

CALIFORNIA DREAMIN': RURAL AFFORDABLE HOUSING IN THE GOLDEN STATE

Report of a Workshop[?] Sponsored by
National Affordable Housing Preservation Associates, Inc.
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Summary

By most national measures, U.S. Department of Agriculture-assisted rural affordable housing in California is in remarkably good condition. In general, properties are well maintained, valuations, like much of the state's real estate, have soared in the past two decades, and, unlike many regions in the American South and Midwest,

[?] On Thursday, January 13, 2005, in Sacramento, California, in cooperation with the California state office of the U. S. Department of Agriculture's Office of Rural Development (USDA/RD), National Affordable Housing Preservation Associates, Inc., (NAHPA) hosted a one-day workshop to examine the present state of USDA Section 515 affordable housing in California and elsewhere in rural and small town America and explore various alternative financing strategies for preserving this critically needed low-income housing.

The workshop was funded by a generous grant from the Fannie Mae Foundation of Washington, DC. In addition to exploring numerous financing alternatives, the Sacramento workshop provided an opportunity for owners of USDA Section 515 properties to meet with prospective for-profit and non-profit purchasers of rural affordable housing and with NAHPA officials and other local third-party intermediaries providing assistance in facilitating these property transfers.

Attendees at the workshop included, among others, senior federal, state, and local USDA/RD officials, California state housing and housing finance agency representatives, both for-profit and non-profit USDA Section 515 affordable housing property owners and managers, lenders actively involved in the low-income housing preservation marketplace, and representatives of several California organizations actively involved in promoting rural affordable housing finance and preservation.

Workshop panelists included USDA/RD officials from the Washington national headquarters and the Davis, California-based state office, a tax accountant experienced in affordable housing finance, officials with several local California organizations involved with affordable housing preservation, and several for-profit and non-profit owners/managers of USDA/RD affordable housing. The workshop was moderated by a NAHPA director who manages a national housing preservation program at the Local Initiatives Support Corporation (LISC).

This report is based on presentations at the workshop and discussions (including post-workshop conversations) with participants, attendees, and other USDA/RD affordable housing professionals. The author and publisher are solely responsible for the accuracy of the statements and interpretations contained in this publication. Such interpretations do not necessarily reflect the views of the U.S. Department of Agriculture or the Fannie Mae Foundation.

properties in the state's rural counties enjoy exceptionally high occupancy rates, with demand for affordable housing commonly exceeding the limited supply.

Moreover, unlike many areas of the country, California benefits from a generally-accepted preservation mentality; both for-profit and non-profit groups appear genuinely preservation-minded in approaching problems facing low-income tenants, governments at all levels are eager to assist developers in saving local affordable housing units, and, underscoring the state's much-heralded quality-of-life image, organizations active in the affordable housing preservation marketplace commonly preserve more than just a property's bricks and mortar – they routinely seek to offer low income tenants various amenities, from community rooms, patios and associated outdoor spaces, to playgrounds and other family-oriented facilities.

Although California USDA officials elude many of the inimical demographic and economic trends commonplace throughout much of the nation's rural heartland – the declining population of the bucolic Midwest or the rising poverty of the rural South – they nonetheless face a stiff challenge of another type: a growing rural population and a generally strengthening rural economy which offers current affordable housing property owners an attractive private-market alternative to continued participation in federally-assisted low-income housing programs. It is in this environment that California-based USDA officials toil daily to preserve their agency's critically important affordable housing stock.

History

Since the early 1960s, the U.S. Department of Agriculture's Section 515 housing program has been the federal government's principal financial assistance program for rural and small town multi-family housing serving low-income individuals and families. Property owners participating in the Section 515 program are eligible for below-market mortgage financing and ongoing rental assistance in exchange for long-term commitments to retain units for lower-income residents. According to the most recent USDA data, more than 434,000 apartment units in nearly 15,900 multi-family housing properties currently participate in the Section 515 mortgage program. Combined, these properties have an outstanding loan principal of nearly \$12 billion.

