Development Seminar Series Workshop 4b: Rental Project Budgeting & Financing

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under contract to NY DHCR/HTFC

Overview of the Seminar Series

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

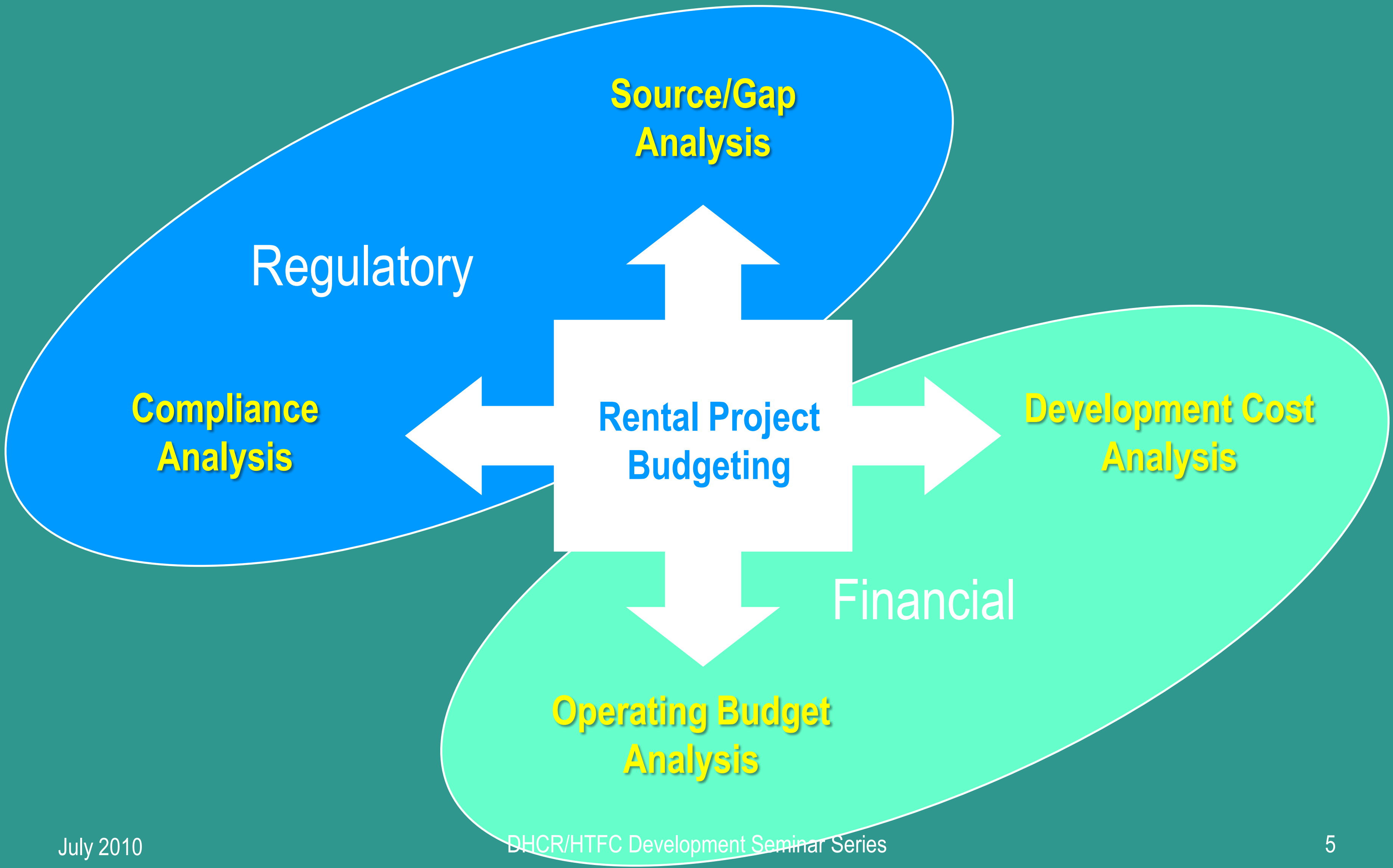
Materials

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

Seminar 4b Topics

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

Elements of Rental Project Budgeting

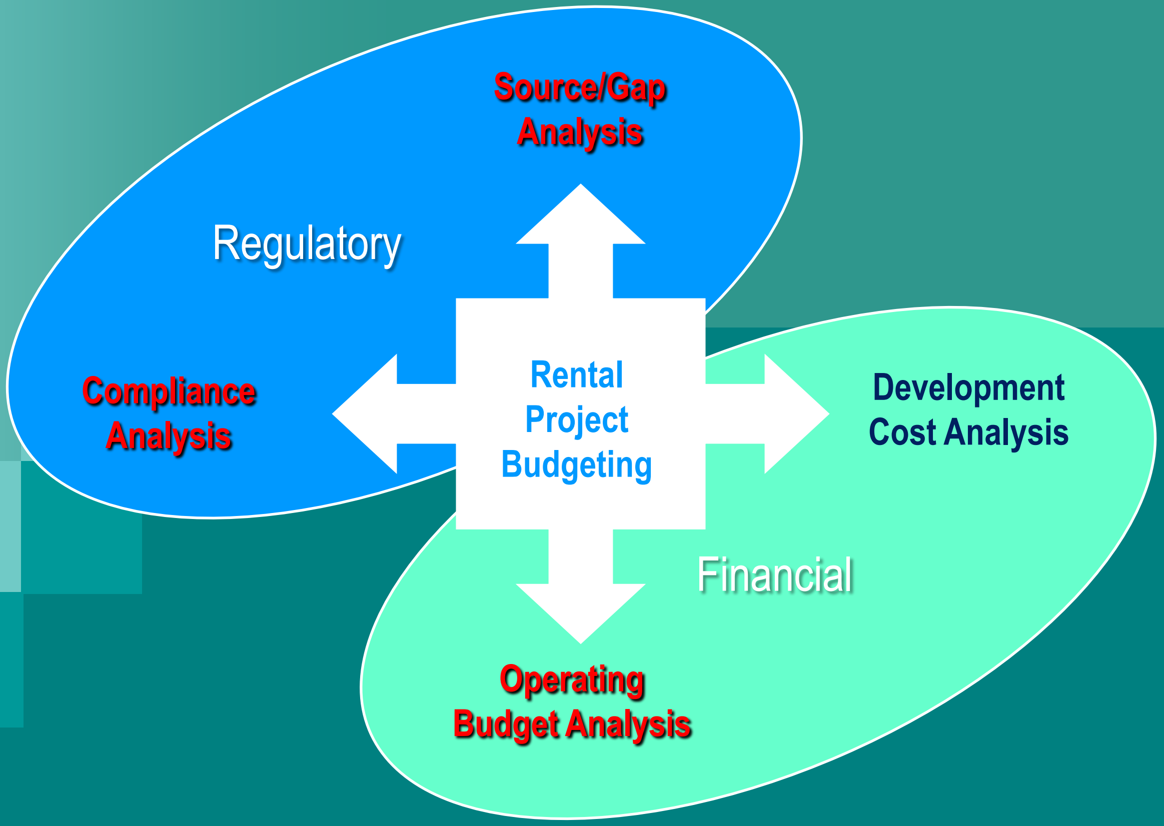


Key Points About Budgets

- Budgets are projections (estimates)
  - Be conservative; include contingencies
- Budgets must be complete
  - Identify all anticipated costs
- Budgets are linked
  - Dev budget decisions impact operations
  - Cutting corners can increase utility & other operating costs
- Budgets are iterative – a moving target
  - Levels of detail added as planning proceeds
  - Adjusted for actual costs during implementation

Budgets

- Development pro forma
  - Sources and Uses of capital funds
  - 2 phases of sources: development & permanent
- Operating pro forma
  - Projection of Income & Expenses
  - Rent-up, stabilized occupancy and long-term



Development Budget

Remember Cost Analysis Principles

- Key OMB Principles
  - Eligible (& allocable)
  - Necessary
  - Reasonable
  - Documentable
- Pre-award costs: + would have been allowable if incurred after award (2 CFR 225 Att B; Item 31 – old OMB A-87)

Budget Templates?

