Designing a Recapitalization

HUD Office of Multifamily Housing Programs
Preservation Clinics

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We Are Now in Step 3

Preservation Process Steps

Choose Your Preservation Options

Step 3: Choose Your Preservation Options

Step 3 involves this decision process:

- What is my best option <u>without</u> needing new money?
- Does that option meet my preservation goals?
  - If yes, go to Step 4 (Apply for Funding and HUD Approvals).
  - If no, design a recapitalization transaction.

Session Objectives

At the end of this session, you will understand:

- What a “recapitalization” is.
- How a recapitalization is designed.
- Key issues to be addressed in designing a recapitalization.

Bishop Mugavero Senior Apartments
Brooklyn, NY

BUT FIRST, SOME TERMINOLOGY

Recapitalization

"Hard Debt" and **"Soft Debt"**

"9%" and **"4%"** Low-Income Housing Tax Credits

What is a "Recapitalization"?

It's a preservation transaction that involves obtaining new money such as:

- ✓ Refinancing your 1st mortgage, including FHA loans
- ✓ Tax credits
- ✓ HOME or CDBG
- ✓ State Housing Trust Funds
- ✓ Foundation grants or loans
- ✓ Specialized preservation funding, perhaps from a Community Development Financial Institution (CDFI)

Key Question:
Does your property require new money or can you get by without it?

“Hard Debt” and “Soft Debt”

Hard Debt:

- Has a required monthly payment.
- The payment must be made, whether cash is available or not.
- Often has a first mortgage (*first lien*) position.

Soft Debt:

- Payment either is deferred, or is required only if cash is available.
- If there is a mortgage or deed of trust, typically it is in second lien position or lower.

“9%” and “4%” Low-Income Housing Tax Credits (LIHTCs)

9% LIHTCs:

- Typically can pay for 80% or more of total development cost.
- Typically competition is intense: 3 or more applicants for each award.

4% LIHTCs:

- Typically can pay for around 30% of total development cost.
- Requires use of tax-exempt bond financing.
- Typically are under-subscribed.
- Due to high transaction costs, typically not efficient for small transactions.

DESIGNING A RECAPITALIZATION

A detailed look at the **thinking process** behind a successful recapitalization.

Before ***After***

Pierrepont Senior Apartments, Brooklyn, NY
Before and Afer Renovation

The Thinking Process

1. What changes do I need to make?
2. What will it cost?
3. How much hard debt should I get?
4. Should I have <u>any</u> hard debt?
5. What's the best way to raise the extra money that I need?
6. Does this transaction require selling the property? Bringing in a partner?
7. What would the future look like after the transaction?

Figure out the costs <u>first</u>.

Then think about how to pay for them.

What Changes Do I Need to Make?

Examples of Changes to the Physical Asset

- Replace old windows and siding
- Replace the roof
- Make utility-saving investments
- Add community space
- Convert efficiencies to 1-bedrooms
- Modernize to improve marketability

Examples of Changes to Operations

- Add service coordinator
- Improve occupancy rates
- Secure adequate reserves
- Benchmark/compare utility usage with other properties

What Changes Do I Need to Make?

Options Related to Current HUD Financing

- Prepay
- Defer repayment of my Flexible Subsidy Loan
- Section 236 IRP decoupling

Explore Rental Assistance Options

- Renew Section 8 contract long-term
- Tenant Protection Vouchers
- RAD 2 for expiring Rent Supp, RAP, and Section 8 Mod Rehab contracts

For more information, attend appropriate workshop or clinic after lunch.

What Will It Cost to Do That? ($ per unit)

Uses	Light Rehab	Moderate	Intensive	"Gut" Rehab
Hard Cost	$10,000	$20,000	$40,000	$75,000
Hard Cost Contingency	$2,000	$4,000	$8,000	$15,000
General Contractor	$1,700	$3,400	$6,700	$12,600
Developer	$2,800	$5,800	$12,100	$23,700
Soft Costs	$2,700	$6,900	$16,400	$35,900
Soft Cost Contingency	$500	$1,400	$3,300	$7,200
TOTAL	**$19,700**	**$41,500**	**$86,500**	**$169,400**

These numbers are examples; your transaction will differ.

