

A Private Developer's Roadmap for

AFFORDABLE HOUSING

*Profitable Rental Apartment
Solutions in Canada*



A Private Developer's Roadmap for Affordable Housing: Profitable Rental Apartment Solutions in Canada

Derek Lobo, Apartment University

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Derek Lobo
Apartment University
905-331-5700
derek@derek-lobo.com
derek.lobo@rockadvisorsinc.com
RockAdvisorsInc.com

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Contributing Editor: Natan Ary
Proofreading: Geri Savits-Fine
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Dedication



I dedicate this book to all the courageous men and women
who put it all on the line to build rental apartments.

These people are my heroes!



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There has never been a more important time to get a project like this into the hands of apartment developers. It took time to bring together industry experts and craft a message that would directly impact the housing crisis and make affordable housing projects more enticing to the developer.

I would like to thank Natan Ary, Ismail Ibrahim, Mark Kay, Noor Khan, and Graeme Stewart for their insight and expertise. Our Rock Advisors team also played an important role in executing the webinars, in addition to the creation of this book. I am blessed with a great team who pull together content, expertise, knowledge, relationships, and skills to make my vision a reality.

I am thankful for all our clients and collaborators! I also need to continually extend my appreciation to Dan Sullivan, whose mentorship and friendship have been pivotal in shaping my strategic thinking and opening new avenues for me to explore both at work and at home.

Thank you all!

A Message from Derek Lobo



The documentary *Shelter: An immigrant story that helped shape a city*, is a chronicle of the immigrants who came to Canada in the '40s and '50s, many of them Holocaust survivors. Some of them went on to build half a million apartments in the city of Toronto during the '60s and '70s. This group of people, probably no more than 20 in all, organized fundraising events and created partnerships to build these apartments. Their example shows us what simple, good government policy and a conscientious private sector can do together.

Had these apartments not been built, I don't believe Toronto would be the city it is today. Just think of all the new Canadians who found attainable housing and proceeded to build themselves a commendable life.

Like many of you, I'm also an immigrant. Originally from Pakistan, my family—my parents and five children—came to Canada in 1966 when I was only eight years old. Surviving only on my father's meagre income, we were fortunate enough to find a decent place to live in the Jane-Finch area of Toronto.

That modest beginning gave us a solid foundation upon which to begin our lives in Canada. The reason I say this is because the first four or five years in a child's development are crucial to their continuing success as contributing members of society.

Coming into a new country, as we did, was a rebirth in many ways. We came to Canada for economic reasons. However, this country was far different from the one we came from. As

kids, having the stability our parents provided gave us all the time and nurturing needed to familiarize ourselves with, and understand, this new culture.

I think I knew it back then, but only on a subconscious level. As my working life progressed, the idea of being able to afford our first home was one of the key reasons we became productive Canadians.

However, that first home didn't materialize out of nowhere. Someone with vision and a keen sense of purpose built that home knowing they were providing an essential component of society's well-being. I believe my family is a personal testament to that.

It's interesting that I moved into one of those immigrant-built buildings. I joke and say, "I read my first lease when I was eight." That's because I helped my parents sublet it.

Of even greater interest, when I began working, it was for those same developers—who were then in their 60s—the ones that built the actual unit we lived in. It's no wonder I see myself as being born for this business.

Working in the private sector, I know that profit is essential. But I also know that having purpose is essential as well. My business experience has taught me that building attainable housing can be both profitable and fulfilling.

So, if you get off to a good start paying 30% or 40% of your income on good housing for you and your family, you're going to settle into life well. I believe solid grounding makes you a better and more productive Canadian.

On the Business Side

As a business person, it is my view that your return on equity from affordable housing can be greater than building conventional apartments for these reasons: 1) the sources of funds are more leveraged (i.e., lower equity percentage); 2) loan terms are more favourable; 3) lease-up is faster; and 4) the vacancy rate is lower, providing you go through the steps needed.

However, there's more work to do here. If we build enough attainable housing, we think many Canadians would have an easier start, and ultimately be more successful, pay more taxes, and contribute immensely to society in general.

