A County in Maryland Is Changing the Model of Public Housing
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By Aashna Shah
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The Fed has hiked rates aggressively to cool down inflation, and while in theory this helps to slow down demand, it can also have the perverse effect of impairing supply. You see this phenomenon most clearly in housing, where higher rates have translated into a slower pace of new development, at a time when housing units are already seen to be in shortage.

One place that is trying to tackle this issue head on is Montgomery County, Maryland. They've adopted an innovative approach aimed at expanding production of affordable public housing even amid higher rates.

In a new episode of the *Odd Lots* podcast about Montgomery County's affordable housing model, Zachary Marks, Chief Real Estate Officer at the Housing Opportunities Commission of Montgomery County and Paul Williams, the Executive Director for the Center for Public Enterprise discuss how what they are doing differs from other affordable housing models.

Typically, affordable housing that gets built in the United States is funded with either the Low Income Housing Tax Credit or Section 8 vouchers. Under LIHTC, housing developers in the US receive tax credits for agreeing to reserve a specific percentage of rent-restricted apartments for lower income households. Section 8 of the Housing Act of 1937 permits private landlords to receive payments of rental housing assistance on behalf of low income households in the US.

One theoretical approach to thinking about the housing affordability problem is to simply allow developers to build more homes and increase supply. Part of the problem though, again, is that in periods of higher rates this impulse diminishes, even if the demand is there. What's more even when more housing is built, developers may be inclined to build more high end units.

"Typically the LIHTC, which is the standard way in which affordable housing is produced in this country at this point, will force a building [to be] somewhere between 80 percent and 100% affordable," says Marks. Montgomery County has been a pioneer in thinking about what the government can do to produce more affordable housing and their solution is to use LIHTC and Section 8 vouchers while also self-financing and building mixed income properties. Montgomery County's mixed income housing model isn't widely practiced yet but creates an opportunity to produce extra housing availability while still supplying private income households.

In an HOC mixed income building, a majority of units are priced at market rate and some are portioned off for affordable housing. "It would basically form a condominium for the market rate units and a condominium for the low income housing tax credit units, effectively executing two transactions, even though they're effectively in the same building," says Marks. This innovative model allowed HOC to deliver affordability in what are "otherwise class A+ majority market rate socioeconomically mixed buildings."

A distinct aspects of these moderately priced dwelling units is that you might not even realize that a building is part of the affordable housing model. Generally, affordable housing units and properties don't come with amenities like gyms, courtyards, rooftops and swimming pools, however, the buildings in Montgomery County run and operate like luxury condominiums. Marks and Williams explain how the HOC has historically approached affordable housing this way and view it as a "financing solution, not construction solution." Since a majority of the units in their buildings go for market rate and only a portion are MPDUs, they strive to produce market competitive projects.

Marks says they often hear from residents that they "didn't even know this was owned by HOC" and both residents of their rent restricted units and market rate units share the same sentiment. The HOC is continuously improving on their affordable housing model and is currently using Montgomery County's Housing Production Fund to "set some higher standards in the market around energy efficiency and even scale."

The Montgomery County Council approved an annual appropriation to finance $100 million in bonds to produce 6,000 new housing units. These luxury buildings that house MPDUs tackle two problems at once because the government agency is able to produce more affordable housing, especially through the HPF, and developers are happy as their Class A buildings fill up with private income renters.

One of the biggest risks from a construction perspective is the permanent operating phase of a building. Once construction is done, developers have to fill their buildings with tenants and there's always a risk of wondering how long it will take to lease it out. "When you do a project like this, if you have a third of your building at these affordable levels, HOC has a line out the door of thousands of households who are waiting for affordable housing so the lease up for affordable units is like the snap of a finger compared to market rate units," says Williams. The amount of risk reduction that comes with market rate, luxury apartment buildings that offer MPDUs keeps both the government side and private equity side's supply growing and Montgomery County, Maryland may have found a way to do just that.

The Montgomery County Model for Affordable Homes
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By Joe Weisenthal, Tracy Alloway, and Aashna Shah
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When people think of publicly funded housing, they tend not to think about modern-looking apartments with all kinds of amenities. But a county in Maryland is trying to completely reframe how we think about public housing. The Montgomery County Housing Authority has been a pioneer in thinking about what the government can do in terms of accelerating housing production, even when the private sector is pulling back due to higher rates. On this episode of the podcast, we speak with Zachary Marks, Senior Vice President of Real Estate at the Housing Opportunities of Commission of Montgomery County along with Paul Williams, the founder and executive director of the Center for Public Enterprise, about what the county is doing, and how the model can be applied elsewhere to create more affordable, abundant housing.

