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Asset Management and Survival of Nonprofit Owners

By Harold Nassau

What does it take for a mission-oriented real estate owner to survive?

Whether nonprofit or for-profit, the answer is clear: positive organizational cash flow. And the key to that answer is ongoing proactive asset management. But the for-profits have always sung this song.

Harold Nassau

Development, especially for Community Development Corporations (CDCs), is under pressure today as never before. Cuts in federal funding lead to cuts in state resources and downward pressure by localities hungry for more real estate taxes, not less. Many owners whose primary cash-generating business lines have been real estate development have used those fee streams to fund key mission-driven activities such as resident services, community engagement, and even general organizational overhead. For these owners, lower odds of winning the next low-income housing tax credit (LIHTC) transaction will raise existential questions.

The question is cash, and the answer is asset management. With rents limited and incomes flat, resources constrained, subsidies diminished, and interest rates as low as they will go, an owner that does not optimize cash flows risks insolvency and extinction. But as one cannot optimize in the dark, knowing what value their real estate assets *can* produce is critical, so that then the owner's management and board of directors can make strategic decisions about optimum balance of mission and revenue.

Not your father's asset management

What constitutes asset management today is a far different practice than many owners and most nonprofits have developed thus far, and bears little relation to the original LIHTC compliance vision. For a new owner with a development just completed and entering operations, the first 10 years of asset management would be imposed from without: LIHTC investors protecting their tax credit flows and aggressively scrutinizing operations and management.

With Year 10, that wanes, and by Year 15 the investors are restless. In the meantime, nonprofits have evolved reasonable ability to oversee property management, steer capital investment and manage replacement reserves, meet compliance and other

The problem today is figuring out how fast the train can go and still stay on the rails—both mission and financial.

Today, CDC portfolios and new development face seven challenges:

1. **Preservation:** Government agencies, investors, and funders continue to reward new development more than preservation. Year 15 deals can demand complex exits and difficult recapitalizations, and it is harder to get development fees on them;

2. **Rising capitalization requirements:** More and more jurisdictions and qualified allocation plans (QAPs) for low-income housing tax credits are either favoring better-capitalized developers (most of whom will tend to be for-profit) or reducing set-asides or points for mission capacity that is sometimes (mistakenly) seen as a substitute for financial strength;

3. **Cost containment:** With more pressure on resources, high development and operating costs hurt the owner's competitive position and political support;

4. **Energy management:** This is a key part of cost containment, but it is also a core for the green values that many CDCs support;

5. **Operational sustainability of the service suite:** Many QAPs require or practically require commitment to provide ongoing resident services, even though these same allocators will not fund the service component in the transaction. The result is a "sinking fund and hope" model where the development pro-forma carries the service suite for five to six years, hoping that when the sinking fund runs out, something will turn up. When it doesn't, the service-providing owner/ manager is left paying the bill.

6. **Outflowing cash:** Owners need their portfolios to provide net cash flow to help incubate new developments (site control, predevelopment costs) and their mission programs on which brand and QAP points depend; and

7. **Services make community:** While we have learned that resident services are an essential component to making affordable housing work, they rarely are funded at the property level. If CDCs are going to compete for resources like Social Impact investing, they will need to have data that demonstrates mission outcomes and are clearly tied financial sustainability.

These strategic goals look very different from the typical asset management responsibilities that we see among nonprofit owners:

- Compliance;
- Reporting;
- Managing the property manager;
- Budget approvals;
- Capital needs; and
- Taxes and insurance.

In many organizations, the asset manager may also have input on new development deals and, in others, the asset manager might also interact with resident services. But overseeing compliance and operations have been the meat and potatoes of nonprofit asset management. Asset management has not played the kind of strategic role that it must if CDCs are going to be viable as real estate owners and developers and continue to deliver on their mission. Improving portfolio performance links to many of the "Big 7." Certainly cost containment, energy management, and effective management of the property manager are

Looking at entities or actors that do something different and better can provide examples that others can observe and adapt.