Many of the housing built 30 years ago has now become attainable housing. But we're not building enough units today to satisfy the current demand, let alone the demand in 30 years. It's my view that attainable housing can only be addressed by an accelerated supply, which can only be delivered by the private market and coordinated governmental programs that simplify and streamline the process.

On the Word "Affordable"

I'm not sold on the word "affordable." It makes me think about metro housing from the '60s, '70s and '80s. This is not what's being discussed within this book.

A better description would be "workforce housing." This would be designed for working-class people with working-class jobs and incomes who are in the middle or the median range of Canadians—in essence, just regular people, but with a more limited disposable income than homeowners.

Introduction



By 2030 everyone in Canada will have a home that they can afford and meets their needs.

- CMHC



The affordable housing market is emerging as an exciting new opportunity for developers, and this is extraordinary for the housing industry. This market promises to quickly become an asset class onto itself. Two factors have come together to make this happen: political will and society's desire for environmental, social, and governance (ESG) responsibility.

The advantage will go to those developers, consultants, brokers, and architects who quickly realize the benefits of working with affordable housing. Those willing to invest time and resources to become programmatically organized can realize the potential profits of this new, and viable, asset class.

As with all emerging opportunities, there are both certainties and uncertainties. The certainties are:

- Strong and continuous demand
- Better financing terms are available
- Pressure on developers, institutions, and government to be socially conscious

Affordable housing fits into these certainties exceptionally well. The key is to generate some liquidity into this market beyond the current municipality-owned nonprofits and into a market where the private sector builds the housing, and the institutions buy and manage them.

The uncertainties are:

- Information is scattered
- The exit strategy
- Exit cap rates
- Education for institutional buyers
- Widespread decisions by municipalities to waive fees to improve the feasibility of private affordable housing initiatives

However, the availability of a learning portal (such as ours), where all pertinent information is readily available and well organized, will allow all stakeholders to always be on the same page. With all government programs detailed, interactions well documented, and sample financial scenarios available, it's far easier for interested parties to take advantage of this growing asset class. And with enough affordable housing being built, exit strategies will become clearer.

Knowing that finding tenants to fill the units is not an issue, buyers will become available. Affordable rental cap rates are equal to or lower than conventional rental market cap rates. However, the stability of tenant availability will help make investments profitable.

Institutional investors may be interested if they are brought into the picture once sources of funds for affordable rental projects are confirmed, or in place—the affordable rental investment then becomes very appealing. It's vital that developers beginning affordable housing projects become fluent with available programs and how they interact, and also understand that there is a viable financial opportunity in this asset class.

What you'll gain over the next five chapters is an early knowledge of the ins and outs of affordable housing for first-move advantage and an awareness that this is a long-term process that can be navigated successfully.

We'll cover:

1. Why developers should consider pivoting to affordable housing
2. Where and what to build
3. Government grants and financing for affordable housing
4. Working with municipalities and stakeholders
5. Developing a business plan to build affordable housing

The affordable market dilemma took years to create and will take just as long to solve. Still, we think governments are now open to developing policies that work for all stakeholders—allowing these policies and private capital to work together to develop an affordable rental housing boom, as was the case in the 1960s and '70s.

Though this is not a new idea, it's one that needs a concerted effort so developers can work within clear guidelines, enabling them to expand this asset class so it can grow quickly and continue in the longer term. This asset class will then fulfil the overdue affordable housing needs in Canada.



Why Build Affordable Housing?

Introduction

Why would a developer want to enter the affordable housing market?

First and foremost, there is an urgent need. The shift away from affordable housing that began in the 1970s, along with the changes in the housing market in general, has left an unfilled gap resulting in many individuals and families unable to find decent affordable housing.

Secondly, we think that once the affordable market gets going, there will be sustainable market liquidity. This is important because you can only develop an asset class once there are buyers, sellers, and support from the trades, consultants, and ancillary services.

Thirdly, with a stable supply of renters, the affordable housing fundamentals are stable and recession proof. There is an exceptional debt environment, in general, with funds available for affordable housing featuring lower rates, and longer terms and amortization periods.

With these fundamentals in place, there is an opportunity for merchant developers to build wealth and a portfolio of

long-term stable assets for their family and for generations down the road.

