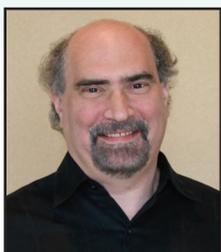


Small Scale Rental Preservation



The Florida Housing Coalition designed and presented a two-part small scale rental workshop: *Acquiring and Managing Scattered Site Rental Housing* sponsored by the MacArthur Foundation's Window of Opportunity Program.

by Stan Fitterman More than 70 percent of the United States' affordable housing stock consists of small scale rental properties. In Florida, there are approximately 400,000 units in multi-family developments containing nine units or less with this stock's average age being 40 years old. Until recently, most of the rental development activities in Florida focused on single family homeownership and large tax credit funded new construction. The housing bust, combined with the creation of the Neighborhood Stabilization Program, has created opportunities for nonprofit developers to acquire and rehab some of these smaller developments. But this business line is not without its challenges.

The workshop provided participants a clear understanding of the financial challenges surrounding small scale development and how to address these challenges. The



Lisa Hoffmeyer, FHC Technical Adviser, discusses the different federal funding sources with workshop participant Kristina Fausel.

training offered tools to help evaluate organizational capacity to implement this business line, help understand the market, as well as funding sources. The first session ended with a discussion about ways to aggregate units that are under different ownership in an effort to reach the economies of scale needed for efficient financing and management. The second part of the workshop focused on property management, including insurance, and ended with a case study of a small deal that faced some challenges.

Small Scale Rental Owners

While larger apartment buildings are often owned by partnerships, real estate investment trusts (REITs), or corporations, small rental properties are truly "mom and pop" operations. Nearly 90 percent of one- to four-family properties and three-quarters of five- to nine-family properties are owned by an individual or a couple. In addition, few private owners of small rental properties are full-time landlords. The majority hold other jobs from which they make most of their living. Indeed, fewer than half of the owners of two- to four-family properties made an operating profit from their buildings, compared with nearly three-quarters of the owners of apartment buildings with 50 or more units.



Robert Von, President of Meridian Appraisal Group, Inc. and FHC Board Member, provided an overview of market assessment during the first part of the workshop.

Most owners of small rental properties have historically been long-term owners, holding their properties for retirement income, long-term capital gains or to pass on to their children. The 1995 Census Bureau Property Owners and Managers Survey (POMS) (the latest data available) found that nearly two-thirds of the owners of five- to nine-family buildings had owned their building for more than 10 years.

The recent foreclosure crisis has also led to some nonprofit organizations becoming “accidental landlords” – using NSP funds to purchase single family units for re-sale, then realizing after acquisition and rehab that the only viable option was rental.

Although they make up a large portion of the nation’s housing stock, small scale rental complexes face challenges that larger deals do not. Small-scale owners are not as well-capitalized and are excluded from the economies of scale that are so important in the tight margins of tenant and property management. Less than 40 percent of the owners of one- to four-family properties made an operating profit from their buildings, compared with nearly three-quarters

of the owners of apartment buildings with 50 or more units. This lack of profitability results in small, if any, reserves for unanticipated expenses. Such budget stress adversely affects the maintenance and repair activities of absentee-owners of one- to nine-family structures. Stegman’s research on Baltimore rental property owners in the 1970s found a correlation between small-scale ownership; poorly maintained, physically deteriorated properties; and abandonment. More recent research has shown that despite the fact that their units are most likely among all property types to have structural deficiencies, 14 percent of small scale owners report spending nothing on maintenance, while 22 percent defer required major and minor repair.

Small Developments and Cash Flow

Table 1 shows the one year cash flow for a six-unit complex, renting for \$750 per month, with \$5,000 per unit per year in operating expenses. The complex loses money, yet the taxable income is positive, further compounding the loss. There are numerous costs in operating rental housing that an owner cannot control, such as mortgage payments, property taxes and insurance. An owner can, however, control how

Table 1 - One Year Cash Flow

		Cash Flow	Taxable Income	Comment
No. of Units	6			
Gross Potential Rent		\$54,000	\$54,000	
Vacancy and Collection Loss		(\$3,780)	(\$3,780)	
Other Income		\$1,000	\$1,000	
Operating Expenses		(\$30,000)	(\$30,000)	
Actual Reserve Deposit		(\$6,500)	-\$3,250.00	50% expensed
First Mortgage P&I		(\$18,524)	(\$13,568)	interest portion
Depreciation (original buildings)			\$0	fully depreciated
Depreciation (capital improvements)			(\$3,250)	prior yr reserves
Amortization			(\$138)	loan costs
Reserve Interest Income			\$300	
Operating Cash Flow		(\$3,804)		
Taxable Income			\$1,315	
Marginal Tax Rate	25%			
Total Taxes	\$328.72			
After Tax Cash Flow	(\$4,132.32)			

Table 1: One year cash flow for a six-unit complex, renting for \$750 per month, with \$5,000 per unit per year in operating expenses.

much he or she is willing to spend on maintenance. If, in the example above, the owner set aside no money for reserves and reduced operating expenses by \$1,800 per year to account for reduced maintenance, the after tax cash flow goes from a negative \$4,132 annually to a positive annual cash flow of just over \$2,500.

