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Investors say RAD Transactions are Different, but Worthwhile

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The U.S. Department of Housing and Urban Development's (HUD's) Rental Assistance Demonstration (RAD) program creates another type of affordable housing in which to invest–and investors like RAD, even though there have been hurdles.

Most notably, RAD brought a different partner to affordable housing transactions: the public housing agency (PHA).

"This is a terrific opportunity to improve the housing stock all over the country," said Mahesh Aiyer, director at Citi Community Capital. "It's been very successful. It's taken a while for housing authorities to understand the program, but bit by bit, it's changed."

As the number of properties that completed their RAD conversion surpassed 100,000 and the current cap of 455,000 eligible units approaches, several people on the investor side shared what they've learned, what they like and what they look for while making a RAD investment.

They range from Hunt Capital Partners, a pioneer in RAD developments, to Citi Community Capital, which has been involved in about 50 RAD developments, to R4 Capital, a syndicator that has worked nationwide with large as well as smaller PHAs.

"Smaller housing authorities who own a small number of properties and are rehabbing all or most of their public housing units will generally partner with a for-profit developer who knows the ins and outs of the RAD program," said Alex Magliozzi, senior vice president at R4 Capital. "Larger PHAs are more likely to have expertise to go it alone."

Beginnings

RAD was enacted as part of the Consolidated and Further Continuing Appropriations Act, 2012–

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and Hunt Capital Partners was an early adopter as a syndicator.

"When RAD started, Hunt wanted to participate in the program due to the similarity with the military housing privatization [the Military Housing Privatization Initiative]–both were programs to bring in private capital and know-how to help provide traditionally government-sponsored housing," said Jeffrey Weiss, president Hunt Capital Partners. "Hunt had success on the military side and Hunt looked at RAD as variant of military housing programs."

Hunt's first deal remains its largest RAD transaction, converting more than a quarter of the Housing Authority of the City of El Paso's 6,100-unit inventory. Hunt is headquartered in El Paso, so the relationship was obvious.

"Why go small, right?" Weiss said. "We did a 1,600-unit RAD transaction."

Not everyone was so quick to jump. Aiyer said there was a period of education necessary for PHAs.

"There are nuances to RAD financing that most PHAs didn't understand," Aiyer said. "The big PHAs have worked with tax credit developments, but the smaller ones haven't. A smaller PHA might have five properties in total and this might be the first time. Education is necessary."

Challenges in RAD

While low-income housing tax credit (LIHTC) equity is only one of several ways to finance RAD developments, it is the most common. More than half of RAD conversions have included LIHTCs in their funding, which required adjustment.

"One of the biggest challenges was the operating expense history," Weiss said. "The way housing authorities budget is they take the operating budget for the year and the operating expenses, including everything–the back office, compliance, everything–and spread it across all of their properties. We had to drill down to get the actual expenses for individual properties going through the RAD conversion. It was educational for us and for the housing authority."

Weiss said requirements of RAD and tax credits were slightly different.

"Optics were different," Weiss said. "One area was the physical needs assessment. The RAD Property Condition Assessment shows how to make the conversion feasible for 20 years. You were allowed to make repairs over a 10-year period and use operating cash flow, but in the tax-credit world, you want to make repairs Day 1 and not rely on projected cash flow."

The risk factor is different on a RAD development compared to other LIHTC transactions.

"Most affordable housing transactions that use LIHTCs have a nonprofit or for-profit developer partner," said Richard Gerwitz, co-head of Citi Community Capital. "If you are the investor or lender and something goes wrong, you can have the option of replacing the developer. It would be a much greater challenge to replace a housing authority."

Working with a PHA generally leads to additional training.

"As a housing authority transitions to RAD, there can be concerns as to whether the authority has the staff to effectively manage the property," Aiyer said. "Initially, it may be wise to have a third-party property manager

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who can make sure that the authority staff is properly trained."

What They've Learned

Over time, investors, private developers and PHAs found a way to make RAD financing work.

"Now that investors are familiar, they like the risk profile," Magliozzi said. "Investors got up to speed quickly and are very comfortable."

Magliozzi said HUD has been a significant help in helping make everyone comfortable with RAD investments.

"I would say it's changed in that we understand the RAD process now and are able to streamline it," Magliozzi said. "HUD has been very willing to take feedback on how it's working and not working and speed things up. Anytime there's a new program, there's a learning curve."

Those involved say that RAD investments require an even greater level of understanding and involvement than other affordable housing investments.

"It's a deeper working relationship than you would think," Aiyer said. "It's not something you simply say 'I would like to finance this.' You need to be in business to do it and understand the nuances. Every transaction has things come up."

What Investors Want

When a PHA begins begins seeking financing for a RAD conversion, investors look for some significant experience.

"If a housing authority comes to us, the first question is 'have you done one or do you have a team in place?'" Weiss said. "Mostly, housing authorities have already partnered with an experience developer. … If it's a repeat partnership, we might do it again, but if it's a new one, we discuss a couple of issues. We ask questions about the scope of rehab and the physical needs assessment. Income verification, how you're going to manage it."

Weiss said that means an understanding of responsibilities.

"The first thing investors ask is about the development team," Weiss said. "Everybody agrees that on the operational side, a housing authority can do it. But can they run the tax credit compliance process? We focus on that. It's more about compliance. Tax credit compliance and HUD compliance may be similar, but the results are different."

Weiss said the penalty for falling out of LIHTC compliance–loss of credits–is much harsher than falling out of HUD compliance.

"We've found a number of housing authorities understand that and immediately contract with a third-party to monitor compliance," he said.

Effect of Market on RAD

When tax reform legislation passed in late 2017, affordable housing took a hit. Those involved say that RAD properties were impacted in a way similar to other tax credit housing, as equity prices dropped.

"I think it's affected by the same market conditions, but there are very different RAD deals," Weiss said. "Well-capitalized, large housing authorities with capital to put in are easier to do, small housing authorities that need capital in small markets, may not work."

William Teschke, director of project management at Hunt Capital, said that RAD transactions may have been more severely impacted for one simple reason.

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"They were maybe hurt more than other tax credit deals, because a good portion of RAD deals tend to be acquisition/rehabs with 4 percent LIHTCs," Teschke said. "Those projects have a lot of losses, which were devalued after tax reform. The resulting hit to equity pricing is significant and some PHAs may not have the money to fill the gap."

However, Magliozzi's experience suggests that those properties actually are more likely to be financed with 9 percent LIHTCs.

"In our experience, we see state credit agencies are more willing to give 9 percent credits to RAD than other subsidized properties," Magliozzi said. "You get a lot of equity and you can do substantial rehabilitation, it's easier to underwrite. In a lot of ways, with RAD, you get the best of both worlds."

Benefits of RAD

As the RAD program matures, those involved in financing the conversions are more and more comfortable.

"Our experience is that in smaller markets, rents tend to be at a level closer to achievable tax credit rents, so there is less overhang risk than with other subsidized properties," Magliozzi said.

Gerwitz said that PHAs have gotten more comfortable with LIHTC RAD transactions, too.

"Interestingly, housing authorities are like working with developers," Gerwitz said. "There are various levels of sophistication. Many are quite sophisticated, almost like a private developer. Then you find some that are less sophisticated and it's much more challenging to work with a complex program. It's like any transaction, there's no cookie-cutter."

Hunt's Weiss said overall, investors are comfortable with RAD transactions.

"Investors like RAD deals," Weiss said. "Most investors are open to it and not scared of it." ❖

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