Our company has made a commitment to enter this asset class because it's an important investment in the growth of Canadian housing. We see a programmatic opportunity to build affordable apartments where the stability is extraordinarily high, and the returns are likely better than expected. We believe that as a company and as an industry we should all turn our attention to affordable housing.

Risk During a Recession

Of all the asset classes in the industry, affordable housing has been affected the least.



Figure 1.1 - Asset Risk by Class

We feel the affordable housing class gives the economy and industry stability. However, developers must also have bandwidth and see a future in that market.

The onus on all levels of government is to get together and streamline the process. The 2021 political platforms from Canada's two largest political parties emphasized the need

for this to happen. The private sector must then respond by designing and building affordable housing. However, there are challenges that must be overcome.

Is Affordable Housing a Human Right?

Canada's main political parties believe affordable housing is a human right. In his speeches, Prime Minister Trudeau has said so. Once housing is formally designated a human right, its definition and surrounding obligations change.



Figure 1.2 - Is Housing a Right?

The UN also considers housing a right. It has reported that the responsibility of housing is the responsibility of the state. If the state is supposed to provide housing, a nation becomes responsible to house its people.

Environmental, Social, and Governance (ESG)

ESG is an umbrella concept guiding businesses.

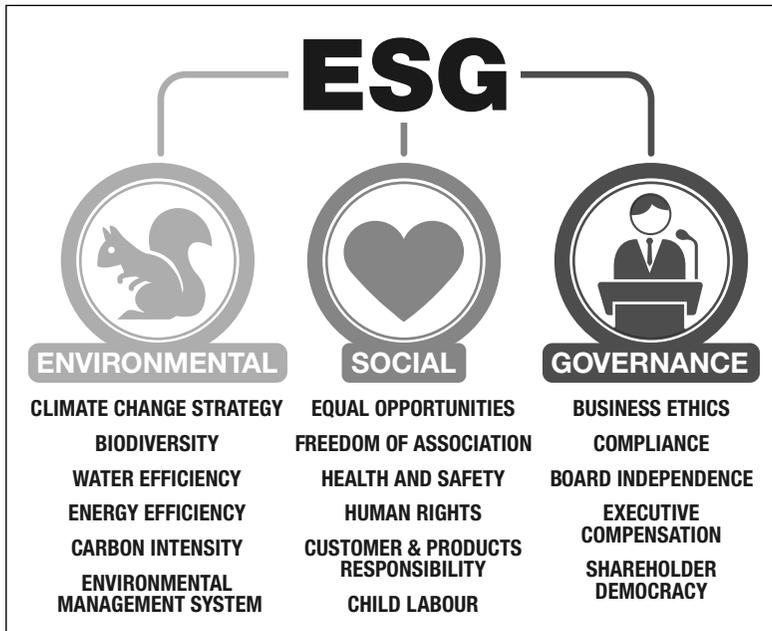


Figure 1.3 - ESG

Though many institutions, public companies, and governments are actively talking about ESG, there is a significant cost to implementing its principles.

Affordable housing fits well into ESG's purview. In our opinion, there's going to be a lot more effort put into building social and affordable housing for low- and middle-income earners in Canada. This is an excellent opportunity for developers and all those that support this industry.

The Current Situation

The current situation and housing environment in the US is not the same as in Canada. The affordable market is well established in the US. In Canada, it is not. For a variety of reasons, Canada must create its own solution to its affordable housing crisis. We feel that, under the current government programs, we are creating our own long-term solution.

The United States

In the US, there are two types of affordable housing: Section 8 and Section 42 Housing. What's important is that affordable housing trades. Once it trades, it results in liquidity.

	SECTION 42	SECTION 8 VOUCHERS
Administrated by	State Housing Credit Agency	Federal (HUD)
Maximum family income	60% of area median income	50% of area median income
Minimum family income	0% of area median income	0% of area median income
Rent restriction	30% of area median income	Market rent
Lock-in Period	30 years	N/A
Profit realized from	Development process	Operation process
Ability to generate NOI	Limited	Strong
Investment return	Fixed at inception	Varies with market situation

Figure 1.4 - Affordable Housing in the US

There's a fraternity of people who work in the affordable housing sector: developers, consultants, lawyers, buyers, and brokers. A developer can build, make a decent profit, then have someone buy the project as a core holding for themselves, or it can be put into a fund or a public company.

