The Demand and Requirements for Impact Investment in Housing Enterprises

A STRENGTH MATTERS® White Paper

With PCV InSight

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Introduction

This white paper summarizes research intended to understand how affordable housing developers can attract capital from impact investors – an emerging field of investors not compelled by regulation to invest in affordable housing, but who prioritize both financial and social returns regardless. The paper captures current efforts and identifies future opportunities for affordable housing developers to tap into new opportunities that impact investing presents.

The research builds on previous publications that have focused on how community investing can be repositioned and expanded by tapping into impact investing markets. Two important recent contributions include:

- **The Community Foundation Field Guide to Impact Investing** – published in 2013 by The Mission Investors Exchange – provides various tools and strategies for community foundations to develop an impact investing practice. Different forms of investment in affordable housing are provided as examples throughout the guide.i
- **Expanding the Market for Community Investment in the United States** – published in 2013 by The Initiative for Responsible Investment, The US SIF Foundation, and The Milken Institute – addresses the challenges and opportunities for the broader community investment market to attract new forms of capital. ii

From this work on community investing, one prevailing recommendation was to focus on specific sector opportunities. In *Expanding the Market for Community Investment in the United States*, the rationale for a sector approach is described as follows:

“Our interviews suggest that one of the barriers to increased investment from all types of investors is that the phrase “community investment” can invoke a sense of disengagement. Investors and managers have told us that community investment is something “that banks do.” [...] For these investors, perhaps, the most likely way to engage them is not through the broad frame of community investment per se, but rather through the sector or social goals most relevant to them. This is especially true for those who define themselves as mission or impact investors in the philanthropic and high net worth communities. These investors may desire a more tailored fit than what they perceive the broader field of community investment offers, but there is potential to engage them more specifically and deeply at scale on those issues they see as most important.” iii

Within community investment, affordable housing is one critical sector with a clear social need and opportunity for impact. According to a recent report by the National Low Income Housing Coalition, there are only 30 affordable rental units for every 100 extremely low-income renters.iv Furthermore, housing is central to the various debates about equitable urban development happening across the country – from rising rents in San Francisco to vacancies in Detroit. There are many potential strategies for how to build ‘livable’ cities that are affordable for everyone, but all strategies must include new approaches to affordable housing. Given this demand for housing solutions, coupled with policy uncertainty and larger changes in the financial industry, it is prudent for the housing developer to explore new financing strategies and partnerships. Impact investing is one tool that can help to facilitate those new collaborations.
The opportunities at the intersection of housing and impact investing are clear; however, capitalizing on this potential will require changes to traditional approaches. In the book *Investing in What Works for America’s Communities*, Anthony Bugg-Levine’s describes how the CDFI sector – a major supplier of capital to affordable housing developers – must leverage the opportunities impact investing presents:

“CDFIs were making impact investments long before the current buzz about them surfaced. As such, they should be well poised to reap the benefits of these increased private capital flows. Yet there is a real danger that CDFIs will be left on the sideline as impact investing takes off. To understand why, and what we can do about it, we first must recognize that the new wave of impact investing creates fundamentally different strategic dynamics for intermediaries.”

To be clear, impact investors will provide only a small portion of the capital needed to meet the demands of the affordable housing sector in the U.S. *Institutional capital* – primarily driven by public policy – will continue to drive the market. Instead, impact investment should be seen as a new source of *catalytic capital* that can spur other investment and inspire a renewed interest in the affordable housing sector.

In *Impact Investing 2.0: The Way Forward*, a new report highlighting successful impact investing practices, *catalytic capital* is defined as: “investments that trigger additional capital not otherwise available to a fund, enterprise, sector, or geography [and] can be transformative, generating exponential social and/or environmental value.” This potential to trigger other forms of capital is what could make impact investment a powerful tool for affordable housing developers. To do so they must determine how to best leverage both *institutional and catalytic capital*, which will undoubtedly require strategic engagement with new investors and creative adaptation of financing structures. This white paper is intended to enable those activities, identifying current challenges and opportunities for new approaches.

**Research Process**

With funding from the Ford Foundation, Strength Matters partnered with InSight at Pacific Community Ventures and The Initiative for Responsible Investment at the Hauser Institute for Civil Society at Harvard University to understand how different segments of the impact investing market can play a larger role in affordable housing markets.

