Underwriting Income-Producing Real Estate Projects: HUD's Section 108 Loan Guarantee Program

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Jeremey Newberg: Good afternoon. My name's Jeremey Newberg and I'm joined by Stan Fitterman. We're from Capital Access. We are HUD technical assistance providers and have been providing technical assistance since 2000. On this webinar, participating are senior representatives from the HUD's financial management staff who run the 108 Program, Paul Webster, Bennett Hilley, Cory Schwartz, Jorge Morales. They'll be at the Q and A's, the questions that you provide, and the goal with this webinar is that you get useful information to develop an understanding, if not a mastery, of underwriting a HUD 108 loan.

Stan and I, working with the HUD financial management staff, drafted the underwriting guides for real estate underwriting projects that is on the HUD Exchange, and the link is at the end of this webinar. We hope that you use it as a vibrant tool to underwrite your HUD 108 loans. Before we start, I feel compelled to just take a moment and mention to any people in Texas, Louisiana impacted by Harvey that your family, your work colleagues are in our thoughts, we wish you safety moving through this troubled time to a better place.

If you are at least successful at CDBG compliance measurement, we believe you should be able to be successful in developing the skills and capacity to succeed with HUD 108 loan underwriting. Why?

Really, it's about managing a series of guided questions and through a checklist of criteria, to find the good, to find where there are problems, and to come up with strategies to address them. In this time together, we are going to provide you with a 108 loan guarantee program overview. We'll introduce you to the credit underwriting guidelines. We're going to introduce you to underwriting strategies for income-producing real estate projects. We're going to look both at the borrower and the project. We're going to have a case study from Los Angeles County California, and go through questions and answers as you provide them.

Now, if there's a slide that we recommend you sear into psyche, it'd be this slide because these are the five key components of underwriting income-generating projects; project feasibility and readiness, project financial analysis, collateral and loan repayment guarantees. However, you have to underwrite the borrowers as well. We have to look at the borrower's experience and

management capacity. We have to look at the borrower's financial capacity and credit-worthiness. As you have questions, please type them. We will provide a valuable experience, and let's proceed.

Okay now, Section 108 is based on the Community Development Block Grant Framework. This is a loan guarantee. It is not a grant. It offers states and local governments a means to access low cost capital, and that's up to five times of your most recent CDBG award. In fact, a recipient, a unit of state or local government, can get a 108 loan directly, for activities, or they can re-lend to a third-party borrower, such as a non-profit, a business, a developer. The thing is you have to repay the loan with project revenue. Years ago, you could use a portion of a CDBG grant to pay the loan. The focus now is can we develop projects that pay the loan on their own.

One of the important benefits of HUD 108 is that it's non-competitive, it's a rolling application, often interest rates are slightly lower than market, and it's a really useful credit tool for projects that have a source of repayment, serve a national objective and that might not directly meet traditional bank criteria. This time together with underwriting is that we will go through how to make a safe and sound loan that will be successfully repaid. Now I'm going to give it Stan to talk about underwriting.

Stan Fitterman: All right. Thank you Jeremey. Underwriting is the process of evaluating the risk of providing financing to a specific borrower for a specific project. What we really want to do here is make sure that the project we are financing is run by an organization that has experience and capacity to do the project, and that the project will have significant capital to pay us back. If something goes wrong, the value of the collateral is sufficient for us to get repaid. Objectives of underwriting: Determine if the potential third party borrower, the folks that we are loaning the section 108 money to, have experience and capacity to undertake the project and have a successful accomplishment record with similar projects.

In reviewing Section 108 loans over the past several years, some of them are quite complex – adaptive reuse of a hotel that's been vacant since the late 90s. It's developing a historic building and as a result, we may think if we have someone who's applying for this that has only done single family home ownership and now wants to develop an adaptive reuse of a nursing home and turn it into a hundred and some affordable rental housing units, unless they have assembled a very talented and experienced team, that might not be the best risk for us to take in looking at a 108 deal. We want people that have experience and a track record with the type of projects they're doing or at least have pulled a team together that has that experience.

We also want to make sure that the market is going to support the revenue, expense and the occupancy projections, which we'll get to in just a moment. Some more objectives of underwriting: We want to confirm that the project development costs are accurately projected. Often done by a third-party group

for new construction term of art for this is a plan and cost analysis, where someone is looking at the actual construction plans and getting an estimate. For rehab projects, the process is referred to as a physical needs assessments or capital needs assessments, in which creates a scope of work for the rehab along with the estimate useful life of the things that don't need to be fixed right away.

It's looking at what do we need to rehab it and how much operating capital or operating replacement reserves will we need in the future in order to make this deal successful.

We want to look at the value of the collateral and make sure it would be sufficient to cover the loan in case of non-payment, in case something goes wrong. I want to remind you here that Section 108 financed economic development projects funded over the past few fiscal years are required to meet the guidelines and criteria in Appendix A to Part 570. These guidelines make sure that we have an acceptable credit risk, and the collateral meets HUD's security requirements. I want everyone to be mindful that if these deals don't pay us back from the actual development itself and the project doesn't generate enough revenue, the backstop is our future CDBG allocations.

Our goal with underwriting is to do everything we can to make sure this deal will be successful so that we don't have to commit future CDBG revenue to pay them.

Let's give ourselves some context here. Let's go through some of the steps in the Section 108 loan guarantee application to completion process. We'll screen potential projects for CDBG program eligibility, does it meet a national objective, do they meet a public benefit requirements and do they meet your community goals. If they're not an eligible CDBG activity or it's not going to meet a national objective, we don't need to waste our time underwriting because it's going to stop there.

