Small Rental Project Financing

Presented by:

Franke Consulting Group

Under contract to DHCR/HTFC

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Workshop Objectives

1. Understand how to construct detailed development & operating budgets for affordable rental housing
2. Explore financing alternatives for small rental projects and working with lenders

Review – Last Seminar

- Is your organization ready?
- Have you selected a “good” project?
- Does the project appear to be feasible (i.e, what is the size of the gap)?

The Budgets

Development Budget

Sources:

- **Equity**
- **Debt**
- **Dev. Subsidies**

Uses

- **Acquisition/SI**
- **Construction**
- **Soft Costs**
- **Working Capital**

Operating Budget

Revenue

- **Gross Potential**
- **Vacancy/CL**
- **Eff. Gr. Income**

Op. Expenses

- **Admin/Mgt**
- **Maintenance**
- **Taxes/Util/Insur.**
- **Reserves**

NOI

NADS

Cash Flow

A Detailed Look At The Development Budget

Purposes of Dev Budget

- Estimate & classify costs (“uses”)
  - Help to identify ineligible costs
- Document funding “sources”
- Help determine feasibility & amount of public subsidy required

HTFC Development Budget

USES	Amount
A. Acquisition Costs (land & structures)	
B. Soft Costs 4. Appraisal 5. Consultant 6. Survey & Soil Borings 8. Asbestos/LBP Testing 9. Architectural/Engineering 10. Construction Manager 11. Legal fees 12. Nonprofit Developer Allowance 13. Cost Certification 14. Insurance & Taxes 16. Interim interest 17. Closing costs, Title, Recording fees 19. Relocation 20. DHCR/HTFC fees	

HTFC Development Budget

USES (cont.)	**Amount**
C. Construction/Rehabilitation	
23. Site Work	
24. Demolition	
25. Asbestos Removal	
29. Residential Construction	
33. Performance Bond Premium	
34. General Requirements	
36. Builder's Overhead	
37. Builder Profit	
39. Construction Contingency	
40. Developer's Fee	

HTFC Development Budget

USES (cont.)	**Amount**
D. Working Capital 42. Initial Operating Deficit 43. Supplemental Mgt Fee & Marketing 44. Purchase of Equipment	
E. Project Reserves 47. Capitalized Operating Reserve 48. Capitalized Replacement Reserve	

HTFC Financing Information

SOURCES	Amount
53. Equity a. Cash b. Land	
54. Sources of Construction Financing a. b.	
55. Sources of Permanent Financing a. b.	

Construction Cost

- Progress level of detail & type of estimate as project planning proceeds:
  - Preliminary feasibility estimate: ave. cost PSF
  - Then a line item budget based on arch drawings or scope of rehab (increasing detail/accuracy):
    - architect’s cost estimate
    - contractor estimate
    - independent cost estimate
    - contractor bids

Construction Cost, cont.

- Primary determinant: scope of work
- Regulatory factors affecting constr cost:
  – Property standards, codes, useful life
  – Davis-Bacon Act
  – Procurement (M/WBE, EEO, Section 3)
  – HTFC: DSU Design Standards
- Builder Overhead & Profit
    - HTFC: BO: 2 – 4%; BP < 10%
- Contingency (HTFC: < 5%)
  – For small rental (esp rehab), 5% may not be adequate

Soft Costs

- Non-acquisition/construction costs
  - Professional fees
    - Architectural/engineering
    - Other: legal, accounting, env review
  - Financing fees/costs
    - Application, appraisal, commitment pts, closing
    - Acquisition, construction/bridge, permanent loans

Soft Costs, cont.

- Construction period expenses:
  - Operating costs during dev phase
  - Constr loan interest
  - Insurance, utilities
  - Interim management
- Construction supervision/inspections
- Marketing
- Developer Fees (incl. consultants)

