Freddie Mac in Opportunity Zones

A Multifamily Market Analysis based on Freddie Mac's Historical Business in these Areas

Opportunity Zones have created a tremendous amount of buzz in the commercial real estate industry, and for good reason – some industry analysts predict that this tax break will be one of the largest in U.S. history. The magnitude of the program is significant as capital gains earned by investors across different asset types are all eligible for tax benefits by investing in Opportunity Zones. The basics of this program were discussed in another report that we released on this topic (located here).

Given the large scope of this program, a copious amount of literature on Opportunity Zones has been published across the industry since the emergence of IRS guidance and has provided great market context. In this paper, our goal is to examine some of the multifamily market characteristics in Opportunity Zones by leveraging our own data. We use our past financing activity to show how the multifamily market in these areas differs from other geographic areas and demonstrate how this segment of our business fits into our broader goal of providing affordable housing to populations most in need.

Below are some of the key findings of our analysis:

- Since 2010, Freddie Mac's business in Opportunity Zones has grown more than 75 percent faster than our business in other areas.
- Rental housing[i] that is affordable to very low-income households is more than twice as common in Opportunity Zones compared with areas outside of Opportunity Zones.
- Although still rare, the percentage of rural rental housing in Opportunity Zones is nearly three times higher than that of other areas.
- Multifamily rental properties in Opportunity Zones tend to contain fewer units. Smaller properties cater to lower-income renters at a high rate which helps explain their prevalence in these regions.

Opportunity Zones are a significant development in the commercial real estate realm. This new tax initiative has immense potential to help communities in need and provide an economic catalyst to turn these areas into vibrant communities of high economic opportunity. Since we have a rich data source with unit-level information at our disposal, we thought that others in the industry could benefit from the analysis of our data since we can use it to examine trends that most traditional, government sources are unable to measure due to data constraints.

[i] Throughout this paper, rental housing refers only to multifamily.

Demographic and Housing Characteristics

Two of the defining characteristics of Opportunity Zones are low income and high poverty. Income is 45.3 percent lower in Opportunity Zones compared with the rest of the nation. Renters in Opportunity Zones fare a little bit better, earning 36.4 percent less than renters outside of these zones. The poverty rate in Opportunity Zones is 28.7 percent – more than twice as high as the rate for other areas in the nation.[1]

The goal of Opportunity Zones is to promote investment in neighborhoods that are economically distressed. As seen in Exhibit 1, the designation of Opportunity Zones generally adheres to this rule.

Exhibit 1: Income Comparison between Areas Inside of and Outside of Opportunity Zones[ii]

	Inside of Opportunity Zones	Outside of Opportunity Zones	National
Median Household Income	$33,111	$60,538	$57,652
Median Renter Household Income	$24,689	$38,796	$36,653
Poverty Rate	28.7%	12.9%	14.6%

Source: Freddie Mac Tabulations of 2017 5-Year American Community Survey. Renter income is based on all renter households.

Opportunity Zones are defined at the census tract level and state governors ultimately decided which tracts would be designated as Opportunity Zones. They had to follow general guidelines based on factors such as median income and poverty rates,[iii] but they otherwise had a great deal of discretion regarding which areas were designated. A report by the Urban Institute showed that tracts that were eligible based on the national guideline had lower income, higher poverty and higher rental cost burden than ineligible tracts. This result is consistent with intuition. However, they also showed that these indicators were even more severe for tracts designated as Opportunity Zones.[2] Therefore, both measures that were used to select areas in need of economic assistance (i.e. the national guidelines and governors' discretion) deemed these indicators to be important factors.

The homeownership rate is another defining housing characteristic in Opportunity Zones. In these areas, fewer than half of all households own their home. This is not surprising since income and homeownership rates are positively correlated, indicating that areas with low income will generally have a high renter rate. Among renter households, the composition of single-family versus multifamily mirrors the rest of the country. That is, both inside and outside of Opportunity Zones, just over 43 percent of all renters reside in multifamily units.

Housing units in Opportunity Zones tend to be relatively old, and this is true for both owner-occupied and renter-occupied units. In Opportunity Zones, 28.7 percent of the multifamily rental stock was built prior to 1960, which compares with a rate of less than 20 percent for other areas. A similar trend is found for owner-occupied units (regardless of structure size), where the rate is 35.2 percent and 26.7 percent, respectively.[1]

[ii] Figures for Opportunity Zones cannot be pulled directly from the Census because they are not a standard geography. Because of this, a different aggregation method was used and the results were normalized to Census output.