When we get through step one, we will underwrite the project for financial feasibility, which is the reason we're here today to focus on that. The HUD will approve our application for a loan guarantee, because of course we're going to write the perfect application. Get the promissory note and contract with HUD. Close and disburse the funds, and then we service the loan. Someone's got to collect the payments every month and someone's got to do any monitoring and reporting requirements that HUD wants.

Jeremey Newberg: This is Jeremey. Have you ever encountered a HUD 108 loan request that didn't meet a national objective?

Stan Fitterman: I have, yes.

Jeremey Newberg: What ...

Stan Fitterman: It was a demo new construction of public housing that was struggled to meet a national objective.

Jeremey Newberg: Hey, how did you handle that?

Stan Fitterman: I believe the recommendation was that it needed to be done by a community-based organization to have them be able to meet a national objective.

Bennett Hilley: Just to clarify Stan and Jeremey, this is Bennett. That one I think wasn't going to meet an eligible activity. I think it could have met a national objective, just couldn't have been eligible to begin with because ...

Jeremey Newberg: The reason why we took a moment to play with that a little bit is that if you don't meet the CDBG's threshold right in the beginning, you're really wasting your time going through an underwriting. You've got to do the compliance thing first, that's your threshold criteria, and then you can move into the financial underwriting. Thank you.

Stan Fitterman: Okay. Let’s talk a little bit about underwriting now. Who does it? There's been two types of Section 108 borrowers. There have been communities that have a low volume. They're going to do one project, a small loan fund, there's going to be a small number of loans per year. Then there are those that do multiple projects or plan to borrow a lot of money and do a number of projects over the years. There are different approaches with how you handle underwriting based on the number of deals you plan to do. If you have low volume of loans, it may make sense for you to contract out the underwriting services.

It might not be economical or practical for you to bring underwriters on staff to do just one loan. Instead, you might want to work with a local bank or a credit union or a community development financial institution. A redevelopment agency or sometimes local housing finance agencies will do the volume to have underwriting in-house and they may be able to take on a deal or two for you. Sometimes local HFAs outsource their own underwriting and there may be an organization, a non-profit or for-profit that specializes in underwriting deals that may be willing to take on your project.

High volume loans. It may be the best idea for you to train current staff or hire staff with underwriting expertise. There are certainly 108 borrowers out there that have in-house underwriting because they do a number of loans a year and are very active. The 108 program can partner with a community development financial institution or another recipient to administer the fund. Programs can also use a hybrid of these. Some grantees will do the CDBG eligibility and eligible use and national objective and public benefit work in-house, then outsource the remainder of the underwriting. In a couple of minutes we will talk about the appraisals and market studies which are almost always done by an outside party and again as we talked about with the smaller lending volume, sometimes there

might be an economic development arm in your city or county or state that can experience doing underwriting.

As we said, a local HFA or local redevelopment authority may have experience with these types of loans that could underwrite 108 loans for you. Okay, so we talked about who, let's talk for a minute about the what.

Jeremey Newberg: You might want to talk closer to the mic if you can. Some people are ...

Stan Fitterman: Okay.

Jeremey Newberg: Have volume.

Stan Fitterman: All right. Is that better?

Jeremey Newberg: Okay.

Stan Fitterman: Duties of the underwriter. We've talked about who might do it, let's talk now about what they do. Underwriters review the credit worthiness of the borrower through the company's personal and financial statements. Jeremey will talk about that in a few minutes. We're going to talk about how they evaluate the trends for the market, how the market is doing, is there going to be a market for this project? They complete written credit underwriting report, we're calling here a credit memo. They do the servicing. They conduct ongoing reviews of covenants, reports, audits, and HUD reporting requirements. Let’s talk about the market study for a minute. The first thing a market study person does is determine what the market area is.

This could be in a densely populated are, one square mile around the project, or three miles around the project. In a more rural and sparsely populated areas, it could be an entire county. Market studies are a data driven evaluation of project feasibility. What we're looking at here is what are the actual rents in the market, occupancy rates in the market what are some tenant improvements or leasing concessions. Similar projects in the market say for office space, are we seeing the owners of office space have to give three months or six months free lease or going to have to do the build-out improvements themselves in order to get tenants, or is there a high demand for office space in the market.

Comparing expenses for comparable properties can tell us what the operating expenses are expected to be for running this development, which will help us know if they have enough income to pay operating expenses and can afford to pay us back. If the projected operating expenses are lower than market, we need to figure out whether or not that's accurate and if it's not accurate, then we might need to adjust them upwards and see if the deal still works. We're going to look at what existing deals are competition for the borrower and the market study is also going to evaluate anything that's planned. That is if there’s

any planned buildings that are going to come on-line before ours, and what that will do to our expected occupancy rates.

The Market area for housing. First they're going to look at the geographic market area - where can we expect to pull tenants from. They will look at the market characteristics, the income, household size, age of households, the renters, how many are owners. One thing that we often forget about when we're doing affordable housing deals - we all know that our programs have ceilings. If you make more than 60% of median, you're not going to live in a low-income housing tax credit project more than likely, at least not in an assisted unit. If you make more than 80%, you're not going to be living in a HOME assisted unit – the HOME program limits incomes of tenants to 80% of median.