When people think of publicly funded housing, they tend not to think about modern-looking apartments with all kinds of amenities. But a county in Maryland is trying to completely reframe how we think about public housing. The Montgomery County Housing Authority has been a pioneer in thinking about what the government can do in terms of accelerating housing production, even when the private sector is pulling back due to higher rates. On this episode of the podcast, we speak with Zachary Marks, Senior Vice President of Real Estate at the Housing Opportunities of Commission of Montgomery County along with Paul Williams, the founder and executive director of the Center for Public Enterprise, about what the county is doing, and how the model can be applied elsewhere to create more affordable, abundant housing. **This transcript has been lightly edited for clarity.

Key insights from the pod:
What is the Housing Authority for Montgomery County — 5:37
How does low income housing typically get financed? — 7:45
What makes the model innovative? — 9:48
How do these projects pencil out? — 13:48
What are the type of homes being built? — 18:49
Can the model be replicated nationally? — 22:16
What are the constraints on expanding the model? — 25:44
What is the case for publicly funded affordable housing? — 29:02
What are the immediate impacts of higher rates? — 32:22

Joe Weisenthal (00:10):
Hello and welcome to another episode of the *Odd Lots* podcast. I'm Joe Weisenthal.

Tracy Alloway (00:15):
And I'm Tracy Alloway.

Joe (00:17):
Tracy, let's do another housing episode.

Tracy (00:19):
Why not? Let's do it.

Joe (00:21):
I think I've said it before to you, I don't know if I've said it like on the show but one thing I like about housing episodes is, like, no matter what, it is just like this permanent source of anxiety for everyone.

Tracy (00:33):
Well, everyone has an opinion on it.

Joe (00:35):
Everyone was born short housing. They need to cover their housing short at some point. If you don't have a house, you're anxious about rent and house prices going up. If you have a house that you own, you might be anxious about it going down, etc. Like there's just, there will never be an era of any market in which I don't think some people are anxious about housing in one way or another.

Tracy (00:55):
Well, housing is a perennial source of interest for sure but I also think we're kind of in this unusual moment for housing as well, because no one, as we've discussed on multiple episodes at this point, no one is quite sure what's going to happen to the market. There's been this discussion of perpetual supply shortages of housing. But at the same time, there's this discussion of, as interest rates go up, whether or not we're going to start to see an impact on prices. It just feels like there's a lot of uncertainty at the moment combined with these sort of long-term structural issues.

Joe (01:28):
Totally, and it feels like there's something, you said structural, and it feels like one particular structural flaw in sort of the way we do housing development in this country. We see it right now, which is that the Fed has been trying to fight inflation to cool things down. A big source of inflation over the last few years have been rent prices. So you want to get down rent, so you raise interest rates and hopefully that cools things down and maybe that works, maybe it doesn't, but one effect that seems to have is it seems to impair the supply side as well. Maybe in the short run you cool things down and rents go down a little bit, but you actually set yourself back, it would seem, in the long term goal of having affordable housing abundance.

Tracy (02:12):
So I remember Jerome Powell specifically said that they [wanted to bring house prices down]. Well, I don't know if he explicitly said that, but something along those lines. They wanted to impact the housing market, bring prices down in order to bring inflation down, which makes a lot of sense. But on the other hand, people want affordable housing for obvious reasons and if you're sort of crushing that market, you can imagine a lot of people are going to be upset.

Joe (02:37):
There was a question to Powell, it was sometime early this year, maybe last year. I think it must've been last year and someone's like, 'Oh, what would you say to someone who wants to buy a house and they see mortgage rates shooting up?' And he's like, 'Well, it's tough, but then we'll cool things down and then things will be better., But all that's really happened is prices are still really high, supply is impaired, rates are up, so housing [affordability is basically the worst level] in like five decades or maybe ever.

Tracy (03:04):
No, I think on record, according to [Jim Egan over at Morgan Stanley].

Joe (03:09):
I think you're right and so then the question is like, what are we doing here? Do we need a different model of housing development beyond what we have in the country right now, where we have like developers and home builders sort of fluctuating how much they build based on various market conditions.

Tracy (03:23):
Well, absolutely and I think historically there have been sort of two dominant ways of tackling the affordability problem in the US housing market. It's either we build more houses, more supply, which as you just pointed out, can be difficult in the current interest rate environment.

