HOME Multifamily Underwriting Template, 9/2/20

Les Warner: Welcome everyone. This is our HOME webinar on the Multifamily Underwriting Template. We're going to be helping you to understand the functions and how you might use the template to do part of your HOME required underwriting. And try to get you a little familiar with it by the end of this session.

So I'm Les Warner. I'm from ICF. Anker Heegaard, who works with us, is from Compass. Anker is the person who actually did the original development of the template that we're going to be looking at today. So I'm going to do some introductions on this, then we're going to turn things over to Anker and he's going to take you through the template itself.

So for our agenda today, I'm going to do a quick review of what the key HOME underwriting requirements are, as a segue into talking about the functions of this underwriting template that's been developed as a tool that PJs could use as completely optional. But it's a tool that's available for PJs to be able to use in completing their underwriting requirements that we're going to be talking about.

And then we're going to turn things over to Anker and we're going to demonstrate how the template can be used by using a case study. So, looking at how you would feed information into that template, how you would feed in your underwriting standards that you've adapted as part of your policies and procedures.

And so helping you to see with essentially live action of a case study that would work. And as part of that, well then, we'll be looking at, so what does the template tell us as we plug these numbers in? What adjustments or adaptions might we need to make as part of this? And so let's just jump into things.

So the purpose of underwriting and subsidy layering and these are a HOME requirement, is to make sure that before we commit HOME funds to a project that we really do a careful analysis of the project itself -- all the assumptions that have been put in place with the projected numbers. We're trying to look at the risk of if we fund this project, will it be sustainable based on the way it's been proposed?

Part of our underwriting also includes things in looking at the marketing on this and whether if we build it or if we rehab it, will there be a demand for those units? Are the partners that we have aligned ourselves with and doing this project, do they have the appropriate skills and the financial capacity? So we're trying to make sure that we have a sustainable project.

We're also trying to size the amount of funds that we put in to this project, if we determine that this project is actually a reasonable risk. So the things that are required in the HOME requirements, are found at 92.250(b) and requires that the PJ is going to look at all the sources and uses, so all of the sources of funding coming in and all the expenses that are going to be related to this project.

Also looking at cost and profit reasonableness so determining whether this is appropriate. What's being listed as cost and also the return that the developer or other partners would have in place. We're also required to look at that market demand. We're trying to make sure is this the right project, is it in the right place, is it affordable; as part of making our decision on whether we're going to commit HOME funds to this particular proposed project.

As I mentioned, the developer experience and capacity is really important. We're really depending on them to be able to, if funded, to be able to get this project completed, so that we can produce affordable housing units and complete the affordability period that's going to go along to that HOME investment.

And then also looking at all the financial commitments that are a part of this project, and Anker will spend quite a bit of time on looking at not only all of the sources and making sure that they're documented, but then thinking about the terms of those commitments and also the timing of when those funds would be available. So moving on to the next slide and I'm assuming it's moving on for other folks. When we look at -- yes, Anker?

Anker Heegaard: Yes. Just confirming [inaudible].

Les Warner: Okay. Thank you. All right. So we have a whole number of related HOME requirements that are going to be part of this analysis. We know that we have maximum per unit subsidy limits and a cost allocation process to go through. You're going to be issuing a written agreement and carefully defining what it is you're funding, how your funds are going to be expended.

We know we have commitment requirements and then of course we have a whole slew of projects completion deadlines. So the underwriting template is not covering all of the functions that you have to do as part of this. But it becomes an important tool, or can be a tool for you as the PJ in completing that process and also documenting.

Of course again we have issues requirements under the HOME program that -- from the point that we commit projects that when we have an acquisition, we have to see the actual project begin within 12 months, same thing with demolition. We can't simply demolish something and not within 12 months begin construction, because we're a housing production program. Of course our HOME property standards are going to apply.

We're going to be talking as we look at the template about the required rent and utility allowances and then of course we have an applicable affordability period, based on the type of project that we're undertaking, whether it's new construction, whether it's rehab. And then based on the investments that are going into that project.

So the underwriting requirements are going to apply to all of your rental projects, your home buyer development project and also applies to our home buyer assistance, when we're providing down payment assistance.

And then keep in mind, if you were to provide your HOME fund in a homeowner rehabilitation program and you made those in the form of an amortized loan, so the folks were actually going to make payment, then we would also have to do underwriting, because we want to make sure that this is going to be affordable and sustainable.

This has been in place since the final rule, the updated final rule, went into effect in August 23rd of 2013, so hopefully this is not news to anyone. And that covers all projects that the HOME funds have been put into. So you might have your HOME funds only in one small subset of the overall funding for that project.

But we're going to be doing underwriting to determine how much HOME funds should go in. Whether this is an appropriate project as part of that. So reference on this, there's CPD notice 15-11, which lays out the underwriting and subsidy layering guidelines that was put out in 2015. If you're not familiar with that that is something that you should pull, look at and there's also a corresponding webinar that goes with that.

So the PJs responsibility, when this is triggered and we talked about being triggered for rental, for home buyer and for our amortized rehabilitation projects, the PJ is required to evaluate that project, against its own underwriting standard. So you cannot say well, let's say I'm a small PJ and the state is putting money in.

You can't simply defer and say, well, someone else has underwritten this. A lender has underwritten this, or the loan income housing tax credit underwriting has been completed. You as the PJ because you're investing your HOME funds, are required to complete this underwriting project and evaluate the proposed investment that you are making.

You can use what those other lenders have already done as a resource for you. But you as the PJ have adopted underwriting standards and policies and procedures and so you're going to be comparing this project to what your standards are, to make a determination of what you should be putting in to the project as part of that.

And so the PJ needs to complete this process. They could have someone working on their behalf. You could contract this out, but you can't simply defer to someone who's not working on your behalf. And you're going to be asked as part of your setup in IDIS, to certify that you have underwritten this that you followed your underwriting guidelines, as part of making this funding decision.