We sometimes forget there's also a floor for who can live in our building. For housing, if rent is going to be $800 a month, we're not going to lease to people who make a $1000 a month. We're likely looking at folks earning $1600 or $1700 a month and that's if they can afford to spend 45% of their gross monthly income on rent. What a market study is doing is looking at that band of income that can afford our rents. They will look at how many renters there are earning between $1700 and what the maximum income limit is. Let's say it's $2400, they will look at the number of renters in that band and determine if there are enough renters in the market area so that the development could be leased up quickly.

Market study folks are also looking at some of our housing stock options that are already available and as we said, can the target market afford the proposed rents or mortgage payments and if not, what other programs may need to be set up in conjunction with the development. I recently worked as an underwriter, not for a Section 108 loan, but a small loan fund where a builder had come to borrow money to do construction of new homes. His price was going to be $225,000. This is in a hot market in an urban area. His target market is going to need purchase assistance to be able to afford these homes. His target market couldn't afford $225,000.

There was a county purchase assistance program that offered sufficient subsidy to be able to borrow from that, so everything was looking good. The problem was that, when we looked deeper into this county's purchase assistance program, their maximum allowable purchase price was $204,000. He was not going to be able to get the subsidy that his potential market needed, therefore his deal wasn't going to work as structured. He's going to have to figure out a way to lower his price or find another market to work in. These are the types of things that a market study should be picking up for you.

The appraisal. The purpose of underwriting is to do everything we can to figure out, evaluate everything we can, in order to make sure that a deal is going to be successful.

Sometimes despite our best efforts, there may be things that we couldn't predict, maybe things that happened that we didn't know were going to happen, things beyond our control that result in a deal not being able to pay us back. The backstop in this case if the deal fails is collateral. In real estate lending, it's usually the property. The appraiser is looking at the value of the property as-is, and what is the market value as completed. So we have an idea of the market value of the property once it is completed and has stabilized - meaning, up and running and leased. Is the value sufficient to cover the amount of the 108 loan?

Project feasibility and readiness, extremely important aspect of the underwriting process. By the time a deal gets to underwriting, we want to make sure that the proper zoning is in place. Rezoning takes time. Rezoning take money and rezonings often can result in an opposition to our deal. By the time we get here, we want zoning to be in place. Most deals will not have building permits by the time they get to underwriting, but they should be able to get a letter from the city or county or the permit issuing agency saying that except for paying the fees, they are ready to pull permits. Usually developers will pay for the permits with their first draw of the construction loan. This is the place where usually we want to see site plan approval.

Site plans are a visual representation of how a deal is going to look on the ground, so it shows the number of parking spaces, it shows the setbacks, it shows where the dumpsters are going to go. In real estate development, they have to be done for commercial deals. Not for single family homes, but for office space, retail space, and for multifamily. Site control we'll talk about in just a second on the next slide. Title insurance, the underwriter needs to make sure that the person or the company actually has clear title to the site and can develop it or if they're buying it, the person, they're buying it from has the legal authority to sell it to them.

Legal description. We need to make sure the lot actually exists. An environmental assessment. Now we want to pause here for a second. In the underwriting process, we're usually talking about a phase one environmental but because this is CDBG, we have already done our environmental review at the application stage before we make any choice limiting actions. The environmental assessment here, we're generally talk about phase one and if necessary, then phase two.

All right. The site control slide. To get through underwriting, the applicant doesn't necessarily have to own the site with a recorded deed, certificate of title, whatever it is in your community that proves ownership. They can have a sale or purchase agreement provided the expiration date on the sale or purchase agreement won't have passed when you expect to close.

A lease or ground lease, this is more common in commercial or retail office or retail space. Usually this is a long-term ground lease. At the very least, you want to determine that the lease term is through the term of the loan or the

affordability period, whichever is longer. All right. Do you need to stop for questions or do we go on?

Jeremey Newberg: We'll, keep proceeding because HUD management staff are responding to the questions and we should just work through the content and then work through the questions towards the end. Now the beauty of HUD 108 is that it can be in the first lane position or subordinate. However, you have to underwrite the borrower as well. We're going to take some time now and look at the borrower experience and management capacity, the legal structure, and the key principals. There are many different ways to show who the ownership entity is.

A couple of key things. All these are counterparties, entities or individuals involved in an organizational structure of whatever we call the borrower. We have determined who owns what, what is their financial strengths and weaknesses reviews and their creditworthiness. The key definition of a principal is that you have an ownership interest of 25% or greater. If that's the case, you've got to have their financials reviewed. Please make sure that every principal is authorized to do business in the United States. Please make sure that you do a review of the HUD list of debarred contractors. The debarred list is really important and it's just good due diligence. Now do the principals all have the experience and capacity to successfully amend the project?

I recommend that if you don't have a copy of the Section 108 underwriting guideline for income producing projects, you can get off the HUD exchange. If you go to page 16 on the underwriting guide, there's an excellent list of questions that comes to the analysis. You're looking for a track record in developing similar projects, a track record of working with public and private partnerships, experience with federal funds, you're looking at management experience and capacity. Some of the questions that factor in management experience and capacity will position the project for success. Who does what? What are their skills and experience? It's the development experience of the borrower for income generating real estate.

We got a question from a person who's just starting out doing rental deals. Who are you bringing on your team to fill in the gaps of experience if you as the principal don't yet have it? How do we structure the deals so that an inexperienced lead has a team that provides the experience. We look at the whole team. Management experience, is really important. They are the ones that live with the project once it's built if it's a rental property. Financial performance of the borrower, are there any pending litigation or foreclosure issues that present what are known as tangent liabilities, any liens. You have to do a search for that.

