Development Seminar Series Workshop 4: Rental Project Budget & Finance

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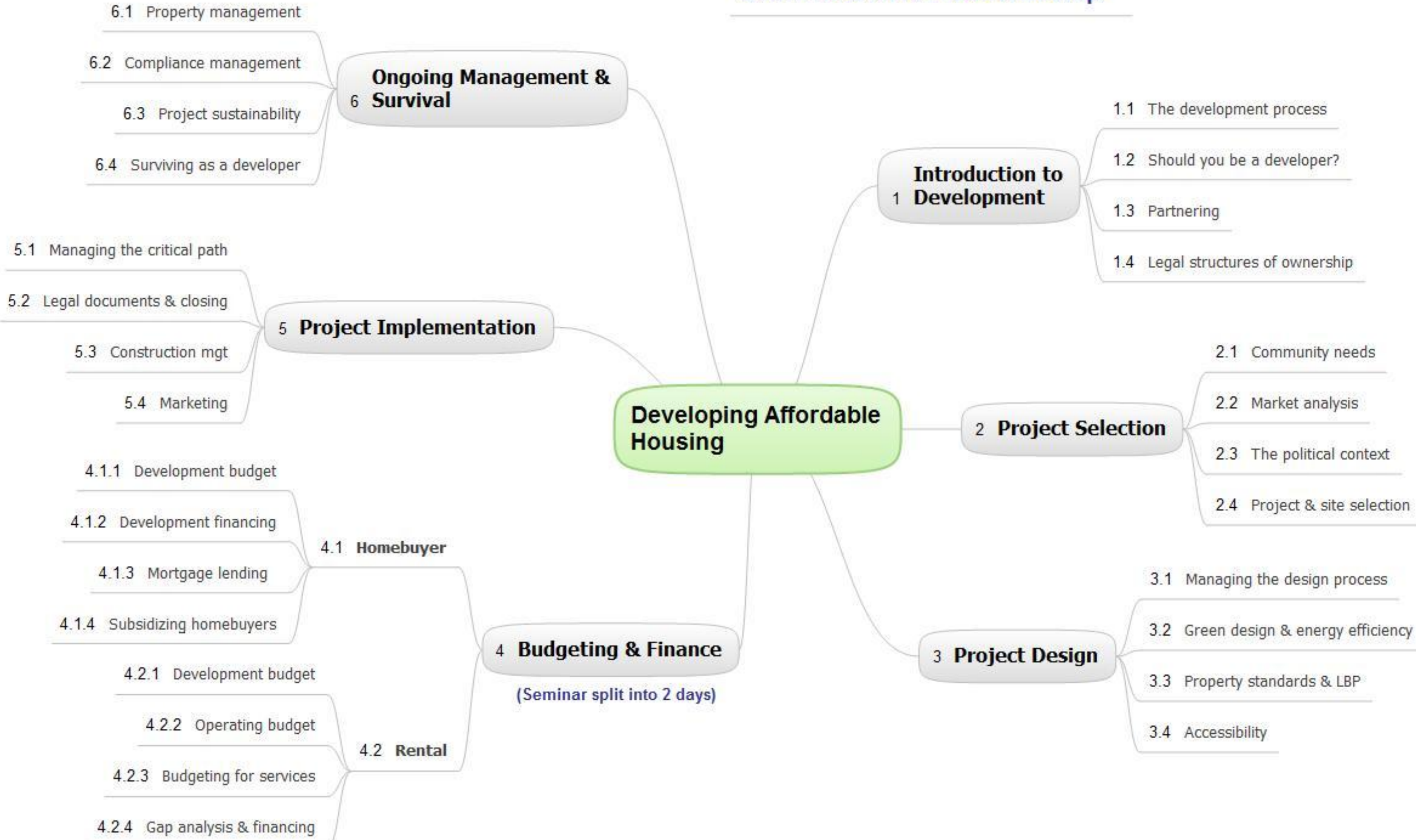
under contract to NY DHCR/HTFC

Overview of the Seminar Series

- 6 workshops:
  - Introduction to Development – May
  - Project Selection – June
  - Project Design – July
  - Project Finance
  - Project Implementation – October
  - Ongoing Management & Org Survival - November

Developing Affordable Housing Seminar Series - Content Map



LPA Mini-Series

- Working with Homebuyers - June
- Lead Based Paint Overview – July/August
- Managing Housing Rehab Programs - October

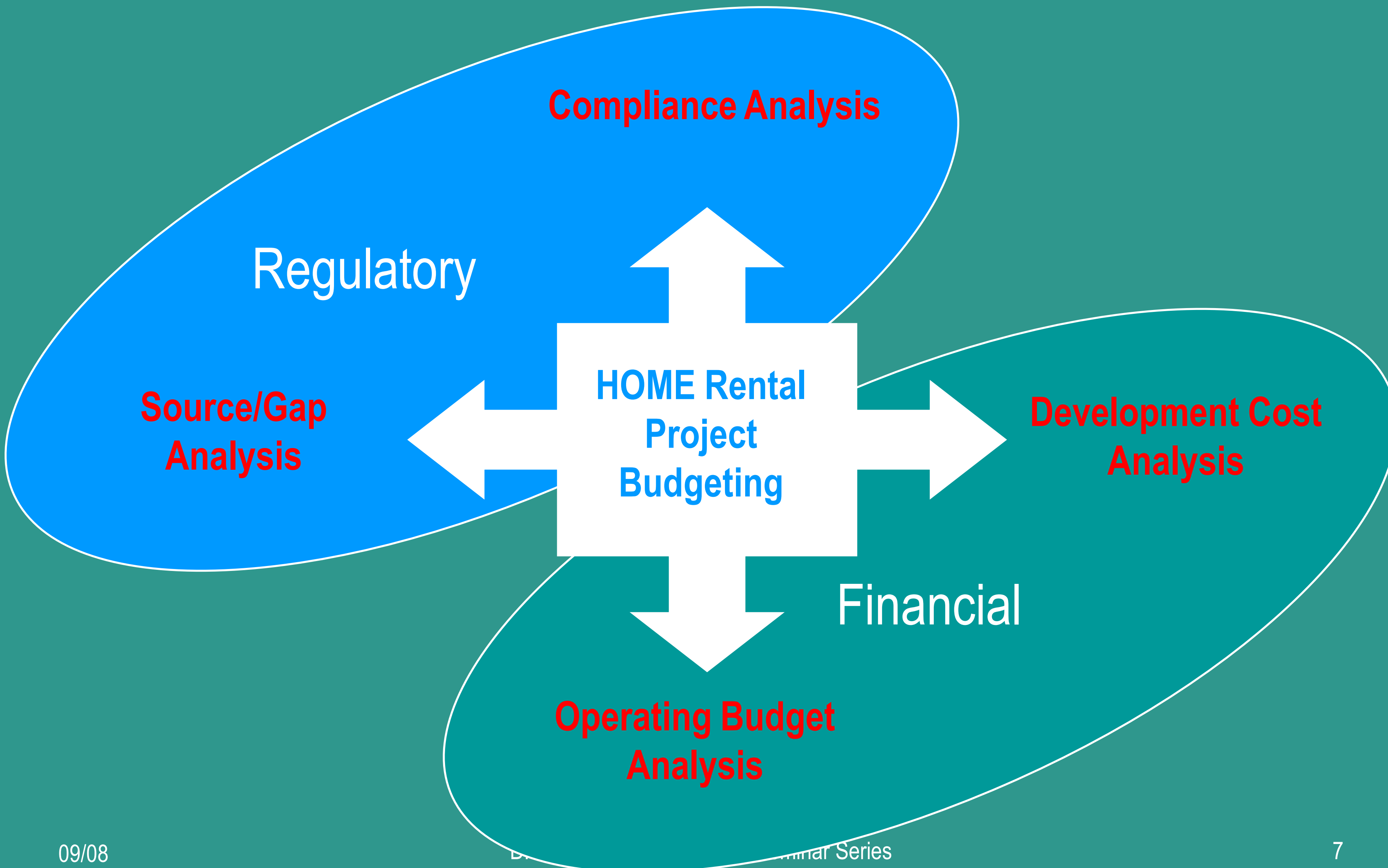
Materials

- Reference manual
  - Supplemental discussions of institute topics
  - For review outside of class
- Each seminar, add:
  - Overheads for note-taking
  - Tools for project planning

