



Building Sustainable Organizations for Affordable Housing and Community Development Impact

Lessons and Recommendations from the Field

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About Enterprise

Enterprise is a leading provider of the development capital and expertise it takes to create decent, affordable homes and rebuild communities. For more than 25 years, Enterprise has introduced neighborhood solutions through public-private partnerships with financial institutions, governments, community organizations and others that share our vision. Enterprise has raised and invested more than \$10.6 billion in equity, grants and loans to help build or preserve more than 270,000 affordable rental and for-sale homes to create vital communities. Visit www.enterprisecommunity.org and www.enterprisecommunity.com to learn more about Enterprise's efforts to build communities and opportunity.

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Executive Summary

Introduction

The Great Recession deeply affected the affordable housing and community development delivery system in the United States. Despite a continued, urgent — and even increased — need for affordable housing and other community development efforts during the downturn, the meltdown of financial markets, including the Low-Income Housing Tax Credit (LIHTC) market, and the decline in real estate values in many areas of the country, stalled many affordable housing projects in various stages of the predevelopment pipeline. This in turn put enormous pressure on the organizations — both nonprofit community development organizations and mission-oriented for-profit developers — that form the backbone of the nation's capacity to develop and operate affordable housing. While the delivery system has recovered to some extent over the past year as the LIHTC market improved and programs made possible by the American Recovery and Reinvestment Act allowed stalled projects to proceed, the effects are likely to persist for some time to come.

Enterprise works with nonprofit and for-profit developers across the country to build and operate affordable housing and community development projects. Our developer partners range from large organizations (nonprofit and for-profit) that develop and operate portfolios across the country, to regional developers, to organizations that work in a particular city or neighborhood. Many of these organizations have always operated on thin capitalization and margins. Given the stresses of the past several years, we have seen development partners of various sizes across the country experience significant cash shortages, close business lines, and even dissolve.

Nonprofit and mission-driven for-profit affordable housing and community development organizations are the engines that provide safety and stability for the residents they serve and their communities' resources. Building sustainable development organizations is an effective strategy for protecting and preserving these assets.

Focus of this Paper

As we work to build and preserve sustainable affordable housing and other at-risk community assets, Enterprise seeks to learn from the experience of our partners and existing portfolio. While organizational failures are still rare in the community development industry, examining them can teach us valuable lessons. Enterprise undertook a detailed look at 10 nonprofit affordable housing and community devel-

opment organizations that closed their doors or were pushed to the brink in recent years. The organizations were located across the United States, and their affordable housing portfolios ranged in size from less than 100 units to more than 3,000 units. Some partners were neighborhood based, while others served an entire state or region. All maintained an extensive array of programs, services and business lines. To fully appreciate the implications of the lessons learned, we also looked at the broader context for the stresses that strained these organizations, including dynamics in the local affordable housing development system. Based on this review, the paper outlines recommendations and issues for further discussion to help strengthen community development efforts and systems across the country.

As Enterprise analyzed the 10 stressed affordable housing and community development organizations, we sought to understand what happened and why, and to draw out common themes and lessons that might be helpful to other developers facing similar organizational issues. In Section 1, we discuss in detail our findings and recommendations.

To better understand the dynamics of affordable housing and community development organizations, Enterprise reviewed a range of factors, including the industry's systemic risks. We then focused on a particular segment of developers: nonprofit organizations that exclusively serve a specific geographic area at the neighborhood-to-metropolitan level or serve a specific population within a metropolitan area. These “place-based organizations” (PBOs) are stewards of a community's assets and have been among Enterprise's key partners. Because key funders and stakeholders are increasingly focused on comprehensive community development at the very local level, we decided to examine the unique opportunities and challenges these organizations face. This is the focus of Section 2.

In order to enhance critical infrastructure issues, we set out to make specific, practical recommendations to both community development organizations and the financial partners, funders and policy-makers that can help to address some of the themes and challenges we identified. These recommendations are discussed in more detail in Section 3.

Overall Recommendations

1. Recommendations for development organizations based on a review of stressed and failed organizations (See Section 1)

- **Strengthen financial reporting and analysis.** Maintain a capable and consistent accounting department that provides timely and accurate financial reporting to board members, senior management, financial partners, and government and philanthropic funders.
- **Beware of significant one-time cash receipts.** Though counterintuitive, pay attention to how significant one-time cash receipts mask an organization's financial difficulty and delay proportionate business decisions.
- **Grow strategically.** Grow incrementally, strategically, and sustainably — particularly if planning to add a property management arm.
- **Cast off resource-draining projects.** Be willing to cut losses before you are certain that the property will fail.
- **Maintain relationships.** Build strong, long term relationships with funders and government partners, both of whom are integral to the success of an organization and its properties.
- **Conduct forecasting and scenario planning.** Conduct realistic planning exercises with an analysis of various scenarios.
- **Diversify Revenue Streams.** Diversify revenue streams by growing strategically into new business areas with the understanding that profitability may take years to achieve.

2. Other recommendations for development organizations based on industry context (See Section 2)

- **Prioritize organizational sustainability.** Affordable housing development organizations must focus on being fairly paid for what they do; this includes fully allocating overhead costs and structuring their deals accordingly.

- **Utilize development criteria.** Create a list of development criteria to help the organization's board approve or decline future projects.
- **Adopt an early-warning system.** Organizations must create an early-warning system for detecting when a property has a problem, and seek assistance in addressing it.
- **Consider collaboration.** Where there is duplication and opportunity to collaborate, organizations should consider taking that step.

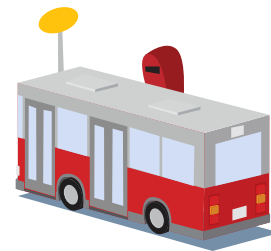
3. Recommendations for financial partners and funders (See Section 3)

- **Incentivize long-term ownership and stewardship of affordable housing assets.** In structuring housing credit transactions, public lenders should ensure that there are financial incentives for effective ownership and operation of the properties. Foremost, this includes lenders allowing cash flow to be paid to a project's sponsor.
- **Ensure fully funded workout projects and portfolios as well as ownership requirements.** When organizations take over troubled projects or portfolios, the funders involved should ensure that they are funded prior to take-over. Also, ownership requirements set by housing finance agencies must be flexible enough to allow for replacement general partners who may not meet all the nonprofit set-aside requirements.
- **Set realistic management fees and structure deals with sufficient cash flow to pay them.** Increase allowed property management, asset management and partnership management fees based on an owner's demonstration of actual, fully loaded management costs.
- **Embrace an early-warning system.** Funders have an obligation to create an environment that does not punish organizations for exposing weaknesses, but rather encourages early discussion of problems.

Mission-based developers are the heart and soul of our field. Implementing the above recommendations will: 1) build stronger organizations, 2) create viable business models, and 3) allow information to flow transparently among organizations, their leadership and funding partners. The community development industry is committed to developing safe, sustainable affordable housing, and the organizations that deliver and safeguard these assets deserve the same level of commitment to support their sustainability.