- Refer to budget formats of funding sources
  - But funders vary on format & content
  - Relying on one format may cause you to overlook costs
- Look at other projects
- Best to build your own from scratch, and then transpose numbers to applications

Development Budgets

- Major categories
  - Acquisition
  - Site improvements/infrastructure
  - Construction/rehabilitation
  - Soft costs & fees
  - Working capital
- Considerations:
  - All costs included
  - Reasonable cost (supported)
  - Costs adequate to promote sustainability

Acquisition Cost Analysis

- Remember project selection guidance:
  - True acquisition cost is all costs to make “shovel ready”
    - Price + infrastructure + site improvements + env remediation + demolition + relocation
  - You can’t “fix” location!
- Budget: cost, cost + transaction/carry costs, value?
- Documentation: cost or appraisal
  - Related party transactions – cost reasonableness
- DHCR: HTF limits acquisition to 50% of award
  - High acquisition cost projects require preservation exception

Site & Infrastructure

- Infrastructure
  - Access/egress
  - Utilities/services to site
- Site improvements
  - Utility connections (& fees)
  - Site prep, grading, etc.
- Environmental remediation

Construction Costs

- Progressive levels of estimation
  - Preliminary (psf), architect, indep. cost estimate, bids
- Contingency – new v. rehab
- Regulatory compliance:
  - Program property standards
  - 504/FHAA
  - Davis-Bacon
  - LBP