Seminar 4 Topics

- Development budget
- Operating budget
- Compliance analysis
- Gap analysis
- Project financing
- Putting it all together

Elements of Rental Project Budgeting

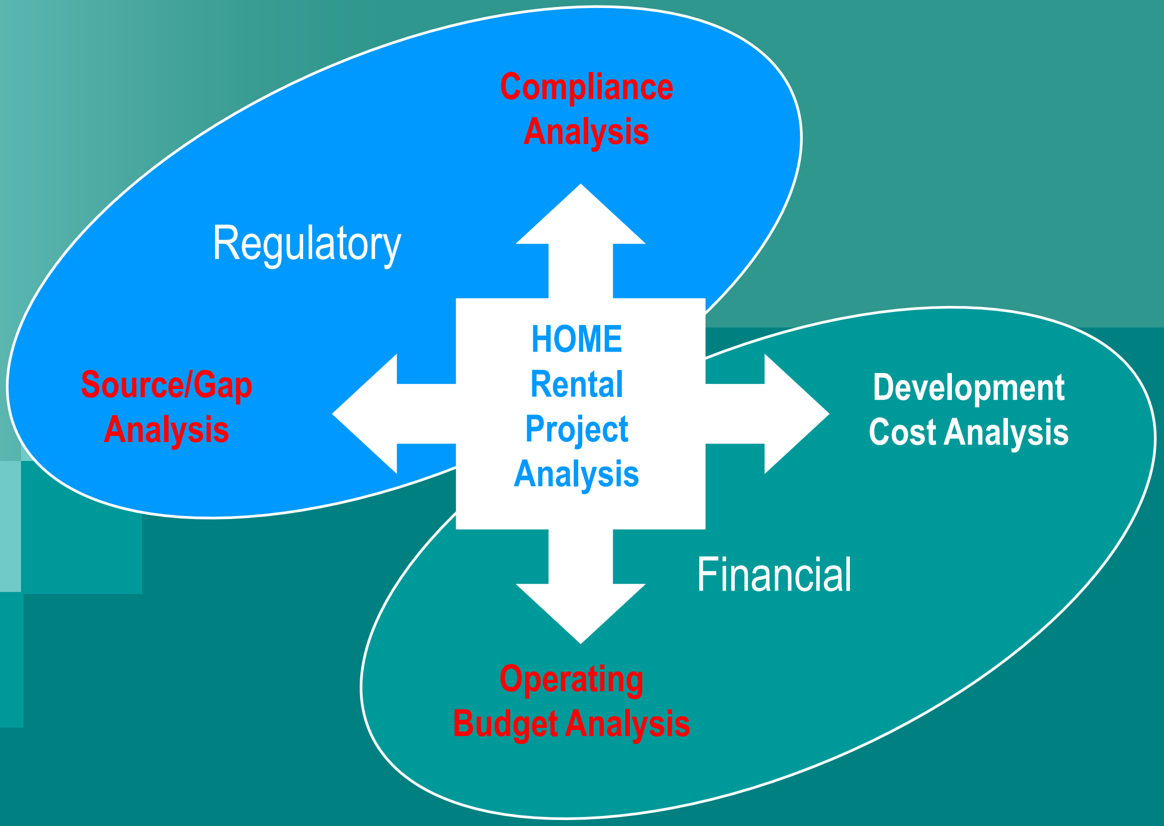


Budgets

- Development pro forma
  - Sources and Uses of capital funds
  - 2 phases of sources: development & permanent
  - Homebuyer: sales proceeds analysis
- Operating pro forma
  - Rental: projection of Income & Expenses
  - Homebuyer: affordability analysis (PITI, debt)

Some Points to Keep In Mind

- Budgets are projections (estimates)
  - Be conservative; include contingencies
- Budgets must be thorough
  - Identify all anticipated costs
- Budgets are a moving target
  - Levels of detail added as planning proceeds
  - Adjusted for actual costs during implementation
- Dev budgets impact operations
  - Cutting corners increases operating costs



Development Budget

Development Budget Analysis

- Analysis:
  - Acquisition
  - Construction/Rehab
  - Soft costs
  - Fees
  - Working capital
- Considerations:
  - All costs estimated
  - Reasonable cost
  - Promoting sustainability

