Fannie Mae

July 2024

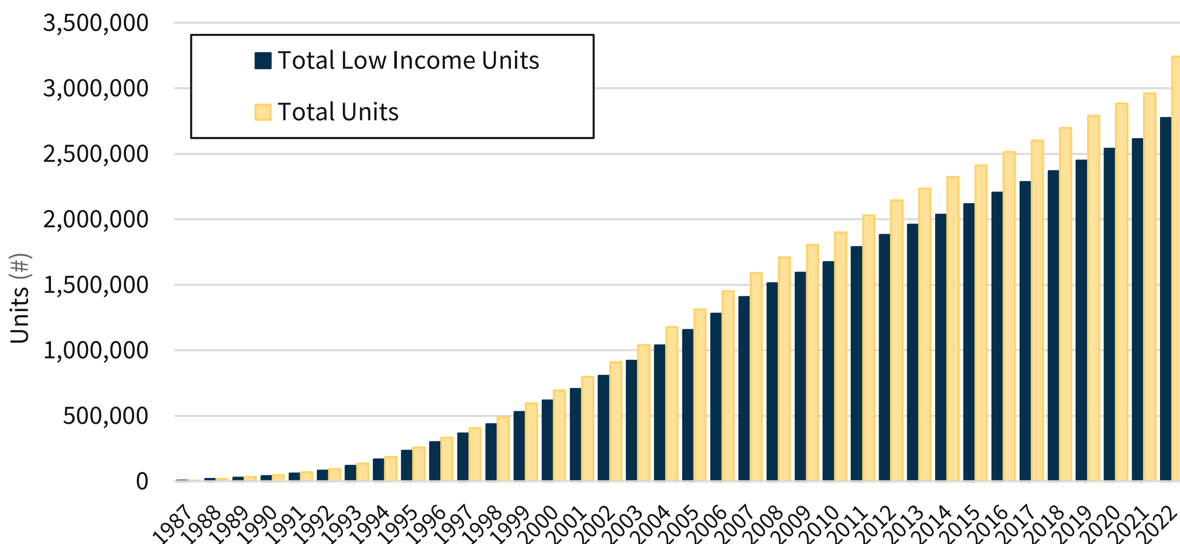
LIHTC Properties Facing Challenging Times

Federally-assisted multifamily properties serve some of the most vulnerable renters in the country. While there are several programs that support affordable rental housing, the Low-Income Housing Tax Credit (LIHTC) program has been one of the most successful. However, developers interested in creating new affordable housing with LIHTC or renovating existing affordable housing while keeping apartments affordable are facing a series of challenges, as are owner-operators of affordable housing. An elevated interest rate environment, increased development costs, and rising operating expenses are currently among the challenges faced by the affordable housing sector.

LIHTC Program Is Prolific

Since its inception in 1987, the Federal LIHTC program has been prolific. According to the U.S. Department of Housing and Urban Development's (HUD) LIHTC database, over 3.2 million units have been placed in service from inception through 2022, the last year for which there is complete data. Of these, an estimated 2.8 million are rent-restricted, and tenants are income-tested annually to ensure that they do not exceed maximum income requirements. This is necessary because the LIHTC program ensures that rent charged for a LIHTC unit provides a significant rent advantage compared to rents at market-rate apartments in many metro areas. That's because the rent for a LIHTC unit (LIHTC rent) is typically designed to be affordable to families earning 50% or 60% of area median income, adjusted for family size.

Cumulative Units Placed in Service Since Program Inception



Source: HUD Low-Income Housing Tax Credit Database, Retrieved June 24, 2024
Notes: Not all properties provide unit counts, there is a lag in reporting and unit count for 2023 will likely rise significantly in future updates. Includes placed in service code 9999=placed in service status confirmed but placed in service year missing and 8888=placed in service status not confirmed.

LIHTC Rents Substantially Lower in Coastal Markets…

Moody's CRE tracks the rent charged at LIHTC units on a quarterly basis using the new asking rent after a new tenant moves into the LIHTC unit. Their data shows that LIHTC rents are most affordable in major coastal cities. For instance, in West Coast cities such as **Los Angeles**, **Riverside**, and **Oakland**, the average asking rent for LIHTC units as of first quarter 2024 was just about half of the average market rent. In East Coast cities such as **Philadelphia**, **Boston**, and **Tampa**, LIHTC rents were about 60% or less of market-rate rents.