Canada

This type of active and sustainable market may soon develop in Canada. But as of now, the transactions related to affordable housing have been few.

Over the last 20 years of transactions, the phrase affordable housing was mentioned in the building description only 40 times. Only 20% of those 40 were between private sector buyers or sellers. All the rest were from nonprofit to nonprofit. However, we think that is going to change.

Getting ahead of that trend can be a significant business opportunity for developers. We sense that we're on the cusp of this change. Our business case is that we predict there will be much more affordable housing built, funded, and, if set up properly, transacted.

Liquidity Is Key

The key to affordable housing, and a unique problem for Canada, is liquidity. In the United States, affordable housing can be built knowing a group of buyers is available. Those buyers then purchase the development and allow developers to move on to the next project, as done in the commercial market.

Without liquidity we don't think we're going to see a lot of affordable housing built because developing apartments is a cash intensive business. Developers need to, and want to, keep their money active.

Example One: Liquidity

This is an example of liquidity and how it is changing in the apartment sector.

If a developer builds 100 units in Toronto, Vancouver, Calgary, or Montreal, they're going to get a fair number (10 to 15) of buyers for that project if they lease it up. But if they build that same project in a smaller market like Peterborough, Stratford,

or North Battleford, Saskatchewan, they will attract fewer buyers. Therefore, the price for the same type of building is going to be less in those smaller centres. Additionally, the cap rate is going to be higher because there is less liquidity. So, with liquidity comes cap rate compression and price increase.

To enable affordable housing to flourish, we will have to create a policy where affordable housing can be built by developers, then owned by the private sector and institutions while remaining affordable. That liquidity will allow cap rates to go down because there will be more buyers at the table.

The point we are making is that, in this last economic downturn, we've seen some groups afraid to invest in high-end buildings located in the downtown core. The same groups are now buying in secondary and tertiary markets, bringing liquidity to those smaller centres. As a result, we'll see more cap rate compression as more buyers come to the market.

If we can create liquidity in the affordable housing sector, there's going to be much more money available and a lot more affordable housing built.

Example Two: Student Housing

We have been involved in Canadian student housing from the very beginning. We've conducted seminars, consulted, and completed brokerage. At first, there were very few buyers. But as the buyers increased, the cap rate compressed.

Student housing is still a secondary- and tertiary-type business; it's not a primary business in Canada yet, but as of late, there have been some positive signs. The gist of it is, if enough product is built, the buyers will be there.

The problem we encountered with student housing is this: pension funds were not interested in buying only one or two

student housing assets—they wanted to see a market like that of Europe and the US where there were many assets to choose from. In essence, it was a chicken-and-egg situation, with developers saying, “Is there a buyer?” and buyers saying, “Are there enough developers?”

However, we believe that with smart policy changes and good financing, liquidity can be brought to the affordable housing sector.

Example Three: Rethinking the Market

Dream REIT has created the Dream Impact Trust for affordable housing. We have completed several studies for this company. They partnered with private developers to build a large redevelopment deal in Toronto's West Donlands.

The client was bound by specific development agreements. Therefore, in the feasibility study, we had to rethink this market in terms of unit sizing, amenity provisions, parking, and market rents versus affordable rents.

Incentives

Incentives at the time of writing:

City of Toronto

1. Open Door
2. CreateTO Housing Now

Provincial

3. Home for Good Program
4. Affordable Housing Lands Program

Federal

5. National Housing Strategy (NHS)
6. National Housing Co-Investment Initiative Fund
7. Rental Construction Financing Initiative (RCFi)
8. CMHC Co-Investment Fund
9. MLI Affordable Flex
10. MLI Market Rental Construction
11. CMHC Incentives: Predevelopment Seed Grants and Loans
12. Other: FCM/grant support for sustainable housing and energy efficiency

Joint Provincial-Federal

13. Canada-Ontario Housing Benefit (COHB) Program
14. Investment in Affordable Housing for Ontario Program

Becoming Business as Usual

Building affordable housing is only going to be successful if it scales to the private sector. How do we unlock the huge amount of land assets we have throughout the region and throughout Canada? Much of this relates to deep retrofits, resilient housing, and complete community redesigns.