[iii] For more information on this, we suggest reading Enterprise's blog post, which lays out the basic criteria that census tracts must meet to be eligible to be Opportunity Zones: https://www.enterprisecommunity.org/blog/understanding-opportunity-zones-eligibility

Freddie Business Analysis

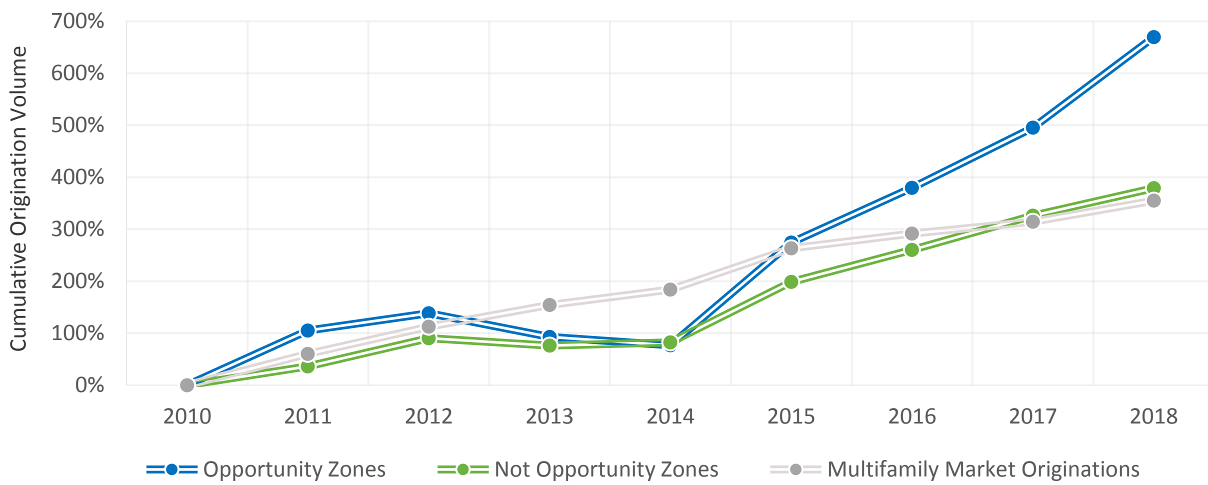
Multifamily rental housing is expected to be a key component of Opportunity Funds. Indeed, of the 117 planned funds identified by the National Council of State Housing Agencies (NCSHA) as of April 4th of this year, 76 have an investment focus of multifamily residential development, with estimated earmarked funds totaling between $18.8 billion to $19.0 billion.[iv,3]

Because of the high amount of future investment activity in this sector, we thought that it would be helpful to examine the current market using unit-level statistics from Freddie's internal data consisting of properties that we have financed. This will provide a glimpse of the characteristics of apartments that have recently transacted.

Number of Units

Of the 630,000 Conventional Multifamily units[v] that Freddie Mac financed in 2018, just over 71,000 were located in areas that are now designated as Opportunity Zones. This corresponds to 11.3 percent of units, which is slightly above the percentage of people living in these areas. The population density of Opportunity Zones is relatively low, at about two-thirds of the national rate, which is typically unfavorable for multifamily rental development. This means that our loans, based just on population concentration, are above the norm of what might be expected. The share of our business in Opportunity Zones has substantially outpaced the growth of business outside of these zones, as seen in Exhibit 2. From 2010 to 2018, total unpaid principal balance (UPB) in Opportunity Zones grew more than 75 percent faster than UPB outside of Opportunity Zones. While this does not correlate exactly with property or unit-level growth, the trend is similar regardless of which metric is used.

Exhibit 2: Cumulative Origination Volume Growth



Source: Tabulations of Freddie Mac's Affordability Summary Database. Unlike other figures throughout this report, this graph uses unpaid principal balance (UPB) which is a monetary figure. As stated above, the trend is similar for properties and units, but since we have better data on multifamily originations than on property or unit counts for the entire industry, we compare UPB change.

[iv] Not all of this $18.8 billion to $19.0 billion is allocated for multifamily development. This is because a fund can have multiple investment focuses, with multifamily being just one of them.
[v] This does not capture every unit that Freddie Mac financed. Only about 70 percent of units from 2010 to 2018 are included in this analysis. We excluded all units that are not eligible for Freddie Mac's affordable housing goals. Student and Seniors Housing are also excluded, as are units that use estimated rent data instead of actual recorded rents at the time of financing. The reason for filtering is to create a consistent sample for each year of data that best represents Conventional units. In this way, figures quoted in this paper are for research purposes only and not intended to represent all of Freddie Mac's business.