And even if we do build more housing, because developers are a savvy bunch, they tend to build more expensive houses for people who are going to pay a higher price so that developers can make more money. And then the other way we tend to deal with affordability is, I think, through voucher programs like Section Eight and maybe building public housing to some extent. But as you point out, there is a third way.

Joe (04:07):
There's a third way. There may even be a fourth or fifth way, but let's at least talk about a third way. So I am excited, we have two guests today who have been working for a while and thinking about are there other models for housing development beyond the two that Tracy just laid out.

I'm very excited. We're going to be speaking with Zach Marks, he's the Chief Real Estate Officer at the Housing Opportunities Commission, Montgomery County, Maryland, as well as Paul Williams. He's the executive director for the Center for Public Enterprise, who's also working on these issues alongside Zach. A little bit of a personal disclosure that I have to get out off the bat, right at the beginning of the episode: Paul and I are friends, we play music together.

Tracy (04:49):
Oh, I thought you guys were joking. I didn't realize you were actually in a band. Oh, so you are actually a member of Light Sweet Crude?

Joe (04:57):
Paul plays. He and I write songs and play guitar together. So if you want to just ignore this entire episode because you've perceived there to be a glaring conflict of interest, you're welcome to turn off the episode right now.

Tracy (05:09):
Paul, do you know I've been forced to buy tickets for your upcoming show? Joe won't comp me. I had to buy them.

Paul Williams (05:15):
That's fantastic. It's good for the economy. It hurts no one.

Joe (05:18):
Exactly. Zach and Paul, thank you guys both for coming on the podcast.

Zachary Marks (05:22):
Thanks for having me.

Joe (05:23):
Why don't we start with you Zach, you've been working in this area, what does the Chief Real Estate Officer at the Housing Opportunities Commission of Montgomery County, Maryland do? Or if you just want to say what the Housing Opportunities Commission does, that's fine too.

Zachary (05:37):
It's a fancy name for really the Housing Authority for Montgomery County, so a fairly typical governmental entity. We also happen to be the Housing Finance Agency, which is a lot less typical. Typically, those are two separate governmental entities, and these are both combined and contained under the HOC shingle, if you will.

And so for a bunch of decades, HOC has been providing affordable housing in different ways. It started as a pure play public housing authority, so just building public housing in the seventies. But over those decades because of where it's located and we can sort of get into some of those drivers if you wish, but kind of because of where it was located, the combination of the housing authority and Housing Finance agency, it has sort of continually innovated around how to deliver affordable housing.

And they've basically developed a large portfolio of real estate assets, which many public housing authorities across the country kind of own public housing and that's it. HOC owns, I think we're somewhere in the vicinity of 9,400 units and it happens to be that Montgomery County Real Estate is very valuable. And so my my job is really to figure out how to further expand that portfolio through acquisition, through new development, and to also make sure that the existing portfolio is continually reinvested in and maximized for its potential.

Tracy (06:55):
I'm going to start with an even more basic question potentially, but what is it that Montgomery County is actually doing that is different to the way we've traditionally dealt with housing affordability issues?

Zachary (07:08):
Yeah, so Montgomery County has answered that question kind of a few times and then the things that it's done have become more standard practice. It started as I think arguably the first to implement inclusionary zoning several decades ago. So that was an inflection point of innovation. They also were among the first to begin to use a condominium regime. This starts to get super technical, but a condominium regime in the way in which LIHTC, low income housing tax credit equity could be used to finance mixed income buildings...

Joe (07:39):
What's the word you said? Condominium?

Tracy (07:41):
Condominium *regime*.

Joe (07:42):
Oh, condominium regime. Okay, keep going.

Zachary (07:45):
So typically the low income housing tax credit program, which is the standard way in which affordable housing is produced in this country at this point, generally speaking because of the rules and the structure of the program, will generally force a building that's somewhere between 80% and a hundred percent affordable.

And what HOC did was it began to basically develop mixed income buildings where the majority of the units in the building were market rate. It would basically form a condominium for the market rate units and condominium for the low income housing tax credit units, and effectively execute two transactions even though, you know, they're effectively in the same building.

And so that was a really important innovation because it was a way in which to deliver what's become HOC’s mixed income model where you have this affordability being delivered in what are otherwise Class A plus majority market rate socioeconomically mixed buildings.

Tracy (08:36):
Let me make sure that I've got this straight. So historically, the government either built public housing or they encouraged private developers to build housing, a portion of which would then be dedicated to lower income households. But what Montgomery County is doing is somewhat different in that they're financing sort of a mix of private income and lower income residences. Is that right?