SECTION 1

Weathering the Economic Downturn: An Organizational Guide Based on a Review of Failed and Stressed Organizations



In 2010 Enterprise took a detailed look at 10 nonprofit affordable housing and community development organizations across the country that had closed their doors or been pushed to the brink of failure. The organizations were geographically dispersed from coast to coast and had service footprints ranging from neighborhoods to regions. While the organizations vary in size and core competencies, and each confronted different market conditions in its respective geographic location, the issues they faced can negatively affect any affordable housing or community development organization—large or small, for-profit or nonprofit. We do not discuss any one organization's experience, but rather point out common themes that emerged.

Of course, market conditions alone, especially those of the past two years, can place enough stress on an organization to cause it to fold, and this was certainly a significant factor in the downfall of several organizations that we reviewed. However, some organizations are weathering the downturn and even taking advantage of market opportunities. The evidence indicates that the deteriorating market conditions intensified weaknesses that were present well before the downturn.

The overall themes and recommendations are outlined in the Executive Summary. What follows is a detailed discussion of our findings in examining the 10 organizations, as well as our specific suggestions in each of these areas.

Financial Reporting and Analysis

What did the failed/failing organizations reveal?

Although financial statements are rarely the starting point for problems, poor financial reporting and a lack of internal controls can lead to a downward spiral that can be difficult to correct. We observed poor financial statements and much accounting staff turnover in the stressed organizations.

Poor Financial Statements

Few of the organizations that we examined had clear, helpful internal financial statements. Many of the statements did not detail performance by business line and/or entity, making it impossible to determine which business lines had generated cash and which ones had drained cash. Moreover, overhead may not have been properly allocated, so any net income reported on each business line was likely inflated. Finally, it appeared that the organizations monitored their operations solely on an accrual basis, making it difficult to identify a cash loss amid an accounting profit. As a result, it appeared that these organizations had income-generating business lines that, in reality, were a cash drain for the entire organization, possibly leading to overconfidence by both the board and senior management about the operating performance of that business. Bear in mind that the emphasis on cash should not undermine the importance of accrual-based accounting, which is a generally accepted accounting principle. An organization's cash position also depends on what it is owed and what it must pay, all of which is captured on accrued statements.

Accounting Staff Turnover

Accounting department staff turnover was a serious problem in nearly a third of the organizations reviewed, particularly for the chief financial officer (“CFO”) position. This contributed to delays in financial reporting, noncompliance with government regulators and weak internal controls.

Complicated organizations with many affiliates, subsidiaries or related entities can create intricate consolidating entities. It is not uncommon for a nonprofit developer who owns 10 LIHTC properties to have more than 20 organizations for which to account. New CFOs learn all the entities, their roles and the flow of funds among them, simply through on-the-job training. This learning takes time and can impede the accounting department's ability to produce financial statements in a timely manner. Frequent turnover can also delay audited financial statements. As noted above, delayed audits send a negative signal to third parties by drawing additional scrutiny and creating a lack of confidence in an organization.

Also, many nonprofits maintain large financial relationships with federal, state and local government agencies. Each of these relationships comes with its own set of regulations and compliance matters that an accounting department must manage. Agencies allow for various eligible expenses, expect differing documentation for reimbursement, and operate on separate timelines. Missteps on these compliance matters can result in delayed reimbursements and a potential loss of funding for vital services.

Finally, turnover and disorganization breed opportunity for theft as internal controls are likely to be lax. In several of the organizations reviewed, just one individual had

complete control over bank accounts with no oversight from any other executives. Improper transactions occurred, including theft; in all of these cases, the organization failed to monitor its cash situation and its overall financial situation. As a result, the theft did not come to light until the organization's cash position became precarious enough to prompt executive director or board scrutiny of each transaction. At that point, discovery of the theft only compounded the problems faced by the organization as it struggled to overcome an already challenging financial situation. Often, insurance will cover these losses; however, there is no compensation for the management and staff attention that is diverted to unravel issues of this nature. Even worse, the organization can become stigmatized in the eyes of funders, government partners and contributors.

Recommendations

Maintain a capable and consistent accounting department that provides timely and accurate financial reporting to board members, senior management, financial partners, and government and philanthropic funders. Stressed organizations tended to have high turnover of accounting staff, resulting in poor financial reporting processes and weak internal controls.

One of the keys to organizational strength is having leadership, including board members, that understands the organization's financial position, so that leaders can make effective decisions. To provide management with the information they need, the following guidelines should be met:

- Internal policies, procedures and controls, including segregation of duties, should be well established and fully implemented. Such policies and procedures not only provide consistency and reliability in reporting, but also serve to mitigate the effects of staff turnover.
- Internal statements should be released in a timely manner, and no more than 30 days after the close of the month. Sufficient controls must exist for the leadership to be able to detect or prevent misstatements.
- Statements should be succinct and provide details for each entity and business line so that management can see which ones are earning a profit and generating cash, and which ones are not. Allocating overhead to each business line provides the clearest picture on financial performance and allows management to gauge each business line's revenues, expenses and cash flow.
- Organizations should have internal cash flow statements that are invaluable in revealing which business units are actually generating cash and which need to be subsidized.

- Organizations should adopt a robust cash forecast for their operations. When realistically prepared, these forecasts can, for example, signal upcoming months of thin cash receipts or heavier cash outlays for predevelopment, and allow organizations to plan for cash shortfalls. This same exercise should be conducted to prepare valuation reserves for their receivables, so that the collectibility may be determined.
- Audited financial statements must be completed in a timely manner. Timely audits not only provide interested third parties with the information that they need, but also give them confidence that the organization is operating competently.

Organizations unable to afford a high-quality CFO should consider outsourcing the position to a local CPA or consulting firm. These firms employ many seasoned accountants familiar with nonprofit and real estate financial statements. Due to their size, they also pose little turnover risk to the organization.

Significant One-Time Cash Receipts

It is important for organizational leadership to recognize how heavy dependence on large non-routine cash receipts, including developer fee payments, are affecting their financial position, and how likely they are to recur. Most development organizations are small, but because they participate in real estate transactions, they show large revenue items or receivables in their financial statements, often months before they are to be collected. When a large payment is received, the organization may appear positioned to expand. A closer look may reveal that the one-time payment can lead to deferral of tough decisions related to either properties or business lines that are running at deficits, with no similar bailout payment in the foreseeable future.

In a related situation, the organization is supported by a large partner or affiliate with the resources to cover the organization's losses. Our review indicates that it is best not to rely on such a relationship for the perpetual funding of deficits. The relationship may change or the affiliate may suffer losses that alter its ability to fund the deficits. In either case, the organization must have a backup-plan, including a means of achieving self-sufficiency.

When invested wisely, collections of large cash payments can further such a goal. Some organizations have invested their excess cash in income-generating investment property or created reserves for a rainy day. Doing so can impose greater fiscal discipline within the organization, improve an organization's balance sheet, and prepare an organization to weather a downturn.

What did the failed/failing organizations reveal?