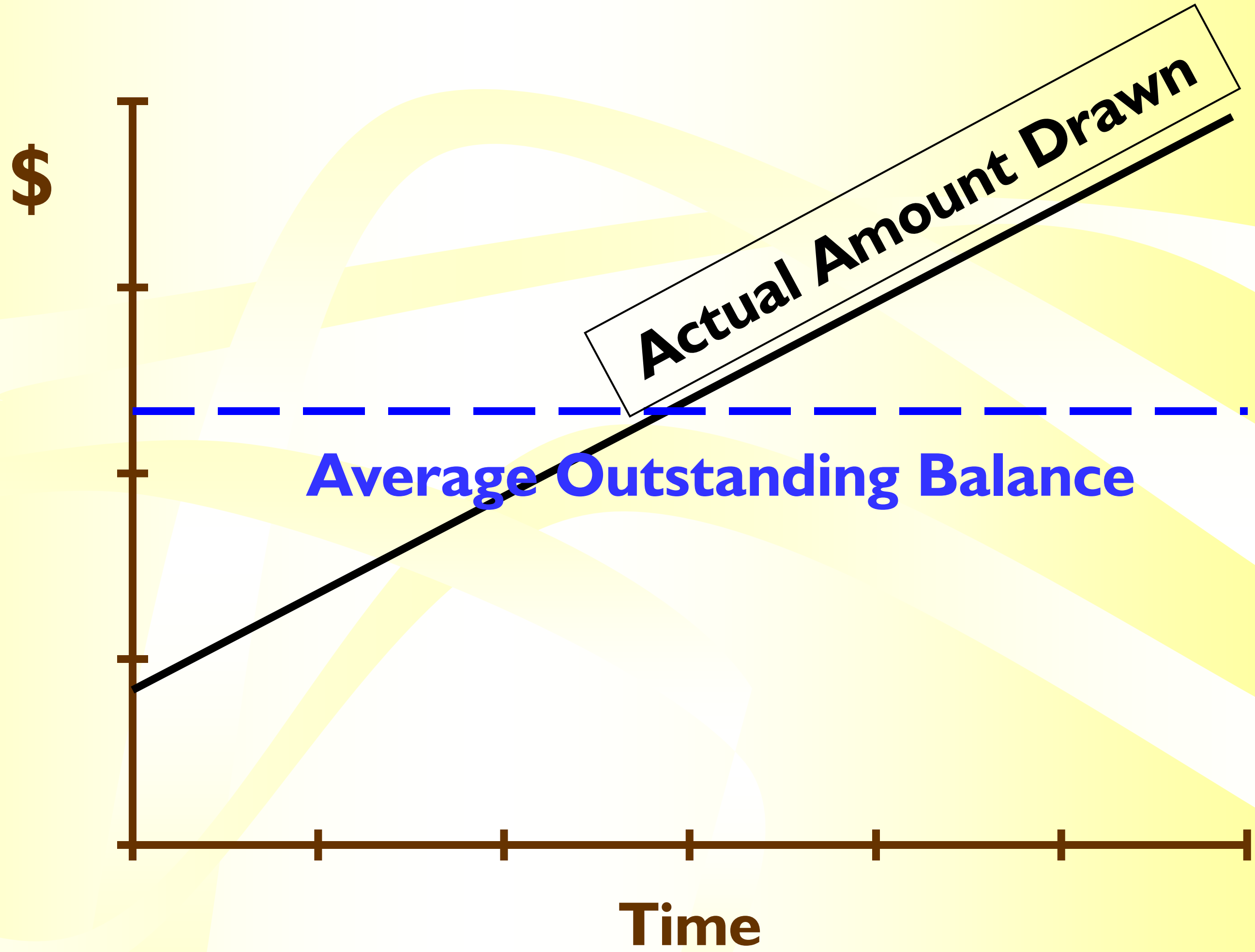
Soft Costs, cont.

- Working capital & capitalized reserves
  - Start-up costs: deposits, furnishings, equipment
  - Lease-up Reserve (Initial Operating Deficit): operating expenses during lease-up
    - Based on absorption rate & break-even occupancy
  - Operating Deficit Reserve: operating shortfalls
    - Sometimes incl. debt service or separate reserve
  - Replacement Reserve
    - Capitalized if cash flow can't support or near-term improvements anticipated

Estimating Soft Costs

- Typical range 20 – 30% of hard costs
  - Depends on project/financing complexity
  - A+E: 4 – 10% of hard costs
  - Developer fees: 5 – 15%
    - Smaller projects v. large projects
    - Complex projects v. simpler projects
  - Financing fees/costs: 1 – 2% of loans
  - Construction interest:
    - estimate interest for 55 – 65% of max loan amount for constr period

Construction Loan: Interest



Cost Reasonableness

- What determines reasonable soft costs:
  1) Program standards (state/local policy, regulations, OMB Circulars)
  2) Prevailing costs in region
     - Use guides, local experts, comp. projects
     - Adjust benchmarks to your project
- Cost certification may or may not be required, but may make sense in larger project as verification