First, in order to better understand the current investment opportunities in affordable housing, we asked three Strength Matters members to develop ‘hypothetical investment opportunities’ in multifamily, nonprofit affordable developments seeking impact investing capital. These three opportunities are included in the Appendix:

- Opportunity #1 sought direct equity investments in affordable housing projects, either as a joint venture or a preferred equity structure.
- Opportunity #2 sought below-market debt and/or equity-like capital for a housing acquisition fund.
- Opportunity #3 sought below-market debt through an Impact Growth Note that would be used to build enterprise-level capacity.
Second, we identified impact investors who may be interested in these opportunities because they are mission-aligned, interested in place-based opportunities, and willing to take a mid- to long-term concessionary position in exchange for added impact. We refer to this segment of impact investors as mission investors, which includes:

- High net worth individuals (primarily via wealth managers)
- Community foundations
- National foundations

Subsequently, the three hypothetical investment opportunities were presented to the mission investors in order to determine what interested them about the investment opportunities and what components would prevent them or their clients from investing. A total of eight interviews were conducted with mission investors based on the hypothetical investment opportunities, and three interviews were conducted with affordable housing developers to further understand the challenges faced when developing these investment opportunities. A list of the organizations interviewed can be found in the Appendix.

The research did not include other impact investors – such as commercial banks, financial institutions, pension funds, insurance companies, and private equity investors – because the goal of this research was to hone in on the specific issues that are encountered with mission investors. We believe there is an opportunity for future research into these other investment segments, which is discussed in more detail in at the end of this paper.

Key Research Themes

The interviews with mission investors and affordable housing developers provided clarity around two important conversations this research can help advance:

1. **Product Structure**: What investment products and tools are needed to meet the social and financial requirements of the catalytic mission investors?

2. **Marketing Alignment**: How do affordable housing developers better appeal to the social goals of mission investors while also demonstrating the market need and opportunity of housing?

**Product Structure**

When it comes to developing a product for mission investors, there is not a one size fits all product. There are several important variables at play, including: scale, return, duration, and liquidity. Two of these variables, scale and liquidity, were identified as the biggest barriers for many of the investors interviewed to invest in the hypothetical opportunities.

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1 We recognize that the term mission investors can be used to cover a broader spectrum of investors. In the context of this report, we use the term solely for the purpose of referencing the kinds of investors considered in this study. We are not proposing a new classification of impact investors.
Mismatched Scales
Mission investors interviewed identified the challenge of scale – from a geographic and portfolio perspective – across all three hypothetical investment opportunities presented. Often the discussion of the investment opportunities began with the caveat “pretend that these deals are located in your target geography”, as often times this is a deal-breaker even before investment terms are discussed. For place-based investors, such as community foundations, this focus on a specific geography makes diversification quite difficult if focusing on affordable housing. Given the larger size of housing deals, will there realistically be enough projects in the local pipeline to allow them to appropriately manage risk?

Beyond the specific geographic constraints, diversification was identified as a challenge by many of the mission investors when determining if the hypothetical investment opportunities would match the kinds of vehicles included in their portfolio. Often the investor perspective is quite straightforward: intermediaries are the vehicle of choice. While some mission investors are beginning to explore a direct investment approach, many investors still prefer to invest in intermediaries for diversification reasons as well as due diligence constraints.

In some cases the second ‘hypothetical investment opportunity’, in a Housing Acquisition Fund, was more appealing to investors, but it was still only diversified across projects, not organizations. Additionally the Acquisition Fund still required a $500,000 minimum investment in the fund, an amount that would over expose most mission investors. In discussing this ‘hypothetical investment opportunity’, one asset manager explained:

“This type of direct housing investment is difficult for our clients. For example with our typical portfolio size, for diversification purposes, we’d look for lower minimum investments.”

In other words, housing deals are complicated and big, and the proposed hypothetical investment opportunities did not provide the necessary investment size or risk mitigation strategies that would make housing deals more accessible for the investors interviewed.

Limited Liquidity
For the mission investors interviewed, liquidity was another barrier that arose frequently. In discussing several of their community foundation clients, one wealth manager explained:

“Community foundations want to advertise their ability to do something creative/impactful with their corpus, but need high returns and liquidity to cover overhead - leading to more MRI-type products. They are mission-aligned but too constrained.”

Addressing this problem of liquidity again leads to the exploration of new product structures that create more accessible entry points for mission investors. In the case of many retail and high net worth individuals, it is difficult for them to commit to locking up their capital for ten years. For context, think about the different considerations you may have when choosing your own mutual fund or ETF. Often individual investors want the option of an early exit, but may still keep their capital in the fund for ten plus years. This form of ‘sticky money’ can be extremely useful; however, housing developers must be cautious that their investor pool is large enough to replace maturing investments when using short-term dollars to meet longer-term financing needs. New investment products could provide new ways to address this type of risk that arises when investors and investees have different liquidity and investment duration requirements.
Marketing Alignment

The second theme that emerged from conversations with mission investors and affordable housing developers was a disconnect between the ways the two groups discussed their social impact. We do believe there is some ‘catalytic capital’ from mission investors that is not reaching housing because it’s ‘boring’ or not seen as high impact. A cautionary note, however, that marketing alone is not the solution. True engagement between affordable housing and impact investing will require both product and marketing innovations working together. On the marketing side, the challenges and opportunities for innovation include discussion around: market need, sector and geographic specializations, impact indicators, and for-profit competition.