The things that we're trying to accomplish as part of our underwriting, we want to make sure that these are projects that we're putting in the right amount of money. We're not over subsidizing, not under subsiding it and we want to make sure that it's going to be sustainable. So you're required to have underwriting standards, policies and procedures as part of that. And you're analyzing this project to determine, is this going to be long term?

Is it going to a viable project that will be able to complete that required affordability period? And so all of our underwriting is always going to cover at least as a minimum, the affordability period for that project. And we're including it as part of that thinking about the reserves that would be

needed to make sure that, as repairs or replacements of systems, or components are needed that we're going to have adequate money to be able to cover that.

Also keeping in mind that our projections need to be able to account for, if we have a change in that market and we have some moderate losses, or we have some of our cost are higher than we originally projected. We want to make sure that these are able to sustain themselves through those periods.

So we're trying to do our best to project what will happen in the future. The important point here is that the PJ itself has a liability. So for a rental housing project, if that project does not continue as affordable housing and complete its entire affordability period, then the HOME funds that were used, or that project because they will not have that -- the affordability requirement for that investment, would have to be repaid.

And so the PJ has a liability and that's why we really want to make sure that the underwriting was well done, so that we're very confident that it will be sustainable in the long run. So as part of that process, the PJ needs to be able to document that they have appropriately underwritten this. And frankly these tools are also a way to remind yourself as you go through this process that you've thought about each one of these required elements.

So the PJ is required to have policies and procedures that lay out the process that you will follow and that would include things like standards, where you would lay out, what is my minimum vacancy rate, or what am I going to assume over time that my rents will increase; so that you're applying those standards to the underwriting to make sure that the projections are reasonable as part of that.

So you need to have a file that shows that you got the documentation that you went through your analysis and to be able to document that, to show that you did your due diligence on that. And keep in mind there may be changes throughout that development period, where maybe they identify that there's an additional -- maybe there's some additional fire suppression, or there's something that happens with their additional cost.

You may need to be revising that funding agreement and you may have to go back and re-underwrite, to make sure that with changes in that budget, or the program design that that project still meets these requirements. That documentation needs to be part of that file also. So this template has been developed as a tool for PJs to use. It's not a requirement, but it is provided as a format that PJs could adopt and then customize to be able to meet their needs.

And we're going to be walking you through how to use that, how to customize it to meet those needs. It also would be the completed template would document some portions of what your required underwriting and that documentation you need to have in the file. And depending on how you use that, you may be using the template yourself in inputting this information and completing that process.

I would think that some PJs will also be using their version of this template, to be able to say to folks, I want you to submit your application with this underwriting template completed and then

the PJ would be reviewing it and evaluating it from that point. So those are policy and procedure decisions that each PJ will have to make about how they will be using that.

So the functions of the template itself, it facilitates the project review, looking at the cost that they're going to be part of that really collecting that information for you to be able to evaluate. Also documenting all the sources of financing for that project, so that you can walk through comparing the uses of funds and the available funds that are there.

And then looking at the cash flow and the projected financial health, throughout that affordability period. And we'll be walking through each one of those functions. This template is not a handles everything that you need as part of this. You'll see that one of the things that's very important as part of your underwriting process, is that market analysis, determining whether these are the right units in the right place. Are they going to be affordable?

That's not part of this analysis. Also your cost allocation process and if you need to look at more on that that's CPD notice 16-15. And again there's a webinar posted on the HUD Exchange that will tell you more on that. That's not part of this template because we now have some standard forms and methodologies for you to use on that.

Also another critical key part of this is, evaluating the developer and making sure that that partner that you're depending on being able to complete this project, having the financial liquidity and capacity to be able to do that that's also not something that's captured as part of this process. We mentioned cost reasonableness, because in many cases we do not have a procurement, a bidding process on these projects.

The PJ has to always be able to evaluate whether costs are reasonable. So the template will help you collect what those costs are for the project, or you're going to have to have a separate methodology to be able to evaluate those costs.

And then again, the underwriting that the PJ is going to need to do, based on their evaluation using this template, are going to be those steps then that you determine whether that project needs to be modified, whether it needs to be tweaked or redesigned in some way. Or maybe as a result of that you determine that this is not a project that you actually want to invest funding in.

So I'm going to turn things over to Anker at this point and let him take control.

Anker Heegaard: Yep. Need control. Can you hear me all right?

Les Warner: I can hear you fine?

Anker Heegaard: Okay. All right. Thanks for that, Les. The division of labor here, Les, is going to give the basic framework and I was going to do a guided tour based on essentially a case study. And so this is where we start to dig into the [inaudible]. The case study is a new construction project, 10 units, 100 percent home, no LIHTC.

So we've constructed this to be a pretty vanilla transaction; and as a consequence, it's not going to cover all of the permutations of a multifamily deal that might run into. But at least our hope and our intention is that it gives you a pretty good understanding of the working functions and capabilities and skillsets within this underwriting template.

Where we find ourselves in the process is that we're sitting in our desk as an underwriter for a PJ. We have all of our emails and files and papers in front of us and we're going to start populating the model, to see how the deal comes together. Once it's been populated with all this basic information, we're going to be able to make some key underwriting determinations and decisions. And we'll see how that evolves as you go.

The basic worksheets or tabs of the underwriting template are shown here, you'll see them. So I don't want to spend a lot of time introducing them, but just be aware that I'm going to go back and forth between a quick introduction of each worksheet and then the worksheet itself.

So the introduction and let me just make sure that I can pull up my chart that I have here, just so I can see if there's anything that comes up as I proceed. The first worksheet that we're going to explore within the underwriting template is the introduction worksheet, which its job is to allow you to basically identify the project by providing some basic information about it.

But it also provides you as the PJ underwriter with a pretty good summary of the functions and considerations in the tool and I'll show that to you when I get to it. So, without further ado, this is the introduction worksheet to the underwriting template. And as you can see the only inputs on this are at the top. Input cells are green background by design and output cells are formulaic. Outputs are going to have a white background.