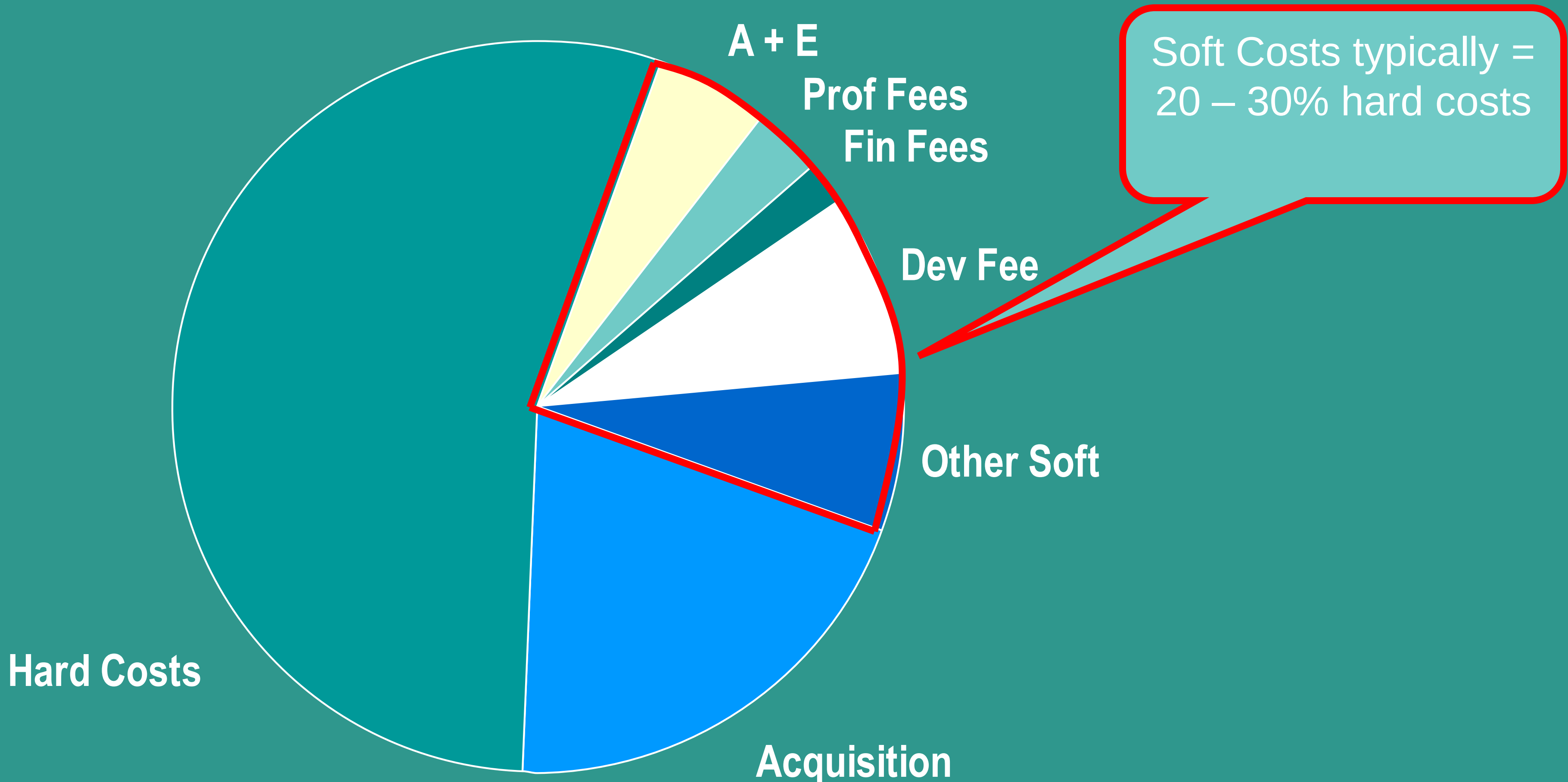
Acquisition Analysis

- Acquisition cost $\leq$ fair market value
- True acquisition cost: price + site improvements + remediation + demolition + relocation (shovel ready)
  - Environmental issues: wetlands, floodplain, SHPO
  - Lack of infrastructure; topography, subsoil conditions
- Location: if unsuitable for market housing, then why is it suitable for affordable housing?
  - Environmental & neighborhood conditions
  - inaccessibility to services and transportation
- Related party transactions – cost reasonableness

Construction Cost Analysis

- Basis of estimate: level of detail; bidding
- Reasonableness: PSF and per-unit cost
- Regulatory compliance:
  - Program property standards: 504/FHAA; Davis-Bacon; LBP
- Adequacy of scope v. viability
  - Compliance period v. useful life
  - Improvements v. operating cost
  - Market competitiveness
- Contingency

Development Budget: Soft Costs

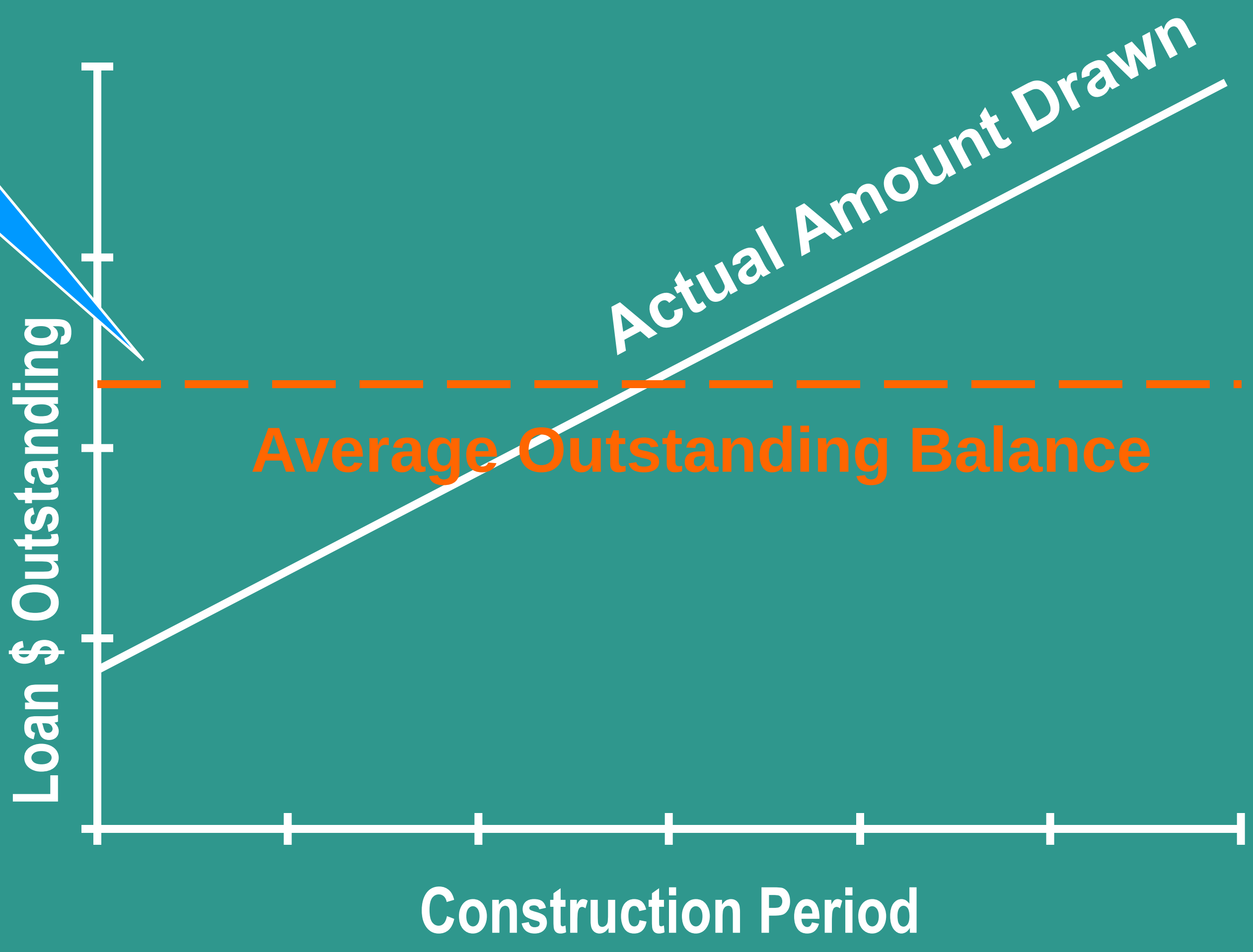


Soft Cost Analysis

- Completeness: all costs reflected
- Reasonableness: typically 20 – 30 %
- Necessary
- Interim holding costs relative to dev schedule
  - Insurance, taxes, security/mgt, etc.
- Timing of soft costs expenditures
  - Fund from constr. financing v. permanent sources
- Related party costs
  - Other fees to developer

