

## **Improving Management and Capital of “Mid-Sized” Rental Property Owners and Developers**

*Summary of a Focus Session Convened by the Joint Center for Housing Studies<sup>1</sup>*

### **Overview**

On February 16, 2006, leaders in the rental housing industry gathered to discuss the access of “mid-sized” rental property owners and developers to capital for predevelopment, development, acquisition, and rehabilitation. The topic is important because a significant portion of the affordable rental housing stock is in the hands of investors that own or have developed only a few hundred or thousand multifamily apartments. These owners and developers are distinct from companies that own a large number of units not only in the number of units owned or developed but also in their access to finance, their degree of financial sophistication, and often the size of the properties they own or develop.

The discussion focused on defining “mid-sized” owners and developers of rental housing, understanding how they obtain capital, identifying the greatest challenges they face in accessing capital, and uncovering pathways and solutions to the greatest problems. The discussion was limited purposefully to issues surrounding capital access and terms. The session did not focus on other known barriers to the production of rental housing such as local development regulations (zoning, subdivision approvals, building codes etc.) and federal regulations (lead paint, Davis-Bacon, etc.) that add to the risk and cost of rental development. Nonetheless, each of these barriers came up in conversation, and each was considered at least as important to the provision of decent, affordable rental housing as the nature of financing middle-sized rental property owners and the small multi-family properties they tend to own.

### **Definitional Issues**

- Middle-sized developers/owners own from 150 to 2,000 to 5,000 units
- Middle-sized-developers/owners own mostly small multifamily rental properties with 5 to 49 units, though some also own much larger properties (as many as 100 to 200 units)
- Larger middle-sized owners tend to operate on a regional scale and smaller owners operate on a local scale

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- There is no standard definition of a middle-sized rental property developer or owner

The participants could not agree on a common definition of a middle-sized rental property developer or owner. However, most participants viewed them as the group of developers that own and operate mostly smaller multifamily properties (5 to 49 units) and have total holdings of anywhere from 150 units up to a total of 2,000 to 5,000 units. Owners and developers with 2,000 to 5,000 units are often regional in scope, though this is not always the case. The participants felt it was useful to distinguish between owners of 1 to 4 unit properties and middle-sized property owners both because 1 to 4 unit property owners tap into different debt markets and because their total holdings tend to be under 100 units.

Industry leaders view the definition of middle-sized rental developers/owners as a combination of the total number of units owned, the typical size of the properties owned, and the breadth of the geographies over which they operate. There is however, no industry standard definition.

### **Developer Types, Operations, and Capital Sources**

The discussion of the type of developers that make up this middle-sized group was more enlightening than the discussion of where to set the upper and lower bounds of the group. As the day progressed it became clear that there are at least three distinct groups of middle-sized developers/owners, within which even further divisions might make sense. The following section describes these three groups and their different ways of accessing capital.

#### **Homegrown For-Profit Developers/Owners**

- Start small scale and usually stay confined to a single market
- Get “hard money” from friends, family, and other non-bank sources
- Some get financing from specialized lenders and local lenders
- Build relationships with local lenders and reach scale slowly
- Often lack strong financial reporting systems and records
- Most focus on market-rate deals that do not require subsidies
- Their lenders have intimate knowledge of local markets and rely on it to lend only to properties that have ample value to service debt if properly managed

- Their lenders size up borrowers effectively but do not codify many of their borrower underwriting practices
- Some of their lenders will offer more flexible line-of-credit-like financing to their best borrowers to help them fund predevelopment work
- Predevelopment financing is scarce and expensive
- Owners tap equity through refinancing to fund predevelopment work
- Access to capital markets remains limited

One group of middle-sized developers is composed of developers/owners that started out small scale, typically with a few properties financed by a local lender, and over time acquired or developed more properties, often with financing and in some cases technical assistance from the lender. Such lenders develop strong relationships with their borrowers over time. Most lenders offer finance that is progressively more substantial and more flexible only if the borrower develops a successful track record with the lender. To defend against potential losses both for relatively unknown borrowers and well-established borrowers alike, these lenders underwrite the property closely and extend credit only on individual properties that the lender believes to have ample value to recover in the event of a borrower default.