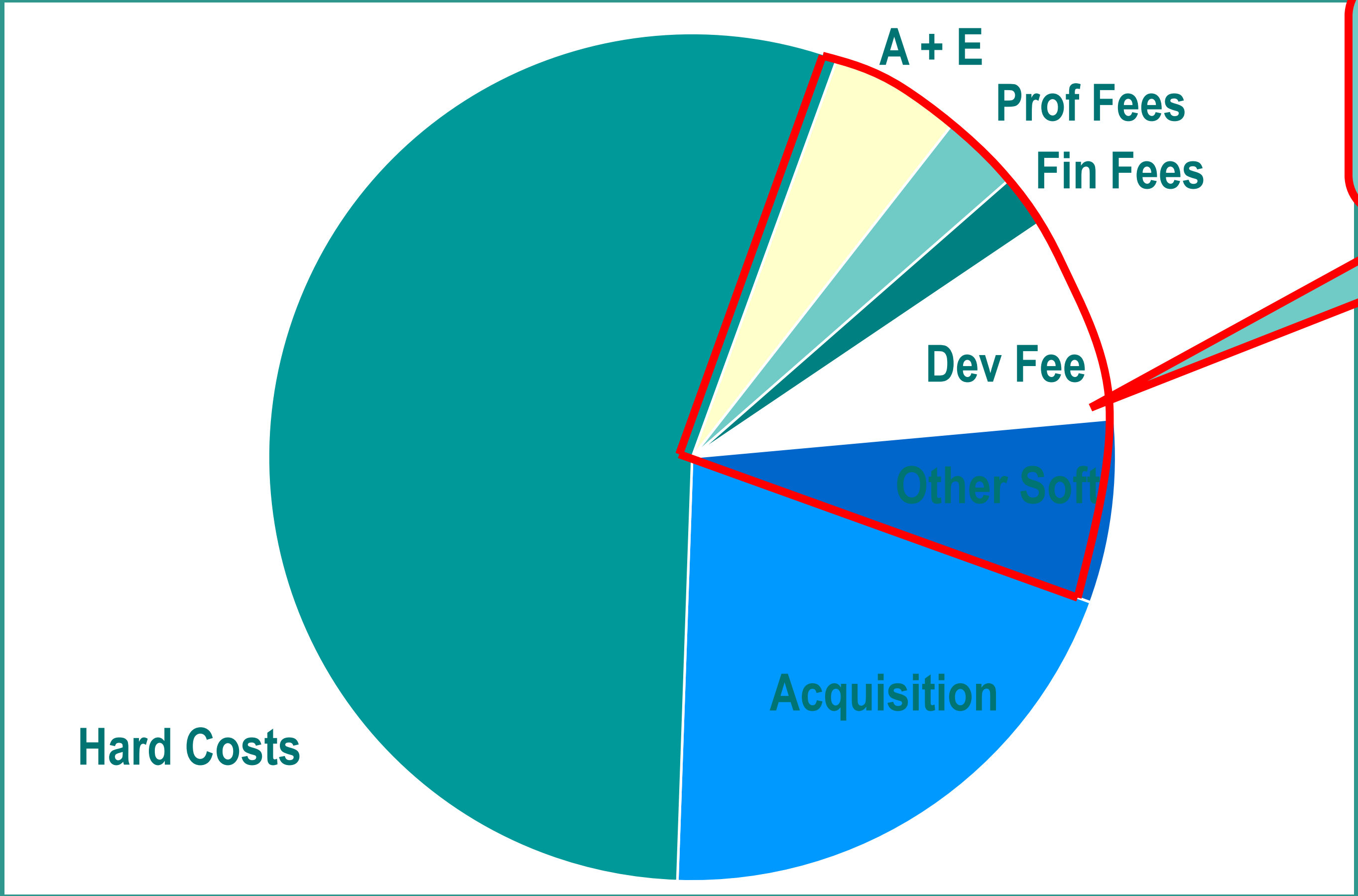
Construction Cost, cont

- Sustainability
  - Compliance period v. useful life
  - Improvements v. operating cost
  - Market competitiveness
- Public underwriting
  - Reasonableness: PSF and per-unit cost
  - Mixed use: break-outs of non-LI, non-res, common areas

DHCR Guidelines

- Contractor: <4% OH; <6% gen requirements; <10% profit
  - Constr mgt – no GC; <5% of constr cost
- Pmt/perf bond: 1 - 2% of constr cost
- Contingency: <10% rehab & small project; <5% new
- Up to 10% HTF for community service facility

•Development Budget: Soft Costs



Soft Costs typically 20 – 30% hard costs; DHCR guideline: 20%

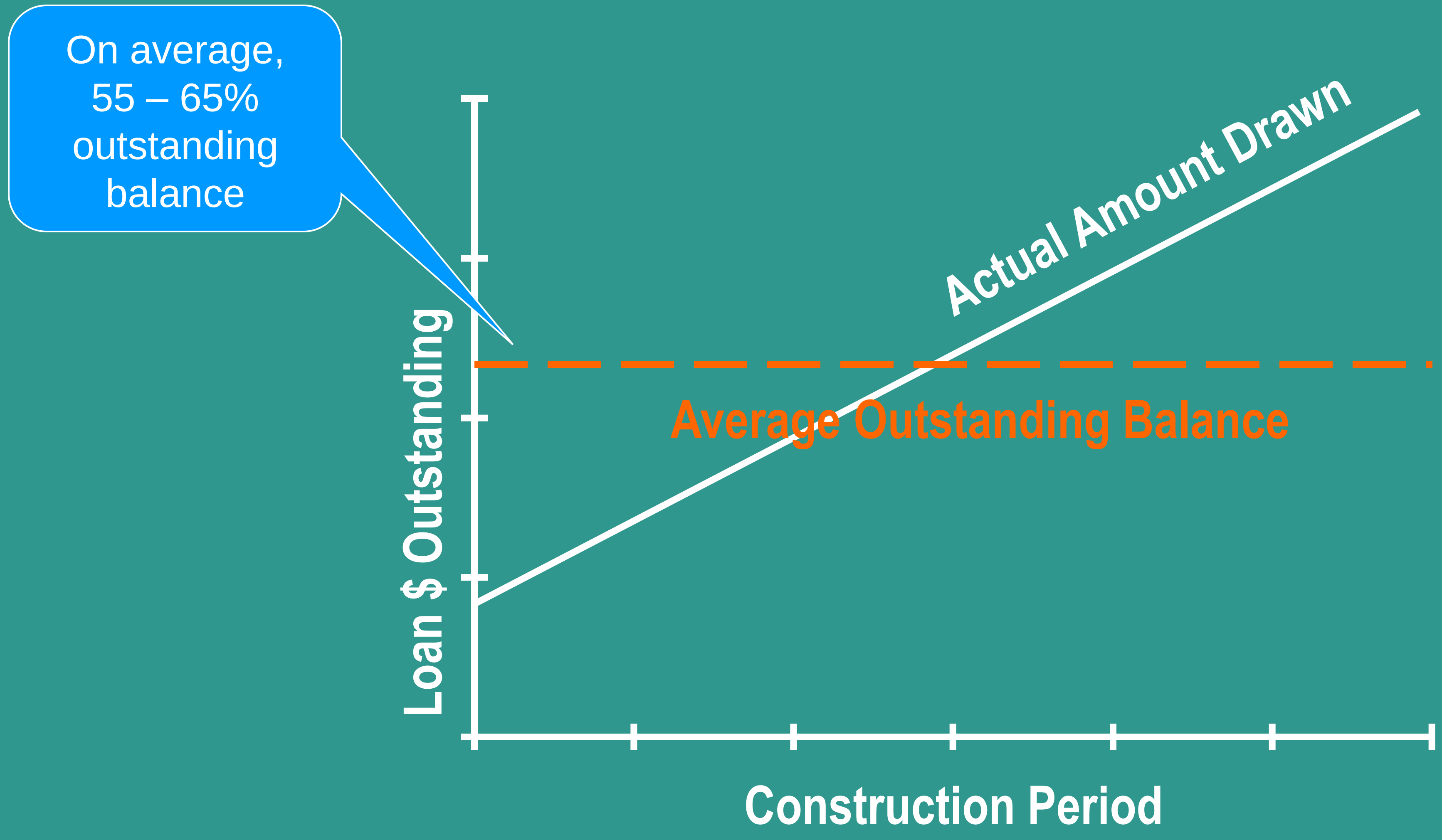
DHCR Soft Cost Guidelines

- Architect: <5% design; <2% supervision
  - lower if multiple similar bldgs
- Legal: <1% TDC
- Consultant: <1% TDC up to $20,000
- Insurance requirements: CPM 5.10

Soft Costs

- Standards:
  - Completeness: all costs reflected
  - Reasonableness: typically 20 – 30 %
  - Necessary for project
- Timing of soft costs expenditures
  - Fund from constr. financing v. permanent sources
- Interim holding costs during development
  - Insurance, taxes, security/mgt, etc.