Construction Loan: Interest

On average, 55 – 65% outstanding balance

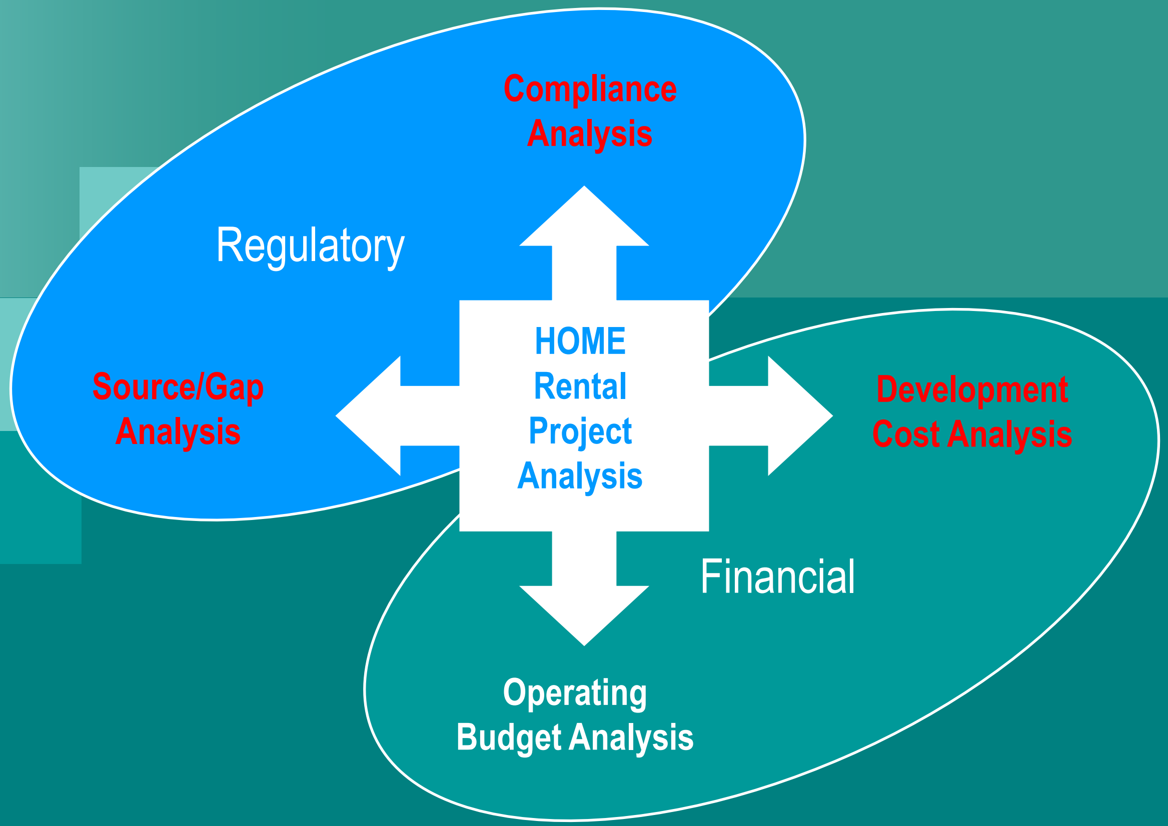


Fee Analysis

- What's a developer fee cover?
  - Inclusive of consultant fees
- Sliding scale of fee: 5 - 15 %
  - Economy of scale: level of effort is not proportionate
  - Smaller v. large projects; complex v. simpler projects
- Identity of interest: developer/builder/other
  - Builder OHPGR
- Tie draws to milestones & accomplishments

Working Capital Analysis

- Initial operating deficit or rent up reserve
- Pre-funded replacement reserve
- Pre-funded operating reserve
- Deposits
- Furnishings & equipment



Operating Budget

Types of Operating Budgets

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

Splitting Services From Operations

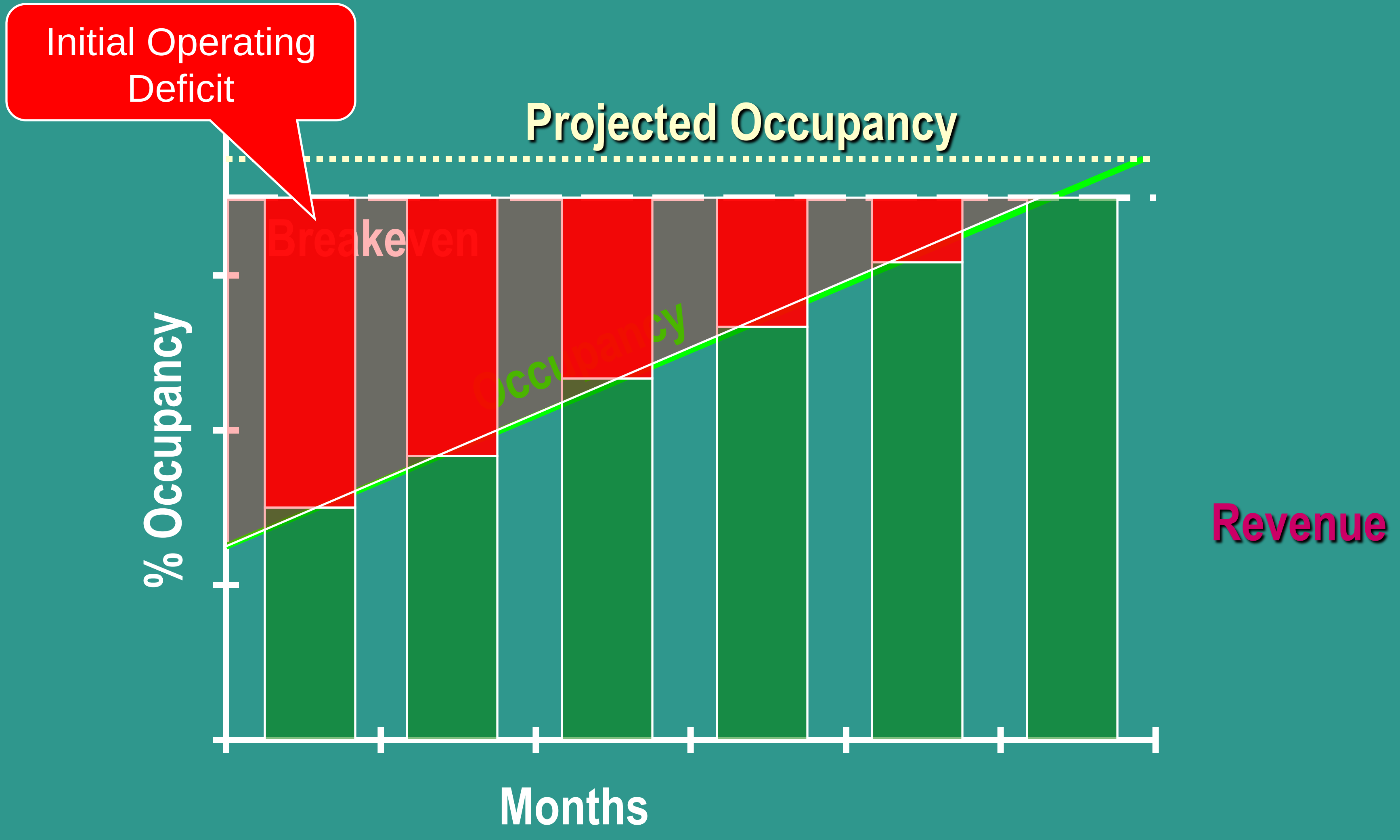
Real estate operations

- Revenue: Rents & other property sources
- Expenses: property operating costs, including prop management

Services

- Revenue: services fee, subsidies, programs
- sxpenses: Service expenditures, including services staffing & admin

Lease Up Budget



Stabilized Operating Budget

- Annualized income & expenses at sustaining ("full") occupancy level
- Used in underwriting analysis:
  - Analyze rent (revenue) & expenses for completeness & reasonableness
  - Stabilized NOI determines maximum loan amount (& used by appraisers to determine property value)

Operating Budget

GPR – Rent roll @ 100% occupancy plus other revenue*

→ ***EGI*** – Adjusted for vacancy & collection loss

→ ***NOI*** – EGI minus operating expenses & reserve contributions

→ ***Cash flow*** – NOI minus debt service payments

Rents

- Reasonableness of rents based on:
  - What is **necessary**?
    - Min Rent to Cover Op Expenses + Debt Service
  - What is **permissible** (by program)?