Zachary (09:08):
Yeah, it's really taking the ownership position in a building that has market rate units is not something that's widely practiced and so it's really taking the position that we should also really be a majority or outright owner of these assets. That's really kind of what's at the core of what they did and what's at the core of this latest, I guess, innovation that we're, I think, here to talk about.

Joe (09:28):
So Paul, let me bring you in here. So in addition to your music, you're also the executive director for the Center for Public Enterprise. Tell us from your perspective what it is about the work being done at Montgomery County that feels different to you and your work in sort of spreading the gospel to other public authorities that could do something similar?

Paul (09:48):
Yeah, the core way I look at the kind of innovative programs that HOC has come up with is that currently all affordable housing that gets built in the United States is funded with either the low income housing tax credit or Section Eight vouchers, that's it. In basically every state in the country, every jurisdiction in the country, those programs are fully oversubscribed.

Every dollar that congress appropriates gets used to build that housing and the waitlist for eligible households, we have to build at the current level for 75 years to get there, it's not going to happen. So the tool that HOC has come up with is something that allows them to, in addition to using all of those current programs from the federal government, they can self-finance and build mixed income properties on top of everything that they're already doing.

So a lot of times in affordable housing policy circles, what happens is you want to take the same pie of federal subsidies and say 'How can we chop it up a little bit differently to make it a little bit better for this person or that person? What this is, is a just completely separate pie and the model is essentially just going out and being a participant in the housing market and building these mixed income projects because of the tools, access to capital, statutory authorities that an agency like HOC has. '

That's what's kind of new and innovative that not very many people are doing. What my organization has been doing on this is essentially take, it's a real simple model, it's not all that much work to do, not very many complicated financial pieces, and we can get into it, but it's relatively simple. Take this model to other agencies that are seeing the same kind of housing market constraints and say 'This is a pretty simple approach you could be using to expand overall production, affordable production and for really a kind of de minimis upfront investment. All you really need to do is kind of think a little bit differently about how you operate as a public agency. You might want to participate in the market and shape it a little bit.'

Tracy (12:03):
Can we talk more about the money aspect of this and the financing arrangement? So you just use the term self-financing, it's government agencies, so I guess they can go out and raise money through the bond market and then just loan that to themselves. Is that the idea?

Zachary (12:18):
I mean that really is generally the idea that I think Paul's like mostly what we're doing is conceptually very simple. It's really just sort of a tweak to how we're employing it. And so, to start with HOC, as the housing finance agency is able to be a lender to its projects and has been for a long time.

The FHA risk share program is really a standard tool provided by HUD to certain sophisticated housing finance agencies that is for the express purpose of producing affordable housing faster and more efficiently. So HOC has been for a long time the senior permanent lender, sometimes construction lender on its projects and so that was already a part of the toolkit.

And so the next piece is really that equity piece. Where does that chunk of equity come from? The part that the debt won't cover. And effectively we worked with our local council to use municipal finance as the source of our construction equity, which typically comes from two places. One, a low income housing tax credit, and as Paul mentioned, that's very limited and we're already doing all that basically, or it comes from the private market, and that is a particularly expensive piece of capital.

Tracy (13:30):
Can you give us an idea of the difference in the cost of capital between public and private?

Joe (13:35):
And maybe if you could just sort of give us like, I don't know, a stylized financial model? I mean, I get the different pieces, but I don't know. So maybe pencil it out in words if it's possible, like what a deal looks like.

Zachary (13:48):
So one of these essentially is taking the conventional American private equity real estate model, and it's just pulling it over to the private side.

Tracy (13:57):
[You mean to] the public side.

Zachary (13:58):
To the public side, I'm sorry, yes, to the public side. Typically in the private sector, conventional

finance is a private bank loan for the construction debt, and then a huge pile of equity because the bank's typically only give you somewhere between 50 to 60% of what you need. Then maybe a private developer puts in a tiny bit of their own, often not, but maybe a little bit.

But, for the most part, it's that big 35% chunk that's going to come from all the folks that inhabit the big tall buildings around the one we're in that fund those projects. And our thought was really take that model, pull it in, and instead of using that capital, we can use our municipal finance tools to basically lower the cost of that capital substantially. And most importantly, from our view is to put HOC in the position as a majority or outright owner of the project, which has all the knock-on effects that everybody likes.

Paul (14:50):
And I think to stylize it a little bit more, and to give some kind of examples, Zach sometimes talks about this project that was built six, seven years ago where it was a mixed income project, HOC was involved in the deal, and this was before these new tools.