Most Section 515 developments are small, averaging about 27 units per property. Residents, who are responsible for paying rent equal to 30 percent of total family income, are generally elderly and predominantly female. Many are handicapped or otherwise disabled. More than a quarter are minorities, an unusually high percentage for rural areas. Average income per household is roughly \$9,400, about 30 percent of national rural median income.

Approximately three-fourths of all Section 515 tenants receive some type of federal rental assistance, principally under USDA's Section 521 rental assistance program, although some Section 515 property owners also receive U.S. Department of Housing and Urban Development (HUD) project-based Section 8 rent subsidies. In

addition to federal rental assistance, more than 70 percent of Section 515 tenants receive some other form of regular federal or state income supplement.

Current Status of USDA Section 515 Program

Properties participating in the USDA Section 515 affordable housing program are aging, often deteriorating, and generally lack the financial reserves necessary to ensure long-term maintenance and rehabilitation. Most Section 515 buildings are approaching old age; certainly most have passed their prime. More than a quarter of all properties are 20 or more years old; nearly three-fourths are more than 15 years old and at the stage of their lives where owners are beginning to encounter significant renovation expenses. Although most properties are structurally sound, they are increasingly in need of new roofs, updated heating and cooling systems, upgrades to meet new building code requirements, and other life-cycle replacements and improvements.

Like many of the properties it finances, USDA's Section 515 program also is past its prime. The peak funding decades of the 1970's and 80's are history, and Congress has shown little inclination to provide the type of rehabilitation financing or rental assistance necessary to allow property owners to properly maintain the Section 515 affordable housing portfolio. Of roughly \$150 to \$200 million in estimated annual rehabilitation needs, USDA has only about \$50 million available. Total rental assistance has declined by more than 20 percent in the past two years. Senior agency managers continue to worry about further program cutbacks, especially given mounting budget pressures and a ballooning federal deficit.

Similarly, although USDA offers Section 515 property owners new low-interest equity loans in exchange for their agreement to remain in the program for a designated term of years, appropriations for new equity financing also have declined precipitously in recent years. At the present time, USDA officials estimate that private for-profit and non-profit developers supply the rural affordable housing marketplace with between \$10 and \$15 million in new equity funding annually, double or triple the roughly \$5 million available from USDA in the current federal budget.

Nationally, about 100 Section 515 properties leave the USDA program each year. Of these, USDA estimates that half no longer serve a low-income tenant market or are not considered sufficiently economically viable to justify continued USDA funding. Owners of the other half, those affordable housing properties USDA managers are most eager to retain, generally leave for economic reasons, either through sale of their buildings to non-USDA participating owners or because they are able to rent units at market rates. Overall, because USDA is not writing 100 new Section 515 contracts per year, the program continues to shrink.

Overall, three-fourths of all Section 515 property owners receive some form of federal rental assistance, including some who participate in HUD's project-based Section 8 program. Although rural rental assistance is by far the largest line item in the USDA/RD budget – nearly \$600 million during the current fiscal year – federal rent

subsidies nonetheless have dropped sharply in the past two years. Participating property owners sign renewable four-year commitments, a recently enacted cutback from the agency's historic five-year contracts, while those with HUD Section 8 contracts typically depend on annual funding renewals. Despite the budget cutbacks, USDA has been able to renew all expiring rental assistance contracts.

Of the total available USDA rental assistance, about 99 percent covers current contracts, leaving very few dollars for new rental assistance agreements with either existing Section 515 property owners currently not participating in the program (or those participating at less than 100 percent of units) or for newly constructed rural rental housing. At the present time, USDA has nearly \$9 million in pending new rental assistance applications, of which agency officials expect to be able to fund only about \$5 million in the current fiscal year.

Agency officials estimate that nationally about 11,000 separate multi-family housing properties – developments totaling roughly 300,000 apartment units – currently are at risk of sale or removal from the Section 515 program. In some cases, these properties may be converted to market-rate housing, making them unaffordable to most low-income tenants. In other instances, owners without for-profit sales opportunities – and no longer benefiting from lucrative federal tax advantages – may allow properties to further fall into disrepair. Either outcome threatens the nation's low-income rural rental housing stock.