Over one-third of the organizations that we reviewed received large one-time cash payments within a few years prior to the financial crisis that they faced. Whether it came from the sale of property or a sizable grant, this large amount of cash minimized the effects of deficits elsewhere. It painted a rosy picture of the organization's finances, even when the organization was losing a significant amount of money through its operations. It also allowed the organization to put off the disposition of troubled properties or resource-draining business lines/programs. In many cases, strategic- and mission-related circumstances discourage disposition. However, it is likely that the large cash transaction prevented the organization from recognizing its precarious financial position. It also allowed the organization to delay strategizing solutions to overcome financial stress, a task that often involves difficult decisions or discussions on systemic and/or strategic issues such as growth of a business line or staff capacity. Nearly one-third of the organizations reviewed faced this situation.

Recommendations

Pay attention to how significant one-time cash receipts mask an organization's financial difficulty and delay proportionate business decisions. Proper cash forecasting, and understanding whether these large cash receipts may recur, is critical to proper business planning. Many stressed organizations showed significant one-time cash receipts within a year or two prior to distress, and did not plan properly for either the use of the cash or its depletion.

Strategic Growth

Done properly, growth and diversification are beneficial to organizations. However, any new endeavor that does not involve an organization's core competencies must have an adequate plan. Organizations should ensure that the proper resources, staffing and skills required for the endeavor are in place to provide the best opportunity for success. It would be wise to start small and grow cautiously and incrementally, with the understanding that new business lines may take years to produce a profit.

What did the failed/failing organizations reveal?

Property Management

The most common business for nonprofit housing developers to move into is property management. Since development organizations are often in the business of owning and operating rental property, self-managing those properties would seem a natural extension of their operations. Self-management can provide an organization with greater control over the property and generate fee revenue, which helps diversify

revenue streams. However, property management is a staff-intensive business that typically requires economies of scale to be profitable. (A general rule of thumb is that a management company must manage at least 1,000 units to be profitable.)

Property management is a particularly difficult business for organizations to start, requiring significant financial and human capital to achieve success. None of the organizations reviewed had profitable property management operations, and most were new business lines created to generate cash for the organization. In some instances, the organization failed to establish the internal infrastructure and expertise necessary to support property management operations. In other instances, the geographic area in which the organization attempted to operate was far too large for its staffing, or the population to be managed was outside its expertise. In still other instances, the property management business never reached the scale required to be profitable.

Low Estimation of Start-Up Costs

Projecting several years ahead is fundamental to benchmarking success. Ideally, an organization makes plans to incur losses on its property management operations during the startup phase, and estimates when the numbers change from red to black as they scale up and/or improve internal operations. Yet, most groups assumed profit from the beginning. Also, their accrual-based financial statements made it difficult to determine that losses were being incurred, since they were accruing management fees that the troubled projects did not have the cash to pay.

Deferred Maintenance or Deferred Fees

Poor economic performance creates problems in two ways: 1) deferral of maintenance and 2) deferral of property management fees (accruing them). Deferring maintenance helps projects to generate cash flow in the short-term, but the costs will eventually catch up to the property and the organization. Deferring maintenance results in poorly maintained projects, leading to lower revenues through lowered rents and/or higher vacancies, and higher long-term expenses. Deferring property management fees means that the property manager is not paid for its work, thereby leaving its costs to be covered by the organization. While this makes the management company look profitable on paper, it shifts resources from the organization into the management business line or entity. This subsidy reduces the unrestricted cash that the nonprofit developer uses to push projects through its predevelopment pipeline. Fewer funds for the pipeline mean either fewer projects or slower moving projects; both result in decreased developer fees.

High Property-Management Staff Turnover

From our research, organizations engaged in property management also struggled to attract and keep qualified staff, so the turnover prevented the organization from obtaining necessary expertise and building institutional knowledge in property management. Similar to accounting staff turnover, a revolving door in the property management department can lead to properties with higher vacancies, slower turns, more deferred maintenance and noncompliance with LIHTC and HUD regulations.

All of the organizations that self-managed their properties (about half of the organizations studied) had property management departments that were not profitable and drained their resources. For many of the organizations, poor property performance meant not being able to collect fees on these underperforming properties, and the cash loss was not properly reflected in internal financial statements.

Similar Issues in Growth of Other Types of Business Lines

Seven of the 10 organizations reviewed either tried to grow their organization too quickly or ventured into new businesses without the proper staffing or strategy. Examples include:

- Adding programs or business lines too quickly without proper staffing or expertise
- Pushing the growth of the development business despite no indication that the pipeline would grow
- Relying on a development partner, third-party property manager, and/or the syndicator's asset management department, without building internal capacity to take over these responsibilities.
- Underwriting a new department at a cash loss with the expectation that other business lines or grants would subsidize the losses indefinitely, and without a plan for self-sufficiency.
- Expanding into a new product, service or geographic area that does not complement the organization's core competencies or represents "mission drift."

Many of the expanding organizations reviewed faced similar pitfalls to those starting property management companies. Vertical integration may appear prudent at first, but may signal a move away from the organization's mission and abilities. Organizations lacking experience in newly adopted business lines face similar problems confronting property management start-ups. A developer or owner of affordable housing

is not necessarily fulfilling its mission by becoming a general contractor. Instead, the board's focus and an executive director's time may be diverted from managing the organization's core business lines and conducting strategic scenario planning.

Geographical expansion deserves special considerations. Local real estate markets and local politics can represent major challenges, and an organization must have intimate knowledge of them to succeed. We found that some nonprofits chose to expand their geographical territory to chase fees and profits. A typical case involved an organization with a slowing cash-flow stream that was in need of a cash payoff. A quick move to a new county seemed to be a sure way to turn a profit. These moves, especially for organizations with thinning cash flow, should not be made without a great deal of planning and a strong, local partner with whom to collaborate.

Recommendations

Grow incrementally, strategically and sustainably — particularly if planning to add a property management arm — with the understanding that profitability may take years to achieve. Stressed organizations pursued new business lines without sufficient planning and expertise.

The following guidelines are specific to self-management, but apply to other new ventures as well:

- **Staff appropriately.** Property management is labor intensive, requiring both property and administrative employees
- **Cover the right territory.** Successful property management strategies have a concentrated geographic focus. The fewer the units, the tighter the target geographic area must be.
- **Start with core competencies.** If an organization is a single-family developer, then focus the new property management on those kinds of properties. If the traditional population served is seniors, then begin with managing senior housing properties. Growth entails some inherent risk, which can be mitigated when an organization builds from its core competencies rather than operates outside of them.
- **Find the right scale.** Property management is a low-margin business that requires a rather large scale to achieve break even, much less generate a profit. It is important to determine at the outset what scale is necessary to turn a profit, what staffing and resources are necessary to achieve that scale, how to incrementally attain that scale, what potential loss is acceptable during the start-up phase, and whether the new endeavor remains feasible in light of the above.