And so you had a private equity investor who had wanted double digit returns and wanted a significant ownership stake and all of that. That building performed very well and HOC saw very little of the benefit of that really high performing building that they had put this money in and everything. And so they kinda went back to the drawing board. How do I get in a better position in a project like this that I'm building? I have these social goals, I want to provide these affordable units, I want to have this long-term permanent affordability. How can I further that goal by being in a better position on the deal?

Well, the way to do that is to bring your own source of capital, to replace that source of capital that's pushing you into a bad position, bring your own. And so they created this housing production fund, which is the tool that facilitates this kind of new model of mixed income development.

And really what it's doing is it's making short-term construction loans, it's essentially replacing what would be private construction equity in a conventional deal, but you loan it from your fund to yourself to your project at a much lower interest rate. And so you're kind of taking on a little bit more of the risk, like why does private equity want really high returns for their investment? Well, because that's what they price the risk at.

That's their job, and that's what they price the risk at. But as the public developer and owner, you're not just eating that risk. You also bring things to the table that lower the risk of the project. You're a governmental agency so a lot of the kinds of barriers, regulatory things to some kinds of development, you can get past those sometimes in a little bit easier way.

And the other really big thing is, one of the biggest risks from the construction to kind of permanent operating phase of a building is the lease up period. Once you're done, how long does it take you to get people in that building and pay rent? And when you do a project like this, if you have a third of your building at these affordable levels, HOC has a line out the door of thousands of households who are waiting for affordable housing.

The lease up for affordable units is like the snap of a finger compared to market rate units and so you're reducing that lease up time risk too. There are other kinds of risk reduction things that you bring to the table.

Tracy (17:20):
I take the point about risk reduction and the lease up period and things like that. But — and my next statement is going to be somewhat facetious — but the PE pricing does seem a little bit ridiculous when housing at this point almost seems like a sure thing? Like, when do rents ever go down? I have yet to experience it.

Joe (17:38):
Tracy has this question every time.

Tracy (17:40):
No, seriously, I have yet to experience that phenomenon in my lifetime.

Paul (17:43):
You know, I actually saw a Bloomberg chart on Twitter this morning showing market rents going down, deflation in rents in some of the cities that had the highest supply increases over the past year. Boise….

Joe (17:55):
So not New York City?

Paul (17:57):
Not New York City. I mean, Boise rents went down something like 5%.

Joe (18:02):
Sunbelt rents are coming down.

Tracy (18:03):
So the answer is move to Boise. Okay. Wait, I realized there is something I should have asked at the beginning of this conversation, but can you describe the types of housing or buildings that you're creating in a little bit more detail?

Joe: (18:13)
Oh yeah, they seem nice. But describe them.

Zachary (18:19):
This is just historically the way that HSC has approached things. We deliver affordable housing through what we call financing solutions, not construction solutions. And so the general idea is

you produce a market competitive project, we need it to be market competitive because it's going to have a majority market rate component in it, but also because we want all of our residents to feel like they're living in a building that a lot of them don't even know.

One of the refrains you'll see is that 'I didn't even know this was owned by HOC.' It's a very common experience for our residents, both the residents of our rent restricted units and those in our market rate units. And so these are class A buildings that are typically built to be competitive with the market.

And I would say even in our more recent iterations, we are actually using the HPF platform to actually set some higher standards in the market around energy efficiency and even scale. So we really try to use the HPF platform for a number of things, but in general, these are just as nice as the Class A. It is a class a rental building. It may be kind of a high density garden or four over one where you have four or five floors of wood frame over a retail or parking podium but we also do mid- and high-rise as well.

Joe (19:28):
You mentioned that Montgomery County has sort of a history of housing innovation. And is the phenomenon essentially, like we all know, like the DC economy has boomed, but there aren't a lot of, especially like people working in government, they don't become rich. The economy has boomed, but they're not particularly high salary. So they need somewhere to live in a booming economy, but they also need to be somewhat affordable. Is that sort of the general economic condition that is forced on the hand of a county like yours?

Zachary (20:00):
Montgomery County's challenge, it's one of the most affluent counties in the country, but it's also one of the most diverse counties, certainly in Maryland and in the country. That's a relatively large county, certainly for Maryland, so I guess low bar, but it's got distinct parts of the county.

You have a significant amount of immigration obviously in the DC area and so you have first generation families that are looking for their first affordable home. They've often looked at Montgomery County schools as that first leg up into this country. You also have lots of, in many cases, progressively minded, but boomers who bought there, it's a relatively young county. In 1950, there were a lot of fields and so it really was that expansion that you're talking about of the federal government where you have this wave of boomers who bought homes for $15 and now they're worth $1.5 million.