    Maximum Rent

    - Utility Allowance

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

Rents → Revenue

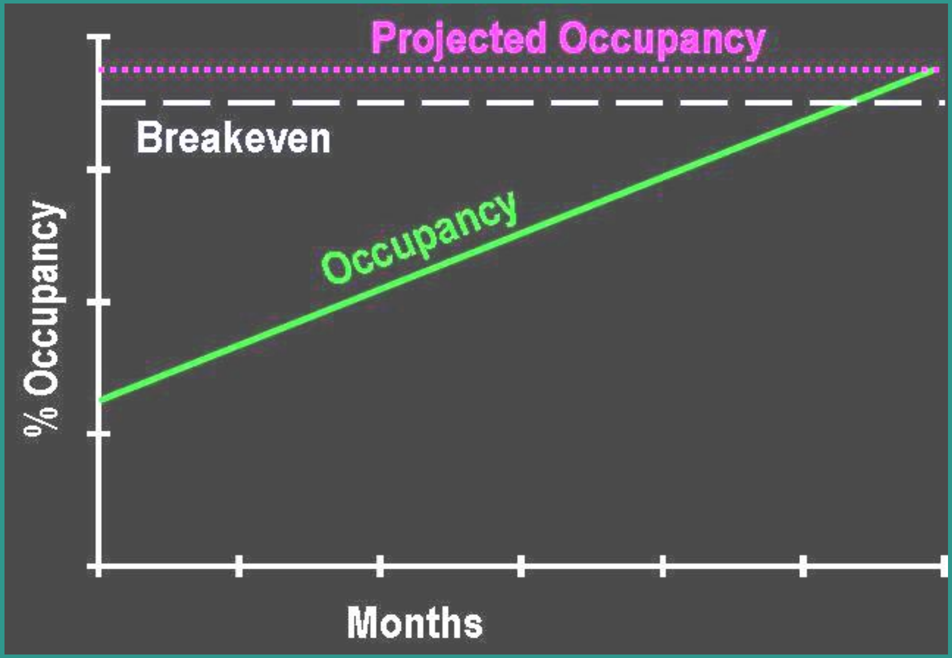
- Estimating vacancy/collection loss
  - What's a reasonable rate for your market/project?
    - Number of turnovers per year
    - Number and length of defaults/evictions
  - Don't use "market average"
  - Affordable housing VCL risks:
    - The greater the rent burden, the higher the default risk & the higher the turnover
- Other income
  - Interest, forfeited deposits/damage charges
  - Incidental income (e.g., laundry machines)
  - Don't use for debt projections unless substantial & regular

Expense Analysis

- Review each line item: within reasonable range?
- Adequate budget for management?
- Adequate budget for planned maintenance?
- Current utility rates & tenant/owner split?
- Sufficient contribution to reserves?

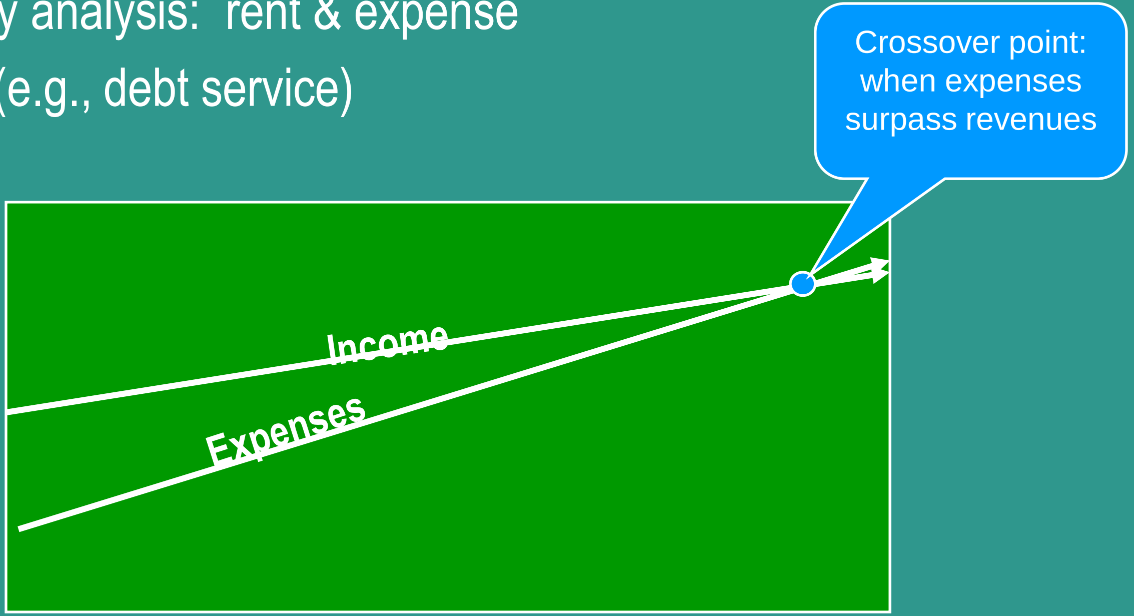
Cash Flow or Breakeven Analysis

- ROI – rate or return on equity invested (if…)
  - Diff methods: cash-on-cash, IRR
- Breakeven – if no equity
  - Occupancy level at which revenues cover expenses
  - Risk if projected occupancy level is too close to breakeven (e.g., less than 5%



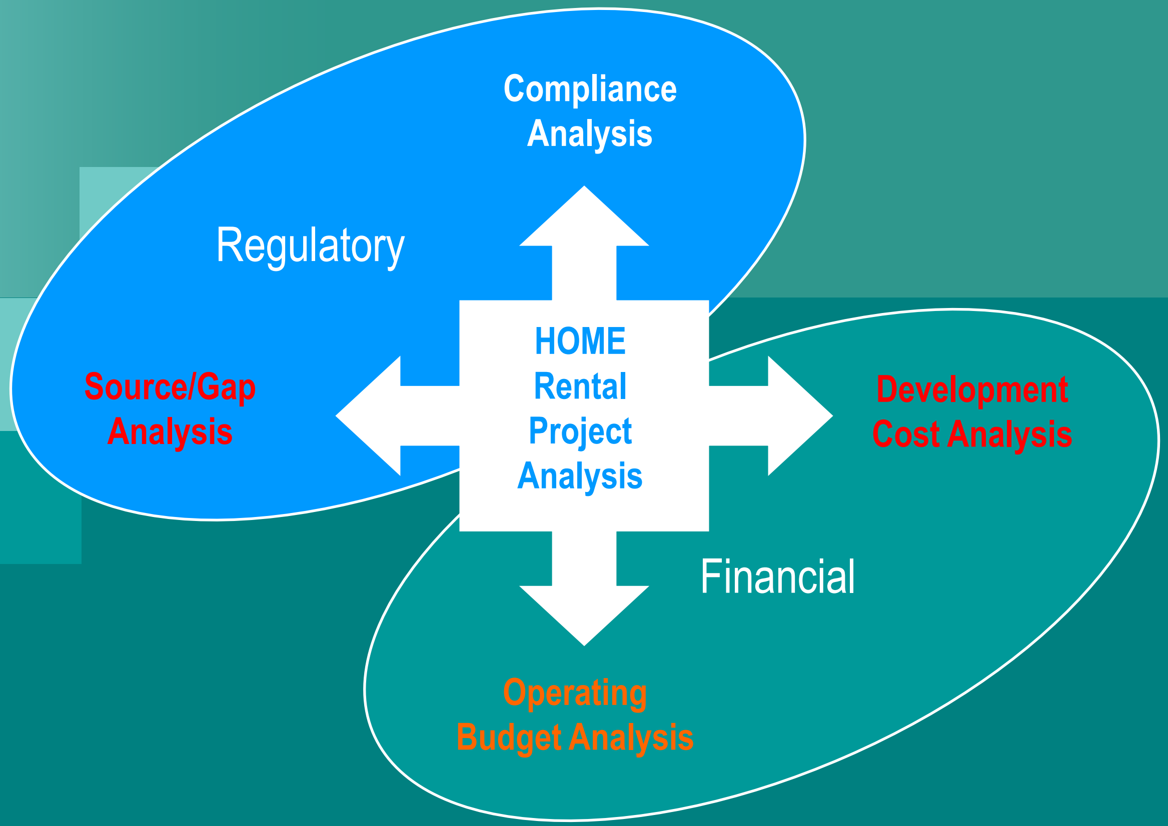
Long-Term Operating Projection

- Trends: 1–2% rents; 3–4% expenses
  - Based on sustaining occupancy budget
- Use to analyze
  - Cross-over point: how far out
  - Budgeting sensitivity analysis: rent & expense
  - Expected changes (e.g., debt service)



How Should You Use Projections?