At some point, these developers/owners may transition to other lenders, but in transitional and weaker markets there are often few choices of lenders; therefore, lasting relationships are common. Also common is for these developers/owners to initially attract debt and equity financing through friends, families, and less formally organized lenders. Many argued that this “hard money” market dominates in many transitional areas and is very expensive. Only some of the developers/owners in such areas can obtain financing from traditional deposit-taking institutions or specialist lenders.

CPC, CIC, and Shorebank were all represented at the roundtable. Each of these is a specialized lender that operates to a greater or lesser degree to serve homegrown developers/owners in these transitional/weaker markets. Conventional local banks and thrifts that serve these types of developers/owners typically limit their funding to project-related debt and do not provide technical assistance to their borrowers. Instead, they rely on local knowledge of their markets and borrowers to make purely project-based lending decisions. It became clear, however, that specialized lenders like those represented at the roundtable, often do more than just

fund projects. Specialized lenders vary in terms of their: (1) degree of reliance on underwriting borrowers versus the property, (2) willingness to extend more flexible credit terms such as lines of credit secured by properties in portfolio, and (3) extension of technical assistance to borrowers. On the spectrum of reliance on underwriting the borrower to underwriting the value of the property, these specialized lenders are apt to rely especially heavily on knowing their markets. At the extreme, lenders are able to make the market and set prices because they are the only available source of financing. Any seller that wants to sell to a leveraged buyer must accept the loan amount the lender is prepared to extend. Lenders also vary in the number of products they offer to borrowers. Some will offer their best customers lines of credit that are equity-like, or at least mezzanine-debt-like, but carry the lower costs of debt and can be used flexibly for operations and predevelopment. Some lenders raise opportunity funds and serve as developers while relying on third parties to do much of the development work. Others offer only standard debt products. Lastly, a small number of lenders offer various forms of technical assistance to their borrowers that make their borrowers more efficient and lower their credit risk.

### **Start-Ups by Seasoned Real Estate Executives**

- Rely on relationships established with lenders and investors when they worked for larger firms
- Attract start-up capital at high cost from those interested in seeding firms created by seasoned professionals
- Build on previous experience to build strong financial reporting and control systems from the start
- Successful players work with many different capital providers, including subsidy programs, which help them raise equity or cover predevelopment costs
- Over time rely more and more on refinancing to raise capital for improvements and predevelopment work
- Aim to operate at least on a regional scale
- Work with local and larger banks
- May be approached by larger banks to partner with smaller, homegrown developers/owners
- Access to capital markets remains limited

A second type of middle-sized developers/owners, represented at the focus session by Mid-City Legacy, LLC and AF Evans, are firms founded by former executives of large rental developers/owners such as Trammel Crow, The Related Companies, and Forest City. These executives tap relationships established while working for large firms or attract other lenders and equity investors interested in working with seasoned executives starting up their own firms. Over time, the most successful of these firms generate enough profits to self-fund predevelopment costs and, in some cases, to buy out original venture capital and other high cost forms of start-up equity capital used initially to fund operations and predevelopment work. Often these firms operate on a regional scale. In some cases, they compete for public funds, such as HOPE VI, that provide more liberal financing that partly covers predevelopment costs.

With a dearth of specialized financial institutions to support smaller scale developers with limited track records, larger banks are increasingly asking these firms to partner with smaller local developers. Larger financial institutions that lack the capacity to thoroughly assess local talent, local markets, and individual properties rely on these middle-sized developers to some degree to make this assessment. By agreeing to enter into deals with these smaller developers on particular properties, without personal recourse and instead only completion guarantees, these firms put their reputations and predevelopment capital on the line. This partnership gives comfort to the large lenders ensuring that the particulars of a deal are solid enough to attract the participation of a professionally managed middle-sized developer.

Unlike the first group of homegrown middle-sized developers, these organizations are built from the start to have strong financial reporting systems and balance sheets. Over time, therefore, they have the capacity to attract a variety of different forms of capital. Although capital becomes less of a problem, predevelopment capital is initially scarce and expensive even for them (and potentially later as well, depending on deal sizes sought).