1. Eden Housing, San Francisco Bay Area

Linda Mandolini, CEO, and Jan Peters, COO determined that the tough California market demanded a more efficient and competitive development and operational model. Eden established cost-containment goals to take an already profitable portfolio and drive it to new levels. Eden set a goal across the board of *reducing expenses 10%* and without sacrificing the kind of housing and services that has been Eden's hallmark. Their current operating expense target is $5,100 per unit/per year. And Eden succeeded. Central to this effort, of course, was energy management (which included portfoliowide evaluation of energy expenses and retrofitting opportunities) and much tighter property management. This is asset management at the corporate level. The critical driver in this success was

· A clear measurable goal that had important competitive consequences;

· Commitment by senior management to the goal; and

· The willingness to drive that commitment throughout the organization.

2. Madison Park Development Corp., Boston

While Eden focused on expenses, Madison Park focused on the financial picture of the organization–the parent–to set operating goals for the portfolio. With a careful eye on where each property was in its financial lifecycle, the CFO and asset manager worked together to create the optimum goals for the organization–not necessarily the maximum goal for each property. The property budgeting process then started NOT with the usual September drafting of budgets based upon prior budgets, but in the May or June review of the corporate audit and financial statement. Instead of asset managing down to the portfolio, Madison Park's asset manager Andrew Kerivan managed up to the organization. The organization set a goal to move from reliance on "lumpy" development fee revenue to a more constant revenue stream from the portfolio. While the driver at Eden was the CEO and COO, at Madison it was driven by the CFO working with the asset manager with, of course, CEO support. Maximizing preservation possibilities depends on maximizing the corporate balance sheet, not just property performance. Some key drivers:

· Close cooperation between CFO and asset management;

· Detailed mapping of partnership agreements and property values; and

· A 'for-profit' culture that also honors mission goals.

3. Aeon, Minneapolis

Aeon takes a hard look at the balance between mission and profitability. Aeon works with its board of directors to measure specific mission outcomes such as affordability, resident satisfaction affordable production, against targeted profitability for each individual property. The Board is deeply aware of the tradeoff between mission impact and financial strength, and it must wrestle with this equation, which includes the strength of the properties AND the organization as a whole. Once the board has set the outcome goals, then it is up to asset management to implement them. Caroline Horton, Aeon's CFO and director of asset management, has developed a matrix that allows the organization to track performance against both mission and financial sustainability projections. This technique positions a CDC to approach funders and investors with a clear and measurable set of outcomes to justify investment–going directly at the big challenges of supporting mission, inviting mission-based investment and sustainability and the property and corporate levels. The drivers?

· CFO drives asset management too;

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4. Homes For America, Washington, D.C., metro area

With 5,000-plus apartments in the D.C. metro area, Homes for America has recast its entire development and asset management divisions. It is weaning itself from LIHTC properties since these deals are so complex and when done in the small scale that nonprofits are often forced into, so unprofitable, that it can subvert both mission and financial goals. Homes for America charges asset managers with the preservation of existing portfolio which means taking on the predevelopment, and in many cases, the entire recapitalization of expiring deals.

The "silo buster" at Homes for America was breaking down the traditional barriers between asset management and real estate development. Key drivers:

· Profit-oriented culture serving mission goals;

· Breaking down traditional silos between development and asset management; and

· In yet another CEO-driven change, Nancy Rase was committed to creating a new business model: Revenue from new development is allocated to the expense of operating the development department, and the balance goes to asset management and resident services.

And, like more and more groups, Homes for America recognizes payment of deferred developer fees as "asset management income" – an important point to which we will return later.

What they have in common

These four examples show common themes:

· The role of asset management is expanded to develop strategic goals that reflect the organization's financial posture, competitive needs and mission commitments;

· In each case, very senior management–executive directors, COOs, and CFOs–made corporate commitments and drove the process across organizational lines. Development, resident services, and portfolio performance, which are so often separate silos and turfs, each with their separate funding sources and goals, are being forced to join together to reach shared goals;

· While the point of attack is different in each of the cases mentioned, all directly take on the Big 7. Asset management is repositioned to take on the new landscape that CDCs must operate in; and

· The change in asset management reflects a deeper change behind the business strategies we have been discussing.