Everything in between is kind of the range of challenges that we have of housing and we have very urban centers. We have taller buildings in Silver Spring and Bethesda and Rockville than there are in DC so there are very urban locations where you have folks employed within a whole spectrum of different industries.

So it's really trying to serve what is an extremely socioeconomically diverse environment and ethnically diverse, racially diverse and so forth. And there have been successes and failures around that over the course of the decades, but that has definitely been the trend for Montgomery County over the last 10 or 20 years.

Tracy (21:43):
Maybe this is a question for Paul, but how replicable is this model outside of Montgomery County? Because as Zach just described, this is a relatively affluent place. I've seen some people make the argument that the county also has an advantage because it's a municipality, and so it's easier to do this model. I don't quite understand that argument, but maybe you can expound on that. But how easy is it to export this particular way of doing affordable housing to other parts of the US?

Paul (22:16):
Great question. I think the first thing to ask is, does the financing work in other places? And I think the really nice thing about the approach is that really the test is if market rate, rental construction pencils in your market, then this works because all you're doing is taking the market rate model, pulling the most expensive piece of capital out of that, putting in your own source of capital, and then all of a sudden you have more room to provide additional affordability.

So if the market rate is penciling, then you can do this. As far as how you get other agencies to find a way to do this or to use a tool like this, there's more than one way to use a tool like this. The city of Atlanta recently started up a program that's essentially, they're trying to copy exactly what Montgomery County's doing and actually we hosted a kind of event last week in Montgomery County bringing together folks from housing agencies around the country.

So we've got people out west, people in the south, people in the northeast, people in the Midwest who run agencies who are interested in figuring out how to do this. No two kinds of programs are going to look identical because everybody's institutional environment in different jurisdictions looks a little bit different. But I think, and Zach talks about this sometimes, there's two main kinds of pipelines you can use for how you get projects in a pipeline for development with a tool like this.

There's one where you're a housing authority, you own a piece of land. You say, 'You know what? I have this land, I'm going to develop it, I'm going to do an RFP, I'm going to find a construction manager, engineer to design the building. I'm going to hire somebody as a feed developer and build me this thing.' You have this other approach, which HOC recently did a project like this where there was a fully entitled project by a private developer that was sitting there on the dirt.

Nothing was built because they couldn't get financing to close the deal. It was fully entitled, it was ready to go. HOC came in and said 'Nice-looking entitled project you got there. How about I come in with my cool new capital, I'm going to come in with property tax relief because I'm a public agency. I'm going to come in and reduce the lease up risk. And what you're going to give me is this increase in affordability that I want, and I'm going to be majority owner.' And a private developer with an entitled project that can't close on financing is like 'Absolutely, please.'

Joe (24:21):
Real quickly, so there's no property taxes because it's the government developing on government land or government programs. How big is that? When you talk about like, we're going to make this pencil out, we're going to expand the supply of affordable housing, how big of a deal is that property tax component in terms of making things pencil out better?

Zachary (24:41):
Definitely a key tool. It really is what allows to do, so as an example, with the housing production fund, the production fund could still function with just the housing production fund itself around producing the housing without any increased affordability but it's really the ability to increase the affordability and to deepen the affordability as well because many of the units we deliver are actually below our inclusionary zoning standards.

So the property tax abatement is probably something like maybe 20%, maybe 15 to 20% of opex, of operating expenses. And it's that relief that feeds into the proforma and allows us to go as far as we possibly can with affordability, with services and, you know, all the other types of things we layer in when we do these projects.

Joe (25:27):
What is your capacity constraint? Like what is the source of, in theory, I imagine there's a demand for many more apartments, there's probably still scarcity. What is the constraint on HOC's side in terms of building out even more?

Zachary (25:44):
I would say the primary constraint, especially as we've entered into this sort of economic environment where, you know, we have 20 projects to choose from that are from the private sector that are all great, they're all tremendous and would add tremendously to the county's housing stock. I would say there are kind of three key, both short and long-term, constraints for us.

One, and it's really, I think the deepest part of the discussion is simply building the staffing and the capacity and the competency around being able to manage, how do you be a public limited partner investor? Like how do you create the staff you need for that out of both sort of what I call found people, the people that were kind of already there, but also attracting the kinds of practitioners you need to be able to scale up like our council wants us to do, like the fund is designed for us to do.