How Much Hard Debt Can I Get?

Depends on:

- ✓ The property's future revenues and expenses – after you have completed your transaction.
- ✓ How large a reserve deposit you need – after you have completed your transaction.
- ✓ Today's interest rates and other key business terms of the loan.

Important!

Maybe they'll loan you less money than you need.

You may need to change your strategy.

Total cost of your transaction, minus hard debt, equals the additional funds you'll need to raise.

Hard Debt – Examples

Plan A:

- Total transaction costs $50,000 per unit
- $15,000 per unit in hard debt
- Therefore, I need $35,000 per unit from other sources.

Plan B:

- Total transaction costs still $50,000 per unit
- Higher Section 8 rents, so I can afford to borrow $30,000 per unit in hard debt
- Now, I need only $20,000 from other sources.

Then there's Plan C: no hard debt, raising $50,000 from other sources, and no mortgage payment.

Should I Have Any Hard Debt?

Probably not, if:

- ✓ Your property's expenses consume an especially large share of its revenues.
- ✓ You need an especially large reserve deposit.
- ✓ It's a small property.
- ✓ Your property receives an increase in revenue through subsidy contracts.
- ✓ You can get by without hard debt.

Just like with your personal finances, sometimes no mortgage payment is the right idea ….

What's the Best Way to Raise the Other Money I Need?

- ✓ If you don't need much money, HOME, CDBG and State Housing Trust Funds may be your best bets.
- ✓ If you need a lot of money, you're probably going to need Low-Income Housing Tax Credits.
- ✓ In between, there are other options.

See the Preservation Financing Resource List.

Sell the Property? Bring in a Partner?

Possibilities:

- ✓ Don’t sell at all
- ✓ Sell, but stay in control
- ✓ Sell, but share control
- ✓ Sell and give up control

… while making sure your mission goals are satisfied

If you want tax credits, there has to be a sale of the real estate

… but there doesn’t have to be a loss of mission.

Examples of Funding Mix ($ per unit)

Sources	Light Rehab	Moderate	Intensive	"Gut" Rehab
New 1st Mortgage	$15,000	$15,000	$15,000	$15,000
9% LIHTC	$0	$0	$0	$136,000
4% LIHTC	$0	$12,000	$26,000	$0
HOME / CDBG	$4,500	$12,500	$22,500	$12,500
State Housing Trust Fund	$0	$0	$20,000	$0
Deferred Developer Fee	$200	$2,000	$3,000	$5,900
TOTAL	**$19,700**	**$41,500**	**$86,500**	**$169,400**

These numbers are examples; your transaction will differ.

What Would the Future Look Like?

This requires developing a *long-term cash flow projection*:

- ✓ Can you cover expenses?
- ✓ An adequate reserve deposit?
- ✓ Long term repairs and replacements (*capital needs*)
- ✓ Mortgage payments (*debt service*)
- ✓ Over the long term (20-30 years)

Not just right now, but later.

When the roof needs replacing again.

Note: You Will Change Your Mind -- And Not Just Once or Twice

- Will the property's cash flow change?
  - Then the amount of hard debt your property can support will change too.
- Will the costs of your transaction change?
  - Then you'll need additional funding.
- Will your preservation goals change?
  - That might have multiple ripple effects.

Things to Watch Out For

- Rents need to be affordable to your intended resident population.
- Your resident services goals need to be met.
- You need enough money to pay for the transaction, even if it costs more than you expect.
- Your Replacement Reserve needs to be adequately funded, even if things wear out earlier than you hope.
- Your property needs to be able to have adequate revenue to cover your operating expenses in order to be able to repay any borrowed funds.

HUD Can Guide You Through the Process

Recapitalization Excel Tools

Finance Calculator
Sources and Uses Calculator

Use these tools to estimate:
- Hard Debt
- Tax Credit Equity
- Sources and Uses

Translate Your Preservation Vision into Numbers!