Development Costs Summary

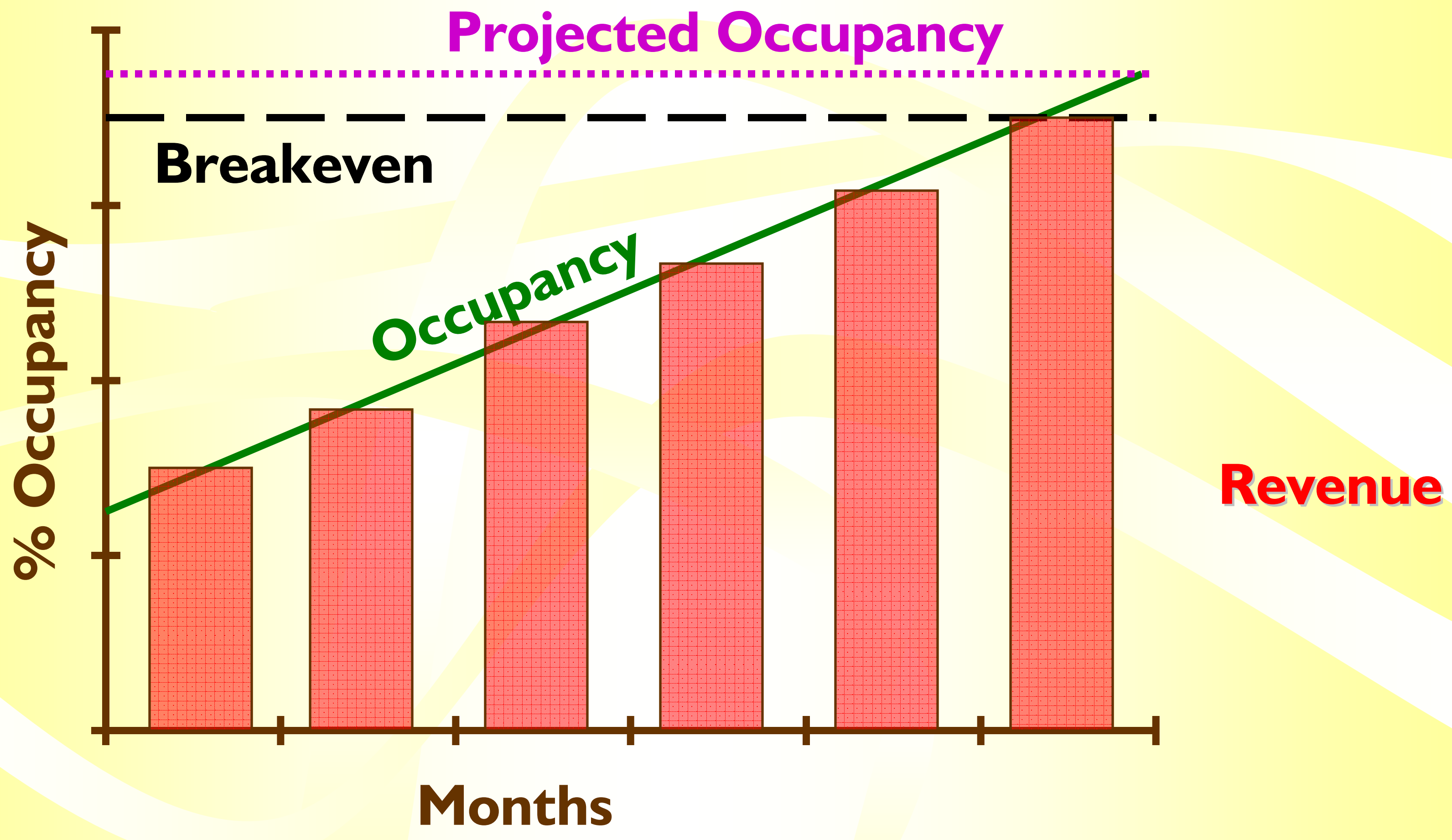
- Progressively more detailed estimating, culminating of bids
- Don’t underestimate or leave out costs just to make the gap smaller
- You will be responsible for costs not included