Construction Loan: Interest



Developer Fee

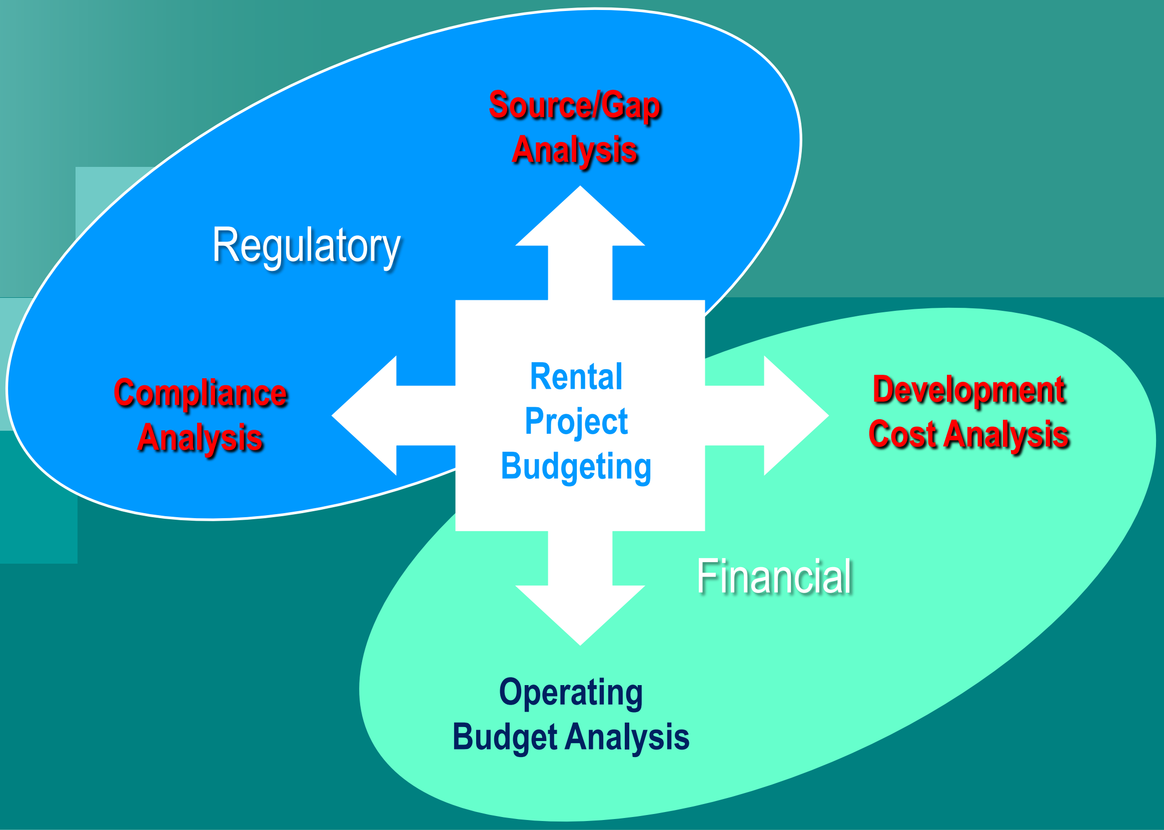
- Ask for full fee
  - If funders won't pay, carry it as equity contribution
- Remember that portion of fee deferred to end of project (fund from permanent financing)
- DHCR Guidelines
  - Fee <10% acquisition + improvements; up to 15% TC
  - Nonprofit dev allowance – greater of10% TDC minus acq or $2,400 ($5,000 for 501(c)(3) bonds)
    - Functions not otherwise compensated; not administrative OH; housing consultant included; 20% holdback for completion

Working Capital

- Pre-funding items for operations
  - Initial operating deficit or rent up reserve
  - Capital replacement reserve & operating reserve
  - Security deposits
  - Office/model furnishings
  - Equipment (mowers, snowblowers, etc.)
- DHCR:
  - Working capital - <2% of TDC
  - Repl reserve: .5% of TCC up to $800/un; up to $4000 per unit to adapt accessible unit
  - Op reserve: if needed, 1% TDC or 50% gross rent

Final Word on Development Uses

- Build from scratch
- Make sure budget is complete
- Be sure to build in contingency & margins for error
    - Don't assume the "best" circumstances
    - If range in cost, don't assume lowest possible cost