And the only place you can actually input anything as I said before is at the very top of this particular worksheet. But let me introduce a couple of things that are also here that are of interest and useful to you. This discussion, narrative discussion here points at something that Les said earlier, which is that this template is not required, but it will help you to comply with many, but not all of the applicable HOME rents with regard to investing HOME funds in multifamily deals.

And Les already covered a couple of points about what's not in here. Obviously, there's no cost to allocation analysis or computation integrated into this, but there is a separate tool available on the HUD Exchange, if you want to do that. I'm going to go down to a couple of pieces of advice here. The basic role of HOME funds in a development is obviously to fill the gap. And so there's a discussion there about gap financing.

Your job as an underwriter when you're investing or considering investing in HOME funds in multifamily deals that accomplish three basic things. You want to ensure that the amount of HOME funds being invested is not less than or more than is appropriate to get the deal built. Too little HOME funds and the transaction will be thin and vulnerable; too many HOME funds and you have over-invested and violated certain subsidy layering considerations.

But you have other considerations as an underwriter aside from simply sizing HOME funds correctly. One is you want to make a determination that the project is reasonably likely to get

built. And perhaps most importantly at the end, we'll come back to this. We want to ensure that the project is reasonably likely to succeed through its HOME period of affordability, as set up by you in your initial underwriting.

Other things discussed in here are the basic introduction to the template and importantly a discussion at the bottom about the Excel format that has been built in that it does make use of macros. And I think very importantly, for those of you who are a little bit sophisticated with Excel, this is a password protected template, so you could only input in the input cells. But we've taken the liberty of providing you with a password, so that if you want to make modifications to it, you can do so without accidentally changing any formula.

So that's an important consideration. So without any more information about that, let's talk about filling it in. So I've built this for training purposes as you can see, with fill and un-fill -- undo fill buttons, just to get through the inputs quickly. And so you don't have to watch me type for two hours. So I'm going to fill it in and as you can see, I would've -- normally I would've typed that.

Excuse me. And we're dealing with Wildflower Apartments, where it is who the developer is, what the date is and what kind of property it is. So with that, we can move on to the next worksheet, which covers HOME and other affordability requirements. So this is the page that captures basic rent and occupancy considerations and restrictions they're going to apply. And so let's go there and let's figure that out.

So, the purpose of requirements is to input key information about Area Median Income, which I'll refer to as AMI, HOME investment limits, HOME rent limits and other key drivers of the information. So let's fill this in. In this case, what we've done is we basically indicated what the AMI is, where we got that information as an underwriter, we should've used the comment box and fill out the information.

What the HOME investment limits are that we got from the HOME field -- the HUD field office and what the HOME rent limits are. And we can go down further and complete some more information. In this case, we've input the market rents that we got from the market rent study provided by the applicant developer. And we've reviewed and accepted and that it's part of our documentary file on the transaction.

At this point there's a rather neat feature set of it, where we can populate what the AMI rent limits are based on the percentage of AMI. So we do it for -- we can do it just for reference for 50, 60 and 80 percent here. And we've included comments to show what that information represents. And then down at the bottom, there's a handy reference chart about what rent limits are as a percentage of AMI.

And that's pretty much all that you need to do on the requirements worksheet. Again it's high level parameter-type information with respect to rent and HOME investment limits. So the next worksheet that we would naturally go to in our progression is the rents and income. This is where we get into property specific information, like the number of units by size, what the utility rates are that are being used for underwriting, and vacancy loss. So let's go there and do that.

As I said before, the prior one was general. Now we're into specific. And if it's specific, you will want to input specific information about the proposed unit rents and the rent limits that are going to apply to each configuration. The configuration will be shown on an individual row and it represents a unique combination of information, so that all of the units on a row are the same in terms of the size and type of affordability restriction that applies to them.

So if you have 30 units, you might have half a dozen different configurations. But let me illustrate by doing the first set of inputs. So in this particular case, we're going to say that there are two units of this configuration that there are 825 units -- sorry, 825 square feet each. Don't worry about the [inaudible] value errors; they'll go away. That they're one bedroom each. That they're, yes, low HOME and accordingly no, not high HOME and accordingly not market rate units.

Not low-income housing tax credit units, not CDBG. And that the rent limits that we want to underwrite to, is low HOME. And you see it starts to fill in some of our data and here it asks what percentage of the maximum rents do we want to underwrite to? And we feel confident that these rents are achievable, we're not going to back off from them and we're going to say 100 percent.

And then it's going to ask us which utility allowance applies to these rents and we're going to say the HOME utility allowance. And then as we scroll back, we can see that it has taken these inputs and has filled in a lot of the parameters as the one-bedroom low HOME units. We're underwriting them at 100 percent of low HOME, the gross, the utility and net rent is what it is and we would do that for each configuration.

So to hit the fast forward, I'm going to fill in the unit mix and it does all of the calculations. And I've also taken a good look at that and as a diligent underwriter, I ventured in a comment about that. And it basically it's 100 percent HOME project; there's a mix of high and low units. There are four ones and six twos. I think typically narratively express the information that's already there.

And I now have my rental income net of utility allowances, $89,568. So I've completed a portion of this process. I'm going to scroll down because there's other features to this worksheet. The template permits you to differentiate between rent loss in the lease-up year, which is what you see here on row 38 and rent loss in the stabilized year which is what we see on row 39.

It's a good practice to do that as an underwriter, but the template doesn't fully support this by permitting the lease-up reserve to show as revenue in the lease-up here. So as a workaround, I've taken that equation out of the mix and I'm treating the first year as a stabilized year in my underwriting.

And I've also input how much longer other revenue is projected. And I've input a series of comments about how I've treated all of this. So I'm done with this page. I've got my rent revenue side thought through and I'm going to go to the next worksheet. The next worksheet is development cost. And this is the tab worksheet that captures the projected total development

cost and allows you to look at a series of breakdowns and analytical representations of that information.

So let's go to that. All of the development costs that the property has been experiencing getting from initial closing through occupancy into an operating entity, rather than a property underdevelopment would be represented here. And you're going to enter all of those and see what it looks like. Again, I have a magical button to fill it in and I'm going to fill it in. So I presumably I've gotten a lot of this information from the applicant developer.