A Detailed Look At Operating Budgets

Types of Operating Budgets

- Lease-up
    - Start-up to sustaining occupancy
    - Forecast initial operating deficit
- Stabilized or full occupancy
- Long-term pro forma
    - Project viability over 5 – 20 yrs

Lease Up Budget



Stabilized Operating Budget

- Income & expenses at sustaining (“full”) occupancy level
- Used by lenders to determine amount of financing (and property value)

Lease-Up v. Stabilized Budget

	Lease-Up	Stabilized
Gross Potential Rent	$ 180,000	$ 180,000
Rent Loss	$ (45,000)	$ (12,600)
Other Income	$ 900	$ 1,800
Effective Gross Income	$ 135,900	$ 169,200
Operating Costs	$ (100,000)	$ (111,402)
NOI	$ 35,900	$ 57,798
Debt Service	$ (50,259)	$ (50,259)
Cash-Flow	$ (14,359)	$ 7,539

GPR → EGI

Gross Potential Rents (GPR)

\+ Other Income*

Gross Annual Income

\- Vacancy/Coll. Loss (5%+)

Effective Gross Income (EGI)

EGI → NOI

Effective Gross Income (EGI)

\- (Expenses)

\- (Reserve Payments)

Net Operating Income (NOI)

\- (Debt Service)

Cash Flow

Rents & Revenue

- Choose the appropriate rent levels based on:
  - What is **necessary**?
    - Min Rent to Cover Op. Exp + Debt Serv.
  - What is **permissible** (by program)?

    Maximum Rent

    - Utility Allowance

    Max. Contract Rent
  - What is **affordable**?
  - What is **market-supported** (“street rents”)?
  - What gives room for future increases?

Rents → Revenue

- Mix of income levels
  - Increasing income while keeping some units affordable
- Estimating vacancy/collection loss
  - What's a reasonable rate for your market?
- Commercial rent revenue (mixed use)
  - Vacancy rate may be different
  - Consider management challenges; marketing
- Other income
  - Interest, forfeited deposits/damage charges
  - Incidental income (e.g., laundry machines)

Estimating Expenses

- Progressive levels of detail:
  - Start with rules of thumb: PUMs & PUPAs
  - Move toward line item estimating
- Key Operating Expenses
  - Management/Administration/Marketing
  - Maintenance & Repairs
  - Taxes, Insurance, Utilities
  - Reserves

Management/Admin/Marketing

- Management fee or staff
    - if staff, payroll & taxes/benefits (~30% of salary)
- Office expenses (supplies, phone, etc.)
- Legal, audit and professional fees
- Marketing:
    - – Initial marketing in development budget
    - – Ongoing marketing in operating budget
    - – Usually nominal amount for some advertising
    - – Affirmative marketing may be required

Utilities

- Costs paid by the property
  - Vacant units
  - Common areas
  - Master metered utilities
- Tenant paid utility allowance may impact rent
- Utility company info or benchmark against other comparable properties

Maintenance

- Think “planned maintenance”
- Costs:
    - Maintenance contracts
    - Seasonal preventive maintenance
    - Annual unit inspections
    - General repairs & janitorial
    - Turnover of vacated units
    - Grounds maintenance, trash removal, pest control
- “Capital” repairs usually paid out of capital budget or reserves, not operating budget

Real Estate Taxes

- Based on assessed value
  - Get information on comparables from assessment office
- Affordable properties sometimes offered:
  - Tax abatement, or
  - Payment-in-lieu of taxes (e.g., a fixed percentage of revenue)

Insurance

- Casualty insurance-full replacement value
- Liability insurance
- Fidelity bonding for on-site staff handling funds
- PJ should be named as an additional insured

Reserves for Replacements

- Deposits for future capital expenditures
- Approaches to budgeting reserves
  - Some use standard rule of thumb (e.g., $250 – 300 per unit per annum; or .5 % of TDC)
  - Property-specific capital needs assessment or useful life analysis
- Contribution affected by level of improvements (& planned maintenance)