- **Track revenues and expenses on a cash basis.** Revenues earned are not necessarily the same as cash paid, especially since self-managing owners can simply accrue fees; tracking cash receipts and payments is necessary to evaluate the business line's performance.
- **Don't forget your obligation to staff.** Bone up on knowledge of employment law, and be prepared to handle unemployment and workman's compensation claims.
- **Learn from the best.** Organizations have been known to successfully start a property management business by paying a good property manager to teach them the business as they managed the properties over the course of three to five years. This may be more expensive at the outset, but will transfer skills and build capacity in the long run.

Resource-Draining Projects

Nonprofit affordable housing developers are in the business of developing properties in pursuit of a mission to create housing for individuals and families who cannot afford market rate housing or require additional services. To be viable, the projects require subsidy, often from multiple sources, each with its own requirements and restrictions. To make matters worse, projects may face community opposition precisely because of the populations that they serve. With all the risk inherent in this kind of development, projects operate on a slim margin and a slight fluctuation in their performance can quickly create a cash shortfall, leaving developers economically vulnerable.

Given these conditions, organizations often must devise countless strategies to push projects over the finish line, and the success of a project can be hard to predict. Nonetheless, by the time it becomes clear that a project will fail, it may be too late to execute a viable exit plan.

What did the failed/failing organizations reveal?

Nearly two-thirds of the groups Enterprise reviewed were severely stressed by deficits from cash-draining properties. It was often two to three deals that drained the organization's cash and precipitated a crisis in the organization's finances. Projects in predevelopment had high holding costs; projects in operation were not cash flowing; projects financed with variable-rate predevelopment or construction loans suffered from unexpected rate hikes that the project could not support. Given limited demand for bonds from late 2008 and on, many projects slated for bond financing ended up in

extended predevelopment, and projects with construction delays that needed bonds re-issued were unable to obtain them. Inevitably, predevelopment and construction projects with cost overruns will result in nonprofit owners deferring most if not all of their developer fees. Since most of our partners rely heavily on developer fees to sustain their operations, losing or delaying receipt of this lifeblood can accelerate an organization's chance of failure.

Some groups acquired property in hot markets. After spending a large portion of their supportable debt on acquisition, projects had little revenue available after paying debt service to sufficiently fund rehabilitation of the units. As a result, units deteriorated quickly and performed poorly. Rents were no longer achievable as vacancy rates rose. When the real estate market fell, organizations found themselves competing with market rate developers to rent units. Given the condition of the property due to inadequate rehabilitation, the market rate stock was far more attractive, and the affordable units faced increasing vacancies and even poorer performance. These highly leveraged properties found themselves unable to service their debt or pay property management fees to the related management company.

As deficits at cash-draining properties became more and more severe, they diverted a great deal of senior management's time. Rather than devising strategies for leading the organization into its next phase, senior management was mired in the day-to-day management of struggling projects.

Recommendations

Be willing to cut losses before you are certain that the property will fail. Stressed organizations continued to fund resource-draining projects until the practice threatened the organization's survival.

In the face of these obstacles, it is imperative that organizations recognize the dangers of cash-draining properties. Such properties typically take three forms: 1) already acquired projects in predevelopment that await a delayed construction closing, and face high holding costs during that process, 2) projects in construction that face considerable unforeseen costs and hurdles before they can reach completion, or 3) operating properties that have negative cash flow without a viable refinancing strategy.

Based on our review, we recommend the following:

- Practice due diligence. Be wary of taking on projects that may become cash drains, and do not take the next step until all the necessary due diligence work has been completed.

- When borrowing at a variable interest rate, plan for an unexpected steep rise in rates. This could include purchasing a rate swap. With rates at historic lows as of February 2011, it is particularly important to consider this now, as rates can go nowhere but up.
- Prepare realistic cash forecasts of both project cash outlays and receipts. Coupled with a cash forecast of the overall organization, this is a critical tool in identifying gaps in cash funding and in helping an organization effectively plan and make timely decisions.
- Management should also institute discipline when planning new projects and decide in advance the points at which they will make “go/no-go” decisions, and when spending additional resources does not make sense. Too often, organizations make a decision to invest more in a predevelopment project based solely on the investment to date, when they should be looking at the future cost and likelihood to succeed.
- Consider multiple strategies for dealing with troubled projects, always including an exit strategy. Spend as much time figuring out how to get out as how to stay in a deal.
- Know when to cut your losses. While letting go of a project with significant sunk costs can be painful, the decision to continue adding resources to the project should depend on its likelihood to succeed.
- Ensure that senior leadership is engaged and keeping a watch on all potential resource-draining projects.

Relationships

As mentioned above, affordable housing typically requires subsidy (capital and/or operating) and may face opposition within many communities. It is imperative that an organization maintain good relationships with government agencies, funders and other community groups. Tumultuous relationships with the housing finance agency or compliance office can cause delays to current projects and loss of gap financing for future deals, while strong relationships can help organizations overcome various challenges, ranging from “not in my backyard” (NIMBY) opposition to cash shortfalls.

What did the failed/failing organizations reveal?

Over two-thirds of the failed organizations reviewed had very strained relationships with government agencies. The strain was often the result of properties being out of compliance. We saw these frayed relationships cause two types of problems. First, deals that had compliance issues or needed extra assistance suffered. Regulators were unwilling to give any leniency or special help toward a developer with whom they had a difficult relationship. Similarly, gap financing providers were less likely to consider more favorable terms or extra financing for a struggling property until the developer had tried every last option. Second, for deals in the pipeline, the developer was unable to receive the next round of funding awards as they had been ostracized. The agency felt no need to support them.

Recommendations

Build strong, long-term relationships with funders and government partners; both are integral to the success of an organization and its properties. Stressed organizations alienated key partners.

Forecasting and Scenario Planning

As noted in several places above, realistic forecasting and planning exercises can better prepare leadership to make tough decisions. Cash-flow projections should be performed on a regular basis with a sensitivity analysis to make sure that various scenarios are understood, including a worst-case scenario. These projections are great discussion starters for the board and senior management so they can make the hard decisions, which may include closing an operating property, writing-off a project in predevelopment or even downsizing the organization. Organizations often focus on events that would rescue them from collapse. Though the optimistic and hoped-for events may occur, planning for alternate scenarios is a key to healthy management and a smart use of leadership's time. If the best-case scenario does not occur, the planning effort may keep the nonprofit from financial distress.

What did the failed/failing organizations reveal?

Although some organizations were aware of their financial issues, each seemingly delayed addressing concerns with scenario planning. Instead, some waited to see whether a number of events would occur to bring them out of the danger zone. We heard organizations optimistically say things such as, "If these three things happen by March, then we will be out of danger." The organizations focused on the possibility that those events, no matter how unlikely, would occur, instead of developing back-up options. Only with hindsight did they recognize that their optimism had posed significant risks to their organizations' financial health.

Recommendations

Conduct realistic planning exercises with an analysis of various scenarios. Stressed organizations delayed devising exit strategies and focused on organization-saving events that were sometimes unlikely to occur.

Revenue Stream Diversity

Many housing development organizations are dependent on developer fee income. The recent downturn has demonstrated that those fees are subject to market fluctuations and more difficult to attain. For organizations that are overly dependent on developer fees, it is critical to seek out other revenue streams to survive. As described above, finding new revenue sources comes with its own risks, such as mission drift and lack of scenario planning.

