Can ESG-funded REITs and Modular Construction Transform Affordable Housing Finance?
Introduction
Strained federal and municipal resources, widening income gaps, deteriorating transportation infrastructure, and rising construction costs were squeezing housing affordability prior to the Covid Pandemic. In the post-virus economy, an uncertain employment landscape and numerous economic challenges will continue to negatively impact the affordability outlook and cloud the social structure for lower-income households.

Given the number of vectors weighing on housing affordability, it is evident that a diversified array of both governmental and market-based approaches are needed to address this crises. The most viable solutions should focus on reducing the cost of capital available for housing, reducing the cost of constructing new communities, improving operating efficiencies and environment sustainability, and expanding access to ancillary supportive services to these communities.

The REIT Center has been analyzing the entire existing affordable housing ecosystem to pinpoint specific areas from where such solutions can be brought to bear on these challenges. The findings of this research are promising. The REIT Center urges a rethink of the status quo, advocating for collaboration by ESG and social infrastructure investors, the use of special-purpose REIT vehicles, and a shift to modular construction to achieve these goals.

ESG & Social Infrastructure Investors
Ensuring adequate housing for low and moderate-income Americans has been the mission of federal policy for nearly one hundred years. The nation’s first public housing and mortgage insurance programs were launched in direct response to the Great Depression, with many additional programs continuing to support affordable housing strategies today. However, these programs are straining public resources and fail to achieve a 360-degree impact on at-risk communities.

Impact, or Environmental, Social, and Governance (“ESG”) investing is a relatively new segment of finance designed to extend the conventional economic bottom-line to include a second bottom line measuring their social impact. Such impacts include sustainability, climate change, and local economic development, such as affordable housing. There is no precise definition of what is considered “affordable” or “workforce” but generally accepted practices target households generating 60% - 140% of the area median income (“AMI”).

Impact investors employing mission-based capital are finding that affordable housing investments boast superior resiliency across market cycles due to lower default rates, stable cash flows, and less cap rate volatility than other sectors. As a result, this sector has become one of the leading investment targets by ESG investors.

Social-Purpose REIT Vehicles
A Real Estate Investment Trust (“REIT”) is a company that owns, and in most cases operates, income producing real estate. REITs have the benefit of not paying corporate-level taxes if they meet a number of stringent criteria aimed at making sure the vehicle strictly owns real estate. Additionally, many REITs hold their assets in an Operating Partnership, which is a unique structure that allows for the deferral of capital gains on contributed assets, much like a 1031 exchange. The combination of a stable income stream and preferential tax treatment, make REITs an ideal investment vehicle for risk-adverse investors.
While most REITs invest in traditional property types, like office buildings and retail centers, a growing number of REITs are increasingly focused on class-B apartments and workforce housing. They are being referred to as “social-purpose” REITs. As individual investors understanding of the housing crises grows, so too does their interest in supporting market-based solutions.

Existing social-purpose REITs are typically capitalized with a combination of small investments directly from high net-worth individuals and larger investments from foundations. These shares are non-traded, meaning their equity interests are not listed on a stock exchange. These capitalization strategies do not maximize operational transparency and investor liquidity but they are a laudable expansion of the affordable housing capital markets and are laying the foundation for rapid expansion in the near-term.

Modular Construction

Modular construction is the process of building all or part of buildings off-site under controlled conditions in a modern and efficient factory. At one end of the modular spectrum, volumetric manufacturing processes complete the entire building in modular components, which are then shipped to the construction site to be assembled. Factory production occurs simultaneously with site-prep and foundation work, speeding delivery timelines and minimizing site disruption and on-site safety hazards.

By incorporating a standardized, manufacturing approach toward construction, developers reduce project costs by 20% and shorten completion times by half, on average, while also reducing material waste. A recent report by McKinsey & Company estimate that market adoption of modular technologies will rapidly grow, ultimately claiming $130B of the US and European construction market by 2030, delivering total cost savings of $22B, and helping to fill a $1.6T productivity gap. At the project level, substantial cost savings are experienced in projects with high design and production repeatability, as the cost per square foot (psf) decreases the more modules are replicated. This is particularly advantageous for multi-family residential use, where unit floor plans are replicated throughout the building and across multiple buildings.

Next Steps

The REIT Center believes that a multifaceted approach, integrating ESG investors, the REIT structure, and modular construction, will result in a meaningful impact to the workforce housing crises. Through a detailed analysis of each of these categorical inputs, a review of industry case studies, and direct conversations, this report will provide practical knowledge about this proposed solution. Early evidences proves that modular construction can reduce the cost basis of residential buildings and the REIT structure allows greater access to favorably priced capital, especially ESG capital. Additionally, the participation of ESG investors allows for the introduction of ancillary benefits like child daycare, healthcare services, and job training.

Public and private constituents have demonstrated a growing understanding of the the drivers of housing costs, the burdens of household finances, and the benefit of healthy interaction with local communities. There are no “silver bullets” to making housing affordable, therefore a creatively-focused collective approach must be taken to bringing multiple solutions to effectuate change. A stable housing ecosystem is fundamental to a healthy and productive society -- the outcome is worth the effort.