New USDA Administrative Notice

In an effort to streamline and simplify the Section 515 housing preservation process, USDA recently issued a new Administrative Notice (AN 4010) which agency officials say will bring USDA transfer procedures more into line with those commonly accepted by private lenders. Among the new procedures, USDA will permit developers to sign equity take-out loans at the time of property transfers, a particularly attractive reform in places like California where property values commonly support such additional debt. The new Administrative Notice also revises outdated USDA appraisal and underwriting standards and strikes a more developer-friendly balance between permissible equity and rehabilitation lending.

The revised USDA procedures permit Section 515 property owners to cash-out excess property reserves as part of an equity loan, bringing total outstanding debt to as much as 100 percent of a property's appraised value. In cases where non-profit organizations acquire and preserve Section 515 housing units, USDA also has doubled its pre-development grant program to \$20,000 to help developers offset various transactional expenses, including legal, accounting, and other soft costs.

Exit Strategies

In many cases, owners of Section 515 properties – particularly limited partner investors boking to escape tax liabilities on phantom income – enjoy few attractive exit

strategies. Sale of either the real estate or limited partner interests commonly trigger both capital gains and recapture taxes on previous depreciation deductions. Moreover, since many Section 515 properties have little or no equity – either due to declining property values, excessive deferred maintenance, or both – property sales generally produce little or no free cash to cover these various exit taxes. Nonetheless, the prospect of paying taxes on phantom income often forces limited partner investors to sell and suffer a one-time tax hit on the property’s negative capital account.

Resyndication poses similar obstacles. Internal Revenue Service rules restrict ownership changes during an investment syndicate’s early years and impose additional limitations which can effect the ability of some limited partners to either remain in or leave an ownership group. Although application of the various syndication rules is at times excruciatingly complex, in general, no more than ten percent of a previous investment syndicate may participate in a new, restructured affordable housing ownership group.

Internal disputes between a property’s general partner and its often numerous limited partners also may arise over the parties’ competing financial interests. Limited partners, who typically own 95 percent or more of an investment group, are attracted by the tax advantages associated with Section 515 property ownership. Once these advantages are exhausted and individual investors face the prospect of paying taxes on phantom income, many limited partners seek a way out. For their part, general partners collect substantial up-front fees for putting syndicates together and, importantly, ongoing payments for administering the investment group and managing its various properties. Even in cases where limited partners are angling to leave, general partners may resist property sales and the attendant loss of this lucrative management income.

At other times, motivations may be inverted; general partners may face an uphill battle convincing far-flung limited partners to sell. Often, these limited partners are unfamiliar with the USDA Section 515 program and have inflated notions of a particular property’s value. Brought into these limited partnerships – principally for the tax advantages – by investment advisors years ago, they resist selling their interests for less than what they believe they are worth, regardless of current market valuations and other constraints imposed on them by the USDA program.

An alternative exit strategy considered by some investment syndicates involves gifting a Section 515 property to a non-profit developer. In these cases, the non-profit organization assumes the outstanding debt on the property. Although the investment group realizes a capital gain on the difference between the property’s appraised value and its investment basis, the taxable amount, if any, will be reduced by the excess of the property’s fair market value above the debt assumed by the non-profit receiver since IRS qualifies this excess as a charitable contribution.

The same situation applies in cases where an investment syndicate sells a property to a non-profit organization for less than its appraised value. In such a case, the excess value qualifies as a tax deduction. In either situation, IRS limits total deductions to no

more than 30 percent of an individual's adjusted gross income (or ten percent of taxable corporate income), although excess amounts may be carried over to future years tax returns.

The Looming Pre-Payment Crisis

The most challenging quandary facing rural affordable housing administrators is how to stem a growing tide of pre-payment requests in the face of this steep decline in federal outlays for rural rental assistance and other financial incentives needed to keep property owners in the Section 515 program. Although the pre-payment problem is exacerbated by several additional factors, including a growing number of owners considering property sales as they near their own retirement or undertake estate planning, at its core the crisis stems from sharply declining federal support for rural affordable housing programs.