Now how likely is the borrower to repay the loan? Looking at the financial strengths and weaknesses of the borrower in detail. To get this , we have to go through a series of financial documents which show assets, liabilities, and getting to a sense of worth in the expense statement, which shows the operations over a period of time, cash flows which show how funds flow in and

out of the project. Real estate holdings, really important, what other properties does the borrower have, how well are they performing? Bank statements and tax returns are ways to verify what's in the financial statements. We're going to go into this now in a little bit more detail.

Remember, as you go through these documents, you dig deep because your job is to tell an accurate story of the financial strengths and weaknesses of the borrower, and so this is how you gather the information to tell the story. The balance sheet is a snapshot of a borrower's financial position at a specific point in time. The balance sheet is going to show what the borrower owns and what the borrower owes. Assets less liabilities equal net worth. For the nonprofit, that would be the fund balance. You want to look at cash on hand. You want to look at accounts receivable and accounts receivable is viewed as a current asset because the idea is that you're going to be paid within a reasonable period of time. If it's not thirty days or less, the period of time starts to become unreasonable, unpleasant, if not painful. If there are notes in the financial statements that say the receivable is 15 months old, you have to start wondering whether or not it's going to get paid.

Liabilities, accounts payable, typically these are the same as that you're going to pay within a reasonable period of time and an accrued liability is where you may have had an operating expense but you're having trouble paying it and it might go more than 90 days. What's the plan to pay it? Notes payable are a loan and then of course taxes.

These statements help you get a sense of cash flow and liquidity for a borrower and these ratios are actually used with small business lending as much as they're used with real estate lending. Here we're focusing on the borrower. The first working capital, working capital is current assets, less liabilities which should be a positive. If it's a negative, you've got problems, you don't have working capital. Quick Ratio, current assets divided by current liabilities should always be greater than one. Equity ratio, that's your total liabilities that by your equity should always be greater than one. You may say well what's an acceptable debt to equity ratio, should it be 1.2, 1.25, 1.5? It depends on the business, on the entity.

The closer it gets to one, the more concerned you should be as you're looking at the overall financial picture of the borrower. What you want to do is if you find an issue with some of the ratios where they start to become low and of concern, call the borrower, engage them in a dialogue. You're doing kind of forensics here where you're trying to say, "Look, I see something. It appears to be a discrepancy. Can you walk me through this? I need this for my credit memo to sell this to my credit committee." Teach the borrower to clarify so that you can tell the story.

Now we move on to an income and expense statement. Does the borrower have a track record of generating sufficient income to meet its financial obligations?

Income is typically revenue from the business activities, any interest from the assets that you have that are invested, less expenses. Depreciation is a function of accrual accounting and you need to clean it up. Income less expenses equals retained earnings. Now this is for a business or real estate. It would be income minus vacancy, minus operating expenses equals net operating income. Net income for the real estate is where we find the money to make the debt service payment. Okay.

Now the question you want to ask as you're looking at the income and expense statement is does the business consistently make a profit, do key principles manage cash to meet their financial obligations, are the borrower's future projections logical and reasonable based on historical trends? Now the cash flow is a very powerful tool to look at how cash flows in and out of a business in terms of ongoing operating activities, such as purchasing an asset or equipment, financing activities, taking debt, paying off debt, acting as a lender. Just don't forget the statement of cash flow because they can often provide important information.

Contingent liabilities, this is where you need to be very focused because sometimes people prepare financial statements that are quite rosy and that's fine, but you need to dig a little bit deeper and this emphasizes other real estate owned. As an example, you may have a borrower that's gotten into a troubled real estate project and if they've personally guaranteed that other real estate project and for the HUD 108 loan, what happens if that troubled real estate project keeps on being in trouble? That's the idea of the contingent liabilities, something that's out there that presents a liability that may occur in the future and you need to understand it.

Tax disputes - the key thing here is you want source documentation from the borrower to give an explanation so that you have an understanding of what happened and the steps that they have taken to remedy or to address it. If you’re not satisfied with that explanation, then that’s a warning that this might not be a good fit. There are situations in life where you have contingent liabilities. The question is how well you understand them and manage them as an ongoing risk. Here we're going to ...

Stan Fitterman: We have a quick question if I can interrupt you for a second.

Jeremey Newberg: Sure.

Stan Fitterman: It is about the debt to equity ratio because you just explained it one more time. I think we might have some confusion over the issue. It's the debt to equity of the company not a specific deal, correct?

Jeremey Newberg: Yes.

Stan Fitterman: Okay, so we had a question about it being less than one. The debt to equity ratio if it's greater than one, that might be a concern, right?

Paul Webster: Yeah, Paul Webster. Can I add something?

Stan Fitterman: Absolutely.

Paul Webster: The equity ratio just is a measure of how much equity the business has relative to the debt, what kind of cushion it has to absorb losses. The higher the debt to equity ratio here the situation, the lower the ratio, less risk all things being equal, but you have to look at that in the context of a particular entity standards that apply to certain industries and some use of the debt to equity ratio for one business were not higher, then it wouldn't be a problem. If it's still something that should be reviewed by the underwriter because if the ratio is extremely high, then that indicates potential problem and risk.

Jeremey Newberg: Okay. Now we are moving on to ... bank statements and tax returns.

Stan Fitterman: I didn't mean to throw off your rhythm there.

Jeremey Newberg: No, no. Review the documents, verify the numbers in the financial statements. The key thing, if the financial statement show $100,000 in cash make sure you get bank statements where balances total $100,000. If not, you need to ask what's up and then information on tax returns is often a good way to verify information on financial statements. Now sometimes there's a difference with accountants and general journal entries and if financial statements are done on a cash basis as opposed to accrual, there may be some discrepancies. Simply engage the borrower in a discussion so that they provide you with that explanation.