Three deep changes CDC need to make

Addressing the seven big challenges requires making the portfolio survive through incremental improvements. But the question posed here is not how can we improve. The answers being sought are the best and the most that can be achieved and then to build a strategic plan to balance them. If this sounds familiar, it should. It is a variant on the traditional for-profit asset management philosophy of finding the highest and best use of real estate. The difference is that highest and best in the world of nonprofits includes more than financial outcomes. It is no surprise then that the CDCs cases we looked at function in many ways like a for-profit. They try to apply the same rigorous discipline to mission as they do the assets and liabilities.

As you look at our challenge list, ask yourself, where in my organization does the responsibility for these challenges sit? And, where can it sit? In most cases, it is your asset manager that sits squarely in the middle of this list. And yet many asset managers in the nonprofit arena do not yet have this larger focus. Among organizations with less than, say 500 units, very few have this capacity. But it is not simply a matter of skill sets, though the new asset management does need a higher level of skills. What is needed is a focused and coherent asset-based culture.

the new solutions. Why is it so difficult for nonprofit real estate owners to tackle the big challenges presented by the changing landscape of subsidy, rents, market, and demographics?

1. As the current structure is dysfunctional, restructure to achieve new higher goals and objectives.

Asset management means "implementing the owner's goals." The nonprofit owner is like a mini-conglomerate and each arm has a different mission. Here is the mission octopus:

The development department saw its mission as maximum production of housing units for the people the organization targets for housing. Good. But developers, as we well know, will often ignore the longer-term needs of a property in favor of getting the deals done and collecting fees. Not so good.

The resident service department saw its mission as providing as much service as they can. Good. But sometimes service providers can become more concerned about the welfare of residents than the viability of the property. Not so good.

Property management is dedicated to keeping the properties going and in compliance. Good. Often they are too busy with day-to-day struggles and crises to think about the long-term health and competitiveness of the property. Let alone the owner's financial goals. Not…well you get the drill.

And, finally, there is the board that is, after all, the owner of the portfolio. Heaven only knows what mash up of goals may be driving the board's thinking.

Oh! Should we raise the possibility that the executive director – under pressure from funders and politicians, just might have a different blend of goals altogether?

No wonder that asset management was not strategic! The owner's goals were often poorly defined and at odds with each other despite strategic plans—plans that would list goals but not reconcile them.

At NeighborWorks America (NWA), we have been working on the culture of asset management for the past 15 years. NeighborWorks America® is a congressionally chartered nonprofit that provides technical support and grant resources to a network of some 250 nonprofits in all 50 states. Some 110 NWA members have an aggregate portfolio of 110,000 rental units and report on their performance quarterly. When a new member that owns multifamily housing joins the NeighborWorks network they are required to participate in a clinic that includes the executive director, asset manager and two board members. A strategic approach to how and why and organization will own and develop real estate has to include the organization as a whole. Board members who may have had a cursory involvement in the development of new deals need to be integrated into the decision-making process as a whole.

2. As bigger may not be better, but it is more sustainable, plan to grow to reach sustainable scale.

While many nonprofits have remained small local, specialized, or neighborhood-based, a great many nonprofits have grown enormously over the past 10 years. The average rental portfolio of a NeighborWorks America member in 2004 was 286 units, while in 2014 the same organizations have an average portfolio of 591 units. The organizations as a whole grew even more dramatically: from average gross revenues of $2.7 million, to $9.9 million, 10 years later. More and more groups are doing line-of-business-based accounting in order to understand the real cost of each activity. And asset management has been the greatest victim of the lack of scale. It is simply impossible to staff asset management at a high strategic level with a small portfolio. The need for efficiency in operations and development are leading to more mergers and strategic collaborations. The NeighborWorks performance data confirm that very small properties perform more poorly than larger properties. Of the 2,000-plus properties reporting about 21% have negative cash flow. But of properties with fewer than 25 units 33% run negative. But scale impacts organizations as well. Of CDCs with fewer than 300 units, 28% have *aggregate negative cash,* while 5% of groups with 500 to 100 units are negative. And, over 1,000 units, NONE are negative. Note that in our four mini-case studies, the

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effective.