Figure 1.5 - Affordable Housing Retrofits

The older apartment boom of this country rivalled any similar apartment boom on the continent, resulting in significantly more multi-residential units built per capita than in the US during this period. At that time, Canada got the policy mixture right to create an enormous private-sector-led housing boom.

Three Key Factors

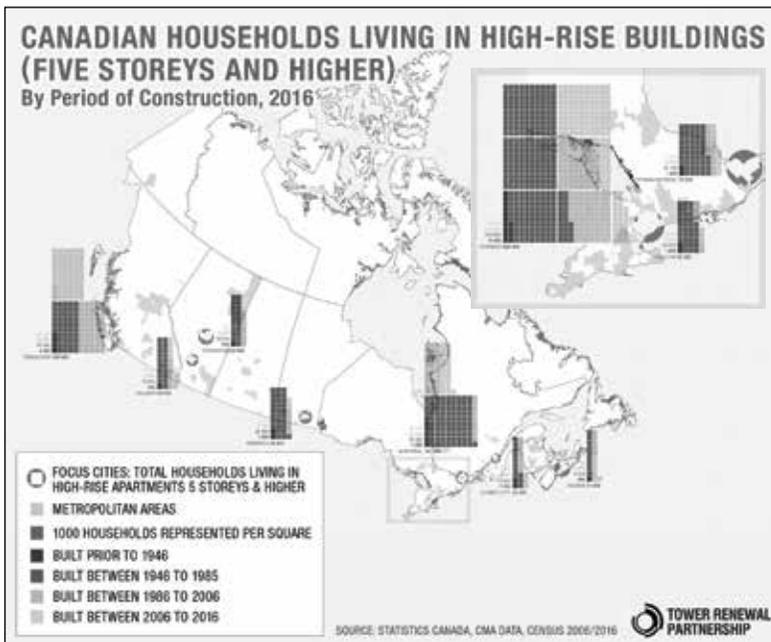


Figure 1.6 - Canadians Living in High-rises

We had regulations stating Canada needs this housing everywhere in terms of: 1) economic policy; 2) favourable taxation from the federal and provincial governments; and 3) a development industry ready to meet demands of a quickly growing country. More than half of all existing high-rises across the country were built before 1980. These still form the bulk of what currently exists.



Figure 1.7 - Retrofit Development

Development stopped in the early 1980s due to many factors. One factor was a tax change that made building unfavourable. As a result, Cadillac Fairview omitted entire portfolios, stating it no longer made economic sense. However, that tax change can be reversed to make affordable housing attractive once more.



Figure 1.8 - Tower Renewal Advisory Network

The Tower Renewal Partnership has many partners focused on optimizing our housing resources—particularly opportunities for more affordable housing development.



By 2030 everyone in Canada will have a home that they can afford and meets their needs.

- CMHC

This is a radical statement—and we have just a very few years left to meet this goal. This drive has led to billions of dollars on the table from different departments of the federal government, CMHC, Canadian Infrastructure Bank, and others. More funds are also on the way as comparable provincial programs. This is money that stakeholders can use to find ways of making development projects more palatable.

Housing Rehabilitation

From the preservation and retrofit space, the figure below shows a recent project turning an older apartment into a net-zero building. It shows the level of government commitments needed to make this happen.