But there's a page here that I want to point out, because we're going to come back and we're going to find too some of this as we go forward. And that piece shows up I think on row 57 if you just scroll down. And it's asking you for reconstruction interest cost as an element of your development cost and that's blank at the moment. So as we go down, we could see where we deal with that.

Just we're going to deal with it in a two-step process. In the first step, we're just going to fill it in very roughly with some micro rule of thumb approach about estimating construction period interest as the development cost. And we're going to base that on construction loan amount, which we don't have yet, we'll get to that and that will fill that cell in.

The other things that I want to point out while I'm on this worksheet are that your inputs here will give you cost per unit and cost per square foot and very importantly you'll also have a comment field that tells -- that gives you an opportunity as underwriter to defend why you believe that's the right number.

So I've filled in a few of these as a representative sample of how somebody might do this. I also want you to pay attention to this initial operating reserve number and that your total development cost in the aggregate from these inputs is just a hair over $2 million. So with that done, we can move forward to the next worksheet and that worksheet is replacement reserves.

I just want to take a break here to give a very brief public service announcement about replacement reserves. I've done a lot of deals over many years and my observation is that reserves are typically underfunded relative to the cost of capital replacements during the period of affordability, under which the PJ has a liability to HUD, for the success of the property as an affordable housing investment.

So getting the reserves right is important and it's important not to rely on a rule of thumb that isn't going to perform well for you -- excuse me, over time. So let's go to that worksheet and see what it looks like. This is the worksheet in the model that allows you to do a simple estimate of reserve requirements. I'm going to do a sample input for one row and then I'm going to go to my automated fill, to show you what it looks like in total.

So this is a new project, new construction and that the HOME period affordability is 20 years. So we want to look at what it costs to keep the property in good shape for 20 years. So we'll just start with a simple one which is site signage and we're going to say there's one site sign. So that's

in each item and that site sign cost $5000 to replace and that it has a 30-year remaining useful life and a 30-year effective useful life.

Effective useful life means when new, what is the typical life span of that item and remaining useful life means from wherever we are in that lifespan, how many more years are left? Because this is a new project, all of these replacement items are going to have an RUL or remaining useful life and an EUL, effective useful life that's the same. So let's still fill it in as if we were going to complete it and now we've got inputs for all of these items.

I mean, you could as a PJ ask developers for this information and fill it in as you're underwriting. But when we fill it in, there's a couple of interesting things to note. This column here is critically important and it asks is that item going to need to be replaced during the HOME period of affordability? The answer for signage is no.

It doesn't need to be because we have a 20-year period of affordability and that item has 30 years of remaining useful life. So that item, the replacement cost of that item, is not going to accrue during the HOME period of affordability, but other items will. And so we then put our appliances, our flooring, our mechanical items and so forth. And where the punchline is, where it all comes together, is this number here which is $6,436.

And what this says is that this property will have a $6,436 per year cost over 20 years to replace items and that that's what the reserves should be set at. So we'll see how that comes together later and I thought demonstrating this toolset could be really interesting and potentially valuable in the way that you underwrite your deals.

So we'll go forward. Next, we're going to do construction schedule. The purpose of this is that HOME funds impose a four-year completion deadline from the date of which you commit your funds. And so having your arms firmly around various timelines, milestones and deadlines is important and the tool includes a series of inputs around that, which I'll show you.

Here you have your intended HOME commitment date, projected closing, construction start, various milestones, when it's -- when you expect things to be completed, when you expect our occupancy to be achieved, so also by the end of this I'd filled it in as the underwriter. And not only does -- are these dates in here, but it provides some popular narrative that indicates what those timelines look like.

And in the comment box, I filled in that these dates meet HOME commitment and extension and expenditure, it's hard to say -- and expenditure deadlines, with sufficient cushion. And you'll notice that a little bit below, there's some formula narrative that shows various measures of the proposed development.

And as an underwriter, I filled in an answer to certain HOME requirements; various information. The cost of the payment and performance bond is included in the construction cost estimate. I've looked at the fact that the developer has adequate cash reserves and that the schedule is okay. So this page is well filled in and we can move on to the next one, which is LIHTC basis.

Now the rule here is they introduce Wildflower Apartments. This is not a low income housing tax credit deal, but the tool, so you know, does provide a pretty basic framework for incorporating tax credit considerations both on the rent underwriting side, as well as on the source side where you can input the low income housing tax credit equity.

This model is in no way a substitute for a robust tax credit underwriting model, but it was developed to be sufficient to allow you to reflect tax credits in the deal that you're underwriting on your chair, with respect to the wisdom, or lack of wisdom in investing HOME funds. So let's go to that worksheet as I show you. This is the low income housing tax credit worksheet.

We're not going to fill any of it in, but it allows you to do things you may be familiar with or not like look at applicable fraction, basis, basis boost. These are the points [ph] of the realm for low income housing tax credit. So we'll just leave that and go back to our deal. We're just going to skip over. So another central element underwriting is operating expenses and if you can't estimate operating costs, then you don't know if you -- if your property is going to be viable.

So it's important to do that and this is an important aspect of underwriting and I have a fill button that allows me to fill it in with the information that we have on our desk. So we've got the annual cost for all of these in the first year that'll later be entered [ph] and you'll see that. As an underwriter, we've been able to enter in some comments about where we got that, or why we think that's the right number.

And it also shows breakdowns for what the monthly and per unit, per year costs are. And if I scroll down, you can see that the totals are there for you. Total operating expenses, you'll see this later, so your number is $48,296. But also importantly, because we did that earlier work on the replacement reserve projection, we can see here that that number is showing up here and it's pulling me from the replacement reserve worksheet.

And that number is $6,436, which is $644 per unit per year. For those of you who are used to tax credit equity driven replacement reserve deposits, you might note that this is substantially higher. One of the reasons for that is that tax credit equity is really on the hook for the first 15 years. But when you're investing HOME funds, you're on the hook for the first 20 and so you have an interest in the reserve deposit that's adequate for a longer period of time.