Enterprise primarily uses two benchmarks to evaluate partner revenue diversification in considering the overall financial strength of a partner. The first benchmark compares developer fee income to net income, and the second looks at each revenue source as a percentage of total revenue. The extent to which developer fees exceed 150 percent of net income, the more an organization relies on a developer fee for break-even operations. Gains, losses, depreciation, amortization and other noncash items should be removed from net income first to create a more realistic comparison. Second, when any one revenue source exceeds 30 percent of revenue, it signals over-reliance on that source. However, consideration is given to the source itself. For instance, rental revenues and property management fees are generally considered stable sources of revenue as long as the portfolio is performing, and revenues are actually received as cash. Similarly, high diversification of grant or fundraising sources is deemed a lower risk than reliance on fewer sources.

Lack of revenue-stream diversity seems to affect small- to mid-sized nonprofits the most — those that previously developed many properties but do not possess a balance sheet that is currently attractive to investors. As their development pipelines slow, fees are no longer earned, putting pressure on the organization's ability to continue to operate as a going concern. Diversification should be thought of in several ways: 1) expanding to develop other kinds of properties or properties for other populations, 2) adding services for current clients and residents, 3) integrating vertically, and 4) growing geographically. The organization must plan appropriately for this growth opportunity and not underestimate the amount of out-of-pocket start-up costs. More than likely, the nonprofit will need to collaborate and form new partnerships, probably with other nonprofits, corporations and government entities.

What did the failed/failing organizations reveal?

The lack of revenue diversity was an issue for nearly all of the organizations reviewed. Because organizations were so dependent upon developer fee income, the prospect of losing that income source pushed organizations to quickly explore other ways of sustaining themselves, sometimes leading to the issues around strategic growth. In some instances, organizations waited too long to engage in the planning necessary to address the shortfalls that a lack of development revenue would bring, leading to insufficient or unsustainable growth.

Recommendations

Diversify revenue streams without losing sight of the need to grow strategically into new business areas and assess how much time it may take before the venture turns a profit. Stressed organizations did not have diverse revenue streams and sometimes tried to add a business line too quickly when developer fees began to shrink.

Conclusion

Based on our analysis, organizational failure resulted from multiple issues. All the themes that led to distress for organizations tended to overlap and exacerbate one another. For example, a group may start a property management department that does not perform well. The poor management of the property may then result in tenants leaving the property, causing the property's noncompliance with state regulations. The noncompliance could strain the organization's relationship with the state housing finance agency, jeopardizing the next tax credit project for this developer-fee-dependent organization.

It is a delicate task to balance all the priorities of running an organization, particularly in difficult economic times, but being mindful of the recommendations discussed in this section can help an organization manage challenges proactively.

SECTION 2

Community Development's Systemic Risks and Their Impact on Mission-Based Developers



The organizations engaged in community development and affordable housing come in all sizes and shapes, employing from two to 200 employees, covering a few blocks to multiple states, and developing high-rise new construction to rural scattered-site rehabs. They are often more than just developers — the best of them take a comprehensive approach to developing communities that involves much more than housing, often offering social services and operating property management companies. While no two of these organizations look exactly alike, most of them share a similar mission: to serve low- and moderate-income residents, some with special needs.

The diversity of the community development field has been vital to the creation and preservation of a myriad of affordable housing options for people in need across the country. Enterprise has enjoyed long and productive relationships with development partners from across the spectrum, including many place-based community organizations, for-profit developers and large national and regional nonprofit developers. In addition to providing equity and debt to projects, Enterprise has also furnished grant and technical assistance to many of these organizations.

Organizations tackling the challenging work of community development and affordable housing are likely to encounter some or all of the organizational issues described in the previous section at some point. Given so many challenges, this section perhaps begs the question: Are mission-based developers the best stewards of affordable housing? What has become clear in our work with developers is that their programs outside of housing development are often the key to making the housing operations viable. In many instances, it would require an inordinate amount of resources to replace the infrastructure and services that a mission-based organization provides — far more resources than it would take to stabilize the existing organizations. As such, building sustainable organizations is the cheapest and most effective way to develop and preserve affordable housing.

In this section, we explore some of the systemic pressures and constraints these developers regularly face that can make organizational issues more likely to emerge and

difficult to resolve. Within mission-based organizations, we highlight Placed-Based Organizations (PBOs). PBOs bring a unique value to community development and may experience some of these challenges more acutely. PBOs target a specific geographic area in which they develop housing and provide services. The services offered cover a broad spectrum, from organizing block clubs and making home repairs to providing case management and mentoring at-risk youth. Because of the relationships that they have built with residents, PBOs create a sense of community within their target area. It is through this sense of community that PBOs safeguard all assets, not just their corporate assets.

Particular Challenges Facing All Development Organizations

Organizations tackling the demanding work of community development and affordable housing at some point encounter some or all of these challenges:

- Tough deals and market risk
- Funder priorities
- Cash-flow financing and non-performing properties
- Reputational risks
- Reliance on developer fees and pipeline pressure
- Potential for collaboration

Tough deals and market risk. Stakeholders may force a mission-driven organization to work on the hardest deals as well as deals that are small, with difficult-to-serve populations and financing or market issues. Because of their complexity, these deals may threaten the long-term viability of the organization and stand in the way of the group ultimately achieving its mission. The hardest deals require the most complex financing with multiple sources, resulting in a labyrinth of regulations. Although successful affordable housing organizations are generally experienced in juggling multiple financing sources, these types of projects still present more risk. Missteps in compliance with regulations can result in forfeiture of one or more sources of financing or prohibit future funding awards.

The tough and difficult properties sometimes originate from another organization's demise. Funders and other interested parties in the city or state may approach an organization to help preserve affordable housing assets. Not surprisingly, there are often issues with the project's or portfolio's operations that must be addressed prior to the

acquiring entity's absorption of these units into its own portfolio. Failure to address these problems may result in financial strain for the acquiring organization.

Funder priorities. Organizations engaged in community development and affordable housing development rely on funders, both private and government, for operating and capital support. While many nonprofit developers and mission-based for-profits develop a reputation for delivering quality affordable housing, they must adhere to the funders' priorities, which may not align with their development expertise or even their mission. In these situations, organizations may experience mission drift or put themselves at risk by acquiescing to the funders' wishes. At the same time, supporting the same programs and projects year after year can create funder fatigue. Funders begin to wonder if their limited resources are being put to the highest, best uses.

Cash-flow financing and non-performing properties. To make an affordable housing development work, some soft financing sources are essential. Most soft capital sources are structured as cash-flow contingent loans. Thus, as a project has cash flow, its debt is paid down. While soft debt lenders often allow some cash flow to be passed through to the sponsor, this amount is usually minimal. This means that the sponsor only has incentive to operate the project between breakeven and the ceiling amount where the soft-debt repayment begins. Further, real estate assets are not true assets as they offer very little future benefit to the organization and do not create the unrestricted fund balance that they could if operated to their fullest potential.