…But Rent Levels Do Vary

However, there is quite a bit of variation among metros, as shown in the table below. In Midwestern metros, such as **St. Louis**, **Columbus**, and **Indianapolis**, the average rent for a LIHTC unit can be up to three-quarters of the average rent for a market-rate unit. Nevertheless, this is still a significant discount from market rate rents.

In fact, as rents at market rate properties rose sharply during the pandemic, more traditionally affordable metros are also seeing a significant advantage in LIHTC rents. For instance, as shown in the chart below, **Raleigh**, **Phoenix**, and **Charlotte** all recorded LIHTC rents that are just 65% or less of market rate rents.

Average Asking Rents for LIHTC Apartment and Market Rate Apartments Select Markets (Q1 2024)

Market	LIHTC Asking Rents ($)	Market Rate Rent ($)	LIHTC/Market
Los Angeles	1,200	2,380	50%
San Bernardino/Riverside	890	1,760	51%
Oakland-East Bay	1,380	2,660	52%
Philadelphia	910	1,740	52%
Boston	1,560	2,940	53%
Fort Lauderdale	1,110	2,070	54%
San Diego	1,290	2,360	55%
Chicago	1,020	1,830	56%
Seattle	1,310	2,240	58%
Charlotte	890	1,510	59%
Tampa-St. Petersburg	950	1,610	59%
Phoenix	940	1,570	60%
District of Columbia	1,310	2,090	63%
Raleigh-Durham	940	1,450	65%
St. Louis	780	1,180	66%
Atlanta	1,050	1,580	66%
Dallas	1,080	1,590	68%
Baltimore	1,050	1,510	70%
Columbus	830	1,140	73%
Indianapolis	850	1,130	75%
Houston	990	1,310	76%

Source: Moody's CRE

Multifamily Affordable Housing Commentary

Mandated Reporting Identifies Resident Characteristics

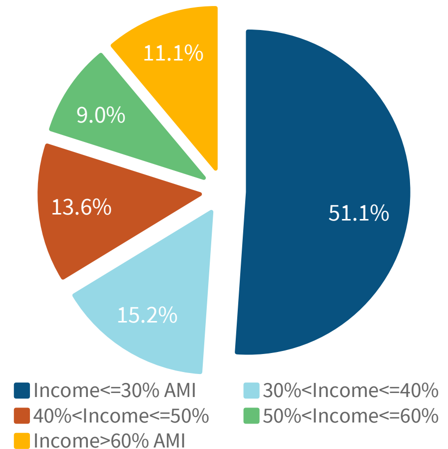
Under the Housing Economic and Recovery Act (HERA) of 2008, state agencies are required to submit demographic and economic data on LIHTC tenants to HUD. HUD's latest summary tables, *Data on Tenants in LIHTC Units,* as of December 31, 2022, provides data on residents of LIHTC properties for almost 2.5 million units. HERA specifically requires Housing Finance Agencies (HFA) to submit information to HUD about income, monthly rental payments of households residing in LIHTC properties, race, ethnicity, family composition, age, and disability status.

LIHTC Best Serves Households Under 60% of AMI

The LIHTC program assists some of the nation's lowest income renters. According to HUD, the median household income of households in LIHTC units was just $18,600 in 2022, and median income was only slightly higher in several high-cost states. For instance, it was just $23,300 in **California** and $19,200 in **Massachusetts**. **New York State** had a median income of just $17,600 for households residing in LIHTC units.

