



# UCLA AFFORDABLE HOUSING POLICY BRIEF

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The UCLA Ziman Center for Real Estate presents the next in a series of Affordable Housing Policy Briefs. This August 2019 Brief considers proposals to help preserve naturally occurring affordable housing” (NOAH) – a crucial housing component in high-cost areas such as California. The Brief discusses why developers often choose to convert NOAH properties into luxury or “low-income housing tax credit” (LIHTC) projects. A case study in Glendale, California examines under what conditions preserving NOAH for workforce housing becomes a better investment than converting to luxury or LIHTC.

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## ‘Naturally Occurring Affordable Housing’ is Disappearing Preserving NOAH is for crucial lower- and middle-income households

By [Maya Saraf](#)

The disappearance of naturally occurring affordable housing (NOAH) remains a persistent problem in high-cost metropolitan areas of the United States. The term NOAH refers to existing Class B and C housing built prior to the 1990s, which is generally affordable for middle- and low-income households. Rents charged for NOAH multifamily units are typically lower than those charged at market-rate units due to their age, condition, outdated design, location, and, in some cities, rent control laws. NOAH often serves as “workforce housing” because it tends to be affordable for middle-income workers who earn between 80% to 100% of Area Median Income (AMI). This segment of the workforce usually includes teachers, accountants, office managers, and nurses who often are unable to afford rents charged at luxury buildings. In addition to subsidized affordable housing, NOAH is a critical piece to meeting the demand for affordable housing in high-cost cities.

*“Without rent-control laws, a market correction, or other similar conditions, NOAH will continue to disappear. A number of cities, including San Francisco, Atlanta, and Los Angeles, have begun implementing innovative programs to preserve the remaining supply of NOAH.”*

CB Richard Ellis estimates that, nationwide, there are approximately 12 million workforce housing units across 66 major metropolitan areas. The multifamily industry removes more than 100,000 of these units per year through demolition or conversion of properties to high-end rentals. NOAH is frequently replaced with new or upgraded Class A luxury buildings that are unaffordable to middle-income earners. Although the supply of workforce housing is diminishing, demand remains high. According to the United States Census Bureau, there are 13.5 million single-family and multifamily workforce renter households. Moreover, the demand for workforce housing also includes higher-income individuals who seek to save money, as well as low-income individuals who have no other options.

## **Investment Considerations**

As a value-add investment, workforce housing typically achieves lower returns than luxury housing conversions. Developers can make superior returns by acquiring and upgrading existing Class B or C assets into luxury Class A properties. On the other end of the spectrum, developers may choose to convert a NOAH property to low-income subsidized housing (affordable to workers earning 60% or less of AMI) in order to access state and/or federal low-income housing tax credits (LIHTC). This can result in a shortage of housing for middle-income workers who rely on NOAH.

Nonetheless, workforce housing projects produce stable cash flows in high-cost areas due to the large unmet demand. Further, government-sponsored entities such as the Federal Home Loan Mortgage Corporation (Freddie Mac) offer favorable loan terms to workforce housing projects because these projects help preserve affordable housing. Additionally, communities and governments are generally supportive of workforce housing because these projects tend to displace fewer existing residents.

Workforce housing also has fewer restrictions than LIHTC projects in terms of required renovation, rents, and hold period. In addition, many high-cost cities in California are currently considering the adoption of rent-control laws, which would greatly reduce the feasibility of luxury housing projects. Moreover, should there be a market correction in the next few years, there would likely be greater demand for more affordable housing such as NOAH for workers who lose their jobs or suffer pay cuts.

## **Glendale Submarket Case Study**

Los Angeles County is a high-cost metropolitan area that has an acute shortage of affordable workforce housing. One city within the County currently experiencing a decline in NOAH is Glendale. The third-largest city in Los Angeles County, Glendale has a citywide median income of \$59,000 - lower than the countywide median income of \$65,000. Average rent in the city across all unit types (studios, one-bedrooms, two-bedrooms, and three-bedrooms) and all asset classes (A, B, and C) is approximately \$2,000 per unit. This is slightly above the countywide average of \$1,900 per unit.

The average rent in Glendale is unaffordable for residents earning between 80% and 100% of the city's median income because tenants would have to spend over 30% of her income on rent. (An individual earning \$59,000 per year would have to spend approximately 41% of her income to afford a \$2,000 per month unit). These rents would also be unaffordable to a tenant earning the county AMI of \$65,000.