And those years, the 16 through 20, have to be relatively expensive years when it comes to replacement needs. Another thing I'll point out before we leave this is that there are various subtotals here by typical expense category. And that there's an opportunity for you as an underwriter to enter in that you're satisfied with this and you believe it's within your range and you reviewed cost and you're taking the opportunity to spend that this is the right answer. So let's move on.

Les Warner: Anker, one quick question.

Anker Heegaard: Yes, sir.

Les Warner: We had a question where they were asking if there are any year over year escalation that's been built into your replacement reserve calculation.

Anker Heegaard: Yes. Well, let me go back to that just briefly and then impartial explanation to the question. So in the replacement reserve, there's no escalation built in here. So this is -- and this -- none of the costs are escalated. But the cost will escalate over time, but so will your reserve deposit. So if you're going to escalate your cost in your reserve deposit, then you'll keep pace with each other.

What we care about for now is what's the number today on the level basis without escalation? And I'll show you when we get to the operating pro forma that this number is going up over time because these numbers here in column F are going up over time. Right. So back to our tour. So we've done a lot so far. Thanks to my macro button, I've been able to fill it in pretty quickly.

But we've got rents and expenses and now we're going to start to get at what our sources are. And in the first mortgage sizing worksheet, you're going to see that we're starting to shape the transaction based on the inputs that we've done to lay the groundwork. So let's go to that. This is the first mortgage sizing page and this where we input our other sources.

It's important to remember that when you're underwriting for HOME funds, one of your goals is to size for the gap. And in order to size for the gap, you've got to know what your development costs are and what your other sources are to get there. So this is where we input our other sources, including the first mortgage.

So let's start with some filling this in and it'll give us some inputs. We know from the financing package that's been submitted to us that this particular deal has a commitment of state housing funds of $500,000 soft money and another one for another $500,000 from the community affordable housing trust for $500,000. And let's say they asked us for $600,000 that we -- this is what we're underwriting, $600,000 of HOME funds.

So we have those as fixed inputs. Now we're going to look at first mortgage size. So I'm going to scroll up for a second here. Okay. So in first mortgage sizing, typically a lender is willing to loan the lesser the loan by LTV, or loan to value or they're going to loan the lesser of that amount, or the amount that can be supported by the net operating income of the property, which is the rents minus expenses minus reserve deposits.

So in this particular case, the lender is saying that this property, after it's built, is going to be worth $800,000; and the lender is saying they're not going to lower more than 70 percent of that amount to give them a cushion between the loan and the value. That amount is $560,000, so that's one of our bogeys [ph]. But now we're going to put our arms around how much debt can the property support from its operation.

So we're going to say if the PJ, as it says in the comment here that we're not going to allow a property this size to have an initial back cover of less than $1.30. And what debt cover means is that it's the relationship between the money available to pay debt and the cost of that debt. Or

said differently that every $1.30 available to pay debt, the property will pay $1 towards debt. It must pay debt, service debt that I'm referring to.

So we're going to input data as a controlling parameter in debt sizing. And we also know that the proposed mortgage lender which is ABC Mortgage, is willing to loan the money at 5 percent and they're willing to have the repayment of that debt amortized over a period of 30 years. So basically, we now have two key numbers, $560,000 and $359,000.

$560,000 is the most that can be loaned according to the lender's loan to value and $359,000 is the most that the property can support based on those debt sizing parameters of debt service coverage interest and the amortization. And because our loan needs to be the lesser of those two, we're basically proposing a loan amount of $359,000. So there'll be more about this.

This is the preliminary input and we're going to test whether that's okay, but this is a good place to start. There's another thing I want you to notice while we're on this page, which is that we've looked at the lender's commitment letter and the lender's commitment letter says that they will charge a one percent origination and financing fee. And we see that that on the $3 million -- sorry, $359,000 loan is going to be $3,590.

But on our development cost worksheet, it says $2,283 and the model is telling us that there's a mismatch between that input and the data that we're underwriting to. So we're going to fix that. So this is the point at which we begin to bounce back and forth a little bit and tighten things up. So let's go back to development costs and let's scroll to row 67 which is here. There's that $2,283, well we believe the number now is $3,590.

And so we're going to update that and this updated based on the lender's commitment letter. And so we're starting to use the model's ability to tell us things in order to improve and refine the underwriting on which we're sizing our HOME funds. So let's move forward to sources and uses. And again, this is where we can see things, the hard work that we have done, begin to come together a little bit.

We see the $359,000 first that we had just got on the first mortgage sizing page. We see the $600,000 that we preliminarily put in that they've asked for. We see the $500,000 from housing trust and the $500,000 from the state. And we see that the development cost that we input earlier are $2,000,072 and the model is very helpfully telling us -- in red ink, no less -- that we're $115,593 short.

So we know that if we were to go into the field as it stands today, there would be a shortfall and so I'll point back to earlier in the discussion when the idea is not to put in too much and not to put in too little. We also have a refinement that we can do here, which is that the developer fee, part of it can be deferred -- and often is in multifamily affordable housing financing -- and the developer here has already agreed to defer $87,000 of the developer fee.

In other words, that's the portion of the developer fee that appears on the uses that is not going to be paid and then become an offsetting source and is repaid to the developer through cash flow. So with that we now see our gap has dropped to $26,593. That way, there's more, we're not done.

So we're going to continue to refine our numbers and there's one more place that we want to do that and that is on the sourcing -- sorry, I missed that one.

But on the source of use by month worksheet. So the key to this and all multifamily developers are familiar with these sorts of analyses, but obviously not only do you care that sources and uses are equal to each other at the end in totality, we care deeply that they're equal to each other at each month in the development process.

So this worksheet built into the template gives you an opportunity to do that. So it looks a little bit scary, it has more input cells than anything else. You can ask the developers to fill this in. But basically all I have to do is hit my magic button and what you can see is the timing of when various costs will be incurred that's happening on rows 8 to 92 and the corresponding timing of what various sources are going to pay in.