As CDCs are gradually being forced to shift from being resource recipients to resource competitors, their real estate divisions are going from being housing programs to a housing business. The old development model included many very small projects, in-fill, and scattered site. While the issue of scale has long been recognized as a challenge to the nonprofit affordable housing industry, it acts as a magnifier for each of the seven big challenges. All this requires profound organizational changes in the CDC business model and in real estate development AND asset management.

3. As what isn't measured isn't managed, strengthen the core: financial systems, IT, CFO.

As nonprofits have grown in size and complexity, so too has the needed for a stronger financial systems and personnel —most dramatically, the need for 'real' CFOs. Many early nonprofits made do with a controller or even a bookkeeper, but nonprofits today are recognizing the need to move to a real CFO to provide the financial base from allocating and assessing the value of business lines and to develop strategies that begin to overcome the silo' d structure outlined. Bringing together the various activities and missions under one financial discipline has been an enormous challenge to the nonprofit world.

The *Strength Matters Initiative* – a partnership between NeighborWorks America, the Housing Partnership Network, and Stewards for Affordable Housing Preservation—was built to bring together sophisticated CFOs from across the sector. Strength Matters has created a knowledge exchange that has not only issued more than 30 white papers on accounting and reporting practices, but their annual meetings continue to build a base for strategic financial analysis and planning.

Last year the convening of the CFOs was joined by the CHAM (Consortium for Housing and Asset Management) convening of asset managers. While asset management may report to the development arm or the executive, more and more groups are understanding the basic affinity and congruence between the asset management function and the CFO function. One of the highlights of the conference was staging the ongoing conversation between CFO and asset managers.

The high-level CFO/asset manager perspective also made it plain that it was necessary to have a stronger data system to provide the comparative and normative analysis. Strength Matters undertook developing a far more sophisticated data warehouse approach that allows for granular analysis of performance in all expense lines and across all the variables of building type, geography, and financing. This effort is still underway. Other investors are also developing powerful data systems, and the commercial market is beginning to develop important tools. CFOs and asset managers of leading CDCs are crying out for new and sophisticated to benchmark performance and project outcomes for different financial scenarios.

Only the sustainable live to see and change the future

The job of asset management is changing to take on the big seven challenges facing the industry. But to succeed the role of asset management in nonprofit organizations has to shift in ways that are so fundamental as to require changes in the very structure of nonprofit real estate developer/owners. CDCs must:

1. **Create consistent business models that unify and reconcile mission goals;**

2. **Develop scaled and efficient portfolios; and**

3. **Create a framework of strong CFO led business discipline.**

To achieve this, what must owners and asset managers do?

1. **Ratchet up skill levels:** While nonprofit asset managers have begun to wean themselves away from a property management perspective, only a minority have the financial perspective and skill of asset managers in the for-profit world;

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3. **Integrate asset management with the CFO in crafting portfolio goals that mesh with corporate goals;**

4. **Measure the impact bottom line:** Limited funds for resident services and the emergence of social impact investing both call out the need to quantify and measure mission goals. Asset managers are going to have to take on more responsibility in capturing the mission outcomes and demonstrating impact on portfolios;

5. **Keep score on green:** Integrating energy consumption and costs into basic asset management reporting; and

6. **Bring the board on the journey:** As the board exercises its fiduciary and business responsibilities for their portfolios, the board members (many of whom are not housing experts) will need more support and information from asset managers. The asset managers in turn must provide the boards with information that both allow a board to act strategically and keeps it out of the weeds of property minutiae.

And then a look beyond…

In a world of constrained resources, flat or declining incomes, and great need, the nonprofit owners are beginning to look for ways to leverage their portfolio; to optimize performance but also to build business systems around their portfolio. We have seen groups go beyond the traditional property management to create third-party asset management businesses, architectural and design firms, construction and rehab companies, weatherization and energy-efficiency businesses.

In this world the asset manager will have to start thinking about how the portfolio can best support a wide range of business interests rather than portfolio performance.

It comes back to the basic question of asset management—What is the highest and best use of real estate? Unless you know, you cannot manage to that goal or any other goal.

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