The pickup of Opportunity Zone origination volume starting in 2015 can be partially explained by the success of Freddie Mac's Small Balance Loan (SBL) program.[vi] Prior to 2015, there were very few SBL properties in Freddie Mac's lending portfolio. Following the creation of this program, financing activity in this market segment increased tremendously, and the effect was felt acutely in Opportunity Zones. Although both SBL and non-SBL business increased in Opportunity Zones at a faster rate compared with other areas, the pickup of SBL business was more pronounced. Specifically, for properties with 50 or more units, Opportunity Zone growth outpaced other areas by a factor of 1.8 from 2014 to 2018. For 5- to 50-unit properties, the corresponding factor difference was 5.2. SBL in the context of Opportunity Zones is discussed more in the 'Property Size' section below.

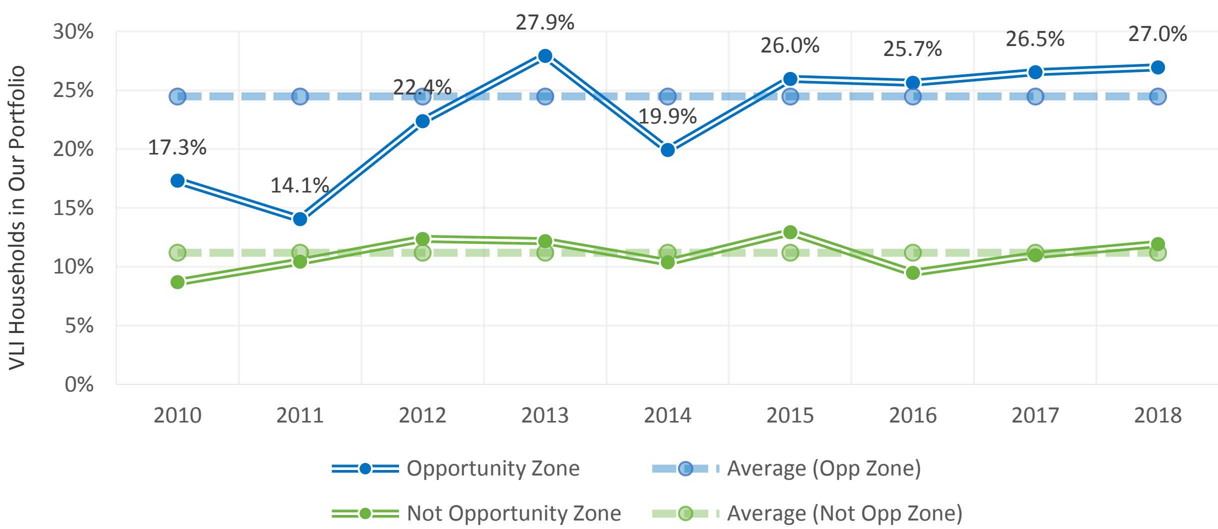
Median Rent

In recent years, rent levels in Opportunity Zones have generally been lower than in other areas. Among Freddie-financed properties in 2018, the median rent of a unit in an Opportunity Zone was $1,015, which is 8.6 percent lower than the median rent of apartments elsewhere. However, the difference in rents is a recent phenomenon; from 2010 to 2012, there was no observable difference in rent values. Since 2013, the disparity between rents in areas inside of and outside of Opportunity Zones has steadily become more pronounced.

VLI Qualifying Units

Opportunity Zones have historically contained a relatively high percentage of units affordable to very low-income (VLI) households (households making at or below 50 percent of the area median income). Since 2010, 24.5 percent of units funded in Opportunity Zones have been affordable to VLI households, compared with 11.2 percent of units funded outside of these zones. This means that Opportunity Zones contain 19.1 percent of Freddie Mac's VLI-affordable apartment units – more than double the market's historical composition of Freddie Mac's portfolio (9.3 percent).

Exhibit 3: VLI Composition by Opportunity Zone Designation Throughout Time



Source: Tabulations of Freddie Mac's Affordability Summary Database. Average lines are based on weighted, not simple, averages.

[vi] For more information on Freddie Mac's Small Balance Loan program, please visit this page: https://mf.freddiemac.com/docs/product/small_balance_loan.pdf. SBL qualification is based on UPB instead of unit count. However, SBL properties will typically have between 5 and 50 units. The unit count metric is the one used for SBL in this paper.

Consistent with this finding, a high percentage of Freddie Mac's Targeted Affordable Housing (TAH) program business comes from Opportunity Zones. The TAH business line finances multifamily properties that have rent restrictions on at least a portion of the units on the property, as a result of either capital or operating funding from federal, state, or local sources, or related programs (such as the Low-Income Housing Tax Credit).