### **Intermediate-sized Non-Profits**

- Start small and evolve over time, like homegrown developers
- Focus on development and ownership of properties with long-term rent restrictions that they hope to keep in the affordable inventory
- Obtain debt financing from a variety of sources but rely more than other groups on Community Development Financial Institutions

- Often rely on philanthropic organizations to finance predevelopment work
- Have difficulty attracting entity-level debt financing
- Rent restrictions make refinancing to fund improvements and predevelopment more difficult
- Must comply with rules and regulations that govern their multiple funding sources
- Access to capital markets remains limited
- As investments age and long-term rent-restrictive contracts expire, must decide whether to try to capitalize the market value of the property to fund other operations rather than retaining restrictions

The third type of middle-sized developers/owners represented at the focus session is a variant on the other two: the intermediate-sized non-profit developers/owners that emerged out of a combination of homegrown evolution, and technical assistance and support from foundations and trade associations. Many also are then able to attract seasoned executives from other lenders to join them. These developers/owners work with local and larger banks and thrifts, but rely on Community Development Financial Institutions to a far greater degree than the others.

Given their non-profit mission, virtually all drive their businesses primarily off of government programs that provide subsidies and financing of various sorts in return for agreeing to restrict rents and verify the income of tenants. Like others that utilize these programs, they face especially difficult challenges in acquiring existing properties and land for development. The application requirements of multiple funding sources which typify these deals make it hard for these organizations to act quickly to acquire properties. Also, taking cash out from refinancing existing properties that have appreciated in value—a primary means of financing new projects—is less available to these non-profits because rent restrictions limit the rate of appreciation in value of these properties. Non-profits that are committed to maintaining the long-term housing affordability of each their properties (and therefore are reluctant to take properties to true market rents and values even when contracts expire) face especially difficult challenges in generating cash flow to fund development from the assets on their balance sheets. Further complicating matters for these entities is the lack of uniform financial reporting standards around subsidized properties that make it difficult for potential lenders and equity investors to assess the true market value of assets.

Like the first category of homegrown developers, non-profits find it very difficult to attract predevelopment capital. They rely heavily on grants and small government programs like HOPE VI and the Federal Home Loan Bank System's Affordable Housing Programs. The most successful of these organizations, however, have begun to get banks to agree to extend lines of credit on reasonably favorable terms based on their balance sheet strength.

### **Secondary Markets**

Middle-sized developers/owners are served primarily by local and regional banks or specialized lenders (like CPC, CIC, and Shorebank) that hold loans in portfolio. The secondary market for loans to middle-sized property owners is underdeveloped. Fannie Mae and Freddie Mac stepped up lending to these owners only when HUD offered them extra bonus points towards Congressionally-mandated affordable lending goals for small multifamily properties. Recently, some efforts have been made by private conduits to tap the capital markets but the demands of publicly rated debt offerings make the economics of these deals difficult for most operators.

There was general agreement that opportunities to pool and diversify risk and tap lower cost capital makes capital markets a potentially attractive way to improve debt financing for middle-sized property owners. There are however, a number of factors that make capital market executions difficult. These include higher due diligence costs, the lack of standards in financial accounting and underwriting, the cost of special reviews demanded by ratings agencies, and, in the case of Fannie Mae and Freddie Mac, many requirements imposed by regulators.

### **Needs and Capital Gaps**

The roundtable participants identified the following needs and capital gaps:

- Attract lower cost and flexible predevelopment capital
- Enable middle-sized developers to act swiftly, without a great deal of paperwork and second guessing by funding sources that hamstringing them when they need to act decisively and quickly—that is, entity-level finance based on the strength of their balance sheet and income statements or opportunity funds with broad discretion

- Purchase loans from accepted *lender intermediaries* that are trusted to properly assess borrowers, markets, and properties and prices without a deep look at the underlying assets<sup>2</sup>
- Cultivate professionally managed *developer intermediaries* that can serve as primary project sponsors for joint ventures with homegrown local developers
- Develop some means to rate, score, or price credit assurances for middle-sized developers
- Create greater standardization of financial reporting, loan terms, and underwriting
- Reduce rules and regulations that add complexity, cost, and delays to the development and acquisition of smaller multifamily properties

There was much discussion regarding the need, or lack thereof, for attracting equity investors, especially large institutional investors like pension funds. Unlike the case of the needs listed above, on this need there was considerable disagreement. Many felt that equity investors—particularly institutional investors—place so many restrictions on operating procedures that it is not attractive capital. Others believed that flows of institutional capital into the sector in the form of equity and mezzanine debt would increase competition and provide opportunities to take well-managed operations to a much larger scale.