A Move Toward Larger, Higher Priced Developments

Given the difficulty in earning a profit on small scale affordable rental developments, it should come as no surprise that as these complexes age they are coming off line, and are not being replaced with new affordable small scale developments. More than one in 10 single-family detached homes, which made up over a quarter of the low-rent housing stock in 1999, were permanently removed by 2009. Loss rates for multifamily properties with 2 to 4 units, accounting for a quarter of the 1999 low-cost stock, were even higher at 15.1 percent

Low-cost units (renting for less than \$400 in 2009 dollars) are most at risk of permanent loss because, as we have seen, the modest rent they earn is often insufficient to maintain the properties in good condition.¹ In 1999–2009, 11.9 percent of low-cost rentals were permanently removed from the stock—nearly twice the share of units renting for \$400–799 and four times the share of units renting for more than \$800. In addition, decade-long loss rates for vacant low-cost units (20.6 percent) were nearly twice those for occupied units (10.9 percent).

As these smaller, less expensive units are lost, the market is replacing them with higher priced units in larger developments. According to the Joint Center for Housing

Studies, in 1999, 13 percent of new rental apartments were in buildings with 50 or more units. By 2009, this share had tripled to 39 percent. In 2009, construction and land costs for units in new multifamily structures averaged about \$110,000, and the median asking rent was \$1,067. To be affordable to the median renter in 2009 (at the 30-percent-of-income standard), the rent would have to be at \$775 or less.

At the same time, many lowest-cost rentals are being permanently lost from the stock, largely because the rents they earn cannot cover the costs of adequate maintenance. In fact, the American Housing Survey indicates that despite the net addition of 2.6 million rentals, the number of units with rents of \$400 or less in 2009 inflation-adjusted dollars fell from 6.2 million in 1999 to 5.6 million in 2009. Many of the losses were due to demolition and other forms of permanent removal. By 2009, nearly 12 percent of the low-cost rentals that existed in 1999 had been lost—twice the share for units renting for \$400–799, and four times the share of units renting for \$800 or more. Many of the low-cost rental units that remain are in older, more at-risk buildings.

What to Do?

So, most of the affordable rental housing in this country is in small developments that are being lost, and replaced with larger more expensive options, pricing out the low income renter. As noted previously the operating expenses of these small developments often exceeds the receipts. How can this stock be kept affordable? One option is for nonprofit developers interested in this business line to acquire a number of small developments. By having at least 70 to 100 units in a portfolio, the owner can begin to realize the

Small Scale Stock

Rental properties with fewer than 10 dwellings (small scale rental) comprise the bulk of the privately owned, affordable rental stock in the United States. Over 70 percent of all lower-income households live in one- to four-family properties. The American Community Survey reports that small scale rental properties house one out of every five American households and two-



thirds of all renter households in the U.S.

The Shimberg Center for Housing Studies reports that as of 2010, Florida has nearly 400,000 small scale rentals. In Miami-Dade alone there were 32,587 multi-family complexes with 2 to 9 units, consisting of over 87,000 units. Broward has 18,364 small scale rentals, with 51,151 units.

economies of scale that come with managing a large number of units. Central to this strategy are that the units are located in reasonable proximity to one another, and to the greatest extent feasible, the units have similar fixtures and finishes. This simplifies maintenance and allows for bulk purchase of parts for repairs as well as at the time of replacement.

Another option would be to create a Real Estate Investment Trust (REIT) that specializes in small scale affordable developments (see side bar). This would facilitate the transfer of ownership from individual to institutional, producing enough scale to obtain professional management and, potentially, more flexible capital. **HNN**

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¹ With rents at \$400 per month the example in Table 1 would have shown a before tax loss of nearly \$15,000. While the taxable cash flow showed a loss as well, for tax purposes, the owner would likely only be able to deduct this loss from profit earned on other real estate holdings.

Look for the two-part Small Scale Rental Workshop to be held in Central Florida late spring / early summer.

Participants highly rated the workshop for increasing knowledge of developing and managing small scale rental housing and networking with other housing professionals.

Real Estate Investment Trusts and Small Scale Affordable Rentals

Created in 1960 by the REIT Act and modified by the Tax Reform Act of 1986, a REIT is basically a mutual fund that invests in real property, other REITs, mortgage instruments or some combination of these elements. Publicly traded REITs provide opportunities for investors to passively participate in commercial real estate ownership. REIT investors enjoy benefits such as liquidity, professional management wealth creation, and dividends. While most REITs tend to be focused on conventional real estate products and assets such as office buildings, apartments, shopping malls, industrial space, or mortgages, they have also grown popular with non-traditional firms specializing in self storage, health care, tower sites, and timber. REITs are substantially less active in affordable housing development and investment. At present, Community Development Trust (<http://www.cdt.biz>), a private REIT, is the only REIT that is active in providing debt and equity financing tools to affordable housing investors and developers.

As proposed by Narasimhan in 2001 and further explored by Apgar and Narasimhan in 2007, a small or S-REIT, could be created that would allow each small scale property owner to swap their property with the S-REIT for an allocation of partnership units (or shares) based on their equity positions in their respective properties. Narasimhan proposed that to capitalize the S-REIT, the S-REIT would issue additional shares to institutional investors at the corresponding per share valuation. These units would in turn entitle the owner to a preferred cash flow and a share of potential appreciation rights, and to the benefit of having the professional local management. In Narasimhan's model, the S-REIT worked – in theory, at a size of 1,200 units.