We often encourage recipients that are running 108 programs to form their own 108 loan committee that review the credit memo, ask questions and provide advice to the recipient lender. You, the underwriter need to gather enough information so that you can clearly present it to your credit committee that are trained to ask questions. Engage the borrower in a discussion.

Credit worthiness, you're going to need to pull credit reports for all key principals. They should be no older than 120 days and if there was a bankruptcy in less than seven years, there needs to be some research on how that went, how materially involved the parties were, does that present a credit risk, and then you want to look that up in public records and include any judgments. Employment references may be beneficial and for business, you may want to look at a business credit reporting agency such as Dun and Bradstreet, but you should be pulling credit reports for all principals.

If you see a lot of problems in the credit report, late payments, charge offs judgements, that is a sign and where there could be issues that this borrower

has difficulty meeting their financial obligations or it's a discrete issue, there was a divorce or a catastrophic event. You want to dig deeper to understand what happened.

Okay. Now we proceed from the borrower back to the project and with this, and we have the makings of what is known as a project development and operating proforma. In single family, you do a project development budget. In income generating real estate, it's the development budget and the proforma for ongoing operations. You want a project development budget that is what you build, how much is it going to cost, sources and uses, what sources will pay for what uses, the property income and expense.

That should go out as many years as you need financing. If you plan to pay off your HUD 108 loan in 15 years, you do a projection in 15 years. Now depending on the size and complexity of the project, you may do a separate rent schedule which is how many one bedroom, two bedroom, three bedroom units or different ranges of commercial space for lease. If a smaller project, you can typically include that just in your operating income and expense budget. Then if you're doing a construction loan, the draw schedule will get a cash flow analysis in a minute and then loan sizing, how you arrived at the loan, an amortization schedule, what will your monthly payments be, how long will it take to pay off the loan. Okay, so let's proceed.

Sources and uses. Do the sources equal uses. More importantly the sources are committed. Promises are not good for an underwriter. Commitments are what's good for an underwriter. What terms are associated with each of these sources? This is really important. The other loans that have a primary position may impact the ability for there to be enough cash to make debt service payments on the HUD 108 loans. Solely you are not just underwriting in the HUD 108 loan, you underwrite every other loan in the deal to clearly understand how each loan operates to make sure that there is a clear pathway for a portion of net operating income to be available to make the debt service payments, so you understand that.

Typically those types of source documents would be a loan commitment letter from source if it's not yet closed and if it's closed, the actual note, mortgage and if there's a security agreement.

Rent roll and tenants, how well do the rents align with the product and market conditions, what is the minimum revenue needed to service the debt. We've seen some odd proposals for a service organization that when it's rent, like 10,000 square foot building and maybe the market rent was at $5 a square foot but because there's a government contract, the developer thinks that they can get $12 a square foot. That is a mismatch of the market because what happens if the government contract runs out.

The rent roll should show current and projected sources of revenue for a project because it's from the rent that we pay the debt service. Income generating real

estate, that can be housing, that can the commercial space. It's good for copies of leases. If there is a tenant that occupies more than 20% of the property, you want to lease carefully. You want to get some sense of the financial stability of that tenant because if you lose that tenant, that impacts your rent and then impacts your net income and how we pay for debt service.

All right, the budget, how do the project line items align with local market conditions? Budget reflects the story of how you're going to build out the project, the component parts, acquisition, cost, hard cost.

You want to see a detailed description of all the assumptions and calculations related to that because you want to be within the market. Also remember with HUD 108, there is a program financing fee. I believe that fee is subject to change each year. I think with 2016, it was around 2.85% and that is an eligible cost. All of the costs that we outlined earlier in the webinar for all the real estate related due diligence, those are also eligible costs that can be included in the loan within context of the project.

Now as we move on, how much do the project increases in rent compare to the projected increases in expenses each year.

You want to see expenses increased by 3% a year but rents only increased by 2%. You can see at what point do you reach negative net income. Hopefully up to year 25, but if it happens in year six, you have a problem. You're going to have to look at the nature of your income and the nature of your expenses. What we're looking for is that the project sustains a comfortable debt service coverage ratio, for the term of the loan. It's a fancy way of saying we want the project to make $3,000 because your debt service has been $500. That $2500 is cushioned from unforeseen and the older I get in life, the unforeseen events become seen, so take that for what it's worth.

Confirm that the project operating budget shows adequate reserves. There are typically three types of reserves, replacement, lease-up, and debt reserve. The roof, windows, the heating ventilation air conditioning system, those are capital items that have a specific life and it could be over the life of your HUD 108 loan if it's 20 years you might have to replace some of these items. You're saving for that event. Operating capital could be depending on the nature of your deal for the first six months, you're going to have a planned operating deficit. You lease up as tenants come in. Can you set up that reserve up front to cover unforeseen? In a debt reserve, it's a tool by lenders where they've looked at totality of the deal but for reasons related to the particular project, made that service coverage ratios below 1.25, it's at like 1.1. You would want to put more cash in a reserve that would be controlled by the lender that you can infuse into the project if an unforeseen negative event occurred. It's all get negotiated as part of the deal.

Okay. Now, it gets fun - cash flow analysis. Can the project operate and have sufficient revenue for debt service? Keep in mind the operating income, it's a

beautiful thing. The more operating income, the easier it is for you to make your debt service payments. Gross rental income, less vacancy, most operating expenses, net operating income. Please, please make sure you include any contributions to reserves as an operating expense. Now CPAs, you may not like what I just said.