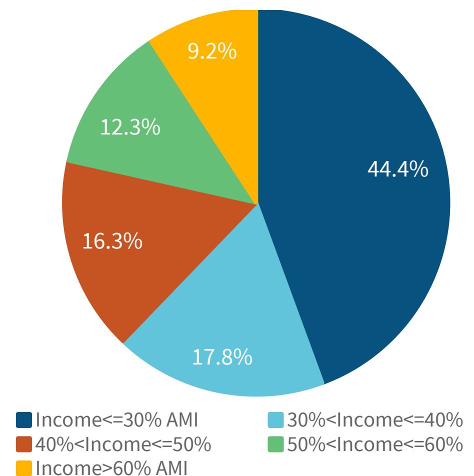
The distribution of the annual household income in properties assisted with LIHTC as a share of the Area Median Gross Income (AMGI) are shown in the adjacent charts, with about 80% of units serving households up to half of the median income for their location. But given the scarcity of the subsidy, many states opt for even deeper affordability, as over half of households earn less than a third of the median income.

Total Annual Household Income Relative to AMGI (2022)



Source: Data on Tenants in LIHTC Units as of December 31, 2022

Total Annual Household Income Relative to AMGI (2017)

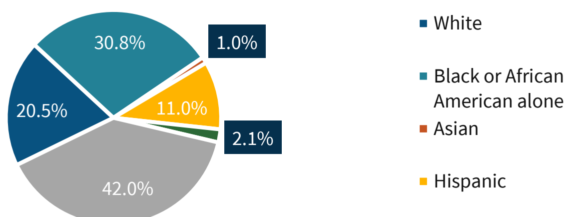


Source: Data on Tenants in LIHTC Units as of December 31, 2017

Income Averaging Has Not Changed Affordability

In 2018, Congress amended the Housing Credit statute to allow property owners the option of income-averaging. Under the new Average Income Test, a household could qualify to live in a Housing Credit property if its income is no greater than 80% AMI, provided the average income limit at the property is at or below 60% AMI. However, the new option has not really impacted the affordability profile of LIHTC properties. In 2017, for example, prior to the adoption of the Average Income Test, just 9.2% of households earned more than 60% of the median income for their location, while in 2022 the share rose only slightly to 11.1%.

Race/Ethnicity of Heads of Households in Properties Subsidized with LIHTC



Race and Ethnicity of Tenants is Diverse

As shown in the adjacent chart, just under a third of heads of households that reside in LIHTC-assisted units are Black or African American alone, about one-fifth are White, and just over a tenth are Hispanic.

* *Other includes American Indian and Alaska Native Alone, Native Hawaiian and Other Pacific Islander Alone, Multiple Races reported*
Source: Data on Tenants in LIHTC Units as of December 31, 2022

Multifamily Affordable Housing Commentary

LIHTC Properties Assist the Most Vulnerable

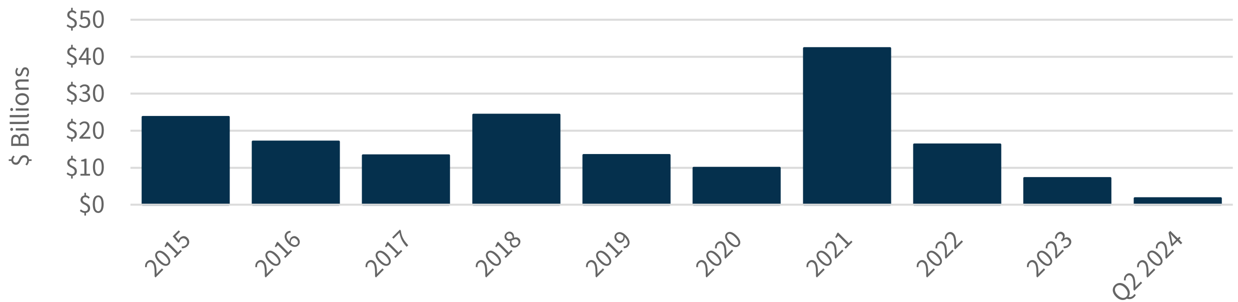
Many states use LIHTC to address affordable housing shortages for families with children, disabled people, and seniors, and the data on household composition reflects this effort. As of 2022, an estimated 30% of households had at least one child under the age of 18, and an estimated 12% of households had at least one disabled member. As the population has aged, the share of senior members has changed as well. In 2022, 37% of households had a member aged 62 or older, up from 32% in 2017.