The difference between when the sources pay in and when those uses are incurred is going to have to paid for by the construction loan. And if you scroll down, what you'll see is that we earlier had a rough justice-broad brush rule of thumb estimate that that would be $25,000. We now see that based on the actual projected timing that's going to be $41,896. So we're going to want to go back to our development cost and we're going to want to fix that.

So we go back to development cost and we go to the cell B57 and we say instead of the $25,744, we want that number to be, here, hold it, $41,896. Now what we've done is we've once again chewed up our cost estimate to the information that we have and it's at this point that we can return to sources and uses. And you could see that once again our shortfall has adjusted, because we've just added a little bit more development cost.

And in that adjustment, now we come to the crossroads. We believe that our mortgage is right. We believe that our other sources are -- they are. We believe that our development costs are right and yet we're still $42,000 short. So as a quick fix to this problem, I'm going to be nice and I'm going to say that the right fix here is to increase the amount of HOME funds they requested.

In other words, they asked for $600,000. It's not enough to get this deal done and we're going to go back to them and we're going to say, you asked for $600,000 and what you really need in order to get your sources and uses to balance is $642,745. And then we're going to return to sources and uses and we're going to see that we have no gap anymore.

That our sources are exactly equal to our uses and that we've got a development budget that is in balance. The mortgage we believe is supportable; the other sources are what they are. The deferred developer fee is -- most of the developer is willing or able to defer. The development costs are all what they are and in some cases, we refine those with information provided by the model.

And to address the remaining gap, we adjusted in this case, the CDBG up. Remember that you could just as easily go through this exercise and find out that while they asked for $600,000, what they really needed was $575,000 and you are not going to commit more HOME funds that

your underwriting establishes is necessary to develop the property after you consider the reasonableness of the various cost.

So with that said, we can actually forward again because we're not entirely done. We want to look at the pro forma, but before we do, we're going to look at the assumptions that drive the pro forma and these are on separate worksheets. These give you an opportunity to set the period over which you're looking at viability and give you an opportunity to step income and expense trends.

In order to do that, you may have policies and procedures. You may rely on data sets. You may mirror some of your requirements to those that are expressed in a tax [inaudible] allocated agency standards. But in any of that you're going to have some and they appear here on pro forma assumptions. In this case your period that you're looking at is 20 years. You are increasing your income by two percent and you're increasing your expenses by two and a half.

And when that's done, there's like a little cheat window that shows you that your property actually gets better over time based on this confluence of factors. So you start out with a $1.31 debt cover, $1.31 and at year 20, its $1.56. It's important to look at this because as we explained at the beginning, your job is not just to ensure that you've got the right amount of HOME money in your development pro forma, but to ensure that the property is reasonably likely to be viable for the period of affordability. So let's look at what that looks like on the operating pro forma page.

Les Warner: And Anker, I think it might be important to just note that those standards that you have, we were just showing on rent escalation some of those other things; those are coming directly out of the PJ's policies and procedures and the standards that they've adopted.

Anker Heegaard: Right. Thanks for that, Les. And sorry if I glossed over that. But just going back here, many aspects of this model are going to reflect your own policies and procedures and standards and guidelines. Actually, it would be a good practice to go and take the template, modify it for your own practices.

Then save that as the master that you are open and use for underwriting, so that you don't have to make these changes every time you use the HUD model, so just as a recommendation. On the operating pro forma page and I just want to maybe go to a different zoom here. You see your income.

This is your GPR, your gross potential rents, your estimated rent loss, other revenue gets you to effective gross income, markets your projected operating expenses, totaled here, minus your required reserve deposit, gets you to a non-operating income in this case in the first year of $30,071, minus the debt service gets you to your cash flow.

You'll note as I said before that your replacement reserve deposit is inflating here and that inflation of the deposit should keep pace with the inflation of cost for those reserve items that you have input under replacement reserve worksheets. You could see that over time this property stays positive. Your debt cover increases and the aggregate debt cash flow adds up to the

developer's cash on cash return and we'll see to that in a moment when we get into the administrative record.

So all of these features are accrued toward a comprehensive and holistic representation of what's going into this property and why is it viable? And what were the assumptions that you relied upon? And why were they reasonable? So the next stage I want us to go to the administrative records.

This is a really great worksheet, because it gives you an opportunity to demonstrate that you looked into, thought about and were in compliance with certain key HOME requirements related to investing HOME funds. And the documentation here doesn't meet all of the things that you're required to do, but it does cover a lot of them. So let's just look at that before we conclude this.

In the administrative record it's all comment boxes. I'm going to fill them in and just show you what I did. In this case, we can say that there's no cost allocation required because all of the units are HOME units. We can say that we've addressed 92.214(b)(3) in this way. We've addressed (b)(2), 250(b)(2) in this way.

In many cases, you may have supporting documentation that it's this elsewhere that you can point to and I'd like to think of the model as a really important key mechanism for -- like the hub of the wheel from which the market study and the capital needs assessment and the owner's commitment letters, all in distant relation to this.

The last thing I'd point out is the summary worksheet. There's no -- there are no inputs on the summary worksheet. But it does pull forward and represent on one page what the property is, what your sources are in the final determination, what your final concluded uses are; where your high and low HOME units are.

There's a nice, very condensed pro forma that shows years 1, 2, 5, 10, 15 and 30 and it also summarizes the owner's returns, in this case the owner share cash flow as a percentage of their deferred developer fee. So back to the slides and I will hand the presentation back to my partner here.

Les Warner: Right. Anker while we're at it, we've got a couple of questions. I've answered a lot of questions, but a couple I wanted to ask you to comment on. So --

Anker Heegaard: You [talking over each other] screen control?

Les Warner: You might, in case you want to [inaudible] back. So, there was a question about where the utility allowances are coming from that we're populating within the spreadsheet and trying to see where those were plugged in essentially.

Anker Heegaard: Absolutely. Excuse me. I'm just going to drink some water here. Too much talking. On the requirements page, you can input the HOME rent limits. The HOME affordability period and the market rents. The utility allowances are here. In other words, that's all you're required to have row 28, is where the HOME utility allowances are plugged in.