Realtors when they're selling commercial properties will take reserves out of the expense because they say it's a balance sheet item, it's an asset, it's from the balance sheet, but cash is king and even if you set aside $400, $500 a unit a year in reserves as part of the operating expense because you're socking it away. It's forced savings, so you don't have that available for debt service as you set up the loan. Now, again gross rental income, less vacancy less operating expenses, equals net operating income and it is from that operating income we derive the funding for debt service. Is operating income sufficient to cover the debt service payments this is what's known as the debt service coverage ratio.

We're going to introduce two ratios to you for the remainder of this training, debt service coverage and loan to value ratio, and these are ratios you use to figure out how to size the loan. For income producing properties we try to get a 1.25 depth service coverage ratio but essentially gives you 25% give or take of excess and you pay your debt service from your NOI with some extra for unforeseens. Now with Low Income Housing Tax Credit projects, you see debt service coverage ratios like 1.1, but there are compensating factors in place that are guaranteeing repayment of the loan. There's other factors in play. The developer may be deferring their developer fee for a period of time that could be set aside for debt service repayment.

If you say that if you go below 1.25 in a debt service coverage ratio that you should deny the loan, no, understand the context and the compensating factors. A compensating factor is there's additional collateral or a guarantee or cash reserve put in place that in the end that if they can't make a debt service payment, this resource is available to make the payment. Take net operating income and you divide it by your debt service payment and that gets you the debt service coverage ratio. The borrower wants to borrow $1 million dollars and pay it off over 20 years with a 5% interest rate. The principle and interest payment is $6,600 a month. With this project the net income has 10,000 a month, so 10,000 divided by 6600 is a 1.5 debt service coverage ratio. Wonderful, wonderful, wonderful.

What if the net operating income is not $10,000 but it's $7500? $7500 divided by 6600, 1.13. Oh deary dear, it's below 1.25. The deal starts to gets thin. Do you say no? Maybe or maybe dig a little deeper and see if there's some compensating factors in the deal. Maybe in a year, there’s going to be a change of tenants in the commercial space and based on your market study at the time you release you're going to get a higher rent. What are the pieces in that puzzle that bring it all together? Now we move on to loan sizing.

Stan Fitterman: Jeremey we had a couple of quick questions. On the reserve accounts like capital reserves, who holds those? Do we allow the borrower to hold them in their name or is there another way that those are structured?

Jeremey Newberg: That is typically part of the negotiation. Most lenders would prefer to have a shared account where the lender has to approve a release of any funds in those reserves, so that's negotiated. Often with the debt service reserve, the lender controls it, but with a capital replacement reserve there would be a covenant where the borrower has access to the capital replacement reserve but every year the borrower has to show that they've been making the contributions, show the separate accounts with the balance, similar to showing evidence that you paid your real estate taxes and your insurance. Debt reserves are totally restricted and capital and operating reserves can be restrictive. They can still be negotiated based on how much risk the lenders want to take. How does that sound?

Stan Fitterman: That's good. I mean another one that I wanted to jump in on and that was when we forecast income increasing at 2% and expenses at 3%, it sometimes will go negative after 10 to 15 years. How do you underwrite those sort of projects and are those assumptions reasonable? One thing that I wanted to point out is that the income in order to be able to have a 1.2 or 1.25 debt coverage ratio is going to be greater than expenses obviously and 2% of income is a bigger number, than 3% of the expenses. A deal that is relative that is well capitalized, they do not go negative because 2% of the income is a number than 3% of expenses.

In small deals and thin deals where there's not much room between income and expenses, then yes that can be a problem go out year eight, year nine, year ten it starts to go negative.

Jeremey Newberg: I fear we're getting so technical that someone might want to criticize us as a grump noodle. I fear it Stan.

Stan Fitterman: It's a technical term.

Jeremey Newberg: On the public benefit deals, why are you underwriting this so hard? We're going to do public benefit work here. What's going on Stan?

Stan Fitterman: I don't want to lose my future years CDBG money. I don’t want Paul or Bennett to yell at me when I send them a deal that doesn't cash flow.

Jeremey Newberg: Okay. The thing is you have to be rigorous or take a safe and sound community investment.

Stan Fitterman: I think so. Yes.

Bennett Hilley: This is Bennett. We see that you have some deals that are higher risk and others that are lower risk. We're looking for you to just balance that across your

portfolio because yes the public really doesn't matter here. In the end, we're going to talk to you about that as well and factor that into the equation.

Jeremey Newberg: Now we get to loan sizing. How do you determine the appropriate size of the loan? Think of loan to value ratio and the debt service coverage ratio as bookends and loan to value ratio is based on the appraised value of the real estate. Now if you're doing improvements to the real estate, it would be the as improved value. Debt coverage ratio determines the maximum amount available for debt service. You take that debt service amount with the repayment term in the interest rate and you get to the loan amount. A little bit deeper on that. All right. How much can we afford based on net operating income? As an example, you have 400,000 in net operating income. You get debt service coverage ratio as 1.25. 400,000 divided by 1.25 is 320,000 that would be available for debt service annually for a straight 20-year term.

The maximum loan amount based on the debt service coverage ratio of 1.25 is 3,722,000. Well, bummer, I need four million and the property is going to be worth $5 million, and you said the loan to value ratio is 80% so I'd be able to get four million in net. Well, the lender will often choose the lesser of the two, the loan to value and debt coverage ratio of our calculation methods. In this example, the lender would choose 3,722,000 rather than 4 million. Why? Based on the debt service coverage ratio, that would have in net operating income off the loan in a safe sound manner.

