Overcoming Challenges to Financing Supportive Housing

For-profit developers of market rate housing can usually borrow a great deal of their funding for projects from banks - the rental income they will generate from market rate rents is enough to pay for both property operations and debt service or payments for the loans. Supportive housing projects house people with extremely low incomes - therefore, owners have a limited ability to pay any debt service on top of the housing operating costs, unless the project has accessed some sort of operating subsidy, such as Project Based Section 8 or Shelter Plus Care vouchers. Supportive housing development must rely heavily on public funding to make the deals work, and must address many different challenges to achieve financial viability.

The "Operating Gap"

Perhaps the most significant challenge of providing housing with rents affordable to extremely low-income people is that the amount of rent that an extremely low-income household can afford to pay is often below the cost of operating the unit in which they live (e.g., the cost of utilities, property management, maintenance and other operating expenses), creating an operating shortfall or gap.

<u>Operating Shortfall Example:</u>
In the rent calculation example below, the allowable rent (after utility allowance) for a household with an income at or below 20% of the area median income is below $300 per month. In California, operating costs for supportive housing range from $300 and $400 per unit per month (without supportive services). As shown below, the result is an operating shortfall.

- Estimated Rent Per Unit Per Month — $250
- LESS Per Unit Per Month Operating Costs — $350
- LESS Per Unit Per Month Reserve Deposit — $ 30
- EQUALS Monthly Per Unit Gap — ($130)

The shortfall will likely become worse over time, because rental income can be expected to increase at a lower rate (2% ± annually) than the rate at which operating costs will rise (4%±).

<u>Solutions to the Operating Gap</u>
In a 30 unit building, a monthly per unit operating gap of $130 per unit per month (as above) equals a total operating gap for the project of $46,800 per year. Most organizations cannot expect to cover such a gap through fundraising activities, nor will a project with such a gap be deemed financially feasible by housing financing sources. In order to solve this operating gap, the project may seek to bring in additional income through a dedicated operating subsidy, or may seek to establish adequate operating reserves through the development financing to cover the gap for the life of the project, or some combination of these two strategies. Another viable strategy is to include units with higher rent levels (not targeted to a supportive housing population) within the project, the income from which can help cover the gap for the lower-rent units.

Note: This document is included within the D*evelopment and Finance* section of CSH's *Toolkit for Developing and Operating Supportive Housing*, which is available at www.csh.org/toolkit2.

Other Challenges for Financial Feasibility:

Limited Ability to Support Debt Adds Complexity
Limited rental income constrains the amount of debt that such properties can support, and requires that the developer secure additional development subsidy (grants and soft loans). Additional sources often mean more complex requirements and a greater administrative burden.

Higher Operating Costs
Supportive housing developments have higher per unit operating costs than other affordable housing. Management staffing, for example, may be higher as additional time is required to work with service providers, complete additional funder reporting, and implement the full complement of programs envisioned to meet resident needs. Also, smaller project sizes are common to minimize the concentration of special needs populations, resulting in lost economies of scale.

Vacancy Loss
Losses in rental income due to vacancies (*the vacancy loss*) can be higher in supportive housing projects than in other housing. Initially, supportive housing properties can take longer to lease-up due to the complications of varied eligibility screening criteria, and during the collaborative process between property management and supportive services staff. Once a project is stabilized, vacancy losses can also occur, for example, when there are rental subsidies such as Section 8 that may require an owner to go through a Housing Authority and its waiting list to draw new tenants. If lists are old, or if a Housing Authority's procedures are cumbersome, leasing vacant units can take longer than the average turn around for non-supportive housing.

The Cost of Services
The limited rental income generated by supportive housing is insufficient to cover the cost of a comprehensive and stable on-site supportive service program. Typically, separate funding is sought to fund services, usually one or two years at a time, with no guarantee that services will remain an integral part of the property. Alternatively, developers seek donated services from providers for which the service provider may or may not have funding once the project is built.

Problematic Funding Programs
The subsidy programs that fund supportive housing do not go far enough to overcome these common challenges to project feasibility. For example:

- Most programs offer only short-term (2 to 5 year) operating and services subsidies, with no promise of renewal.
- Many programs require that rents equal a percentage of residents' actual incomes (rather than a fixed low rent), but do not provide an ongoing source of rental assistance to assure operating expenses can be paid into the future.
- Individual supportive housing funding sources are typically not sufficient to cover the total development cost of a project by themselves, resulting in the need to combine multiple sources that have requirements that conflict with one another or with the supportive housing model.

Overcoming the Challenges:

There are many innovative strategies for financing and developing supportive housing, and new ideas and models are being developed all the time. Some key strategies for successfully overcoming the identified financing challenges include:

Advocating for Operating Subsidies
In spite of the fact that operating subsidy programs typically provide only short-term commitments with uncertain renewals, such subsidies are a critical component to feasible, service enriched supportive housing developments. Advocacy for these resources at the local, state and federal levels has shown positive outcomes for creating new and/or targeting existing subsidy programs for supportive housing development and operations.

High Debt Service Coverage
When debt financing is used, it is often necessary to not take out the largest loan possible, but rather to keep a high debt service coverage ratio. While there may appear to be excess cash flow in early years, the project must also maintain positive (or at least break-even) cash flow for the mid- to long-term. Large amounts of debt that need to be services or repaid should be avoided whenever possible.

Capitalized Reserve (or Sinking) Funds
A reserve fund can be used to create a reserve to fund operating shortfalls and/or services in future years. Such a fund can be capitalized in the development budget (sometimes referred to as a "capitalized reserve") and/or funded with any excess cash flow in the early years of project operations.

"Mixed-Income" Properties
Including a range of affordability levels within a development, or incorporating supportive housing units in a broader affordable housing proposal, can help ease the problems of limited rental income, the inability to support sufficient debt, and operating shortfalls over time.

Accepting the Risks
A great deal of supportive housing has been built with this approach. Often organizations serving homeless and extremely low-income persons are accustomed to taking a high degree of risk since this is the only way they have found to achieve their mission. It is typical to simply assume that an operating subsidy or services grant for a property will be renewed or that funders will be flexible with regard to their requirements in the event renewals are not granted. And, it is common to strive for only 10 to 15 years of positive/break-even cash flow in spite of 30 to 60 year regulatory requirements. The supportive housing development industry has built a great deal of socially valuable housing based on this approach. However, the industry needs to continue to strive for financial models that better serves our organizations, properties, residents and, ultimately, our communities.

Note: CSH's *Toolkit for Developing and Operating Supportive Housing* contains many other documents that may be useful for understanding supportive housing financing issues. Please see the tools under *Assembling the Financing* in the *Development and Finance* section of the *Toolkit*, at www.csh.org/toolkit2development.