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

A 4th Budget: Services

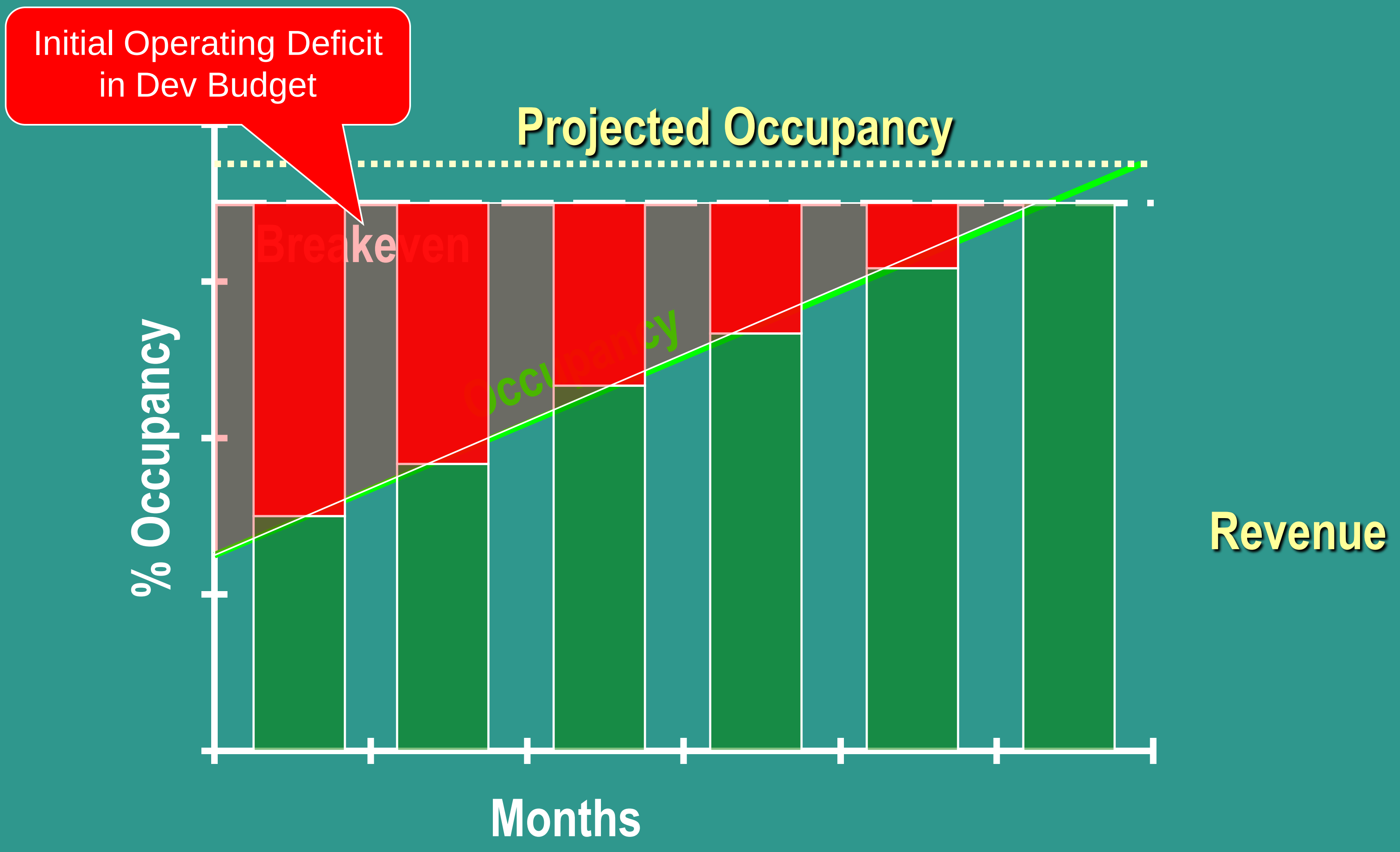
Real estate operations

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

Services Budget

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

Lease Up Budget

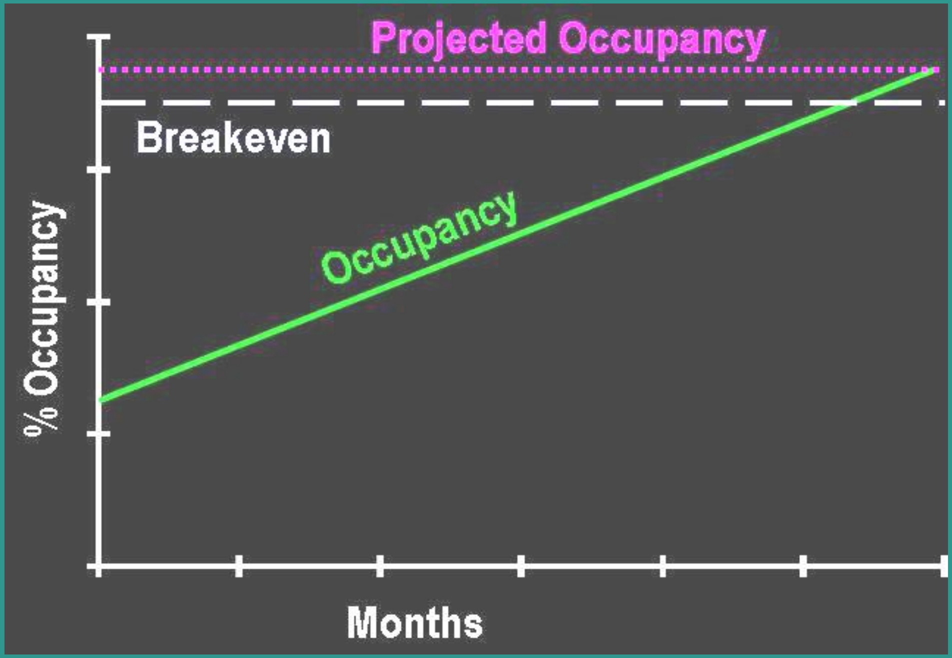


Stabilized Operating Budget

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

Cash Flow or Breakeven Analysis

- Rate of return models not relevant if no equity & limited cash flow distributions
- Breakeven analysis is more important
  - Occupancy level at which revenues cover expenses
  - Risk if projected occupancy level is too close to breakeven (e.g., less than 5%



Key Elements of the 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

Operating Expenses

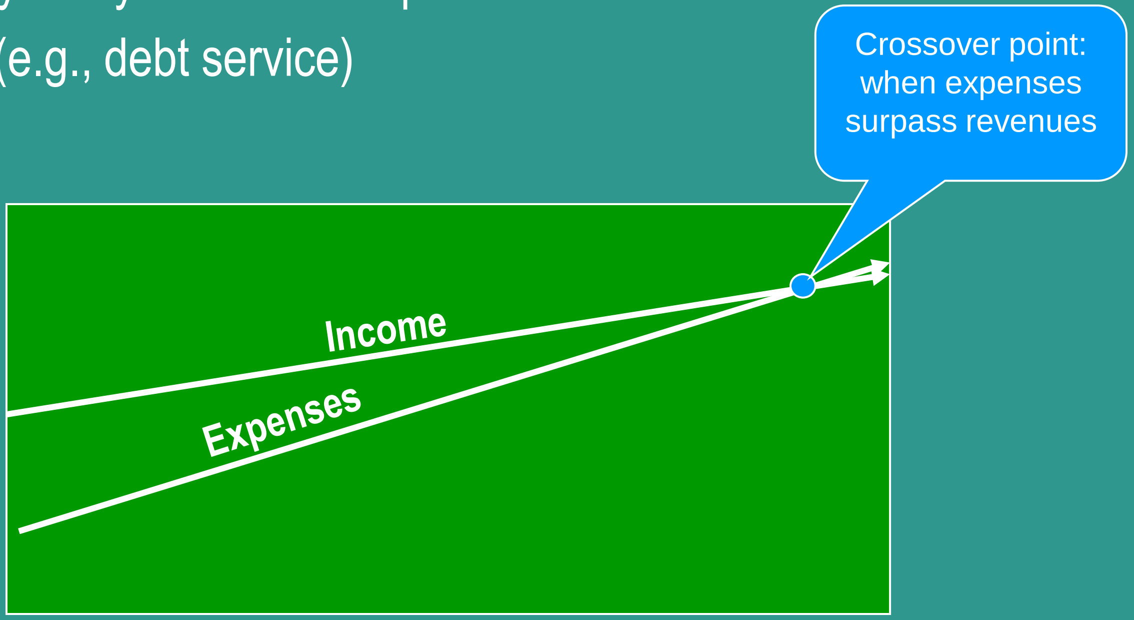
- Major categories:
  - Admin/mgt, maintenance, taxes, utilities, insurance, reserves
- Use PUMs/PUPAs from other projects
- Analysis:
  - Review each line item: within reasonable range?
  - Budget for management?
  - Budget for planned maintenance (not 1st yr repairs)?
  - Current utility rates & tenant/owner split?
  - Sufficient contribution to reserves?

