration and services.** Then, determine whether low-income tenants could still be housed in the facility if the core operating subsidies were eliminated. This approach creates an "alternative use analysis" that demonstrates the economic feasibility of other options.

2. **If possible, use a shorter amortization term.** This may require one or more of the operating sources to provide more support for debt service. This option can work in many situations.
3. **Use different payment schedules over the term of the loan.** For example, use a very short amortization term during the first few years of the loan if the project has a public-sector contract with a high level of subsidy. This approach uses the public subsidy to pay down the mortgage principal as much as possible in the early years of the loan. To underwrite the later years, beginning with year four for example, assume a reduction in income to a realistic level trended to year four. Amortize the remaining balance over a longer period as needed. If the subsidy is renewed in year four, continue the rapid amortization employed during the first three years. If the subsidy ends after three years, the loan has been paid down substantially, and the risk to the lender has been reduced. In some situations, several payment schedules (beyond the two phases illustrated here) may have to be developed, and then built into the loan documents.

Shelter Partnership, Inc.

Shelter Partnership, Inc. is a nonprofit agency established in 1985 that provides assistance in the development and maintenance of short-term and transitional housing programs, permanent housing, and supportive services for the homeless and potentially homeless throughout Los Angeles County. The organization serves as a sturdy bridge between frontline agencies serving the homeless, public officials whose policy decisions impact those agencies and their clients, and members of the private sector who share its concerns. The following are the key services offered by the agency.

- Funding and technical assistance for service providers which provides resources such as the sponsorship of VISTA volunteers, the Training Institute, and a $500,000 bus token program.

- The Shelter Resource Bank Project provides basic resources for service providers to offer their clients. The free products are distributed to nearly 200 frontline agencies serving the homeless and very poor.
- Creation of collaborative applications. Since 1994, Shelter Partnership has garnered $200 million in federal funds for Los Angeles County.
- Needs assessment reports, most often commissioned by local policy-makers, provide timely, invaluable assessments of the area's critical needs and resources.

Shelter Partnership receives general and project support from foundations, corporations, local and county funding sources, and many generous individuals. The organization utilizes these funds efficiently, spending less than two percent of its expenses on administration.
Shelter Partnership, Inc.
523 West 6th Street, Suite 616, Los Angeles, CA 90014
(213) 688-2188 / www.shelterpartnership.org

Keep the loan-to-value ratio as low as possible in the beginning or have it reduced as much as possible by the end of a short-term operating contract. This way, if problems occur, other income and development sources can be more easily attracted to participate in the deal by committing additional funds or providing assistance in finding a substitute borrower. If the problem is management rather than economic viability, the lender can obtain the assistance of the appropriate public agency to replace the borrower with a more capable sponsor; the loan documents should allow for this assignment.

To strengthen a proposal, require additional reserves or third-party guarantees. This option may be the most difficult to apply since it usually means securing additional support from government agencies or private funders who are already participating in the deal. However, there may be public guarantee programs that can serve in a back-up capacity on a case-by-case basis. If not, it may be worthwhile to create a state or regional guarantee pool for special needs housing. This would provide additional incentive for conventional loan support.

Make sure the developer has both a short- and long-term vision for the project. While the construction and initial operating years are critical, it is equally important to pay attention to the longer-term issues of property maintenance and management, the viability of public-subsidy contracts, and the maintenance of operating reserves. Operating budgets should be forecast at least 10-15 years out, and contingency plans should be established to deal with any number of potential situations.

To lower costs and provide expertise, use the services of specialized intermediaries. Organizations like the Corporation for Supportive Housing, the Low Income Housing Fund, and Shelter Partnership, Inc. can help through the provision of technical assistance to developers and by their ability to structure and package complex financial deals. It is important to remember that financing special needs housing, especially in the start-up phase, is expensive. But the returns can be both socially and economically rewarding in the long run.

The Corporation For Supportive Housing
The Corporation for Supportive Housing (CSH) is a national nonprofit intermediary that supports and advances the work of organizations providing housing and a link to healthy community life for the most marginalized Americans--people who are extremely poor, and who face chronic health challenges and multiple barriers to employment.

In its eight local offices, CSH works with nonprofits and government agencies to:

- help local organizations gain the financial and technical assistance they need to build housing with services;
- create cutting-edge demonstration programs and experiment with promising models to test new ideas;
- facilitate sharing of successful techniques and strategies throughout the industry; and,
- streamline and improve development and funding systems. As of December 1998, CSH had committed more than $34.4 million toward the development of more than 8,200 supportive apartments. And, through the National Equity Fund, CSH has placed over $140 million in corporate equity into projects across the country.
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Corporation for Supportive Housing
50 Broadway, 17th Floor, New York, NY 10004
(212) 986-2966 / www.csh.org

About the Author

Dan Leibsohn is presently the executive director of Community Development Finance, a nonprofit financial and research organization, and the head of Capital Flows, a consulting organization.

From 1984-1998, he was president, executive director, and founder of the Low Income Housing Fund (LIHF). Prior to his work at the LIHF, Mr. Leibsohn served as senior associate at the San Francisco Foundation Housing Task Force, municipal loan coordinator for the City of Berkeley's Housing and Development Department, and worked for the League of California Cities. He has also worked extensively with community organizations in other parts of the country, and has published several articles and reports. He serves on numerous boards including the Affordable Housing Advisory Council of the Federal Home Loan Bank of San Francisco, the California Community Reinvestment Corporation, the National Association of Affordable Housing Lenders, and the Skid Row Housing Trust and the Property Management Company.

Mr. Leibsohn graduated from the University of Michigan with a degree in Economics and received a Masters in Public Administration from Harvard University where he also studied city planning. He is a licensed real estate broker.