Decline in Sales Due to Higher Interest Rates…

CoStar breaks out property sales for different types of federally-assisted properties. While not a complete record of sales transactions, the data provides insights into trends. Given the stable performance of federally-assisted properties during the pandemic-induced recession of 2020, investors were attracted to this asset class in 2021. As shown in the table below, investors purchased over $42 billion of LIHTC properties, about 2.5 times the average annual sales volume recorded in the three years prior to the start of the pandemic. A significant portion of the portfolio sales in 2021 came from Blackstone Real Estate, which acquired a couple of large portfolios containing over 90,000 units for an estimated $10.6 billion to launch an affordable housing company called April Housing.

Consistent with trends in the conventional multifamily market, sales of LIHTC properties declined in 2022 and 2023, according to CoStar, as interest rates increased, as seen in the chart below.

LIHTC Property Sales (2015 – Q2 2024*)



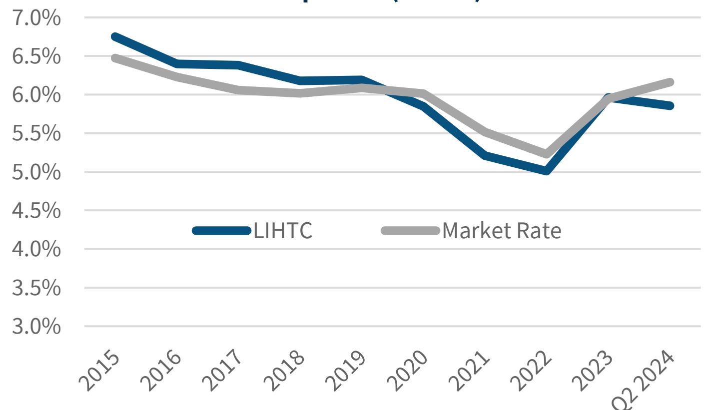
Note: Includes Affordable and Market Rate/Affordable Rent Type with Rent-Restricted Affordable Type

*Source: The CoStar Group, Inc. * Through June 25, 2024*

… Which Also Pushed Up Cap Rates

This was reflected in capitalization rate trends as well. As shown in the chart to the right, the pandemic saw the average cap rate for LIHTC properties decline substantially, most likely due to the perception of decreased risk by investors because federally-assisted properties received additional rental assistance during the pandemic. The average LIHTC cap rate declined to 5.2% in 2021 from 6.2% in 2019, according to CoStar, as low interest rates fueled increased investor appetite. In fact, the average cap rate for LIHTC properties sold ticked below the average cap rate for market-rate properties. Cap rate trends have since reversed

Capitalization Rates for Sales of LIHTC and Market Rate Properties (Actual)



Source: The CoStar Group, Inc.

course and increased to 5.9% as of Q2 2024.consistent with increasing cap rates in the multifamily market overall. That's because the Federal Reserve began raising interest rates in March 2022 to to curb elevated inflation. As a result, borrowing became more expensive because investors were requiring more yield to purchase properties. The average cap rate rose to 5.9% in 2023, consistent with increasing cap rates in the multifamily market overall. Increased cap rates for LIHTC properties have made it difficult to recapitalize an aging LIHTC stock and develop new LIHTC stock. However, increased cap rates are not the only the only challenge faced by affordable housing developers, owners, and operators.

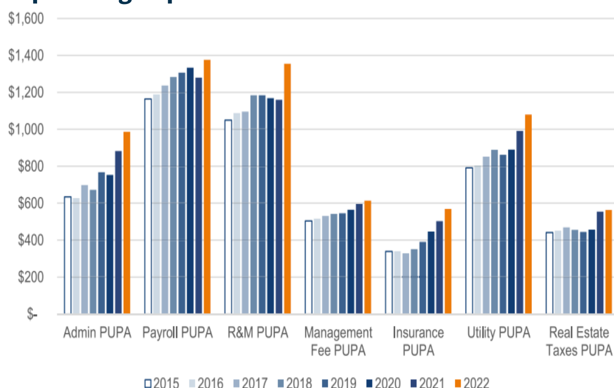
Increase in Operating Expenses

In general, affordable housing properties benefit from lower real estate taxes more than market rate properties, as local municipalities and states are willing to sacrifice tax revenue to help keep rents affordable. However, LIHTC properties incur larger administrative expenses relative to market-rate properties, due to a variety of compliance requirements, including means testing for renters of affordable apartments.