The Affordable Housing Market Need

Often investors interviewed commented that the affordable housing market is seen as something taken care of by larger banks and institutions. One asset manager succinctly captured this viewpoint by asking:

“Would the market for affordable housing disappear if impact investors didn’t step up? It’s unclear.”

There is an educational component needed to encourage impact investor participation in the face of the larger market activity driven by the CRA and tax credits. Because of these larger institutional influences, it is difficult for mission investors to see clearly that there are many opportunities for real impact outside of these institutional and commercial markets. Another question posed during an interview with an asset manager honed in on this conflict:

“Is a lower cost of capital a 'have to have' or is it a 'want'? This is a tricky conversation for an impact-motivated investor to have.”

It will be a difficult task for affordable housing developers to articulate this market need. A recent survey by the Global Impact Investing Network and JP Morgan found that around 45 percent of self-identified impact investors already invest in some form of housing. How, then, can affordable housing developers prove that new, innovative opportunities for impact still exist in housing, and they need the help of mission investors to make them happen?

Sector and Geographic Specializations

This research confirmed the previous US SIF finding that impact investors look for investment with impacts in specific issue areas (e.g. health, transit, education in addition to housing) or geographies. Focusing on these specific impacts of housing can make it less 'boring' in the eyes of mission investors, but the challenge is crafting these more targeted opportunities in a way that doesn't make the investor base too narrow. As one representative from a national foundation explained:

"How you talk about housing will depend on the investor you are targeting. For example, foundations that traditionally invest in housing will require different approaches than the broader impact investing market that's new to the space.”
Again, confronting this challenge will involve a combination of marketing and product solutions. For example, another national foundation interviewed invested in a fund with larger geographic reach because the fund was able to segment their investment allocation and impact reporting to a specific region. This form of innovative product structuring can allow funds to remain attractive to a broad base of investors, while still leveraging the more exciting sector and geographic lenses.

**Impact Indicators**
Traditional measures of impact used by housing developers do not translate to impact investing markets. When reading through the ‘hypothetical investment opportunities’, one asset manager asked:

“What is AMI? Our clients would be confused by that number.”

Area Median Income (AMI) is not a concept that mission investors are familiar with. Even if it was understood, it would likely not provide a compelling argument for impact, compared to other measures. Many mission investors are currently focused on the green, ‘LEED’ segment of housing because the environmental impacts are quite compelling. It’s easy to measure and track, for example, how many tons of carbon were offset or how many gallons of water were conserved by an investment. By contrast, what measurable social impact do you actually get for your dollar in housing? Where affordability and environmental impact indicators are both vying for the attention of mission investors, the current set of social metrics (like AMI) used by affordable housing developers are not doing justice to the true impact of their projects.

**For-Profit Competition**

When asked about similar projects they had invested in, many mission investors interviewed mentioned investments in for-profit real estate developers. For example, several mentioned green investments and one national foundation discussed an innovative investment in charter schools. Neither of these examples are direct competition for affordable housing; however they are often considered in the same segment of an investor’s portfolio. Additionally, while not mentioned by the mission investors interviewed, there are a number of for-profit developers successfully providing affordable housing products. In these scenarios, how can nonprofit developers distinguish themselves from for-profit developers’ social/environmental impact and perceived higher rates of return?

In order to engage more mission investors, nonprofit developers must make the case for how they are creating impact beyond that of for-profit projects, and why this added impact might justify a slightly lower return in some cases. When describing their investments in for-profit developers, one asset manager stated:

“Non-profits haven't done a good enough job at positioning themselves as scalable and profitable from our perspective, even though they can be.”

In order to successfully position themselves among the other housing and real estate opportunities presented to mission investors, affordable housing developers will have to start by deploying a variety of the tactics discussed above.
What’s Next?

From our interviews, it is clear that there is a need for new housing products that better engage mission investors. This leads to the next question: is there a need for an entirely new product, or can we build upon and expand the current products already under development? Many housing groups and CDFIs/intermediaries involved in the housing field are already developing products that attempt to address both product issues of scale and liquidity (see ‘Current Product Examples’ box). There may, however, still be unmet needs that will require entirely new products.