Since 2013[vii], nearly 22 percent of all TAH business came from Opportunity Zones, compared with 8.7 percent of all Conventional business. Viewed from a different angle, we see that 22.1 percent of all business in Opportunity Zones went through the TAH program, despite the fact that the program only captures 10.3 percent of all of Freddie Mac's business.

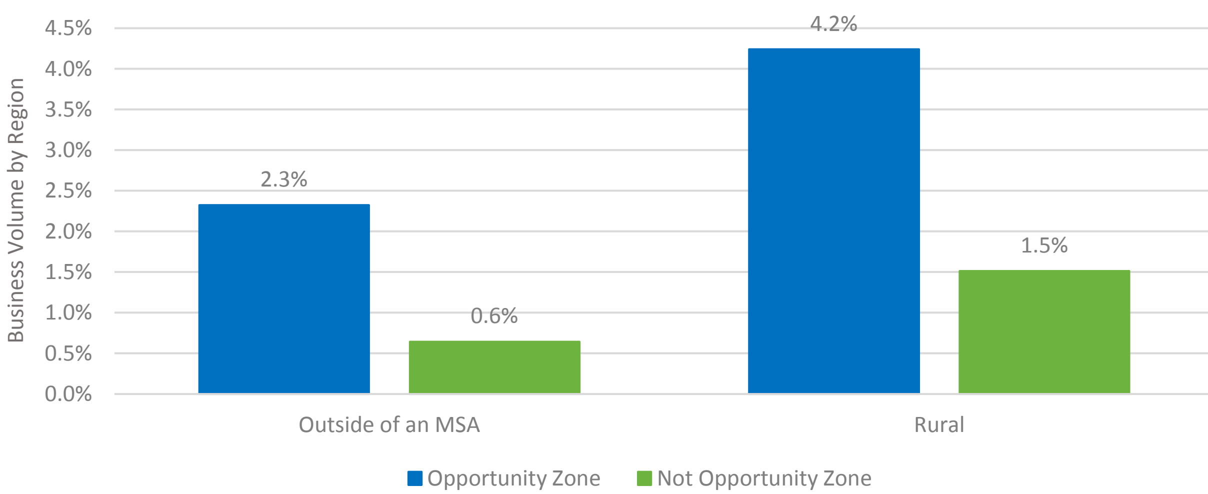
MSA/Rural Concentration

Historically, nearly all of Freddie Mac's business has been in metropolitan statistical areas (MSAs) and only a very small amount is done in rural areas.[viii] This is largely because apartments are more common in densely populated areas. Outside of metro areas, we tend to lend more heavily in areas that are designated as Opportunity Zones.

As seen in Exhibit 4 below, in 2018, only 0.6 percent of Freddie Mac's non-Opportunity Zone business came from outside of MSAs. This rate is slightly higher in Opportunity Zones, where 2.3 percent of units are outside of MSAs. While this disparity seems small, it does indicate that the probability that a unit financed outside of an MSA is in an Opportunity Zone is nearly double what would ordinarily be expected, since just under a third of all units financed outside of MSAs were in Opportunity Zones despite these areas only making up 16.3 percent of non-MSAs by population.

The story for rural areas is similar. The rate of rural housing in Opportunity Zones is more than triple that of other areas. The overall rate is still very low for both – 4.2 percent versus 1.5 percent – but still relatively high since the rural/non-rural population breakout inside of and outside of Opportunity Zones does not differ significantly.

Exhibit 4: Opportunity Zone Composition Outside of MSAs and in Rural Areas (in 2018)