Owners' decisions to pre-pay their Section 515 mortgages and withdraw from the USDA affordable housing program also are commonly motivated by rising land values, particularly in California and other coastal states where assessments have risen dramatically in the past two decades. There, unlike in the country's heartland, land values have generated significant equity for property owners, creating a powerful pre-payment incentive for those owners keen on serving a higher-income tenant base or converting properties to non-housing uses.

For USDA managers eager to retain low-income Section 515 properties in the midst of an overall rising rental marketplace, higher land values translate into the need to finance larger equity mortgages. Nationally, USDA equity loans – all of which come with new minimum 20 year program use restrictions – average about \$450,000 per property, although along the coasts and in certain recreational areas of the country these mortgages are sometimes significantly higher.

The federal government had few requests for pre-payment of Section 515 mortgages during years when it had adequate rental assistance available to support tenant rents. At the present time, USDA has about 100 pre-payment applications pending, 30 of which have no program use restrictions. Although some owners seek to leave the Section 515 program because they want to develop their properties for uses other than housing, in general USDA managers are confident that owners requesting pre-payment could be enticed to remain in the Section 515 program if Congress appropriated sufficient funds for new equity mortgages and rehabilitation loans.

Franconia Associates, et al. v. United States

A 2002 United States Supreme Court decision has accelerated an already escalating pre-payment trend. Prior to 1980, Section 515 borrowers were permitted to pre-pay their USDA mortgages without limitation. In 1988, in an effort to stem the loss of low-income rural housing caused in part by a growing number of Section 515 loan pre-payments, Congress imposed restrictions on pre-payments by pre-1980 borrowers.

Several hundred Section 515 borrowers sued the federal government in 1997 for breach of contract under terms of their pre-1980 loans. Plaintiffs alleged that the promissory notes governing their Section 515 loans guaranteed them an unfettered right to pre-pay at any time and thereby gain release from the USDA program and the restrictions it places on a participating owner's property.

Relying on a federal statute requiring claims against the United States to be filed "within six years after such claim first accrues" (in this case by 1994), lower courts dismissed the actions as untimely filed. Ruling unanimously in *Franconia Associates, et al. v. United States*, the Supreme Court said Congress's 1988 action limiting a Section 515 property owner's pre-payment rights constituted a repudiation of the parties' bargain, not a present breach of the loan agreement. Thus, breach will occur – and the six-year statutory limitation period will commence to run – only after a borrower tenders pre-payment and the federal government dishonors its obligation to accept the pre-payment and release its control over use of the property that secured the loan.

The Supreme Court's *Franconia* ruling also opened the door for Section 515 borrowers whose previous attempts at pre-payment were rebuffed by USDA to sue for damages, which plaintiffs predicted could exceed \$800,000 per effected property. A subsequent United States Court of Claims decision found the federal government liable for damages, a ruling that may lead to a new wave of pre-payment litigation and place additional pressure on USDA to devise new preservation strategies to deal with a growing pre-payment crisis.

Preservation Financing Alternatives

I. Secondary Mortgage Market

To overcome federal budget cutbacks in the Section 515 program, National Affordable Housing Preservation Associates (NAHPA) cooperated with USDA managers and officials at Fannie Mae to develop an alternative financing method for owners eager to sell or refinance and rehabilitate their properties. Faced with steadily declining direct federal support for low-income rural rental housing, USDA managers view the development of a market-driven financing model acceptable to private lenders and the mortgage investment community as a way to both streamline the current transfer process and, most importantly, bring secondary mortgage market capital to many thousands of "at risk" Section 515 properties.

Under the financing model promoted by NAHPA, USDA has agreed to subordinate existing federal mortgage debt, allowing new first mortgagees to bundle acquisition and rehabilitation loans for sale on the secondary mortgage market. USDA also has agreed to reduce interest rates on the assumed Section 515 debt to one percent, to extend the loan term, and, in some cases, to forgive a portion of the outstanding principal. By accepting a second mortgage position and offering property owners substantial interest rate and principal concessions, USDA hopes to leverage its limited budget funds into many times that amount in permanent private-sector financing to preserve rural and small town affordable housing.