CohnReznick estimates that since 2015 the median operating expense growth rate for LIHTC properties was 3.5%, which tracks closely to the 3.0% industry standard for underwriting operating expenses. However, as shown in the left chart below, from 2021 to 2022, CohnReznick recorded an increase of 8.2%, the largest operating expense increase since the firm first reported operating expense data in 2015.

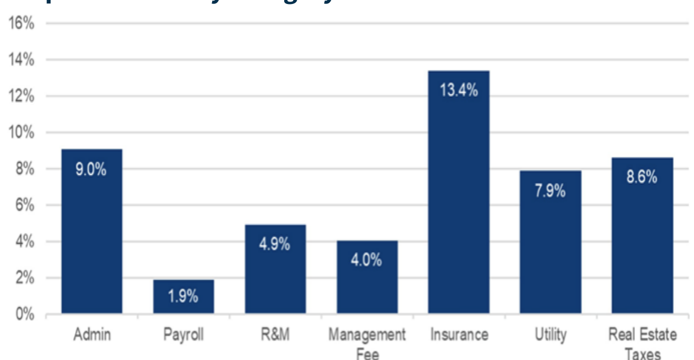
As shown in the chart below right, the fastest-growing expense of the seven operating expenses tracked by CohnReznik is property and casualty insurance, which increased 13.4% on average annually from 2020 to 2022. This reflects the growing cost of climate disasters and is consistent with insurance increases at market-rate properties. However, due to HUD-determined maximum rent increases designed to keep rents affordable, LIHTC properties cannot easily absorb large increases in insurance premiums. In addition, administrative expenses increased 9%, and property owner paid utilities increased 7.9% over the same period.

Operating Expense Trends



Note: PUPA = Per Unit Per Annum

Expense Trend by Category 2020-2022



Source: CohnReznick Affordable Housing Tax Credit Study, November 2023

Deferred Maintenance Addressed

There were fewer repair and maintenance expenses during the pandemic. In speaking with owners and property managers, they noted that this was most likely due to fewer unit turnovers, and a reluctance among tenants to report items needing repair. The CohnReznick Affordable Housing Tax Credit Study released in November 2023 notes that the high 8.2% operating expense increase likely reflects a "catch-up" period in 2021 and 2022 when properties

addressed deferred maintenance items built up during the pandemic. Another factor that drove the increase in costs was likely the high rate of inflation during 2021 and 2022 .

Operating Expenses Outpaced Revenue

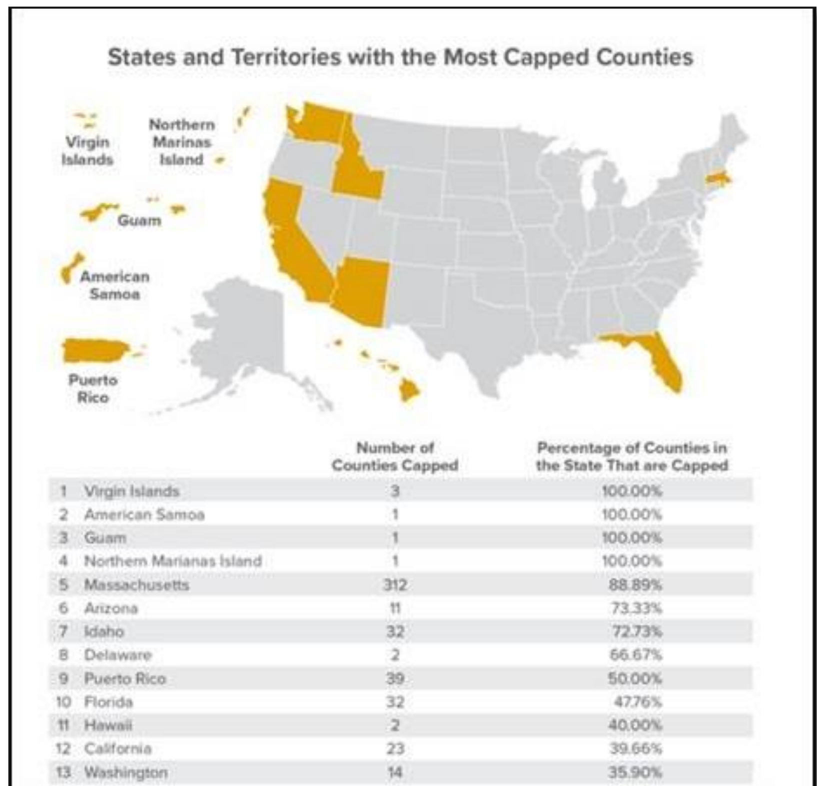
Unlike market-rate properties, maximum rents for LIHTC properties are set annually by HUD. While operating expenses rose 8.2% in 2022, CohnReznick estimates that revenue only grew 3.0% over the same period. This leaves operators of LIHTC properties with difficult tradeoffs between spending on operating expense categories. In some cases, according to one property manager, staff positions may remain unfilled at certain properties, staff cutbacks may be implemented at others, and resident services may even be curtailed.