Ultimately, we must dig deeper into the specific needs of developers and investors to identify the need for these new (or adapted) products. Because housing transactions are extremely complex, both sides must be willing to ‘roll up their sleeves’ and engage in direct conversations to develop new vehicles that will meet everyone’s final and social objectives.

In addition to new vehicles and products, these investor/developer conversations should also consider revising existing policy tools and incentives. For example, because large pools of capital are needed for initial acquisition and predevelopment phases, local jurisdiction involvement in a housing fund may be essential to attract new mission investors and achieve the sheer volume of capital required. Alternatively, some form of tax incentive for the foregone return could incentivize increased participation of mission investors. The AI3 (Accelerating Impact Investment Initiative) is an example of one effort working to identify such opportunities, and could be an important facilitator and policy partner. 

Affordable housing developers must also work to overcome the need for education of new investors by identifying accessible entry points into housing transactions. This will require developers to not only create new products, but also new marketing approaches. Some housing groups have already recognized these marketing challenges and are working towards innovative solutions. Yet there are still many questions to be answered, including:

- When developing a fund, how can specific sectors or regions be segmented in the reporting process?
- What language and metrics best describe the scalable impact of affordable housing developers?
- How much additional impact do nonprofit affordable housing developers create, when compared to for-profit developers?

Strength Matters could play an important role in supporting the development of these new products and marketing approaches by continuing to share best practices among their network of affordable housing developers, as well as continuing to reach out to the impact investing community to solicit their direct feedback on proposed solutions. Specifically, there are several opportunities for the Strength Matters network to build on this initial research:

### Current Product Examples

#### Impact Investment Notes

The Calvert Community Investment Note and the Enterprise Community Impact Note are two products that allow for small, relatively liquid investments in housing enterprises.

#### Real Estate Funds

Housing Partnership Equity Trust (HPET) is a national Real Estate Investment Trust (REIT), providing mid-term capital (3-7 years) to affordable housing developers. In the future, HPET intends to provide a tradable product, creating additional liquidity for investors.

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This document is a product of STRENGTH MATTERS®, a collaborative initiative among national and local organizations in the affordable housing field, co-sponsored by NeighborWorks® America, Housing Partnership Network and Stewards of Affordable Housing for the Future.
• **Case Studies:** By documenting existing impact investing products in the affordable housing sector, we can better understand the tools and solutions that already exist, and continue to identify the product gaps and marketing challenges that must be addressed. These case studies would be well aligned with current Strength Matters research documenting the experience of housing development organizations in amassing, attracting and managing capital at the enterprise level. Currently four case studies have been published through this research.²

• **Identifying opportunities to layer capital:** This research focused on mission investors; a subset of impact investors with a specific motivations and investment needs. Beyond understanding how to attract catalytic capital from mission investors, a next step is to understand how to leverage that capital with other sources of funding. For example, EQ2 loans from commercial banks also provide concessionary capital to affordable housing, but have a different set of motivations and priorities that are policy-driven. Other institutional investors, such as pension funds, can also be motivated to invest in their local communities, as highlighted in the 2012 report *Impact at Scale.*³ Future research to understand how to align the motivations and investment requirements of institutional capital with those of mission investors could unlock powerful opportunities for affordable housing developers.

• **Investor-Developer Forums:** It is also clear that this research approach is only one part of the solution. There is a need to create more opportunity for affordable housing developers and impact investors to interact directly. Because needs and priorities vary within both investor and developer communities, real solutions are only likely to arise when the right parties align. Strength Matters could help increase these opportunities for alignment through the development of pilot products or by convening stakeholders across communities of practice.

• **Streamlined access to information:** Increasing the availability and accessibility of market information could also spur new connections between impact investors and affordable housing developers. A clearinghouse of affordable housing investment opportunities could leverage online tools and technology to ensure effective ‘matchmaking’ with impact investors. This clearinghouse/online platform would also provide an opportunity for affordable housing developers to streamline the metrics and messaging used to discuss the social impacts of their projects. This would enable investors to more easily vet and identify the financial *and* social components required of their portfolios.

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² Case studies can be found at http://www.strengthmatters.net
Appendix

Investors Interviewed

- Sonen Capital
- Equilibrium Capital
- Imprint Capital
- Veris Wealth Partners
- F. B. Heron Foundation
- Kellogg Foundation
- Maine Community Foundation
- New Hampshire Community Foundation

Housing Developers and Investment Intermediaries Interviewed (separate from the scenario development process)

- Enterprise Community Investment
- AHC Greater Baltimore
- Tenderloin Neighborhood Development Corporation

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