DHCR Guidelines

- Rent plan – 7% vacancy/collection loss
  - non-residential self-sustaining (15% vcl unless renting)
- Op exp. – comparable projects
  - utility allowance on architect's estimate
- Cash flow – nominal (e.g., $35 PUM)
  - DSC capped at 1.3 for LIHC; no cash flow in excess
  - Developer payments limited to 50%, 50% HTFC debt service
- Reserves
  - Repl reserve – annual $400 HTFC; $250/yr bond; $300 LIHC
  - Op reserves – annual to 50% gross rents; excess cash to OR

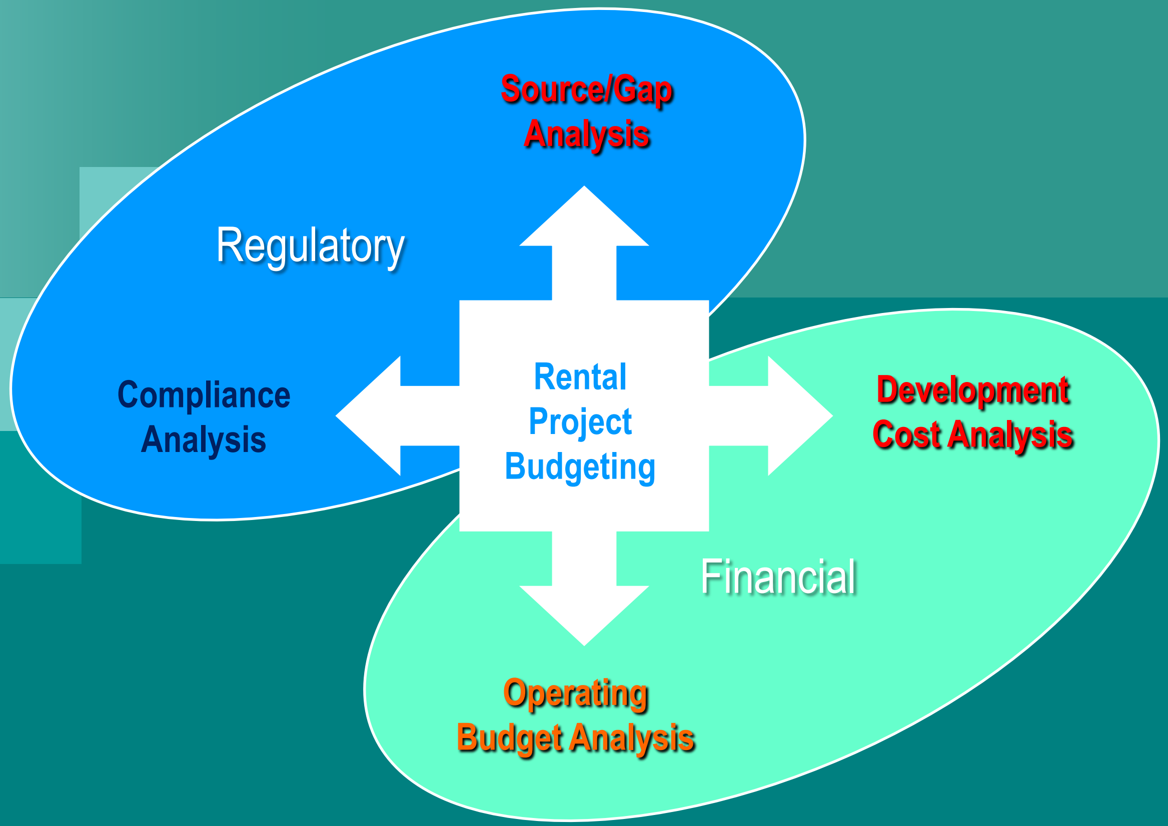
Long-Term Operating Projection

- 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)



Final Word on Operating Budgets

- Separate services from real estate
- Analyze lease-up to determine rent up reserve
- Find your breakeven point and “margin”
- Use long-term projections to find the crossover point



Compliance Analysis

Compliance Analysis & Budgeting

- Funding sources have strings that affect budgets:
  - Occupancy and rent limits affect revenue
  - Compliance period may affect level of improvements
  - Property standards (& labor standards) affect hard costs
  - Closing costs affect soft costs
  - Compliance & reporting may affect admin/management cost
- Need to anticipate the likely funding sources, and adapt budget to comply

Compliance Analysis

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

Layering Analysis

- HOME/Other Federal + 1 other public 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
    - Comply with each program’s rules for assisted units
    - If multiple sources in a unit, comply with the most restrictive

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 – ensures project revenue, but not many available
  - 202/811 & RD
  - SRO, McKinney, special needs
  - PHA conversions of certificates
- Tenant-based – can't count on it or underwrite it
  - Existing certificates/vouchers
  - Welfare to Work; Self-Sufficiency
  - Mark-to-Market, HOPE VI, etc
  - HOME TBRA