New Ceiling on the Cap for Income/Rent Increases for VLI in 2024

HUD imposed a new income/rent limit ceiling in 2024. According to Novogradac, since 2010, HUD has had a cap on income limit/rent increases* for its Very Low Income (VLI) category. The cap is the greater of 5% or two times the change in national median income, which would have been 14.8% in fiscal year 2024. However, the cap now has a 10% ceiling due to this change in methodology. HUD has stated its intent was to make the cap more predictable.

As shown in the adjacent map, eight states appear to be the most impacted by the imposition of the 10% cap on the ceiling. In these eight states, a third or more of counties are subject to the 10% cap. These states are **Massachusetts**, **Arizona**, **Idaho**, **Delaware**, **Florida**, **Hawaii**, **California**, and **Washington**.

Novogradac notes that, over the past 14 years, the cap has been above 10% only three times and mostly by just one or two percentage points. As a result, 2024 was a big exception.



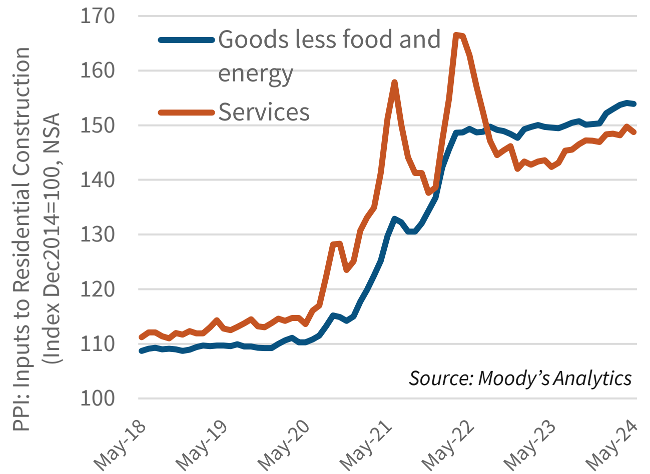
		Number of Counties Capped	Percentage of Counties in the State That are Capped
1	Virgin Islands	3	100.00%
2	American Samoa	1	100.00%
3	Guam	1	100.00%
4	Northern Marianas Island	1	100.00%
5	Massachusetts	312	88.89%
6	Arizona	11	73.33%
7	Idaho	32	72.73%
8	Delaware	2	66.67%
9	Puerto Rico	39	50.00%
10	Florida	32	47.76%
11	Hawaii	2	40.00%
12	California	23	39.66%
13	Washington	14	35.90%