So that's certainly, I think, really one of the deepest parts of this discussion. Is really just then. And then there are other, you know, on the financing side, obviously our aim is to fully subscribe to the revolving fund, so we've largely done that. And so to some extent it's just the size of the fund and that's fine, that's probably the easiest thing to solve [because] it's just a budget adjustment.

But then the last piece is things that start to get into things like guarantee capacity. So if we're using a private bank loan and the bank has come to us and said 'Look, we really trust you guys. We think you're excellent practitioners, but while we're under construction we need you to guarantee X percent of the loan and across enough deals,' that starts to be an issue relative to a balance sheet, even as that balance sheet is growing because of the production.

And so it's one of those things that we watch very, very carefully to make sure that not only are we thinking about how we just finance this deal, but we're also very, very cautious. We work with our financial advisor extensively on really keeping an eye on that guarantee capacity. We're actually rated by Moody's to make sure that when Moody's comes in for their annual review, that we're always keeping that in mind so that there are no surprises. We obviously want to keep that capacity in a good place and there are innovations elsewhere in the country that we definitely did not do that are good solutions for that. It's really a host of things between just plain old people power and then some of the larger implications of taking a governmental entity and really supercharging it.

Tracy (28:05):
Well, I'm going to ask a devil's advocate question, which I have a *teensy* bit of sympathy for, as someone who has spent a lot of money on terrible apartments in New York for a long time. But what do you say to people who argue that it's unfair that the government is subsidizing people to be able to live and , you know, as you describe it, these are nice buildings with a lot of facilities and people on low incomes are able to live in places that they otherwise could not afford?

And then related to this, in an ideal world, wouldn't the solution for this just be for companies to pay higher wages? So that people *could* live in nice places? Well, and then on that note, like why do we have taxpayers who are subsidizing, like someone who's earning minimum wage at Walmart so that they can actually live somewhere close to where they're supposed to live?

Paul (29:02):
I think there's a couple answers to questions like this. One is just kind of a moral answer of, is it fair in a society for people to pay 70% of their income to rent? Some people have different answers to that question, I have my answer.

The other one, just on an economic growth point of view, I think it's important to consider it from the point of view of if you took 10, 20% of all households in America and doubled their housing payments overnight, what would that do to consumer demand in America? That'd be very bad for consumer demand. It'd be very bad for growth. It'd be very bad for broad economic growth. I don't think anyone who works in business wants to have a massive reduction in consumer demand by doubling people's rent payments overnight. So I think there's moral reasons, and I think there's economic reasons why you want to have housing supports for people.

As far as a fairness question, I think a really important way to look at this program is what are we doing to stabilize housing production across the business cycle? One of the things that we're seeing now is that when we have a rates environment like we have today, we're just seeing housing, not pencil at all. Nobody's being able to close deals. You have entitled land ready to go and it's just not going to get built even though there's housing demand. And so when I talk to other agencies, what they're telling me is, 'My God, I have dozens of entitled projects that I would love to see built around my city.'

Joe (30:26):
Sorry, what's an entitled project?

Paul (30:28):
It basically means you've gone through all of the architecture and engineering to get it approved. You've gone through all these kinds of approvals to get it ready to develop and you're ready to move. You just need to close on your financing.

Zachary (30:37):
It's really a development application process. So every place has got some version of it, but it basically means that you've gotten through what's usually called something like a site plan approval. But basically, if you go to the permitting agency, they're going to look at it and say 'Yeah you've met all the conditions of the legal zoning of the property and you can now build.'

Paul (30:55):
But you can't build if you don't have the capital and so that's where, if you have a program like this that can scale to many agencies, many places around the country. Obviously one building doesn't have a macro effect, but if you have every state running a program like this, you may have lower dips in housing production kind of across your business cycle.

Tracy (31:15):
The idea of smoothing the cycle in a sort of classic Keynesian fashion, I guess is the interesting one for me. The other interesting pro argument I could see in this is the idea of avoiding enclaves of super rich people. So you get sort of high, middle and low income people all living together, which kind of goes some way to alleviating labor shortage worries. It feels to me like so much of the labor shortage debate this idea that 'Oh, we can't get waiters or waitresses or maid or cooks or whatever,' is actually a housing shortage issue and this could go some way towards solving it.

Joe (31:53):
Just on the point about building through the cycle, because that was one of the things we discussed in the intro. Is that true? I mean, in practice has it been your experience that this

model is able to do that such that at a time when you're seeing entitled projects not get off the ground, you're not impaired?

Zachary (32:11):
It's definitely tougher because again, all we're doing is getting an advantage, we have that capital advantage, but there's obviously...