What I did is when I programmed this, is I said that the utility allowances for 50 percent rents are this. And I basically made it the same as the HOME utility allowances. There's a comment, or there should be a comment box in here about where that came from, but I guess I never filled that in. And that's what it comes from whatever the utility allowance framework is for your HOME units.

Les Warner: Right. And I sent out that folks hopefully know you're required a methodology and you've got I think four options on that and there's some a HOME fire which I sent out the link. So that's something that the PJ has to have put in place their utility allowance schedule that they're going to use for the project.

Anker Heegaard: Great. Excellent.

Les Warner: On that same page I think, there was a question about why are we listing market rents? And of course, in this case I think all of our units are HOME units, but in some projects obviously we will have some market units, some HOME units you might have some tax credit units.

Anker Heegaard: Well, let me answer that. So you should always note your market rents, if for no better reason than to demonstrate that your proposed affordable rents are below market and it's not always the case. It's possible; it does happen that the market rents are actually lower than the affordable rents.

And as a practical matter, you're not going to be able to rent a unit -- unless it's a project based subsidy unit in which the tenant is only paying 30 percent of their income. You're not going to be able to rent a unit for a rent that's higher than market. That's just some practical reality of the world, is that you can't say to somebody well, you have to be below a certain income level to live here and it costs more than the exact identical apartment across the street that doesn't have this program.

So I would always recommend putting those rents and I think and I could express this out and I think if we had lower market rents, you get a flag, so -- let me just see. I was just flagging that to say that you're violating that. So the model is smart but it's not brilliant. So I always -- but I think that's the answer to your question, Les.

Les Warner: Thanks. So we have another question about, on the first mortgage sizing tab, they're asking, should you use the funding sources provided during the construction phase, or the permanent financing sources and uses? And saying that they found that bridge loans can screw up the calculations on sources and uses.

Anker Heegaard: Yeah. That's a great question, Les. So you pretty much have two choices and you can't make a match between them. Choice one is always show your permanent financing, which is what I've done here in this demonstration. And choice two is to show your interim financing, your construction financing, but if you do that, you have to show it both as a source and a use.

In other words, it comes in as a source, but has to be paid off as a use. So I don't think -- from my part, having I've done this a lot -- in a model like this, my preference would be to annotate that there's construction loan on a certain amount and then it's the bridge loan and then it's going to be paid off, but not to -- not to muddy the water by representing anything rather than the permanent financing.

Please understand, of course, that for purposes of this demonstration, we've intentionally done a somewhat stripped down and simplified presentation of a deal and that every deal except from wrinkles and complications and -- so we're not able to go into all of those in this training.

Les Warner: Okay. And I'll just, as part of this scenario, on one of these where we looked at it and said well they actually need -- they've asked for $600,000 and they actually need another forty-some thousand dollars on this. We're going to have situations where the PJ has set their maximum amount that they provide at $8,600,000 is I know in my experience everybody seemed to always apply for what our maximum was and try to back into those other funding sources.

So in the case where they are needing more than our program would provide, I'm assuming that first off, you'd be making sure that they were actually maximizing private financing and that the project could support. But there are going to be times when we might be then saying, we can't fund this project unless you can bring additional sources to the table. Anker you want to throw anything else out there on that scenario?

Anker Heegaard: Yeah. Thanks. I mean this is a deep topic. If you got to -- let's say we've had this problem and I can just illustrate this as quickly as possible. Let's go back to first mortgage sizing and let's say that we were really limited, but we didn't have $642,000, we had $610,000. That's it. Grab the money. If we go back to sources and uses, we can see that there's a gap there of $32,000.

And there's a lot of ways to solve this. One way is to go in and say, the term I hear from developers always when they run out of money is that they're going to value engineer the project. And the question I always ask is, well, can't you do that before you show up? BSo there might be the ability to solve that $32,000 problem.

That way we could also go and we could say, we size this on a $1.30 debt cover and really that's aspirational and this deal could -- we believe it could survive at a $1.25 debt cover. That produces a larger mortgage and now on the sources and uses, we only need $18,000. So it's a fiddling thing to -- but before you can do the fiddling, you got to kind of get your facts laid out so that you know what to fiddle with.

I'd like to fully populate it and if I have a problem, then it's a conversation with the developer. It's an exploration into where am I comfortable reducing cushion in the deal? Have I answered your question at all, Les, or am I just not sure?

Les Warner: No, I think -- I think that's good. Let me throw another one at you. So I'm starting to answer this, but I'll -- it's probably easier to do live. So we had someone write in saying, you

know, their staff really doesn't have the capacity to handle all this to make sure it's completed and analyzed properly. What do you suggest that we do?

Well, the PJ is required because they're overseeing this funding before they make that investment. They're going to have to make sure that this has been completed. Now that could be done by your own staff. That could be that you hire a contractor with the appropriate skills and that's done on a project by project basis.

The issue is that you have to be able to certify that you have -- if you're going to do this kind of project, then you either have to have the staff capacity in-house. Or you'll have to work with an outside provider, much like you would do, many people doing multifamily may contract out the environmental review, or if we're working with lead, you're hiring a lead contractor.

So you would be going through procurement generally for that. But it doesn't necessarily have to be completed by in-house staff, but it does have to be someone who's working on your behalf and has the right skills to be able to do that. You still as the PJ, would have to have policies and procedures and the standards that you're going to use in doing that. Anker, anything you want to add to that?

Anker Heegaard: Yeah. I'll say a couple of things about it. I think there's a -- just to be perfectly honest, there is a problem with the environment, which is that if underwriting takes a lot of practice and it's complicated stuff and so the people who get good at it are people that do a lot of it.

And in many cases, PJ's don't have enough money to do enough deals to develop the internal capability to do it, particularly when the person at the other side of the table is a developer that does it for a living to the exclusion of all else. So for that reason, I think you're right, Les that either you've got enough volume and enough budget to have that capability on staff.