- Watch for crossover point under 5 years
- Use to plan/implement rent increases
  - Test different rent increases, look for cost controls
  - Small annual increases better than big change
- Analyze impact of debt service adjustments or need for refinancing
- Require for workouts/distressed projects



Compliance Analysis

Compliance Analysis

- Project eligibility
- Eligible costs
- Cost allocation/assisted units
- Occupancy
- Rents
- Property standards
- Compliance period

Layering Analysis

- HOME/Other Federal + 1 other <u>public</u> source
- Elements of Layering Analysis
  - Cost analysis
  - Fee analysis (incl identity of interest)
  - Source analysis: adequate, not excessive
  - Operating analysis: reasonable cash flow
  - Gap analysis
- Two other implications:
  - Consult with other public lenders
  - Final underwriting & gap calculation

Combining Multiple Public Subsidies

- Maybe trigger subsidy layering requirements
- Compatibility of funding sources
- Initial & ongoing compliance with multiple regulations

Typical Combinations

- HOME & CDBG
  - CDBG not eligible for new construction
  - CDBG useful for acquisition, infrastructure
  - Different Davis-Bacon thresholds
- LIHTC & HOME or CDBG
  - Methods to invest HOME & OBRA93 exception
  - Rent limits slightly different
  - HOME: contract rent; LIHTC: tenant contribution
  - Over-income rules
- HUD 202/811 & HOME/CDBG
  - Small gap & additional improvements

Combinations, cont.

- McKinney & HOME/CDBG
  - SHP, Shelter+Care, Sect 8 SRO
  - Projects with no ability to amortize debt
  - McKinney money for services/operations
- RD 515 rehab/restructuring
  - Often with LIHTC
- MRB/4%/HOME
- Other models?

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

Combining HOME & LIHTC

- Intended to work together, but two problems:
- Similar but not identical rules,
  - Most reconciled by following “most restrictive”, but
  - Over-income conflict (HOME requires rent adjustment, LIHTC forbids it
  - Resolution: LIHTC over-income rules prevail (HCDA92)
- If HOME is treated as “Federal”, may limit project to 4% credits (rather than 9%)
  - Resolution: HOME loans treated as non-Federal (OBRA93)
    - But 40% @ 50% threshold for Tax Credits & no 30% QCT/DDA bonus (Qualified Census Tract/Difficult Development Area)

Investing HOME In LIHTC Projects

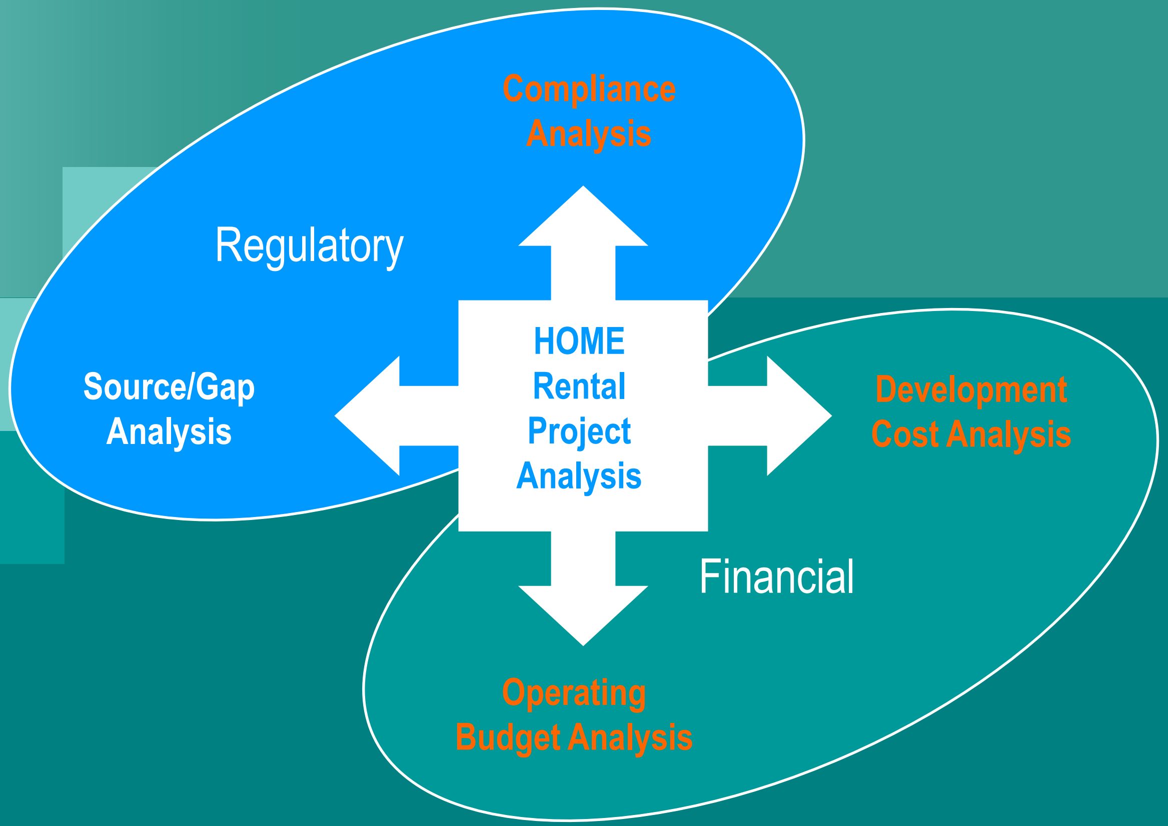
- HOME investment options:
  - HOME as Applicable Federal Rate (AFR) loan (market rate); eligible for 9% & 30%
  - HOME as grant; not in basis – eligible for 9% & 30%
  - If 4% project (e.g., MRB, RD, other Federal) HOME can be soft loan without impact
  - OBRA93 exception – HOME as (below market interest rate) BMIR loan; eligible for 9% but no 30%

HOME/LIHTC Compliance Issues

- 50%/60% v 50%/80%
- Rent limits: tenant contribution v. HOME rent limits
- Property standards: UPCS v. HQS
  - Inspection requirements differ
- Recertification/over-income
- Compliance periods

HOME Impact on LIHTC

- May affect basis if BMIR loan
- May force some VLI/50% occupancy
- May restrict rent revenue on HAUs
  - VLI units
  - HOME rents (FMRs) might be below LIHTC limits
  - HOME limits certificate/voucher total payments
- May complicate compliance



Gap/Layering Analysis

The Gap

Getting to the Gap

Development Budget

Sources

- Equity
- Debt
- Dev. Subsidies ______

Uses

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

Operating Budget

Revenue

- Gross Rents
- Vacancy/CL ______
- Eff. Gr. Income

Op. Expenses

- Admin/Mgt
- Maintenance
- Taxes/Util/Insur
- Reserves ______

NOI

NADS

Cash Flow

Gap Analysis Steps

1. Review op revenue & cost reasonableness
2. Compute NOI
3. Capitalize Net Available (using DSC factor) to compute maximum debt
4. Subtract debt, equity & other subsidies from TDC to determine “gap”

- Gap review questions:
  - Are rents maximized given market and limits?
  - Are other loans/equity maximized?
  - Are mgt, maintenance & reserves adequately funded?
  - Is there excess cash flow available to amortize public loan?