Figure 1.9 - Older Apartment Retrofit Into a Net-Zero Building

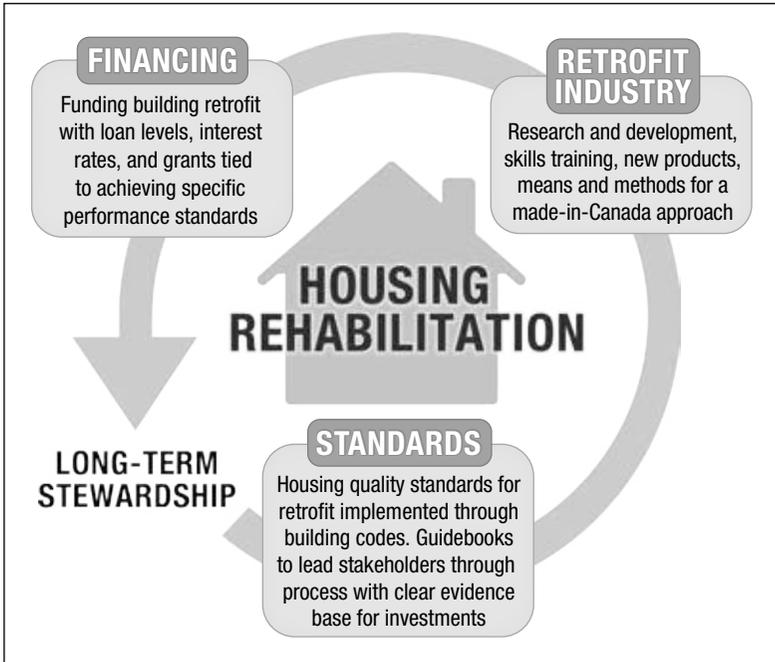


Figure 1.10 - The Financial Environment

This is really about the right financial environment, building to specific standards, and making sure that we have industry readiness to bring workers to the table.

We think we know that there are certain indicators showing the market is changing in some spaces—there’s an endless supply of opportunities and endless renter demand. This is an important change.

Case Study: Surplus Land

One area of focus is surplus land. For an owner of an asset with surplus land, significant opportunity exists.

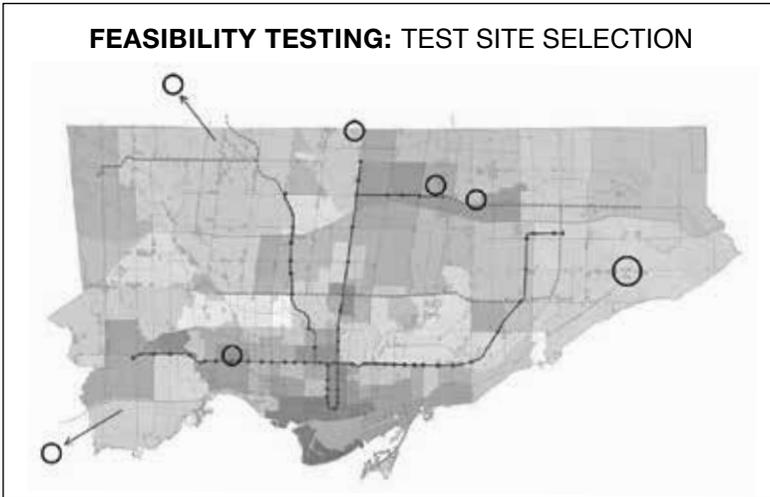


Figure 1.11 - Finding Test Sites

Astoundingly, there is more than 2,000 hectares of surplus land associated with older buildings that can be developed within the Greater Toronto Area (GTA) alone. These surplus lands are prime for affordable rentals as demand in these locations has been proven and they are in heavily populated areas. A block-planning study can be completed at the outset to maximize the potential density of the surplus land.

The following pages show an analysis we performed for the province examining best practices to make this happen.