New first mortgages will originate with Fannie Mae-approved Delegated Underwriting and Servicing (DUS) lenders, who will service the loans and – once sufficient numbers of loans have been placed – sell the long-term debt on the secondary mortgage market. Local USDA managers will oversee property rehabilitation, where necessary, and allow borrowers to set aside escrows for property taxes and insurance. The first transaction financed under the Fannie Mae-DUS model – the sale of a USDA Section 515 property in upstate New York to a local affiliate of Alexandria, Virginia-based Volunteers of America (VOA) – was successfully concluded in early 2004.

A century-old national faith-based non-profit organization, VOA purchased the 22 year-old 40-unit Adirondack Apartments in Saranac Lake, New York, from a limited partnership controlled by AIMCO Inc., a leading for-profit owner and manager of multi-family apartment buildings. Capri Capital, a Fannie Mae-approved DUS lender, placed a new 25 year \$515,000 mortgage on the property at 6.9 percent. Although Capri's underwriting yielded only about \$6,000 per unit in rehabilitation financing, VOA's capital needs assessment of the property identified rehabilitation requirements of roughly \$12,000 per unit. Critically, USDA agreed to reduce the interest rate on the existing \$1 million 40 year mortgage from nine to one percent, freeing up more \$80,000 in annual operating cash which VOA will use to finance repair and rehabilitation costs over the next two to three years. The property also received an \$80,000 weatherization grant from the New York State Department of Housing and Community Development.

Federal officials allowed VOA such flexibility in meeting the property's rehabilitation needs in part because Capri underwrote the new mortgage without considering operating revenue derived from the building's 100 percent HUD project-based Section 8 rent subsidy. Although most Section 515 preservation lenders now commonly include rental assistance in calculating a property's revenue stream, Fannie Mae's underwriting guidelines exclude rent subsidies since they are subject to future renewal.

Transaction costs for this first-of-its-kind preservation financing were understandably high, especially given the overall modest purchase and rehabilitation costs. Nonetheless, VOA officials were generally pleased with the transaction and noted that they now have standardized documents which may be used on other similar future purchases. Although the Fannie Mae-DUS model is unlikely to overtake more traditional tax credit and bond financing, it could inject some much needed new capital into the Section 515 affordable housing preservation marketplace, especially in California and other markets where property values will serve as adequate loan collateral.

For its part, Fannie Mae has set aside \$100 million for a new DUS-lender pilot program to finance rural affordable housing preservation. The pilot program will fund 30 year mortgages covering acquisition and rehabilitation expenses, although rehabilitation only loans also will be considered. Fannie Mae has set a loan-to-value ratio of 65 percent for new first mortgages, excluding existing indebtedness from any assumed USDA debt. The secondary market lender currently is assessing two large Section 515 portfolios and

believes its new mortgage product could find a particularly strong market in California and other areas of the country with high property valuations, positive occupancy histories, and high levels of federal rental subsidies.

In general, Fannie Mae is interested in financing the preservation of portfolio-sized Section 515 properties. As with most sales of smaller, lower-valued properties, transaction expenses for various pre-closing services, including legal and accounting fees, often dictate that Section 515 properties be combined for purposes of sales and rehabilitation financing. Often, these transaction costs make otherwise attractive preservation options prohibitively expensive. Nationwide, average Section 515 property indebtedness is roughly \$675,000 per multi-family project, while average new equity financing is about \$450,000 per property. With average soft costs for various due diligence, legal, and accounting services approaching – and in some cases exceeding – \$100,000 per transaction, sales of larger rural affordable housing portfolios clearly is the preferred alternative.

II. Low-Income Housing Tax Credits

High transaction costs may be particularly problematic in purchases partially financed by the sale of Low Income Housing Tax Credits (LIHTC) allocated to the states by the U.S. Department of the Treasury. Although some USDA managers believe they could spend “full time closing tax credits deals,” tax experts caution that LIHTC financing may have limited applicability for non-portfolio sized Section 515 purchases in part because of the high transaction fees involved compared to the relatively low property valuations of individual rural affordable housing properties.