When properties operate at a loss, the owner organization must provide out-of-pocket funds to subsidize cash-draining properties. Due to financing restrictions on each property, housing owners are expected to operate and monitor each property individually instead of allowing the organization to manage risk across its real estate portfolio. This is inconsistent with how large market-rate housing developers and financial institutions operate. Given these constraints, one poorly performing property could have negative consequences for the entire organization and thereby the entire portfolio.

Owners must also consider what happens to the properties at the end of the compliance period. As LIHTC projects approach Year 16, organizations need to carefully consider the strategic steps necessary to bring these properties onto their balance sheets. Most LIHTC deals need recapitalization and are saddled with debt, including soft-source debt, which may have tax consequences for the LIHTC investor if forgiven during the tax credit compliance period. In addition, many deals are without significant reserve balances. Unless stabilized, these assets may put the organization and its operations at risk. Many organizations are the owner of last resort and therefore, there is no one else to whom the property can be sold or even given.

Reputational risks. Strong organizations guard their reputations carefully. Unlike a private developer, a nonprofit that slips up on one project seldom has the opportunity to start over. Effectively then, to the financial partners, the group is only as good as its last deal, even if that deal was a no-win situation. This line of thinking carries over to organizational issues, too. A nonprofit developer may be hesitant to raise red flags or concerns about its financial health to its funding partners for fear of losing future capital and operating awards.

Reliance on developer fees and pipeline pressure. Developer fees are unrestricted earned income that can cover overhead, government match, subsidy to operating properties, and equity or predevelopment financing for the next deal. Owners are encountering two challenges with developer fees. First, many groups are not earning the fees to which they are accustomed because, in the last couple of years, many investors have turned to the largest and most experienced developers. This has dried up the development pipeline for many smaller organizations, at least for the short term. Second, when deals are closed, investors have started pushing development fee payments later into a property's operations. While the fees will still be earned, the developer does not receive payment for those fees until the next year or later, adding to cash-flow strain. Finally, an organization may have to forgo developer fees when it encounters cost overruns and/or significant delays with hard-to-develop projects.

Organizations that develop housing often are heavily dependent on developer fee income. Income from other sources is frequently restricted and cannot cover the costs of running the organization. In most markets, operating affordable housing does not generate substantial income. As a result, organizations must continually find the next deal to keep afloat. Both government and investors require an organization to maintain unrestricted funds (net assets or equity, for the most part), meaning their development pipeline must continually grow.

Potential for collaboration. Staff of affordable housing organizations must be available to residents, tackle complex development projects, and maneuver through mazes of regulations. Yet organizational budgets for salaries are usually limited. In an environment where resources are constrained, shared services and out-sourcing are cost-effective ways for groups to balance their budgets. Two or more organizations sharing staff members or contracting for CFO services may allow organizations to better meet their missions. Also, collaborating on staff may be the first step for organizations engaging in deeper partnerships by joint venturing on projects or potentially merging into one larger developer. For some organizations, merging is a viable solution.

Place-Based Organizations (PBOs): Advantages and Challenges

Place-based organizations, or PBOs, play a unique role in community development, accounting for a large portion of affordable housing units in operation and under development. They are one of the pillars of the affordable housing industry and the community development field. PBOs perform a myriad of neighborhood activities, ranging from development to crime prevention, that help build a sense of community.

The distinguishing characteristic of PBOs is their targeting of specific neighborhoods. They view the neighborhood as the focal point for political and social networks, civic engagement, and social and economic empowerment. They therefore can bring unrivaled credibility, expertise and commitment to communities and projects. These organizations have in fact been a central and enduring instrument in the nation's efforts to revitalize depleted communities for nearly five decades. Due to their comprehensive community development strategy, PBOs can be seen as the protectors of all community and affordable housing assets in their service areas, not just the ones they own.

Most PBOs explicitly state their geographic boundaries in their mission statement, and their boards are charged with keeping them focused on the residents of these areas. Because of this mission, PBOs often employ and professionally develop local residents. They know the residents and hear their concerns and needs. With this targeted view, the organizations understand the real estate markets as well as, if not better, than anyone.

Many PBOs began as community organizing groups in the 1970s with a focus on returning communities to their stronger pasts. They took on housing to serve the residents of those communities by providing better-quality affordable housing and improving the neighborhoods in which those homes were situated. It is this background that often gives them the most credibility and strongest position for protecting the long-term affordability of housing units today. While many groups may have intended to decrease their housing development and ownership activity as stability increased in their neighborhoods, those organizations have seen a continuing need to provide housing and community services, and an increasing need to protect affordable housing from encroaching gentrification. As a result, their presence continues to be critical to the health of communities.

PBOs provide the intangibles to a neighborhood, including the sense that the residents are part of a community that cares about them, from which they can derive services and support, and to which they are obligated to reciprocate. Communities

in which these organizations work often have a sense of “ownership,” resulting from the countless hours that staff spend on community planning boards, neighborhood associations, tenant organizing, business improvement districts and even property management. This intangible sense of community protects all of a neighborhood’s assets, not just the PBO’s. Residents become invested in building a better place to live and in turn they are stabilizing force in their neighborhoods.

In sometimes fragile communities, where crime can be an issue and public services may not be delivered consistently or effectively to the neighborhood, a PBO can play an important role. These organizations are connected to concerned community residents who feel as if they are part of the local PBO, serving as their “eyes and ears,” alerting the PBO to problems related to a project or similar community issues. These residents maintain a subtle knowledge of the positive and negative aspects of the community landscape, which allows them to overcome obstacles that may delay other affordable housing projects. PBOs also may have a network derived from their multiple properties within a tight geographic area where maintenance staff know one another; as a result, PBOs can mobilize local resources or services efficiently.

PBOs may also be disproportionately affected by the particular challenges facing mission-based developers. Their special local connection almost invariably comes with limits to market, sponsorship and capitalization.

Particular Challenges for Place-based Organizations

Tough deals and market risk. A PBO developer’s risk increases as its board and/or community pressure demand that the organization address abandoned eyesores and vacant buildings that are hindering the community’s economic growth. Thus, they may have little choice but to take on difficult deals despite adding greater risk to their organization or portfolios. In addition, the development risk increases due to the variety of project types within a PBO’s service area, such as commercial and residential (both multifamily and single family), new construction and rehabilitation (including historical and even adaptive reuse). Gaining expertise in these various types of development takes years of experience. When local officials or organizations approach a PBO with a project or portfolio to take over, there is a lot of pressure on the organization to “save the day” and to not hold out for additional resources to ensure a property’s successful performance.

One inherent risk for such PBOs is geographic concentration. The portfolios of PBOs are highly correlated with their local economies. If the area’s economy is strained, then all of the PBO’s properties will feel some pain regardless of the organization’s actions.