Capital Gap Sources

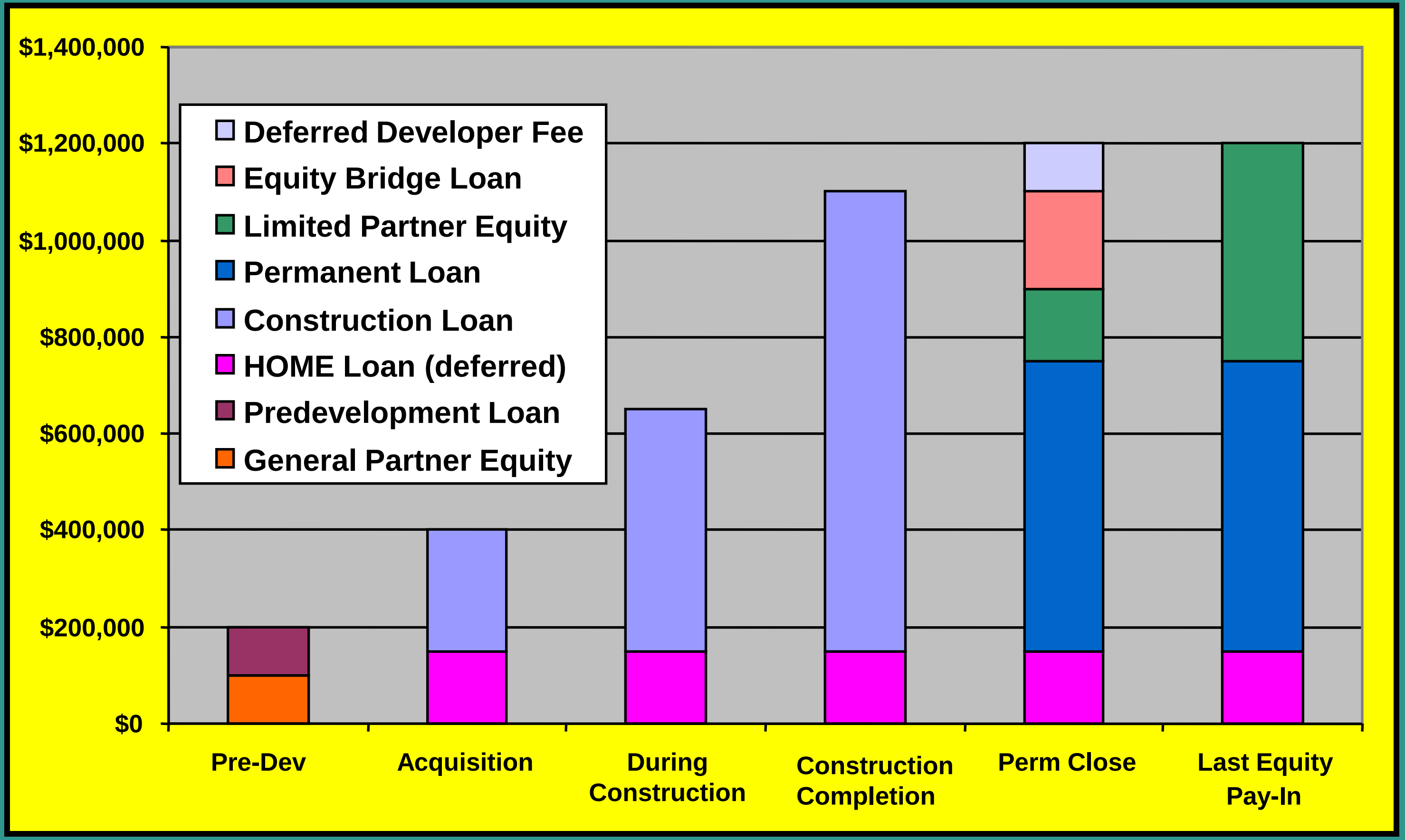
- HOME
- Tax Credits – larger projects (or pool)
- CDBG (local or Small Cities)
- USDA Rural Development (former FmHA)
- State HTF & Other
- FHFB Affordable Housing Program (AHP)
- Watch for GSE affordable housing fund (Congress)
- Other: Foundations: grants & PRIs
- Owner contributions/equity

Project Financing

Phases of Financing

- Pre-development
  - Equity/capital advances & pre-development loans
  - Repaid/rolled into construction financing
- Acquisition
  - May be part of construction financing or separate
- Construction
  - Usually combination of construction loan & some gap sources
- Permanent
  - Conventional/primary loan
  - Gap funding from public agencies & foundations
  - Possible equity/bridge loans (syndication)

Rental Example of Financing Changes



Pre-Development Funding

- Upfront planning costs:
  - Site control & title research
  - Preliminary plans (schematics) & engineering
  - Environmental & site analyses
  - Consulting costs, application fees
- Usually repayable (sometimes forgivable)
  - Rolled into construction/permanent loans
- May need environmental clearance
- Sources: ADOH, other public, foundations

Acquisition Loans

- Developers may self-fund or take interim loan
- Interim financing:
  - Conventional loans: usually not more than 50% LTV
  - May be rolled into construction loan (if acquisition coordinated with construction start)
- Public loans for acquisition:
    - CDBG
    - HOME requires development plan
    - If Federal, contingent on environmental review

Construction Financing

- Pays for construction costs till perm closing
- Less than perm $ -- usually no more than 80 - 90%
  - Some costs deferred to permanent closing: perm fin costs, partial dev fee & some working capital items
- May be a package deal with permanent lender
  - Construction to permanent
  - Or a buy-sell agreement between lenders

Construction Financing

Construction uses

- TDC minus:
  - Dev fee (portion)
  - Perm financing/legal costs
  - Some marketing costs
  - Capitalized reserves

Construction sources

- Equity
- Construction loans
- Public gap sources?

Construction Lenders

- Public agencies: may do construction lending
  - Requires staff capacity, underwriting & risk management
  - Unless financing not available or need to reduce interest cost
  - May opt for private lender to administer loan
  - May advance funds during construction as part of perm.
- Conventional lenders like construction 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 & pays for other development costs incurred at permanent closing
- Rental
  - Usually some primary financing, either conventional or public; typically from 20% - 70% of TDC/value
  - Public subsidies fill the gap; usually no amortization (cash flow basis?)
- Homebuyer
  - Permanent is buyer financing (1st mortgage)
  - Sale proceeds used to pay off construction

Primary loan

- Sources:
  - Conventional lenders
  - Finance authorities: MRBs
  - Other public
- Shop around as terms can vary across lenders
  - Permanent lender may want construction loan as well
  - Terms (fees, costs) are negotiable
- Think/talk like a lender: think underwriting

How Lenders Underwrite

- Risk assessment
- Market risk
- Borrower risk
- Project Risk
    - Completion risk
    - Financial feasibility risk
    - Viability risk
- Portfolio risk

Completion Risk

- Factors that might impede completion of the project on time (readiness to proceed):
  - Site control (required as threshold)
  - Approvals required
  - Extent of local opposition/support
  - Firm construction costs
  - Availability of resources to complete; firm commitments
  - Capacity of developer to manage & team to perform on schedule