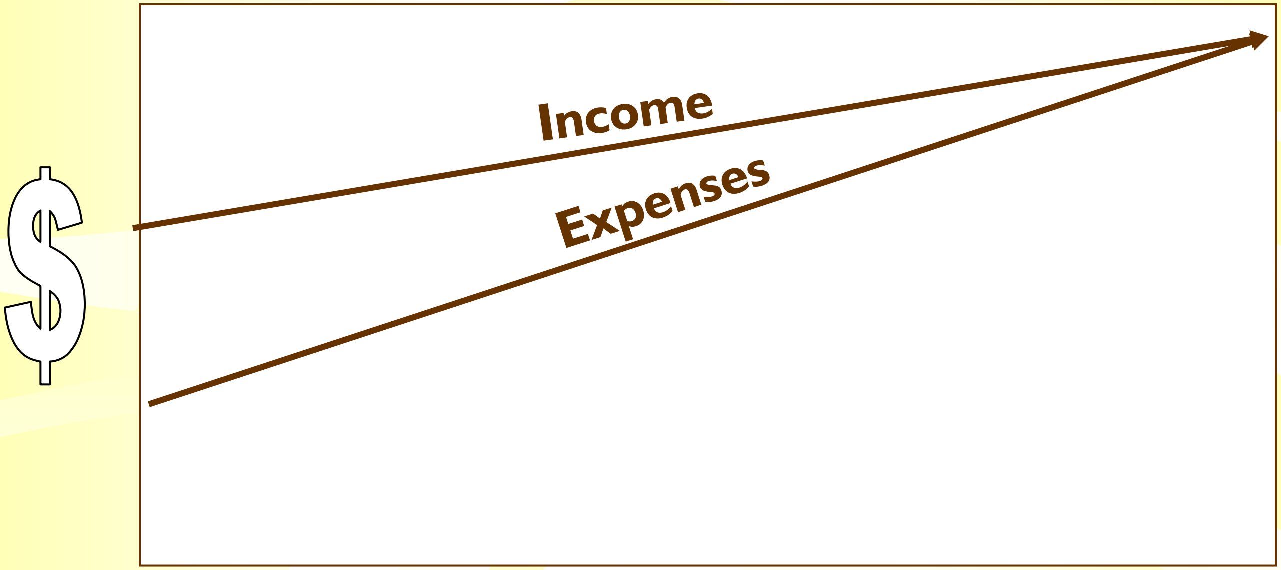
Operating Reserves

- On-going reserve in case income shortfall
  - Not the lease-up reserve (initial op deficit)
- Funding – combination of:
  - Pre-funded out of capital budget &/or
  - Monthly contributions
- Typical goal:
  - build up 3 – 6% of operating budget
  - 2+ months of debt service

Long-Term Operating Pro Forma

- Usually 5 to 30 year pro forma period
  - HTFC: 5 yrs
- Based on market/straight line trends
  - Usually 1 – 2 % rents; 3 – 4 % operating expenses
- Helps lender analyze:
  - ability to amortize loan over time
  - adequacy of reserve buildup
  - revenue/expense **crossover**

The “Crossover” Point



How Should You Use It?

- Use to plan/implement rent increases
    - Small annual increases better than big single change
- Update spreadsheet: current budget/actual
- Watch for crossover point under 5 years
    - Test different levels of increase in rents, look for cost controls
- Also plan for debt service adjustments or refinancing