Funder relationships and priorities. Based on years of community involvement, PBOs tend to know the local government officials and philanthropic officers and vice versa. PBOs have built relationships with elected officials as well as the departments at city hall. Without a doubt, knowing this system creates a competitive advantage for PBOs and allows them to have a fighting chance on the hard-to-develop properties, knowing that the city will be there to assist them. For example, PBOs sometime use their local political capital to support special needs or affordable housing projects facing NIMBY concerns.

In addition, some PBOs rely on local government and funders for operating grant support. This reliance sometimes pushes PBOs to accept funding that is contingent on funders' latest plans and trends, regardless of whether they are consistent with the needs of the organization and its constituents. This creates a quandary for PBOs and may result in mission drift for these organizations, especially when such funders are local council representatives and municipal departments who will also impact the success of a PBO's property or portfolio.

Non-performing properties and reputational risks. Due to their local nature and limited geography, PBOs are especially susceptible to 1) non-performing properties due to higher correlation within a PBO's portfolio and 2) more local reputational risks given the influence of local and state funders. The reputational risk may be divided into two categories: development risk that all mission-based developers face, and property operational risk. The second presents a unique problem for PBOs and could snowball with non-performing properties. For example, if a PBO has a poorly performing property (which may or not be the fault of the organization), residents and potential residents might think twice about moving into another PBO property, even one that is well-maintained. This reputational risk adds to the organization's portfolio risk.

Pipeline pressure and reliance on developer fees. A PBO may have limited development opportunities in its service area, thereby pushing the organization to take on even harder and more difficult projects. The organization relies heavily on developer fees to pay for operations and many of the services that help create a neighborhood's sense of ownership. Also, if an organization is a certified Community Housing Development Organization (CHDO), then it must develop affordable housing within a specified time period or risk losing its status. Organizations seek to gain CHDO status because it can mean access to operating support and other capital.

Potential for collaboration. While PBO staff is typically committed and talented, they may duplicate the service and operations of adjacent or competing local organizations. PBOs have many local relationships that may be well suited to collaborative

endeavors; in some instances, these relationships may lead to merging two adjacent PBOs. Collaborations and mergers cut costs but they may have negative consequences, too. A particular strength of PBOs is their ability to make residents feel that they are “the eyes and ears” of the PBO; however as PBOs share staff and/or merge, residents may feel less a part of the new, larger organization.

Conclusion

For organizations focused on community development and affordable housing to be strong and sustainable, it is critical that we rethink the current development process and examine the pressures, incentives/disincentives and opportunities that impact decision-making and available choices. As government financial resources become less accessible, maintaining the current delivery system for creating and preserving affordable housing is the most cost-effective option. It’s important for interested funders and financial partners to consider their roles in relation to PBOs. PBOs protect community assets, advocate for resources to develop affordable housing, withstand political pressure from NIMBY, and ensure the safety and viability of the housing in their communities, regardless of whether they own or operate the housing.

Recommended Changes for Long-term Health in the Community Development Field



Our review of stressed and failed organizations in an environment with unique challenges for mission-based and place-based organizations suggests broader lessons for all actors in the affordable housing field. We must all work together to strengthen the existing infrastructure for developing and preserving affordable housing and other community assets. Based on this perspective, below are some recommendations intended to help ensure the long-term preservation of affordable housing and community assets. The first set of recommendations is for community development organizations; the second is for financial partners and funders.

Recommendations for Community Development Organizations

Prioritize organizational sustainability. Affordable housing development organizations must focus on being fairly paid for what they do and structure their deals accordingly. Too many organizations are willing to sacrifice a sustainable approach to net income and cash reserves in order to meet their mission. Time and again, organizations do not collect fees, simply give away their services, or artificially hold rents low in the name of mission. Without an organization, the mission will surely not be achieved. While the merits of maintaining a sustainable approach seem simple and straightforward, it takes great discipline to implement.

Allocate all costs. Affordable housing developers must focus on their overhead costs and correctly allocate them to their business lines. If an organization finds that its costs exceed an acceptable limit for an investor or lender, it should still advocate for the full costs. Establishing transparency between developer and investor is paramount to creating sustainable organizations, but this transparency is dependent on mutual trust and a willingness to understand the issues. If an organization cannot negotiate a higher rate, it should perform a cost benefit analysis to decide if this is the right business in which to be engaged, or identify the point and time at which sustainability can be achieved. While it is critical to properly allocate overhead, our review found that struggling organizations typically did not properly calculate the direct and indirect costs associated with a program or business segment. Overhead allocation

can be a tedious, time-consuming exercise and the calculation itself may be complex and difficult. However, it is a necessary component to understanding the full cost of specific programs and business lines.

Utilize development criteria. If an organization owns and manages property, it should create a list of development criteria as well as long-term operations criteria, to help its board approve or decline future projects. At a minimum, organizations should consider: 1) minimum paid developer fee, 2) minimum management fees, and 3) minimum cash flow from operations. The organization should add and modify criteria as necessary for the given situation. Mission-based affordable housing developers often take on the hardest to develop projects such as the vacant, abandoned eyesore that is the critical link to a revitalized block or community gateway. While developing such a property might be vital to an organization's mission, the project should not be pursued if sufficient resources or market conditions are lacking. Organizations need to create development policies that their board can use to determine whether a project warrants approval.

Adopt an early warning system. An organization should create an early warning system for detecting when a property has a problem. The problem may occur during predevelopment, construction or operations. The warning system should trigger a response when the developer needs to approach the financial partners and funders for support. Two recurring themes in our research involved affordable housing owners continuing to put funds into resource-draining properties, along with a “failure is not an option” mentality. As a result of this mentality, affordable housing developers sometimes do not approach financial partners and funders when challenges arise, assuming their request will negatively affect a future deal, or hoping the deal has hit a temporary road bump and will improve soon. While financial partners should maintain an open door policy for groups that approach them early, developers, for their part, must adopt a proactive and realistic approach and alert financial partners and funders sooner rather than later.

Consider collaboration. Because of redundancies and resulting overhead costs, smaller organizations are starting to share back-office work or are outsourcing this work to consultants. An organization may share a chief financial officer, bookkeeper or IT specialist with at least one other group, or it may outsource these positions to local firms or consultants. These functions present the fewest challenges for collaboration because they are the least neighborhood specific. However, collaboration is beginning to expand beyond the back office to include sharing resident service providers and even some development staff. This sharing allows the organization to continue to offer services to its residents and, ideally, build the intangibles that a sustainable community development organization needs in order to protect its community's assets.

Recommendations for Financial Partners and Funders

An affordable housing developer's financial partners and funders have a vested interest in making sure that the organization's properties are long-term assets for the organization. Without community development organizations, preserving affordable housing would be more costly, *if preservation is even a viable option*. Financial partners and funders looking to preserve affordable housing resources should be cognizant of the issues that organizations face (as outlined above). It is critical that projects be structured to ensure recurring revenue to the organization, thereby making the development organization less dependent on up-front cash developer-fee payments. The following policy recommendations are intended to help create a sustainable business model for mission-based developers.

Incentivize long-term ownership and stewardship of affordable housing assets.