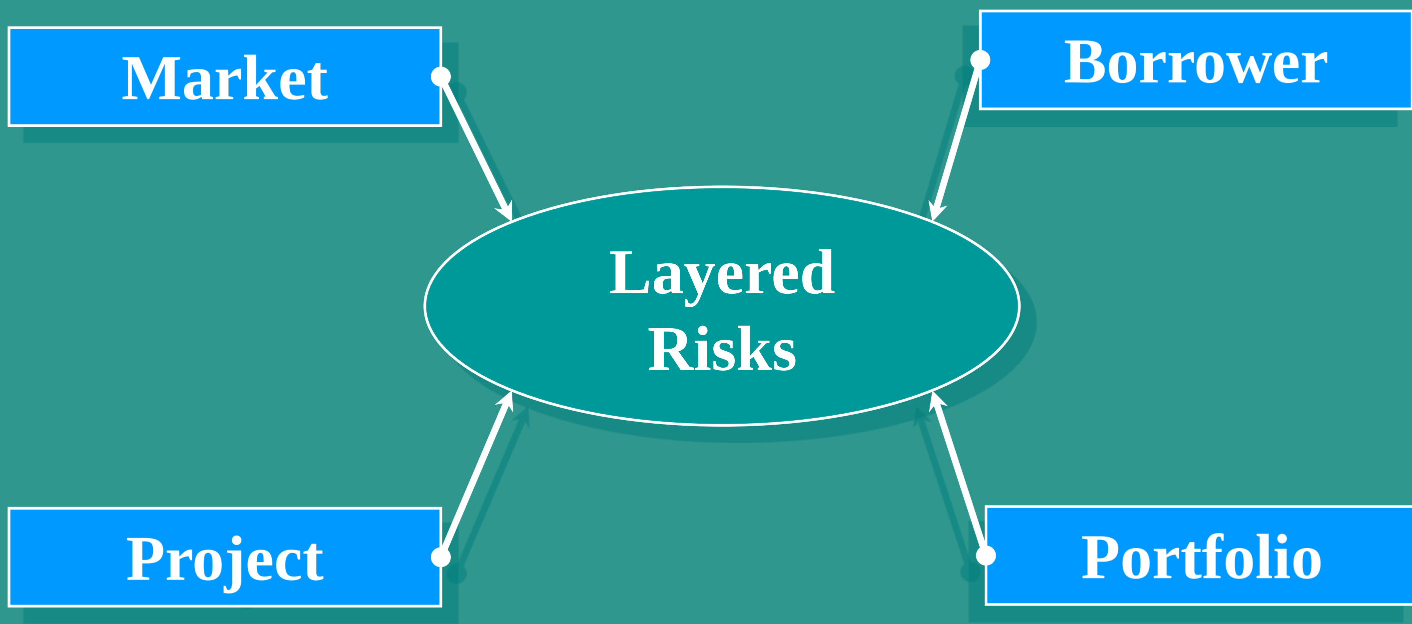
Feasibility Risk

- Risks project won’t meet expectations
  - Cost reasonableness
  - Ability of team to perform, work together
  - Adequacy of funds
  - Risk of cost overruns; delays in occupancy
  - Rent up risk
  - Adequacy of initial operating deficit
  - Occupancy levels; vacancy/collection losses
  - Spread between occupancy level & breakeven point
  - Operating costs reasonableness

Viability Risk

- Risks that project will not remain financially & physically healthy over loan/compliance period:
  - Market competitiveness
  - Maintenance of occupancy over time
  - Ability/willingness to increase rents: revenue increases exceed operating cost increases
  - Quality of management
  - Planned/preventive maintenance
  - Adequate reserves (capitalized/annual)

Layering of Risks



Cash Flow Loans

- If primary loan maximized, cash flow = DSC margin
  - Can't be required debt service
  - Primary lender would add into coverage calculation
- Paid out of cash flow
  - Other deferred debt & developer fees paid out first?
  - Maybe only a portion of cash flow (e.g., 50%) with remainder directed to reserves, operations
- Issues: (1) determining if cash flow; (2) operators who spend to avoid having cash flow

Inter-Creditor Issues

- Layering; disclosure of changes in sources
- Terms of advances
  - Public $ first in: local commitment; pro rata alternative
  - Public $ last in: filling the gap; completion required
- Subordination
- Enforcement of compliance terms
- Foreclosure /deed in lieu of:
  - restrictions extinguished; but funds still repayable
  - Notice of default
  - rights to intervene; successor/assignee; forbearance

Putting It All Together

Lessons from HOME Rent Study

- Rent Exception Study: 7 states; M2M projects
- FMR's impact HOME rents
  - Caps some rents in 95% of jurisdictions
  - Low rents capped in 55% metros & 92% non-metros
  - FMRs affordable down to 46% AMI
- FMR's are close to market (average 99% of FMRs)
- Many properties have vacancy > 8%
- Operating expenses higher than anticipated
- Reserves lower than needed

Lessons from HOME Rental Workouts

- Too much hard debt
- Underfunded capital needs
- HOME compliance problems
- Inadequate funder coordination
- Can't overcome market weaknesses
- Competition among affordable projects
- Ownership/management problems
- Design/construction problems
- Legal covenants vulnerable
- Lack of early warning system

Build Sustainable Projects

- Understand/ensure market competitiveness
- Fund physical improvements beyond minimum codes: useful life beyond compliance term; energy efficiency
- Avoid excessive debt; margin of error
- Fund reserves out of capital and operating budgets
- Plan for planned maintenance & quality management
- Implement annual inspections
- Implement project-based budgeting & financial reporting

Budget for Real

- Under-funded development: your risk
- Under-funded operations: your long-term burden
  - You'll be raising money in the future to subsidize operations
  - Remember opportunity cost
- At the same time, keep it simple

Avoid Under-Improvement

- Increased default/foreclosure repayment risk
  - National HOME rental workout team findings
- Impact of deferred improvements on operations:
  - Expenses: rising repair costs, more emergency repairs
  - Revenue loss: slow lease-up; tenant quality, rebates
- Time involved in workouts
  - Exception to double-dipping limitation
- Bricks & mortar legacy of program: your name on it!

Rents – Give Yourself Room To Move

- Danger of using maximum rents
  - HOME rent limits don't always increase
  - Higher rents means higher vacancy/collection loss
  - Can only assist projects at time of development
- Start 5 – 10% below; this means bigger gap
- Commit to regular rent increase in the long term
  - Nonprofit operators not inclined to increase rents until…
  - But smaller regular rent increases are better

Anticipate the Buyout (if applicable)

- If LIHTC, LPs can be bought out after 15 yrs
  - Need to be ready, now is the time to start planning
- Buyout plan:
  - Identify nonprofit sponsor with ROFR
  - Land lease
  - Subsidy mortgages due to sponsor
  - Developer fees contributed to sinking fund for buyout
  - Rollover provisions in HOME loan
- IRS proposed rules for buyout: 6/19/07

And Some Final Thoughts

- Remember that public subsidies trigger compliance
  - Multiple public sources trigger layering analysis
- Think like a lender
  - You must anticipate/address lender concerns
  - What risks will they see -- market, borrower, project?
- Communicate your lenders

Wrap Up & Evaluation

- Final questions?
- Evaluation
- MLFranke@aol.com

- Next development seminar:

  5. Project Implementation
     - Albany: 10/15
     - New York City: 10/16
     - Buffalo: 10/22
     - Syracuse: 10/23
- Next in LPA series:

  Managing Rehab Programs
  - Saratoga 10/7
  - Rochester: 10/8
  - Poughkeepsie: 10/28