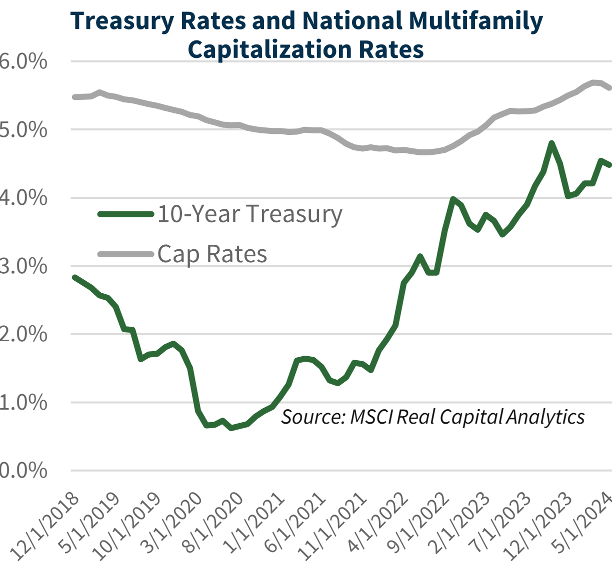
Source: Novogradac

** For mor information on how HUD sets rents and rent and income increases please visit:*
[Income Limits | HUD USER]
For more information on how the LIHTC program works, please visit:
[The Low-Income Housing Tax Credit: How It Works and Who It Serves (urban.org)]
And *[The Low-Income Housing Tax Credit Program: A Comprehensive Review]*

Construction Costs Remain Elevated

In addition to higher management and operating costs, another challenge for affordable housing is that developers are still facing high construction costs, as shown in the adjacent chart. Building material prices collectively are up 39% since the start of the pandemic. While the cost of lumber has recently come down from pandemic highs, it remains 22% higher than in the spring of 2020. Similarly, since that time, gypsum/drywall is up 51%; ready-mix concrete is up 34%; interior paint is up 35%, and exterior paint is up 63%, according to their respective Producer Price Indices. Developers also continue to face increased costs from construction labor.





Developers Facing Financing Gaps

Developers also face challenges in financing construction. As shown in the adjacent chart, after lowering rates during COVID, the Federal Reserve increased interest rates rapidly in 2022 and 2023, which also increased the cost of debt. Rising interest rates also meant that investors were seeking higher yields to make equity investments. In addition, projected revenue from LIHTC properties has not grown quickly since affordable properties cannot command the same rents as market-rate properties. Due to these three factors, many multifamily properties now support less debt and equity than in the previous low-interest rate environment of 2020 and 2021. As a result, projects must find additional sources of equity and/or financing to "pencil out."

HFAs/Developers Face Challenges Since Advent of COVID…

Even projects that appear to be viable during the planning process may face unexpected cost overruns that create additional financing gaps. The National Council for State Housing Agencies (NCSHA) released a study in 2022 that details the challenges developers are facing, as well as the approaches HFAs are taking to overcome these financing gaps.

Stakeholders interviewed for the report consistently reported unexpected cost increases of around 30%, and some developments faced even larger gaps. In fact, the report indicated that "…nearly all deals that were awarded LIHTCs from 2019 to the present have faced significant, unexpected cost increases after being awarded credits."

According to the report, "…one HFA reported that 39 of 42 projects awarded 9 percent tax credits in 2020 requested additional funding, with requests ranging from $145,000 to $5.7 million, to help cover unexpected cost increases… while pre-COVID-19 costs averaged $150,000 per unit, costs had risen to over $200,000 per unit (a 33 percent increase)."

…but HFAs Rise to the Challenge

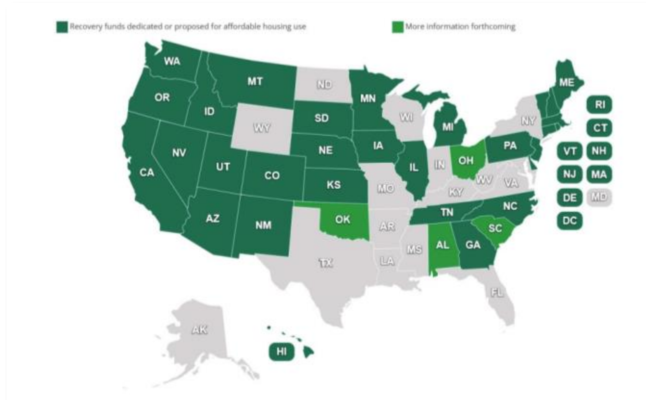
Nevertheless, many HFAs have risen to the challenge. According the NCSHA report, states are using a variety of funding sources and flexibilities to fill financing gaps, depending upon local circumstances. For example, some offer administrative flexibilities by allowing changes to some aspects of the project, such as the number of units, amenities, and community space. While states have an annual limit on the amount of 9% tax credits – generally used for new construction – many states are granting the allocation of future 9% tax credits to close a funding gap on a particular project. HFAs are also allocating additional tax-exempt bonds to certain projects that were awarded 4% tax credits. However, this can be a limited option once a state reaches its annual cap on tax-exempt bonds, which was the case in over half of states in 2022 including such states as Texas, Pennsylvania and Florida. States may also look for flexibility from developers by asking them to defer more of their developer's fee, among other measures.