We recommend that, in structuring housing credit transactions, public lenders ensure there are financial incentives for effective ownership and operation of these transactions. Where projects have cash-flow-contingent loans, we recommend that residual cash flow be shared between loan payments and cash flow paid to the project sponsor, with the majority going to the sponsor.

Many funders, especially state and local government agencies, do not require annual payments on their mortgages, but instead structure their loans as cash-flow contingent. The source of these funds is typically state or federal appropriated sources that are structured as loans for LIHTC purposes. This favorable financing is a major benefit to affordable housing projects because property income is insufficient to pay these loans as must-pay debt. However, when large secondary loans claim most or all of the potential cash flow of the project, there is little ability for a project to generate ongoing cash flow for the owner/operator, and little financial incentive for the owner to operate the property efficiently.

In addition to perpetuating development organizations' continued dependence on developer fees, such transaction structures increase the developer's organizational risk at the portfolio level. While owners may have to subsidize properties that run a deficit, thereby taking on downside risk, the financial structure allows little or no upside for properties that perform, leaving the organization to use its own capital to subsidize a struggling property instead of cash flow from within the portfolio.

Ensure fully funded workout projects and portfolios as well as ownership

compliance. Organizations stepping in to take on a troubled property or portfolio, as well as the funders and financial partners around them, need to look critically at the needs of the project and/or portfolio to ensure that the cycle of portfolio stress

does not expand. When an owner of affordable housing begins to fail, there is often an effort among the organization's staff and funders to protect the housing and community assets. This cannot happen at the expense of the organization that is willing to take on the assets. Examples of funder support include: 1) capitalizing larger reserves, 2) allowing bigger fees for the acquiring organization, and 3) relaxing a property's rent restrictions.

Many housing finance agencies (HFAs) have strict rules governing their nonprofit set-aside requirements. For example, the nonprofit must be an organization incorporated within the state with a service area, including the county where the project is located. If a nonprofit owner in these stricter states goes out of business and the property needs to be repositioned, these properties may be out of compliance when there is no replacement general partner that meets the HFA's definition. The HFA should exercise flexibility with its ownership requirements to preserve the affordable housing project.

Set realistic management fees and structure deals to pay them. We consistently found that property management and other related fees earned and (hopefully) received by the owner do not cover the entire cost of administering and sustainably operating the property. Funders and/or regulators could increase allowed asset management and property management fees based on the owner's demonstration of actual, fully loaded management costs. As mentioned above, owners need to change their policies to ensure they are allocating full costs associated with management collecting fees. Funders could also assist by allowing a higher management fee percentage or per-unit, per-year amount.

Embrace an early warning system. As discussed above, owners need to develop an early warning system so they can take appropriate action when a project is at risk of teetering. Owners need to feel confident that their financial partners and funders are willing to fine-tune a project before a restructuring is needed. Funders must send the message to owners that it is okay to stumble on a difficult property so that organizations do not think properties must be on the brink of failure before they will receive help. Just as the developer needs to create the early warning system, the funder must build a way to work out deals, which includes allowing developers to come to the table early for small fixes before they become big issues. Currently, there is not enough openness for an "early to the table" way of thinking. Some funders even place developers on an internal watch list if any modification discussion is introduced. Instead, a mission-based developer should be encouraged to come to the funder early and potentially be punished for waiting until a problem has grown too big to be resolved with minimal intervention. Transparency is the key to building trust between these two parties.

Summary and Next Steps

Given the results of our analysis on stressed sponsors, we see an urgent need to create a stronger, more sustainable business model for mission-based developers. The above recommendations are designed to provide easy-to-implement ways to achieve sustainability. The most immediate way to preserve affordable housing is to increase funding via cash flow from property operations to the current system of developers and owners. Further, it is incumbent on community developers to make disciplined business decisions and understand the critical need to build organizations that will last over the long-term. It is in the best interest of all funders and investors to ensure that mission-based developers have a sustainable business model to continue doing what they do best — preserve and develop safe, decent and affordable housing.

Conclusion

The Great Recession has caused great strain on our industry and its mission-based developers. These developers are paramount in the challenge to deliver and preserve affordable housing. In this paper, we first examined what kinds of organizational weaknesses and risks caused sponsors to be stressed — some to the point of failing. Next, we discussed the systemic challenges developers face, especially place-based organizations. Finally, we made recommendations for both developers and public funders to consider. These recommendations are designed to help organizations become more sustainable and in the process protect the nation's affordable housing stock.

We repeat our recommendations below, categorizing them based on the following themes: 1) funders and government can help build strong organizations, 2) developers should focus on creating viable business models, and 3) developers should make information transparent and useful.

1. Help build strong organizations that can sustain affordable housing for the long term. (Recommendations for funders and government)

- **Incentivize long-term ownership and stewardship of affordable housing assets.** In structuring housing credit transactions, public lenders should create financial incentives for effective ownership and operation of properties. Foremost, leaders should allow more (if not all) residual cash flow to be paid to a project's sponsor.
- **Set realistic management fees and structure deals with sufficient cash flow to pay them.** Increase allowed property-, asset- and partnership-management fees based on an owner's demonstration of actual, fully loaded management costs.
- **Ensure fully funded workout projects and portfolios as well as ownership compliance.** When organizations take over troubled projects or portfolios they should be funded prior to take-over. Also, ownership requirements set by housing finance agencies must be flexible enough to allow for replacement general partners who may not meet all the nonprofit set-aside requirements.
- **Embrace an early warning system.** Funders have an obligation to create an environment that does not punish organizations for exposing weaknesses, but rather encourages early discussion of problems.

2. Focus on organizational viability and business models. (Steps that owners/developers should take and funders can encourage)

- **Prioritize organizational sustainability.** Affordable housing development organizations must focus on being fairly paid for what they do; this requires fully allocating overhead costs and structuring their deals accordingly.
- **Grow strategically.** Grow incrementally, strategically and sustainably — particularly if planning to add a property management arm.
- **Diversify revenue streams.** Diversify revenue streams by growing strategically into new business areas, understanding that profitability may take years to achieve.
- **Utilize development criteria.** Create a list of development criteria to help board approve or decline future projects.
- **Cast off resource-draining projects.** Be willing to cut losses before you are certain that a property will fail.
- **Maintain relationships.** Build strong relationships with funders and government partners; both are integral to the success of an organization and its properties.
- **Consider collaboration.** Where there is duplication and opportunity to collaborate, organizations should consider taking that step.

3. Make information comprehensible and transparent, and proactively address issues. (Steps that owners/developers should take and funders can encourage)

- **Strengthen financial reporting and analysis.** Maintain a capable, consistent accounting department that provides timely, accurate reporting to board members, senior management, financial partners, and government and philanthropic funders.
- **Beware of significant one-time cash receipts.** Though it might seem counterintuitive, pay attention to how sizable one-time cash receipts mask an organization's financial difficulty and delay proportionate business decisions.

- **Conduct forecasting and scenario planning.** Conduct realistic planning exercises with an analysis of various scenarios.
- **Adopt an early warning system.** Organizations must create an early warning system for detecting when a property has a problem, and seek assistance in addressing it.