You should do a debt service coverage ratio calculation of what it would take to pay off four million and see how far below 1.25 does your debt service coverage ratio go and are you willing to take that risk. That's at the end of CDBG funds, will take that risk if something is wrong. Is this you Stan?

Jeremey Newberg: Hi.

Stan Fitterman: Okay. Mute was already off when I hit the mute button to take myself off of mute. Something we have been talking about is ways to make sure that we don't need to make a call on our collateral, but sometimes deals do not behave the way we think. Our backstop for that as we've discussed is collateral. How do we secure our loan? In real estate deals, it is a lien on the real property. If 108 program is providing all or a majority of the financing for the deal, we might be in first position. It is often the case that we are a small portion of the project cost, so the Section 108 loan, might be in a subordinate lien position.

Collateral may be in the form of a debt service reserve account. I've actually seen this recently on a deal we're working on where the funds where funds that are being collected from a ground lease are going to be put into a debt reserve account that in case something goes wrong, funds are there to start making the payments. Section 108 lenders, the CDBG grantees often require personal or corporate guarantees from the borrowers. When they do so, they also underwrite whoever is providing the guarantee to make sure they legitimately

can provide repayment or start making the payments themselves if the deal starts to get in a position where it cannot cover its debt service.

Okay. As we've said, often Section 108 programs are not a 100% of the financing. There are multiple sources of financing in these deals because often that's what it takes to get them to fruition. When there are multiple sources of financing, we need an intercreditor agreement that establishes the subordination level of each loan, and it's important to ensure that the Section 108 lender is sufficiently protected. In the underwriting guide, we have a number of items in there to be on the lookout for in these intercreditor agreements, especially if the Section 108 loan is in a subordinate position

Credit memo, the report. This is the narrative, this is what ties everything together. This is which takes all those pieces we've been talking about for the past hour or so and puts them into a comprehensive, easy-to-read narrative format, gives us a project summary, confirms that the project meets CDBG eligible activities and national objectives and other requirements. It covers the borrower's credit and management capacity. It also includes a review of third-party reports. In my experience, the third-party reports are always included with the underwriting report. It has a copy of the market study, the appraisal, the phase one or if required phase two environmental, a summary of the property management company and their experience in doing like deals.

All these deals have risk but they also have mitigating factors, so it outlines the risk that something could go wrong and what are the mitigating factors we have identified that we think mean the deal will be successful. Finally, we've got the recommended loan terms. Is a guarantee required, if so, for how long? What's going to be the interest rate? What's going to be the term of the loan? What's going to be the collateral for the loan, and conditions under which the loans will be made?

Jeremey Newberg: You can find an outline, a simple outline of the credit memo on page 39 of the underwriting guide, and one of the things to consider with the credit memo, the reason why it's such a useful tool is once a loan is approved either internally or through a credit committee structure and their sign-off, most of the information in the credit memo can be used to populate your loan settlement documents with terms and conditions. It's a very important exercise that you hold yourself to the discipline of drafting your credit memo. In addition, if you're monitored, it's a wonderful way to show how you did the analysis of your project, and there's multiple benefits to abiding by the discipline of a credit memo. Thanks.

Stan Fitterman: Another thing I also wanted to mention at the credit memo stage is that many communities, many 108 borrowers, have a loan committee. The CDBG grantees have set up a loan committee that will look at the credit memo, ask questions, ask pointed questions. If you're the one presenting the credit memo, one can go as far to say they ask annoying questions, but they are trying to make sure that the loan is as you presented it and if they see anything that might be a risk or something you should pursue a little further, they'll bring it to your attention.

Many communities have a loan committee or credit committee, that is totally in-house staff, so a large community that does a lot of these loans. Might have the folks in-house that are going to serve on the loan committee.

Sometimes people look outside their own organization and perhaps will bring in someone from an economic development lender or sometimes often bring in a couple of bankers or someone from a CDFI with experience in underwriting.

Covenants, the things that we tell the borrower they have to do and then on the next slide, we'll see some of the things we tell the borrower we don't want them do. We want them to inform us if they're any litigation or claims pending against them. We want them to maintain financial records consistent with GAAP or generally accepted accounting principles. We want to maintain insurance and pay their taxes and any liens on time.

We want them to agree that they will perform and operate the deal as they promised.

Here's what we don't want them to do. We don't want them to take on other debts without our permission. We don't want them to stop operations because that would threaten our ability to get repaid and we don't want them to make any guarantees that could obligate the business to repay other loans that could result in less cash available to pay back our Section 108 loan. Well, let's back up for a second because we're going to switch to the video in a second, but Bennett are there questions that you want us to handle or should we go on to our video?

Bennett Hilley: We should probably go on to the video and then we'll answer some questions at the end.

Stan Fitterman: Okay, fantastic. Chantelle, I believe you're going to queue up the video and set it up. This is a case study of a section 108 loan in West Hollywood.

Jeremey Newberg: In conclusion, big rigorous and robust loan underwriting should equal a healthy HUD 108 loan portfolio. Underwriting must take place for each and every loan, underwriters can be in-house staff or outsourced. It's the function of the volume of your activity, the complexity of your activity. There's no either or, it's balancing what you do well with areas where you need help. Our goal with this training was to outline what must be covered and what you can do or what you would want to hire other people to help you do. Underwriting evaluates the viability of a particular deal and concurrently for income generating real estate, it underwrites the capacity of the borrower as well.