Combining HOME & LIHTC

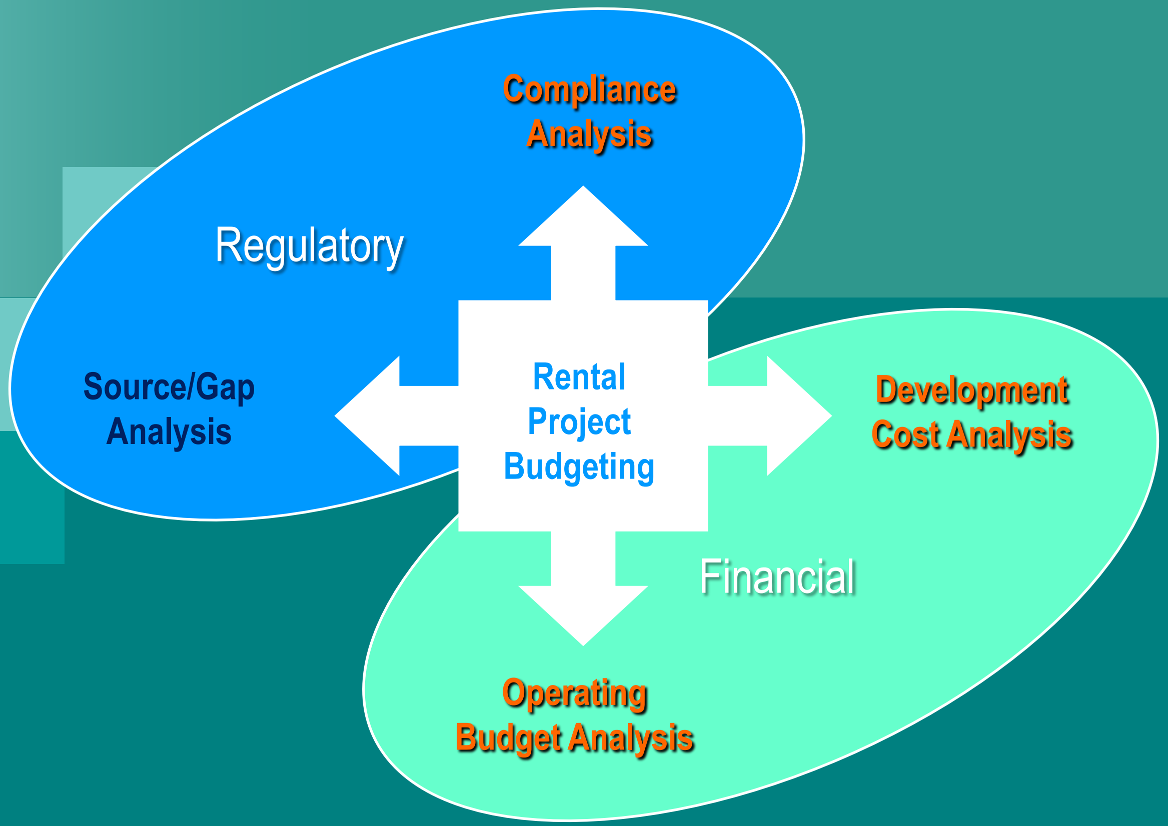
- Intended to work together, but two problems:
- Similar but not identical rules,
  - Most reconciled by following “most restrictive”, but
  - Over-income conflict (HOME requires rent adjustment, LIHTC forbids it
  - Resolution: LIHTC over-income rules prevail (HCDA92)
- If HOME is treated as “Federal”, 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)

HOME/LIHTC Compliance Issues

- Rules are "close" but not identical
  - Occupancy: 50%/60% v 50%/80%
  - Rent limits: tenant contribution v. HOME rent limits
  - Property standards: UPCS v. HQS; inspection requirements
  - Recertification/over-income
  - Compliance periods

Final Word on Compliance

- Sources will affect development & operating costs
- Multiple subsidies mean multiple sets of rules
  - Usually the most restrictive will cover both
- More sources is not necessarily better
  - You will have to live with complexity for the life of the project



Gap/Layering Analysis

Getting to the Gap

The Gap

<u>Development Budget</u>

Sources

- Equity
- Debt
- **Subsidies** _____

Uses

- Acquisition/SI
- Construction
- Soft Costs
- Working Capital _____
- TDC

<u>Operating Budget</u>

Revenue

- Gross Pot Rents
- Vacancy/CL _____
- Eff. Gr. Income

Op. Expenses

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

NOI

Debt Service

Cash Flow

Gap Analysis Steps

1. Review op revenue & cost reasonableness
2. Compute NOI
3. Capitalize the Net Available (using DCR factor) to compute maximum debt
   - Divide NOI by DCR to determine NADS
   - Divide NADS/12 to get monthly payment; divide by Mortgage Constant
4. Subtract debt, equity & other subsidies from TDC to determine "gap"

Soft Debt Fills the Gap

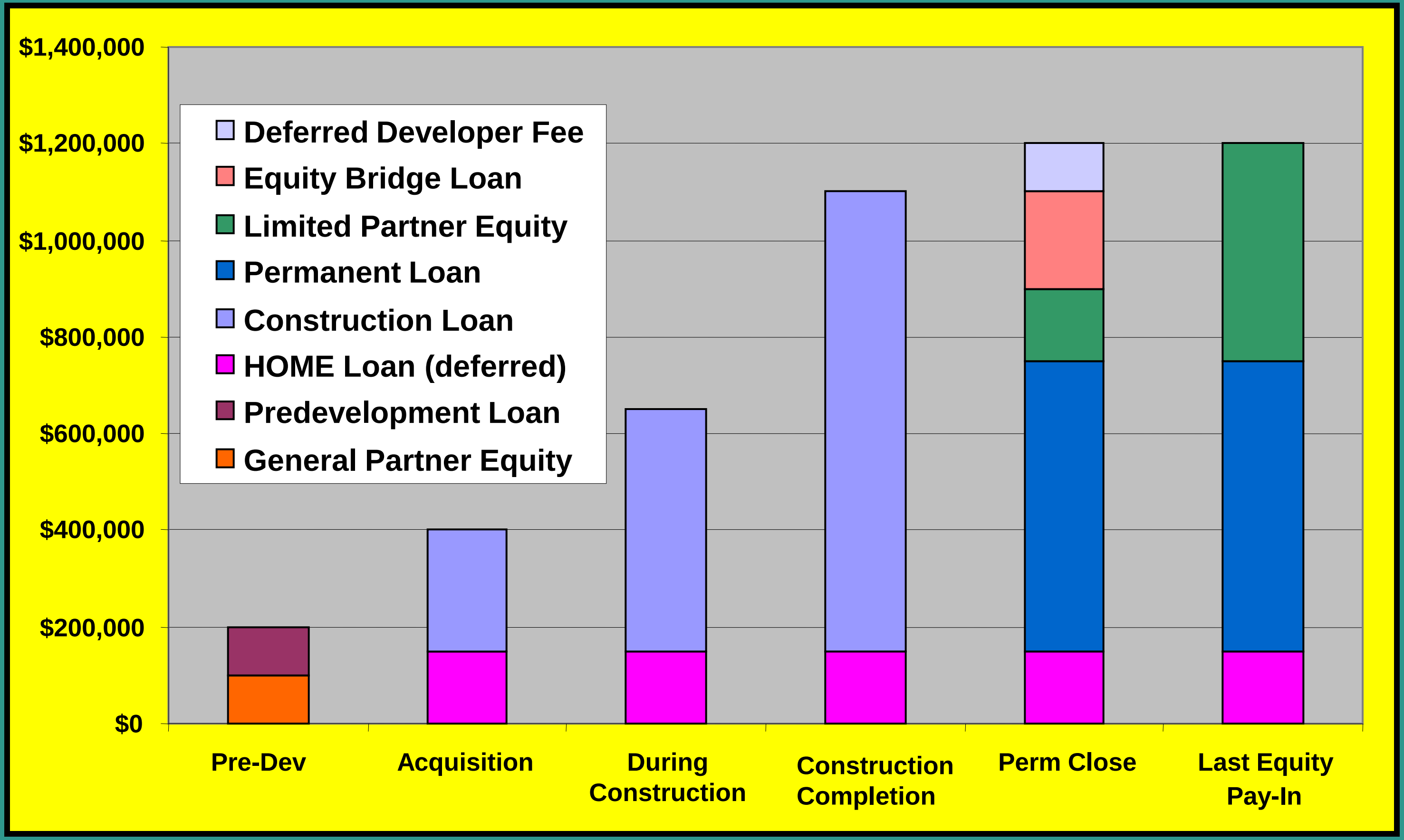
- Multiple public & foundation sources
- Must be grants or “soft” debt
  - Available cash flow taken for “mandatory” debt service
  - Mandatory debt service on gap loans reduces primary debt
- Cash flow loans: payments only out of cash flow
  - If primary loan maximized, cash flow = DSC margin
  - Other deferred debt & developer fees paid out first?
  - Maybe only a portion of cash flow (e.g., 50%) with remainder directed to reserves, operations