Tracy (32:19):
You're still impacted by higher rates as well, right?

Zachary (32:22):
Absolutely, we're impacted by higher rates. We have some built in because we're using tax exempt financing, all these sort of different buffers that we have that further help us be this countercyclical agency. But there's no question it's harder, but we're about to close a very large transaction. It'll be our second housing production fund deal, and it's had to weather the entire runup of both costs and rates and it's still going to close. And having been in the private sector, I can tell you it's not a transaction that would have any prayer of closing in this environment.

Joe (32:52):
Just real quickly, are there a lot of projects that you see right now in Montgomery County, or Paul, that you see elsewhere that some ground was broken or some plan was set in motion in 2020, 2021 that's currently just not being worked on? Is this a huge thing, unfinished entitled property developments?

Zachary (33:10):
It's much more like projects that basically are prepared to pull building permits and start, but can't get that financing and we've seen that even six months ago. I was probably looking at maybe six to 10 that had been presented and now it's got to be 20 to 30.

Paul (33:26):
I was talking to some folks in Massachusetts at one of their agencies who are very interested in deploying a tool like this who [were] telling me [about] dozens of entitled properties in the Boston Metro area that seem like they're not going to move right now.

Joe (33:40):
Tracy, I think we have further episodes to do...

Tracy (33:45):
Of course.

Joe (33:45):
… On uncompleted housing that people desperately want but that because of our attempt to fight inflation housing is being kept scarce around the country. I think much more to be done on that topic.

Tracy (34:00):
This is the ultimate irony of fighting supply-led inflation with higher interest rates.

Joe (34:08):
Zach and Paul, thank you so much for coming on up on *Odd Lots.*

Paul (34:11):
Really happy to be here.

Joe (34:26):
Tracy, actually that last point about just the surge in non-completion of development is pretty alarming. The fact that it's significantly different than it even was six months ago at a time when people are frustrated by rents, at a time when people are frustrated by housing shortage. And the fact that in the last six months planned completions have gotten worse is pretty damning I would say.

Tracy (34:50):
That was kind of a crazy number but also I guess it gets to the whole point of maybe doing this sort of public-private financing. This idea of having a smoothing effect on the housing cycle or having a sort of backstop for capacity at a time of higher interest rates. But then to that point, there are limits. And even [with] Montgomery County, Zach was talking about the guarantees and having to present their finances to Moody's every year and get a rating for muni bonds and things like that. But there is an impact of higher rates there as well.

Joe (35:26):
By the way, it looks like they have a AAA rating, at least Montgomery County does. That's the nice thing looking at the terminal while we were doing this. So [they're] very well-rated across all three of the major credit rating agencies. This idea of using the public balance sheet in some way is really interesting.

Also, I thought Zach's point about one of the major constraints, and again, I think people tend to maybe abstract these types of things away, if you could have a public sector or a public authority, be a landlord in some capacity, be the owner of what looks like normal market rate construction, but do you have the personnel capacity to run it?

Tracy (36:06):
Yeah, it's not the government's expertise, right? The big advantage of the government or the big specialty of the government is basically a lower cost of capital, not actually execution on a lot of things. There are some exceptions like when we talk to the Department of Energy, they have a lot of energy experts who are able to evaluate projects. But in general, I think the big advantage of the government is the lower cost of capital and this kind of puts it to best effect.

Joe (36:34):
No, it's really interesting to think about. Personnel is a constraint and hiring is a constraint right

now and public sector hiring is a constraint right now. It's one area in which public sector authorities across the country have had issues [is] hiring. So it's interesting to see how you can transfer the ownership of the financing to the public sector in some way or another but then still it doesn't mean that you don't have some of these key constraints. Construction is another one, it doesn't matter who it is. If labor is scarce, if materials are scarce, if you're waiting on cooling equipment or whatever, it's going to be tough.

Tracy (37:08):
So, pros: smooth the housing cycle, expand housing capacity, create more vibrant communities where there's a mix of low income and higher income residents. And I guess cons: some people are inevitably going to think this is unfair. Wait, can I just say I'm in a bad housing mood because my toilet has been broken for like six months?

Joe (37:32):
You're just resentful right now.

Tracy (37:33):
I am and also my neighbor drilled a hole in the partition wall and I didn't have any hot water on Sunday either. Oh, and the intercom's not working.

Joe (37:42):
This is all true. I've been hearing a lot about this. For listeners, this is why Tracy is resentful of other people getting a good deal on nice apartments.

Tracy (37:52):
Shall we leave it there?

Joe (37:54):
Let's leave it there.