Fueled in part by active tenants' rights groups, Glendale's municipal government recently passed a citywide "Rental Rights Program" ordinance. The ordinance consists of "right-to-lease" regulations, relocation assistance requirements and "just cause eviction" restrictions. The right-to-lease regulations require landlords to offer renewal to tenants 90 days prior to lease expiration. Tenants then have 60 days to accept the offer. If a landlord is seeking to increase a tenant's rent above 7% within a 12-month period, a tenant has the right to seek relocation assistance from the landlord. The amount of the relocation assistance is calculated as two times the area "Fair Market Rent" (as determined by HUD) plus \$1,000. Finally, the ordinance limits the reasons for eviction to a list of 12 actions, and may in some circumstances, trigger relocation assistance requirements. These new requirements greatly add to the cost of luxury conversion projects and may instead incentivize the preservation of NOAH.

Accordingly, we prepared a case study to analyze under what circumstances preserving NOAH as workforce housing achieves better returns than a luxury or LIHTC conversion. A hypothetical 100-unit multifamily NOAH property in Glendale was used to model the different returns achieved from converting the property to luxury housing, maintaining the property as workforce housing, or converting the property to LIHTC housing. Two scenarios were modeled for the three different housing projects: 1) assuming a “Pre-February 2019” scenario with late-cycle market conditions and no rental rights laws in place, and 2) a “Post February 2019” scenario wherein rental rights laws have passed and a market correction has occurred.

### **Glendale Case Study: Pre-February 2019 Scenario**

In the Pre-February 2019 scenario, the value-add luxury conversion project achieved far greater returns than maintaining the property as workforce housing or converting it to LIHTC housing. Although renovation costs for the luxury housing conversion were higher than for the workforce housing project, a developer could still achieve returns in the 20% to 30% range by dramatically increasing rents (by as much as 150% to 200%). Maintaining the project as workforce housing had lower renovation costs, but a lower return on investment due to the reduced rents (i.e., rents affordable to tenants earning 80% of AMI). Similarly, converting the property to LIHTC housing was also unattractive because the tax credit equity was not sufficient to cover project costs even with the assumed debt financing. It should be noted that although the luxury housing conversion had the greatest returns, it would have likely created other impacts such as displacing existing residents.

### **Glendale Case Study: Post-February 2019 Scenario**

In the post-February 2019 scenario, maintaining the property as workforce housing achieved better returns than converting the property to luxury or LIHTC housing. Because a market correction has occurred in this scenario, it is assumed that fewer residents could afford luxury housing. Glendale’s recently passed rental rights ordinance would not restrict drastic rent increases associated with the luxury conversion projects; however, there would likely be substantial costs associated with relocating tenants who could not afford the new rents. As a result, the luxury housing renovation was assumed to have stalled with fewer rent increases achieved, resulting in returns of only 8%. The LIHTC housing project was left with a financing gap even after accounting for tax-credit equity and debt financing. Maintaining the project as workforce housing resulted in returns around 20% due to the stable occupancy and the modest rent increases achieved after light renovations of the property. It was also found that returns on the workforce housing project could be improved by at least 100 basis points through a real-estate tax exemption or shortening of the hold period.

## **Discussion**

The case study highlighted what political and economic conditions would be favorable to improving returns on NOAH preservation projects. Without the passage of rental rights laws, a market correction, or other similar conditions, the disappearance of NOAH will continue to be a critical issue facing high-cost metropolitan areas. Accordingly, a number of cities, including San Francisco, Atlanta, and Los Angeles, have begun implementing innovative programs to preserve the remaining supply of NOAH in their cities.

The City of Los Angeles recently introduced a NOAH program intended to fund the preservation of these assets. In addition to providing a per-unit subsidy to fund the costs of acquisition and rehabilitation, the City works with the developer to obtain a property-tax exemption. The exemption places a covenant on the property that restricts rents to 80% or less of AMI. The program funding is intended to assist the developer in making light renovations to a NOAH property and preserving it as workforce housing. One of the main challenges, however, has been the substantial costs required to upgrade older buildings to meet current building standards. Moreover, it is difficult to assess these costs prior to construction, and therefore it can be difficult to determine whether a project is feasible during the pre-construction period. Accordingly, the City is now determining how to reduce costs and streamline the process for securing funding and implementing necessary renovations.

Should other cities such as Glendale choose to adopt similar programs, special attention should be paid to the costs of renovating old properties to comply with current building standards. Although rental rights laws help in the preservation of NOAH, they should be treated as one strategy in the tool belt. Other strategies such as the possibility of granting real-estate tax exemptions or relaxing certain building standards for older properties should also be explored, as they are a critical piece to improving returns on workforce housing projects and making NOAH preservation a more attractive investment.

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