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: PJ/entitlement, 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 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
- 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?)

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

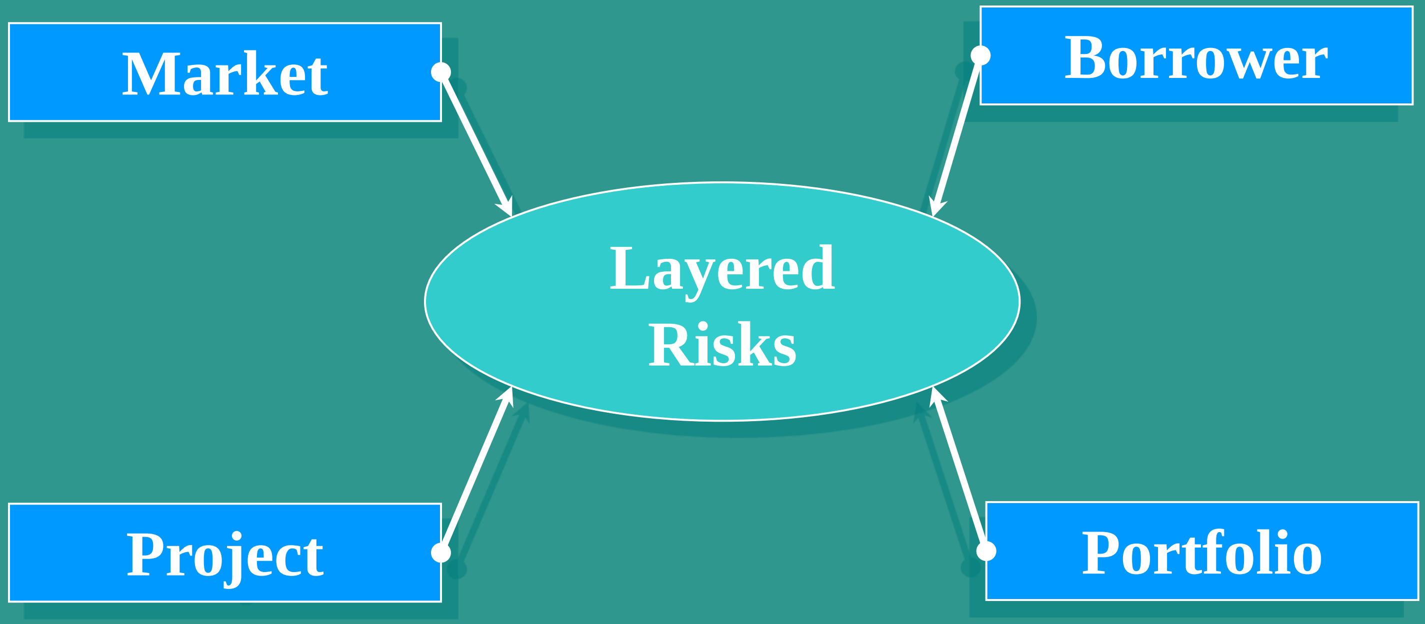
Feasibility Risk

- 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



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)
- National Housing Trust Fund (regs coming)
- Other: Foundations: grants & PRIs
- Owner contributions/equity

DHCR Financing Guidelines

- All sources contractually obligated before closing
- Debt supported by op budget
- Follow primary lender DSC
- Balloons before end of regulatory period must be able to be refinanced without affecting rents
- Excess cash flow to HTFC debt service (or reserves)

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: lien priority
  - Enforcement of compliance terms & repayment
- Foreclosure / deed in lieu of:
  - Notice of default
  - Rights to intervene; successor/assignee; forbearance
  - Survival of use restrictions

Putting It All Together

Lessons from HOME Rent Study

- 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
- Compliance problems
- Can’t overcome market weaknesses
- Competition among affordable projects
- Ownership/management problems
- Design/construction problems

Build Sustainable Projects

- Understand/ensure market competitiveness
- Fund improvements beyond minimum codes
  - Useful life beyond compliance term; energy efficiency
- Avoid excessive debt; leave a margin of error
- Fund reserves in both capital & operating budgets
- Budget planned maintenance & full 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
- 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 subsidy loans

Wrap Up & Evaluation

The Big Points to Remember

- Don’t leave out costs
- Every development decision affects operations
  - Development & operating budgets are linked
- Find your breakeven point and margin
- Avoid the crossover point
- Analyze financing needs by phase
- Keep subsidy sources under control
- Think sustainability

- Final questions?
- Evaluation
- MLFranke@aol.com
- Enjoy your summer!

- Next seminar:

  5. Project Implementation
     - Albany: 9/14
     - New York City: 9/15
     - Syracuse: 9/22
     - Buffalo: **9/23**