Also, there was some discussion of other ways to attract equity-like capital without selling stakes in the ownership of the entity. The most appealing of these is Opportunity Funds where investors put up capital and entrust the entity to identify and pursue deals that meet some predetermined terms but offer latitude to the entity in picking projects and investing capital in predevelopment work.

### **Pathways and Solutions**

There was general agreement that several paths might lead to scalability of financing to middle-sized developers and owners and to the smaller multifamily rental properties they tend to invest in.

- ***Assessing Creditworthiness of Developers:*** One of the most significant impediments to stimulating more competition for lending to middle-sized rental developers and owners is the difficulty in assessing their creditworthiness. The market is inefficient because no process

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<sup>2</sup> Some felt this is already starting to place in the private conduit sale of small multifamily property loans, though others believed that the conduits were relying on trusted developers rather than lender intermediaries to stand in place of a detailed review and look through to the underlying real estate assets.

has been put in place to score the creditworthiness of middle-sized developers/owners. Instead, the knowledge of how to identify good operators is tacit, not codified. Four pathways were discussed to overcome this inefficiency: (1) develop a rating or scoring system—a rating agency or credit scoring company would have to develop a scoring method and demonstrate its empirical validity; (2) develop credit assurance products – a third party would offer insurance or guarantee that is attractively priced and covers some of the risk of borrower default; (3) develop systems for rating lenders to bypass the need for developer/owner scores, rating systems, or credit enhancements – in lieu of rating developers, capital market players could delegate underwriting to approved seller/servicers; and (4) develop systems for rating only developers with strong financial reporting systems and rely on these developers in turn to put capital at risk and partner with middle-sized developers that do not have strong reporting systems and records.

- ***Expanding Entity-Level Debt and Finance:*** Clearly, predevelopment capital is scarce and expensive. Even start-ups led by seasoned executives struggle to draw attractively priced predevelopment funds. For start-ups this is unsurprising because they have not yet accumulated assets or established a track record. The larger middle-sized owners however, that have strong balance sheets (with assets exceeding liabilities and demonstrated cash flows sufficient to service debt) should be able to attract debt to cover predevelopment costs without having to justify to a lender each project they want to undertake. It was suggested that in the case of non-profits it is difficult to get entity-level finance as a result of confusion over the true value of the underlying assets because they may sometimes be based on capitalizing restricted rents while others are based on assuming a market value of a property even though its rents are restricted for an extended use period. One pathway to a solution, currently being pursued by NeighborWorks America, is to convene a group of chief financial officers and major national accounting firms to develop a best practices platform for internal and external financial reporting for Community Development Real Estate Institutions. Lack of conventions for reporting cash flows, as well as the difficulty reconciling General Accepted Accounting Principals with real estate accounting, makes such an effort an important step.
- ***Aggregating Equity Ownership:*** Already larger lenders are starting to turn to larger middle-sized developers/owners to partner with smaller middle-sized developers/owners. Several

participants felt the logical next step would be to roll up smaller middle-sized developers so that the acquirer achieves the scale it takes to tap the capital markets. A variant on this approach mentioned, and discussed in an unpublished paper, is to have the federal government establish and subsidize a Real Estate Investment Trust with the public purpose of rolling up ownership of smaller multifamily properties in underserved markets.

- ***Overcoming Other Market Inefficiencies:*** Other solutions mentioned were to work with federal and state agencies to streamline and standardize applications and requirements for different subsidy programs, develop financial reporting standards for middle-sized developers, and develop common appraisal and environmental review process for small multifamily properties.

## **Conclusions**

In conclusion, lenders to middle-sized developers may have difficulty taking their models to scale because they rely so deeply on an intimate knowledge of local markets, properties, and developers with whom they have established relationships slowly. Though some are operating in multiple markets, none are yet national in scope. Unless the capital markets decide they can rely on the track records of these lenders and provide them liquidity, these lenders will lack adequate access to an important pool of capital. In addition, many middle-sized developers have reached the limits of the size they can or want to achieve. Taking financing for these developers to the next step will require developing more scalable financing models and perhaps finding ways to aggregate developers so that more of the small property stock ends up in the hands of large organizations that can tap capital markets.