The scarcity of tax credits and pressure within state housing finance agencies to use them to fund significantly more expensive urban housing and new construction also may serve to limit their availability for Section 515 property preservation. This has been the experience in several states, where officials have questioned the widespread applicability of LIHTC financing for rural projects due to the developments’ generally small scale. Nonetheless, USDA officials and affordable housing legal and financial experts agree that tax credits will continue to play an important role in preserving rural affordable housing, particularly where buyers successfully consolidate one or more smaller properties into larger portfolio-sized transactions.

In California, for example, roughly half of the Section 515 preservation transactions completed in the past two years have involved combining separate properties into single large developments, in several cases aggregating as many as 100 or more affordable housing units into one project. In one notable transaction, three separate properties were combined to create what is by national Section 515 standards one 161 unit mega-project. Overall, nearly all of the state’s successful USDA preservation transactions have involved tax credit financing combined with either tax exempt bonds or, in some cases, third party lending.

A pending proposal by the California Tax Credit Allocation Committee (CTAC), the state agency responsible for writing rules governing the low-income housing tax credit program, could dramatically alter the use of tax credits in Section 515 preservation financing. Under the CTAC proposal, developers would forfeit the customary fee of 15 percent of a project's acquisition basis in exchange for higher fees paid on the basis of rehabilitation costs.

To encourage more of a project's capital to be applied to rehabilitation and other property improvements, the proposed CTAC rule also would establish a minimum rehabilitation expense of \$10,000 per unit in order for a preservation transaction to be financed with low-income housing tax credits. Although this rehabilitation expense threshold would not have effected the majority of California's recent Section 515 preservation transactions, where average costs for property upgrades exceeded \$16,000 per unit, it likely would have restricted tax credit financing for at least nine projects where rehabilitation costs per unit were in the \$10,000 or less per unit range.

Escalating fees for tax credit-financed affordable housing preservation also is a concern for some national investment syndicates. Because nationally most of a typical Section 515's total preservation costs are in property rehabilitation, many syndicators are looking for properties where high rehab costs will justify high – and rising – tax credit transaction fees. In some cases, syndicators want to see rehabilitation costs of \$20,000 or more per unit, a benchmark which poses a problem for many California properties which are generally well maintained.

Washington Mutual is by far the most active tax credit lender in California's Section 515 housing preservation marketplace; half of the 26 preservation transactions closed by California USDA officials in the past two years have been financed by the bank's community lending operation. Overall, Washington Mutual financed the preservation of 850 USDA-mortgaged or HUD-insured affordable housing units in California during 2004. Borrowers included local housing authorities and both for-profit and non-profit developers.

Wherever possible, Washington Mutual prefers to consolidate separate Section 515 properties into larger projects or engage in simultaneous multiple preservation transfers with the same borrower. In combining properties, the lender has ruled out crossing county lines to avoid including units subject to varying tenant income/area median income eligibility standards, although USDA officials say this should not pose a problem. Average transaction costs for a typical Washington Mutual tax credit/tax exempt bond financed property transfer are about \$100,000.

III. Bond Financing

Transaction expense burdens also apply to the sale of state-backed tax exempt bonds to finance Section 515 affordable housing preservation. Substantial legal and accounting fees dictate that bond financing be used exclusively for larger portfolio purchases. However, as with tax credit financing, bond sales may be an attractive Section

515 preservation alternative, particularly in cases where a non-profit organization is consolidating a group of USDA properties into a larger portfolio sale.

A recently concluded Section 515 affordable housing purchase by the Mercy Housing System of Denver illustrates the type of larger portfolio sale preferred by USDA officials and most third-party investors and lenders. In the Mercy Housing transaction, two ownership entities in Washington State sold a Mercy affiliate 30 separate Section 515 properties encompassing nearly 1,000 low-income apartments. USDA agreed to subordinate nearly \$21 million in existing long-term mortgage debt and to provide \$8.8 million in new rehabilitation financing for required property upgrades.