Source: Tabulations of Freddie Mac's Affordability Summary Database

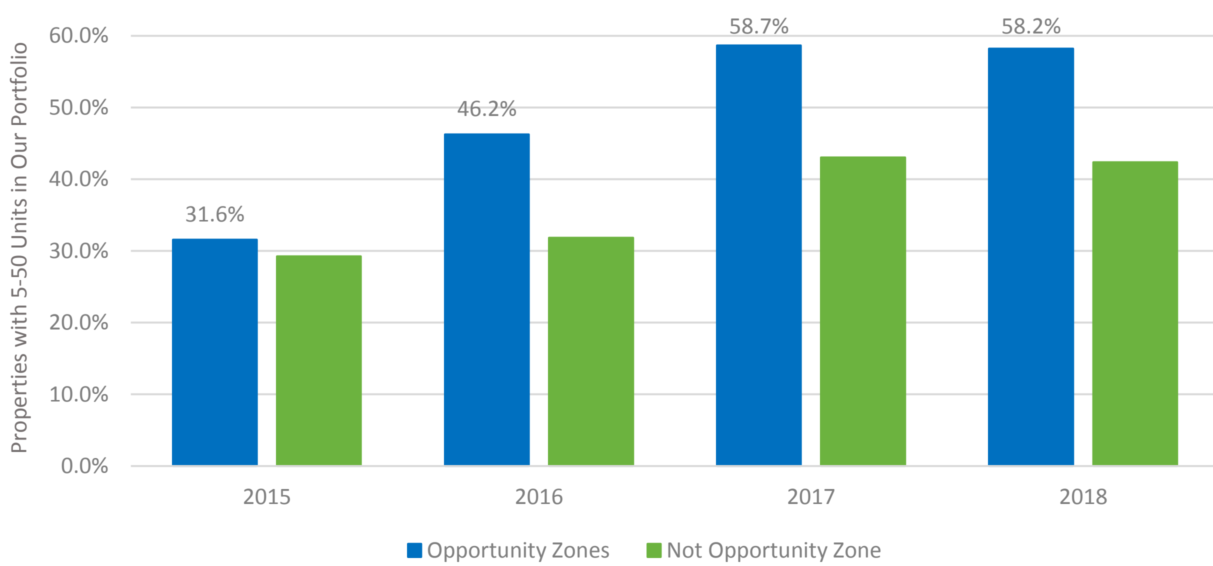
[vii] For this business line, we only have reliable data going back to 2013.
[viii] As defined by the Federal Housing Finance Agency (FHFA) for the purposes of Duty to Serve. Rural areas can be inside or outside of MSAs.

Property Size

Between 2010 and 2014, only 6.7 percent of Freddie Mac properties in Opportunity Zones and 4.3 percent of properties outside of Opportunity Zones had between 5 and 50 units. From 2015 to 2018, this jumped to 52.3 percent and 37.9 percent, respectively. In 2018 alone, the corresponding rates were 58.2 percent and 42.4 percent. Small multifamily properties generally have fewer amenities than larger properties and are better suited to serve low-income populations. Because of this, intuition would suggest that Opportunity Zones account for a relatively high percentage of our SBL deals.

While the number of 5- to 50-unit properties skyrocketed starting in 2015, the effect in Opportunity Zones and non-Opportunity Zones was not substantially different. The rate of 5- to 50-unit properties financed by Freddie Mac in Opportunity Zones after 2014 increased by a factor of 7.8 relative to the period of 2010 to 2014. However, the corresponding rate outside of Opportunity Zones was 8.8 times higher. From this, we see that Opportunity Zones have always had more 5- to 50-unit properties and that this trend became more obvious following the SBL program's launch. Exhibit 5 shows the percentage of 5- to 50-unit properties that Freddie Mac has financed in the last four calendar years. Prior to 2015, the highest annual percentage of small multifamily property loans either inside of or outside of Opportunity Zones was merely 11.9 percent (recorded in 2010).

Exhibit 5: Share of 5-50 Properties Since 2015



Source: Tabulations of Freddie Mac's Affordability Summary Database

Small multifamily properties provide affordable housing to a relatively high percentage of tenants, and thus the growth of this sector is crucial in the fight against the affordability crisis. From this analysis, we see that not only do Opportunity Zones consist of a disproportionally high percentage of SBL properties, but that the percentage has grown in recent years.

Conclusion

Opportunity Zones are communities that have been identified on local levels as being prime candidates for social and economic improvement as a result of increased investment. Investor interest in this initiative is already high and will likely continue to grow as more investors become aware of the opportunities for financial gain and social impact. If success is measured by the effectiveness of bringing new capital to these neighborhoods, then this initiative appears to be moving in that direction.

Our analysis shows that Opportunity Zones receive a high rate of housing assistance, especially for lower-income families in these areas. The census tracts that governors identified as being economically distressed and in need of capital infusion overlap quite well with areas that Freddie Mac targets for affordable housing assistance. Our mission is to promote housing affordability for families who struggle with high rental cost burden and our historical financing activity in these areas showcases our commitment to this goal.

Transparency helps a market operate efficiently, which is why providing market context should help to both optimize capital allocation and mitigate some risks associated for all stakeholders. Opportunity Zones will prove to be an interesting case study from both the perspective of real estate operators and local residents. As development activity begins and the results are tracked by both Freddie Mac and others in the industry, many lessons will likely be learned regarding best practices for community revitalization efforts in the future.

[1] Freddie Mac Tabulations of 2017 5-Year American Community Survey
[2] https://www.urban.org/sites/default/files/publication/98445/did_states_maximize_their_opportunity_zone_selections_7.pdf
[3] https://www.ncsha.org/resource/opportunity-zone-fund-directory/