Or you contract it out and then you hire somebody who on a consulting basis who can fulfill that role and explain it and lead the decision making to you, but perform the analysis. It's what I do. I do it for a lot of government clients and I think it's the right value proposition. You go to specialists when you need that sort of help.

Les Warner: Okay. Got a number of more questions for you. So one of the questions is, if we have a first mortgage with a balloon payment, how do we reflect that in the template?

Anker Heegaard: Great question. You're going to have to modify the template. It doesn't permit that as it's currently designed, but with a little bit of Excel talent, what you would essentially do is, you'd get into this section here and you'd put in the amount of loan that's due when it's due and the new proceeds from the new data.

The short answer is that you'd have to modify the template, although it's not a complicated modification to make. Is that helpful or not?

Les Warner: Yeah, I think that was good. We've got a couple of more questions that are related to standards and where those come from. So one of the questions was about debt coverage ratios and should they be different for different types of deals?

So for instance, they had a policy that was at 1.2, but they're wondering about using a higher ratio for deals that have a risk, a different risk factor. And then also a question about what's the allowable, which is the most common question. "What's the right number for an allowable developer fee?" Now, how do you develop those standards that you're going to use?

Anker Heegaard: Well, a couple of thoughts. One is that smaller deals tend to merit higher debt service cushions than larger properties, all else equal. And that's because the -- on a small property, the cash flow is not a big amount of money, so it's not enough to address the slings and arrows of outrageous fortune as it is on a larger property.

In other words a 1.20 debt cover on a big property may produce $50,000 of cash flow. And on a small property may produce 3000 of cash flow and you've got to get to a number that you can work with. So in a more sophisticated, under ready, you tend to underwrite to a minimum operating expense cushion.

And that cushion is cash flow expressed as a percentage of operating expenses. And so you have two standards, so you want to make sure you hit both of them. So as a rule of thumb, you would -- you could develop a policy that said, smaller properties, more high risk, less experienced developers. All of those factors should point you in the direction of higher debt service coverage ratios initially and larger properties --

Les Warner: I seem to have -- Anker, I seem to have lost--

Anker Heegaard: Experienced developer [inaudible].

Les Warner: You were coming in and out at least for me.

Anker Heegaard: [Inaudible] I don't know how that had happened, but probably for everybody, so I apologize. So yes, larger and smaller debt coverages based on property characteristics is quite appropriate. What was the other one left that was one half of the question?

Les Warner: Developer fee and then debt leverage ratio.

Anker Heegaard: Right. So developer fee, again could easily be set up to be different types of fees in different circumstances. My view is that developer fees are well earned often. Developer may have a number of deals that they invest a lot of money in that never get off the ground and therefore they never get paid for it.

So it's the way our business works. It's typical rule of thumb, is that a developer fee could be in the range of 12 to 15 percent of total development costs, but it's not common that all of that fee is collected out of development sources, often fairly large chunks of that are differed and are recovered out of cash flow in the deal.

So having a good sense as to what the rules are and when those rules should be adjusted for circumstance is -- makes for better underwriting. Because you don't want to apply a rule that applies to 150 unit of tax credit property to a 10 unit property without considering whether you're not inappropriately using that rule.

Les Warner: Great. One more, maybe one last question here. A question about noticing that capital reserves are low, however, tax credit investors and lenders often won't agree to the higher amount that may be required by the HOME jurisdiction. And they're saying that it's -- that they need to match the lenders, investors underwriting standard.

Well, the bottom line is, if you're going to put your HOME funds into the project, it has to meet your standards or you're not going to be willing to invest in that you as the PJ have a risk for this project if it does not survive.

And in some cases, for instance, with the low income housing tax credits that risk is born by the investor. And in this case for the HOME fund, it's being -- it would be a risk that the PJ itself would be dealing with. That's a broader --

Anker Heegaard: Yeah, you've --

Les Warner: Go ahead.

Anker Heegaard: Well, you've hit on something interesting which is that a lot of the PJs that are investing HOME funds feel very much back seated and defy the tax credit rules. And with the tax credit rules, they're $350 in policy. You have to keep a couple of things in mind. You could require a higher deposit, not a lower one than they mandate.

They may not want to have a higher deposit because in their view it constraints the supportable debt that property can have. But as I said before, part of the problem is that, as a HOME -- as a investor HOME fund is a HOME under, you're looking at viability over a longer period of time, then the tax credit investor is looking at.

And so you want to ensure that you're not signing up for having a property that is going to have a capital replacement needs shortfall in the later years of the period of affordability over which you're accountable to HUD for the success of the property. And having that discussion and being clear about it is super important. Thanks, Les.

Les Warner: Great. So we've actually gone past our allotted time slightly. I wanted to clarify; we have not scheduled an office hour for this session. The slides, it does have that reference. And we have been able to answer the questions as they've come up through this section. I would suggest however that I think and I would suspect that Anker would agree that I think what you're all going to need to do if you're interested in using this template is to work with it. Experiment with a project, plugging in numbers.

As we mentioned, all the materials including the recording and the slides will be posted on the HUD Exchange, we think probably by next Friday. It will depend on getting all the parts assembled and ready to go. But I think the best way to learn this template and see how you might be able to use it or modify it is going to be to experiment.

Anker, any closing words you want to offer here?

Anker Heegaard: Yeah. Thanks, Les. It's been a pretty exciting opportunity to develop this model so that it populates. I did note a couple of the questions that came to me about whether these populated models might be made available. And so I'll put that back to you Les about whether that macro populated model as an example might be something that HUD wants to offer people. It's nice to be able to see what it looks like when it's filled out.

Les Warner: Yes. That will be made available.

Anker Heegaard: Great.

Les Warner: All right. Thanks, everybody. We hope that this webinar was helpful for you and we encourage you to take a look. We included on the HUD Exchange, if you go to the homepage and under the Tools tab on the left-hand side, you'll see the link for the multifamily Underwriting Template. And encourage you to pull that up if you're not already familiar with it and see if that might be a useful tool for your program. Thanks, everybody, for participating.

Anker Heegaard: Thank you.

(END)