Other Solutions Implemented Since the Beginning of the Pandemic

States are looking at all options available to fill gaps, including both short-term and long-term solutions. As shown in the map below left, some states are taking advantage of recovery funds provided by the 2021 American Rescue Plan Act, which provided a total of $350 billion to government entities to support their response to the pandemic, including providing affordable housing under certain conditions. According to the NCSHA report, as of June 30, 2022, a total of 29 states had allocated nearly $9 billion in recovery funds to a range of affordable housing purposes and local governments have committed an additional $5 billion of recovery funds. For instance, North Carolina allocated $170 million of recovery funds to the Workforce Housing Loan Program, which is a state-funded nonrecurring gap lending program designed to encourage the development of Housing Credit apartments with deeper income targeting, if cost overruns can be tied back to the pandemic.

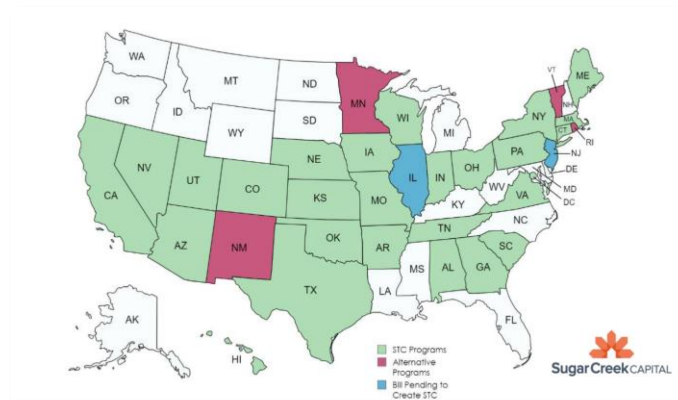
In addition, HFAs are using state-available sources of soft funding such as State Housing Trust Funds which can help fund Tax Credit Housing in some cases. In addition, according to the NCSHA report, these can include local housing development loans. Finally, many states are adopting a state housing tax credit to supplement LIHTC. As shown in the map below right, most states have implemented state-level tax credit programs, and Illinois and New Jersey have bills pending to create a state tax credit program. These can also be used to close unexpected funding gaps.

States Devoting Fiscal Recovery Funds to Affordable Housing



Source: NCSHA Filling Funding Gaps: How State Agencies Are Moving to Meet a Growing Threat to Affordable Housing

Status of State Level Tax Credit Programs



Source: Sugar Creek Capital

LIHTC Program Overcoming Challenges

The LIHTC program is important because it provides affordable housing for some of the nation's most vulnerable residents, including children, seniors, and those with disabilities. However, since the start of the pandemic, it has faced multiple challenges due to high construction costs, increased borrowing costs, increased operating expenses, and a variety of other factors. As a result, since the advent of COVID, completing and rehabilitating LIHTC properties has required additional resources. However, the resources available to state and local jurisdictions, which could be used to close funding gaps during COVID, are ending. This, combined with a higher rate environment for the long term and the effects of climate change as seen through higher insurance costs, makes operating and developing LIHTC properties very challenging. While borrowing costs may decrease somewhat when interest rates start to decline, as we currently predict they will, other challenges are likely to remain. As a result, many HFAs will likely have to continue to find creative ways to handle unexpected funding shortfalls.

Tanya Zahalak

Multifamily Economics and Strategic Research – Economics

Advisor Economist

Multifamily Economics and Strategic Research

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