Final Thoughts: Op. Budgets

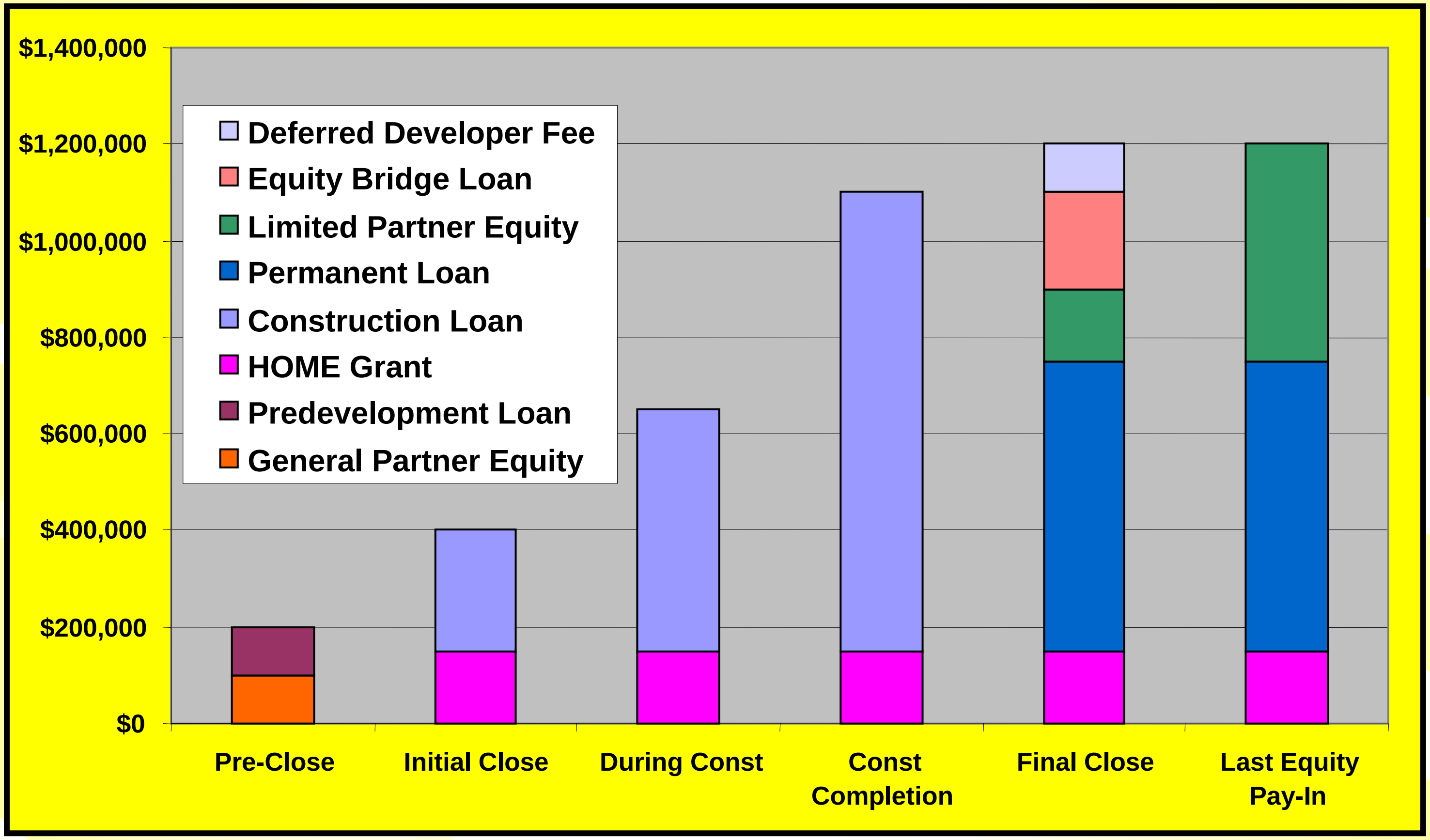
- Can you contain costs?
  - Operating costs
  - Development costs: procurement
  - But don't be unrealistic or hide costs
- Are you planning for reasonable rent increases?
- Don't forget to treat reserves and mgt fees like third-party expenses that have to be paid each month
  - You can't serve if you don't survive

Financing the Deal & Working with Lenders

Major Financing Phases

- Pre-development
  - Equity/capital advances & pre-dev loans
- Construction financing
- Permanent financing
  - Conventional/primary loan
  - Gap funding from public agencies & foundations
  - Possible equity/bridge loans (syndication)

Financing Changes Over Time



Will funds be available when needed?

Construction Financing

- Pays for construction costs till perm closing
- Less than perm $ -- usually 80 - 90%
    - Some costs deferred to permanent closing: perm fin costs, partial dev fee & some working capital items
- Often a package deal with permanent lender

Construction Lenders

- Public agencies: may/may not do constr lending
  - Construction lending requires staff capacity, underwriting & risk management
  - Unless financing not otherwise available or need to reduce interest cost
  - May opt for private lender to administer loan
- Conventional lenders like to do this lending:
  - Short-term lending
  - High interest rate
  - Underwriting & management structure in place
  - Risk mgt: bonding, insurance, letters of credit/ guarantees, structured draws & retainage, takeout loans

Permanent Financing

- Takes out construction loans
- Usually some primary financing – conventional or public (MRB)
- Public subsidy to fill gap
    - Gap can be large when no Tax Credit equity

Computing Permanent Financing

1. Determine Net Operating Income (NOI)
2. Apply Debt Coverage Ratio (DCR) to determine maximum mortgage debt
3. Determine LIHC equity or Other Debt
4. Determine TDC
5. TDC - Debt/Equity Sources = Gap