I took the liberty because I was trained as a commercial banker -there are the five Cs of credit and I realized working on this since the HUD 108 program is based on the CDBG regulatory architecture, we need to add a sixth "C "to the five Cs of credit so here goes. Capacity is cash to pay the loan as agreed. Capital

is the borrower's investment in the project. Collateral is the real estate and/or other assets and guarantees to pay the loan if the project cannot. Conditions, purpose of the project. It's the state of the market in which the project will perform. Character is the experience and track record of performance of the borrower and its team. The sixth C is compliance, how does the project embrace and adhere to CDBG community impact goals by meeting a national objective.

So, the five Cs of credit for HUD 108 lending have a sixth C, you heard it here. Now let's take a moment for question and answers, and I just want to say I've been looking at the question and answer and it's been really powerful to see HUD 108 financial management staff respond to questions as we go, so that's pretty dynamic and exciting. Bennett, how would you like to handle this?

Bennett Hilley: Great. I think everyone's been getting answers directly, but we're going to go over a few that we thought were applicable across the board, but anyone will review afterwards to make sure we've responded to everyone's question individually as well. We'll get started with a few that we thought were universal. One we got was from a newer entity and would like to collaborate with one of us experts and ask your application and processes who to contact. I think both Cory and Jorge from our team has provided their email. You can just get in touch with the Section 108 guarantee program. I think there's some contact information. If Stan or Jeremey if you go to the last slide or pull my contact information.

Website also has a lot of information and of course Jeremey and Stan are with Capital Access who's our TA contractor as well. We're happy to follow ... [Crosstalk 01:22:08] Call us early. Another good one, is a startup business not eligible for 108 and I think those questions were because we were covering the history of a business. We have seen startup enterprises that communities have loaned to ... This especially when we're talking about worker owned cooperatives that will have a high social impact, so it's just for those it's about other types of underwriting for the one that we approved recently. There was a cooperative and it was actually an aeroponic lettuce growing facility.

One thing we looked at since the business didn't have operating history was to make sure that they had commitments from buyers of their produce. That's one example, but startups can be done but it of course takes very thorough underwriting in terms of the startup.

Paul Webster: Yeah, this is Paul Webster. Let me just add to this. I want to mention what we're talking about today is underwriting income producing real estate projects. We'll also be providing guidelines and conducting webinar for business underwriting. Sometimes with the startups, you're talking about an ongoing business or something that will be an ongoing business and we would normally underwrite that in as more of a business loan rather than that an income producing real estate project. But to reiterate what Bennett said, the product that we see right from vanilla kinds of real estate deals to more unique deals and any project we finance under Section 108 as long as it meets our own criteria, we look at onto a

community that we give you that loan is adequately secured or not. Sometimes that requires some extra credit enhancements beyond just the project itself.

Bennett Hilley: Just to go into ... We also saw a number of housing questions come in, especially new construction of housing after some of our responses. New construction of housing is much more limited under both CDBG and Section 108. This is I think because there are other programs at HUD including HOME that helps finance new construction housing, but it can be done. It can be done through an entity, which is a CBDO, the community-based development organization, it's a designation. They can do in specific scenarios new construction of housing. Usually I know many cities are facing especially an affordable housing crisis meeting more on...

One thing I often see is new housing, but it's created through the rehabilitation of another type of building, so therefore you're doing rehabilitation in order to deliver the housing. It can be used for housing, especially when you're talking about rehab for a single family or multifamily. Okay.

Paul Webster: One of the questions I think specifically asked is could you undertake project assistance to a for-profit business as part of an economic development project to provide which just happens to be involved in the construction, and that's from the beginning of the program, a determination was made that that could not be done. We operate under the CDBG program rules.

Bennett Hilley: Just to add that though, if it is a mixed building and there's a commercial use on the first floor and new housing above, that can be possible under the programs if the ownership structure for the commercial floor is different than the residential floors so more and more communities are focused on that. Another question which is a good one, and I appreciate this one. It says that our community typically loans our CDBG dollars away so the benefit here seems to be able to access greater capital to do so, how long are the typical loan terms and maximum amount of time.

Not every community out there, I'd say most of them are not always lending their CDBG funds, so I applaud you for leveraging them even more so, but yes the 108 program if you're already lending your CDBG dollars is a way to just access greater capital especially if you're thinking about larger real estate projects that can make ... That way you can keep it outside of your typical revolving loan fund. Typical loan terms are up to 20 years, so that's the thing for that question. Another one we had and I might defer to Jeremey and Stan on this. A borrower is a non-profit, especially a non-profit housing developer whose personal financials would we be reviewing, are there different kinds of underwriting standards for a nonprofit.

Stan Fitterman: Well, the nonprofit provides the guarantee. While the nonprofit has a board of directors, basically you're underwriting the financial position of the nonprofit as an entity, because nonprofits do not require members of the board of directors

to personally guarantee a loan. It's all how well the nonprofit can show their financial strength based just on the balance sheet of the nonprofit itself.

Bennett Hilley: Great.

Paul Webster: Now we're running to our allotted time. This is Paul Webster once again, and the director of the Section 108 office. I want to thank everyone for participating in this call. The number of questions that we didn't get to on air, we're trying to get to them directly, but always feel free to contact us directly if you have questions and you need to follow up on the questions that you asked today. Contact information is provided on the screen now, so please take advantage of the opportunity to get back to us and we'll be happy to help you. If we can't answer a specific question, we'll find someone who can. Thank very much and have a good rest of the day and rest of the week. Thank you.