Most of the remaining funds for the \$42 million purchase and rehabilitation of these section 515 properties came from a \$10 million State of Washington tax exempt bond issue. The Washington State Trust, a state agency, provided some much needed bridge financing, and Mercy assumed control over about \$1.8 million in various reserve and operating accounts. The 30 properties also will benefit from significant property tax abatements from local county governments.

Mercy's Washington State acquisition further underscores the benefit of portfolio-sized transactions, especially where high-fee bond funding is the financing method of choice. In such cases, paperwork requirements are often less burdensome and USDA generally allows sellers to combine property reserve accounts. Similarly, the new owners usually are permitted to aggregate rental assistance contracts and other federal subsidies among all the acquired properties. According to USDA managers, the key is to consolidate the previously separate mortgages into one loan. Although these transactions are often very complex and benefit from a patient seller, in general agency officials advise that the only major concern is to avoid combining groups of properties across state lines, since respective state laws often pose unacceptable obstacles to property consolidations.

California's Section 515 Portfolio

Although California's 421 Section 515 properties account for less than three percent of USDA's national portfolio, projects generally are larger than the national average – about 45 apartments per property, compared with 27 nationally. In aggregate, the state's Section 515 housing stock accounts for about five percent of total outstanding USDA mortgage debt, roughly \$575 million. The median age of California USDA properties is nearly twenty years; more than half were constructed in the decade of the 1980's. Only three new Section 515 properties have been constructed in California since 2000.

Of these properties, California USDA officials have identified 149 currently “at risk” developments, those with either no federal program use restrictions, expired use restrictions, or properties with use restrictions expiring in the next two years. Another 122 properties are considered “vulnerable” – those with use restrictions expiring between 2007 and 2017 – including nearly 100 properties which will be free of federal program

restrictions in the next five years. Overall, nearly 65 percent of the state's Section 515 units face some degree of exposure, creating a near-term challenge to USDA managers who readily acknowledge that many of these properties easily could be converted to market-based rental housing.

Defying a national trend among rural properties, vacancy rates at the state's USDA-mortgaged units have plummeted in recent years; at the beginning of 2005, average Section 515 building occupancy exceeded 95 percent. Vacancy rates have fallen by almost two-thirds in the past six years even in the face of generally rising average Section 515 rents, which have jumped by more than 40 percent during the same period. These trends underscore the state's fairly robust rural economy and, unlike the outlook in many other rural areas of the country, provide a favorable economic backdrop for USDA's preservation efforts.

Among factors favoring the preservation of this housing stock is the California portfolio's high rate of rent subsidy. More than two-thirds of "at risk" Section 515 properties receive at least 50 percent USDA rental assistance or HUD project-based Section 8 subsidies; nearly 40 percent of these at-risk properties receive 90 to 100 percent federal rental assistance. California USDA officials have successfully preserved 26 "at risk" section 515 properties in the past two years, in about half the cases consolidating two or more once-separate properties into larger affordable housing developments. Nearly all of these properties – 23 of 26 – were financed with tax credits combined with tax exempt bonds or, in a few cases, third party loans.

Although by national standards, total acquisition, rehabilitation, and transaction costs for a typical preserved California Section 515 property are high – about \$71,000 per unit – that cost pales in comparison with the whopping \$175,000 per unit estimate for new affordable housing construction. Of the \$71,000, about \$24,000 represents assumption of existing USDA mortgage debt, roughly \$16,000 covers rehabilitation costs, another \$16,000 funds owner take-out equity, while the remaining \$15,000 covers various transaction soft costs, including legal, accounting, and, where applicable, developer fees.

California's recent Section 515 experience underscores a long-term national shift from public to private financing of these rural affordable housing preservations. In the past two years, total private-sector Section 515 preservation funding in California has exceeded \$20 million. By contrast, state-wide USDA preservation financing during the past *six* years has totaled just \$8 million.

California Affordable Housing Transfer Notice Requirement

Since July of 2001, California owners of affordable housing have been required to notify state and local government officials – and recognized non-profit affordable housing organizations – at least 12 months prior to pre-paying a low-income mortgage or selling a property. Notice is required even in cases where an owner is merely *considering*

pre-payment or sale. A second notice is required six months prior to any anticipated property transfer.