Figure 1.12a - Spaces Available to Retrofit

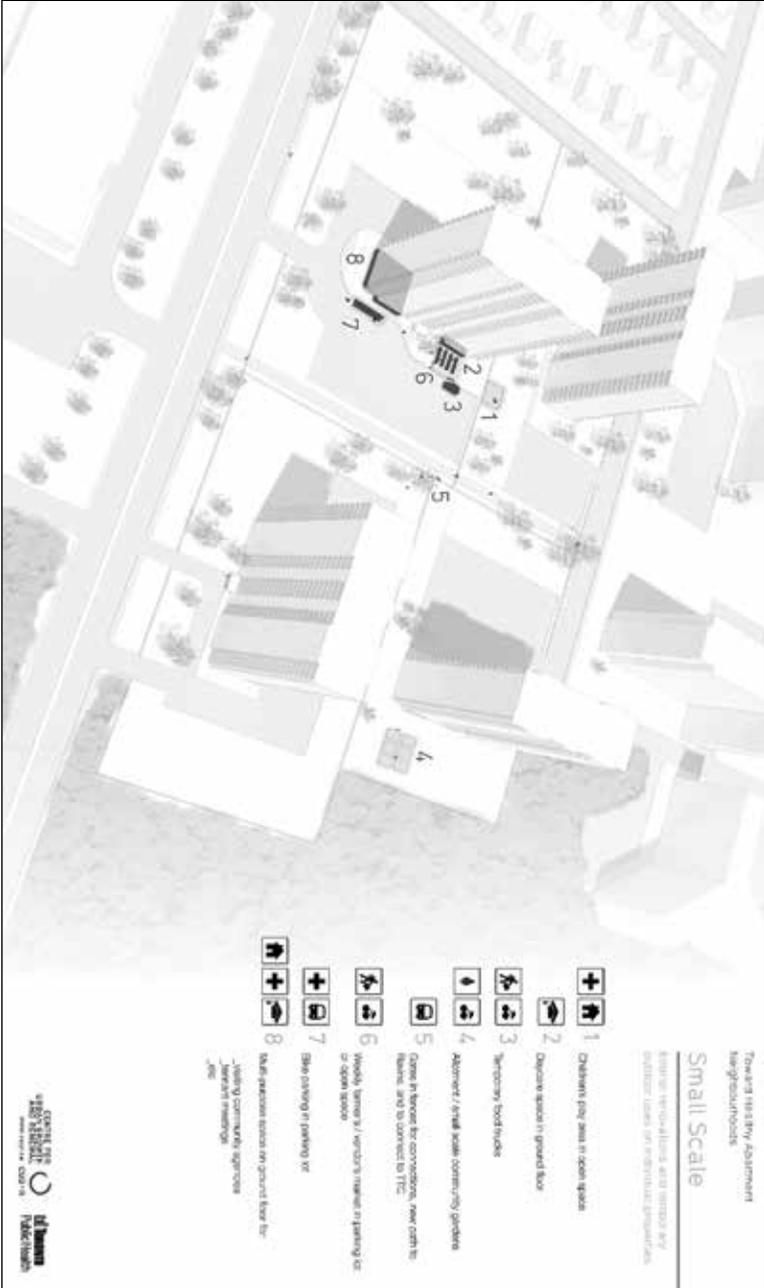


Figure 1:12b - Spaces Available to Retrofit

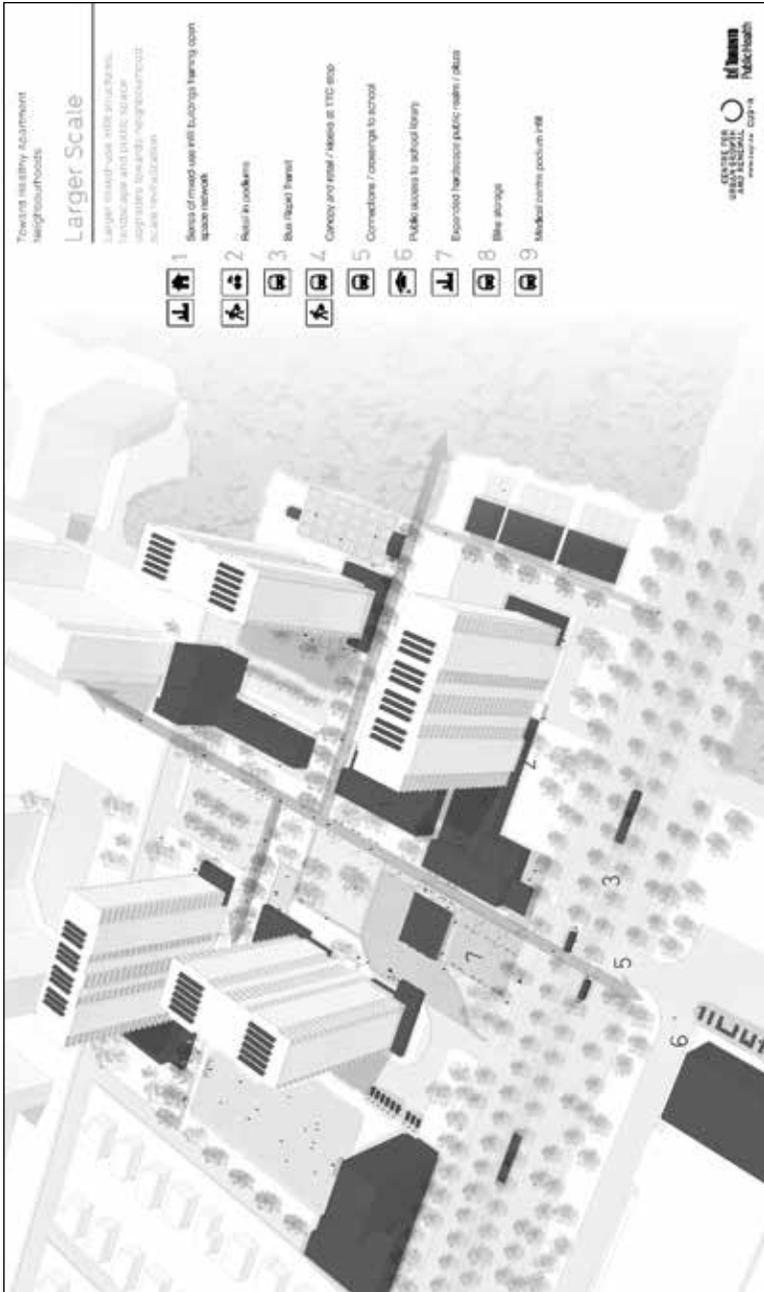


Figure 1:2c - Spaces Available to Retrofit

There are many examples from the UK and elsewhere—one is shown below. In effect, when the policy alignment is right, there are many places to build beyond those stuck in the centre.

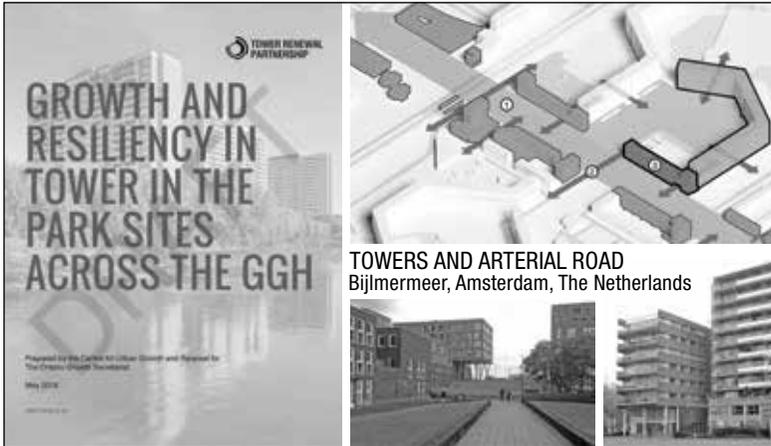


Figure 1.13 - A European Example of a Retrofit

Outside of central locations, such as Peterborough or peripheral regions of the GTA, or other large cities, there's more resilience for affordable rentals because land values are lower. However, rental rates are also lower. Risk is reduced by bringing affordability versus the absorption rate for luxury (which might be lower in some of these peripheral zones).

Case Study

The following case study compares three projects: a project with 100% condo, one with a mix (70/30) of market/affordable that met all the program criteria, and one with 100% affordable rental.

By stacking some of the available incentive programs, you can still make the returns you're expecting. If a joint venture is created with a landowner, some of the land costs go down, making it even more financially favourable.



Figure 1.15 - Development Analysis

Conclusion

There is a huge opportunity here. I would encourage developers to take a close look at all current programs. If you are an owner, leveraging the sites you own and making partnerships with the municipality also helps. It benefits everyone if you are viewed as part of the housing solution.

Many apartment owners have older buildings with excess space that can be utilized for more density. However, these people are now second- and third-generation owners—no longer the original builders. They would make good joint venture partners for developers (who can bring their development skills to the table). Owners have property management skills and land. Often, the land is enough equity to build the deal, with the right kind of capital stack in place.

What we find most interesting is, part of the capital stack could be seed funding and grant funding. However, a municipality may have reasons to oppose such a project because of Yellow Belt policies that under-zone these properties. However, by bringing affordability to the table, the municipality might be amenable to see these projects through because they align with their affordable housing push.