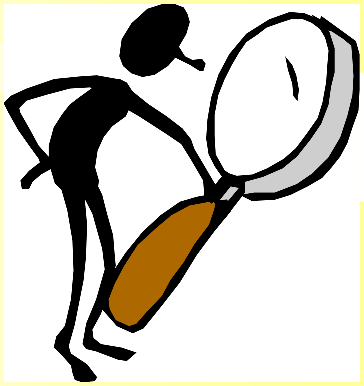
Primary loan

- Sources: conventional lenders, MRB, other public
- Shop around as terms vary in comm lending
  - Permanent lender may require constr loan as well
  - Terms are negotiable
- You’ve got to think like a lender

Key Lender Metrics

- Loan-to-Value
- Debt Service Coverage
- Developer Liquidity
- ROI or Breakeven Analysis

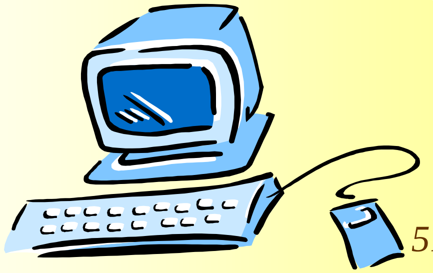
Loan to Value



- Collateral Value
  - Loan to value (LTV)
    - Loan amount/fair market value
    - Usually no more than 60 -80% for rental
  - Total loan to value (TLTV)
    - All debt (amortizing & deferred): value
  - Appraisals

Debt Service Coverage

- Only a % of NOI assumed available for debt service
  - Revenue/expenses estimates can be wrong
  - Cash flow as return on equity
- Debt service coverage factor: 1.05 – 1.3



Equity & Liquidity

- Equity contribution
- Liquidity – esp if no equity
  - Developer needs cash to advance for costs until reimbursed
  - Typically, 5 – 10% of total development costs
  - Lenders look at balance sheet, cash on hand
- Developer fee deferral & guarantee

ROI or Breakeven Analysis

- ROI – analysis of cash flow and rate or return on equity invested
  - Diff methods: cash-on-cash, IRR
- Breakeven point – if no equity
  - Occupancy level at which revenues cover expenses
  - If projected occupancy level (i.e., adjusted for vacancy/collection loss) to breakeven spread is too small (e.g., less than 5 points), a high level of risk assigned

Capital Gap Sources

- HOME
- Tax Credits – larger projects (or pool)
- CDBG (local or Small Cities)
- USDA Rural Development (former FmHA)
- State MRBs, HTF & Other
- FHFB Affordable Housing Program (AHP)
- Other: Foundations: grants & PRIs
- Owner contributions/equity

Types of Rental Gaps

<u>Capital Gap</u>

- Costs in excess of maximum available debt and equity
  - Inability to repay
- Usually funded by public soft loans or grants:
  - Deferred
  - BMIR
  - Cash flow basis

<u>Affordability Gap</u>

- Operating costs & debt service > what LI renters can afford
- Rental assistance:
  - Project-based
  - Tenant-based

Affordability subsidies

- Project-based – not many available
  - 202/811 & RD
  - SRO, McKinney, special needs
  - PHA conversions of certificates
- Tenant-based
  - Existing certificates/vouchers
  - Welfare to Work; Self-Sufficiency
  - Mark-to-Market, HOPE VI, etc
  - HOME TBRA

Working with Lenders

- Lenders think in terms of underwriting
  - Developers need to anticipate lender concerns
- Underwriting is risk assessment
  - Market, borrower, project (& portfolio)
  - Public lenders also consider public purpose, affordability, compliance & gap/layering analysis
- Working with lenders
  - Disclosure & communication
  - Negotiation

Putting It All Together Activity

Some Final Thoughts

- Never forget the market! Development is an economic activity, not a social one.
- Keep it real – don’t force-fit the numbers & don’t omit costs.
- Think like a lender.
- The project will be a long-term & visible legacy – think viability, not just feasibility.
- Be prepared to walk away!
- But if you have a project that is feasible & viable, full steam ahead.

Wrap Up

- Evaluation
- Future Seminars:
  - May: Joint Ventures & Partnering
  - June: Homebuyer Projects
  - July: Property Management
  - August: Designing Energy Efficient Housing Projects (ICF)
  - September: HOME and LIHC Compliance (ICF)