Exemptions to this notice requirement are allowed if properties are undergoing a “preservation” transfer, defined as multi-family housing units where eligible tenants’ incomes will not exceed either 50 percent of area median income (AMI) for buildings receiving some level of federal rental assistance, or 60 percent of AMI for properties with no rental subsidy.

The notice rule, enacted by the California legislature to prevent quickie conversions of critically needed units out of affordable housing programs, also requires sellers of low-income housing to grant non-profit organizations a right of first refusal to purchase properties on the same terms offered a for-profit buyer. During the first six months, sellers may only sell properties to qualified preservation-oriented buyers; during a second six month period, property owners may sell to any interested purchaser, although sellers must still grant a qualified preservation-oriented purchaser the right to purchase on the same terms offered any prospective for-profit buyer.

Outlook for California Section 515 Program

California USDA officials are genuinely optimistic about the prospects for saving much of the state’s Section 515 rural affordable housing stock. Although they are mindful of the pitfalls which lie ahead, they nonetheless exude confidence in their mission and, critically, the ability of their state’s preservation community to accomplish the task. In part, this optimism stems from a highly favorable rural economic environment, driven by a trifecta of steadily rising property values, historically high demand for affordable housing, and a growing rural population. By any measure, California’s rural affordable housing marketplace is, if not unique, certainly not the norm for the USDA Section 515 program nationally.

Among the factors favoring the preservation of California’s Section 515 portfolio is the nature of those properties classified as “at risk.” Most are larger than average and receive above average levels of federal rental assistance. More than two-thirds have at least half of their units subsidized, while nearly 40 percent receive either USDA or HUD rental assistance on 90 to 100 percent of units. Roughly 15 percent of California’s Section 515 housing portfolio – about 75 properties – has been preserved in the past several years and USDA managers have set aggressive goals for saving most of the remaining “at risk” projects by 2010.

In this quest, California USDA officials have demonstrated enormous creativity and flexibility in bringing transactions to closing, expediting various regulatory approvals and routinely granting exceptions to burdensome regulations in cases where requests for relief were previously just as routinely denied. In several recent transactions, agency managers have turned out property appraisals in as little as one week.

In cases where a conventional “as is” appraisal fails to adequately support a property’s acquisition price, California USDA managers have permitted developers to value properties on the basis of less restrictive “rehabilitation” appraisals which include the value of scheduled property upgrades. Similarly, USDA officials have negotiated with lenders to underwrite properties based on presumed long-term rental subsidies – in one case working with officials at the California Housing Finance Agency to underwrite a property’s 100 percent rental assistance for 30 years. While more traditional underwriters such as Fannie Mae are leery about including renewable federal rent subsidies when scoring properties, in general California lenders are increasingly comfortable including long-term rental assistance when calculating an acquired property’s revenue stream.

Future Challenges

The central challenge facing local USDA managers in California and elsewhere throughout the nation is to preserve as affordable housing as many Section 515 properties as possible, either through direct federal intervention or by facilitating the transfer of properties to groups committed to managing them under the USDA program umbrella. That task, problematic in any event, will be made all the more difficult by historic declines in federal support for affordable housing programs.

This paucity of public funding for rural affordable housing is having one unintended positive result: it is forcing USDA managers – and their private-sector counterparts – to think evermore creatively about alternative preservation arrangements. The new Fannie Mae DUS-lender model is an example of an alternative financing arrangement USDA managers hope will lead to a significant infusion of private-sector capital into the rural low-income housing marketplace, especially in California and other states where high property values and high occupancy rates would appear to support more conventional underwriting. Other similarly creative hybrid financing arrangements also are beginning to emerge, bringing increased promise to rural affordable housing preservation practitioners.

Although in the end only a significant increase in federal funding for rural affordable housing programs – including rural rental assistance, rehabilitation loans, and take-out equity financing – is likely to result in the preservation of many border-line USDA Section 515 properties, creative intervention by for-profit and non-profit groups dedicated to rural low-income housing preservation is likely to play an increasingly important role in successfully responding to this impending rural affordable housing crisis.