



Targeted Community Reinvestment:
HUD's Section 108 Loan Guarantee Program as a Financing Tool

**Underwriting
Income-Producing Projects**

*Including:
Residential, Office, Retail, Industrial and Mixed-Use Real Estate Projects*



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- I. **Section 108 Loan Guarantee Program Overview**
- II. **Introduction to HUD's Credit Underwriting Guidelines**
- III. **Underwriting Strategies for Income-Producing Real Estate Projects**
- IV. **Case Study: Los Angeles County, California**
- V. **Question & Answer**

Underwriting **Income-Generating Properties**

**Project Feasibility &
Readiness**

**Project Financial
Analysis**

**Collateral & Loan
Repayment
Guarantees**

**Borrower Experience
& Management
Capacity**

**Borrower Financial
Capacity &
Creditworthiness**

Section 108 Program Overview

- Based on the Community Development Block Grant (CDBG) framework
- Provides loan guarantees, not grants
- Offers states and local governments a means of accessing low-cost capital (up to 5x their most recent CDBG award)
 - Most often, they re-lend this financing to 'third party' borrowers (non-profits, businesses, developers) and repay the loan with project revenue
- Awarded on a non-competitive basis, using a rolling application process



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Underwriting Basics

Underwriting is ...

the process of evaluating the risk of providing financing to a specific borrower for a specific project.

Objectives of Underwriting

- Determine that the potential 'third party' borrower has the experience and capacity to undertake the project
- Confirm that Borrower has a successful accomplishment record with similar projects
- Verify that market conditions support the revenue, expense and occupancy projections

Objectives of Underwriting

- Confirm that project development costs are accurately estimated
- Verify that project cash flow will be adequate to cover the debt service on the loan with a reasonable cushion
- Ensure that the value of collateral is sufficient to cover loan loss in the case of non-payment

Underwriting **Section 108 Projects**

- Section 108-financed economic development projects funded over the past few fiscal years must meet the criteria in **Appendix A to Part 570 - Guidelines and Objectives for Evaluating Project Costs and Financial Requirements** (See appendix in *Underwriting Guide*)
- These guidelines are incorporated in the **Underwriting Guide**



Funding a Loan Guarantee - Application to Completion

Step 1. Screen Potential Project(s) – for program eligibility, national objective, public benefit and community goals

Step 2. Underwrite Project(s)- for financial feasibility

Step 3. Apply to HUD for Loan Guarantee (for Project or Loan Fund)

Step 4. Receive Approval/Commitment from HUD

Step 5. Finalize Loan Terms with HUD

Step 5. Execute Promissory Note and Contract - Receive Loan Funds from Lender



Community Strategies for Underwriting

Consider volume of loans to be undertaken:

- Low volume: Single project or small loan fund (4 or fewer loans per year)
- High volume: Multiple complex projects or large loan fund (5+ loans per year)



Low
Volume



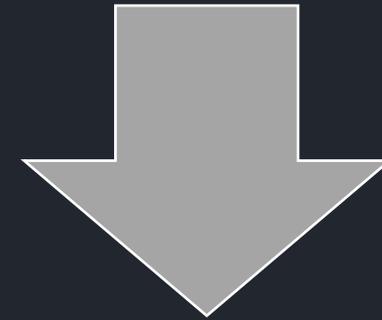
High
Volume



Underwriting - Low Volume of Loans

Consider getting outside help:

- Contract for underwriting services
- Work with local bank or credit union
- Engage a local lending institution - such as a Community Development Financial Institution (CDFI)



Low
Volume



Underwriting - High Volume of Loans

Consider developing in-house capacity or forming a long-term partnership:

- Train current staff or hire staff with underwriting expertise
- Partner with CDFI or qualified subrecipient to administer the fund
- Contract with firms specializing in appraisals, market studies
- Coordinate with another department or agency such as an economic development department, housing finance agency or a redevelopment authority



Duties of an Underwriter

- Review credit worthiness of borrower through company and personal financial statements
- Evaluate trends, projections, performance, market conditions, collateral
- Prepare written credit underwriting reports
- Conduct ongoing review of covenants, monitoring reports, audits, credit reports

How will the market respond to the proposed project?

Key Components of Market Study:

- Defines project's market area and assesses current market conditions
- Contains a precise, data-driven evaluation of the project's feasibility
- Includes the prospect for long-term performance of the property given demographic trends and economic factors

Conducted by an outside party

Market Study: Housing

Project Feasibility & Readiness

- What is geographic market area?
- Market characteristics: income, household size, age of households, renters or owners?
- What similar housing stock/options are already available?
- Can the target market afford the proposed rent or mortgage payments? If not, what other programs may need to be set up in conjunction with development?

Property Appraisal

Project Feasibility & Readiness

Will the property be enough collateral to cover the investment if the project fails?

- Appraiser should have experience with the local market and proposed use and be state certified
- Appraisal must be no more than six months old (Industry Standard)
- Underwriting process uses both:
 - ✓ Current Market Value (“As-Is”)
 - ✓ Prospective Market Value (“As Completed”)

Project Feasibility & Readiness

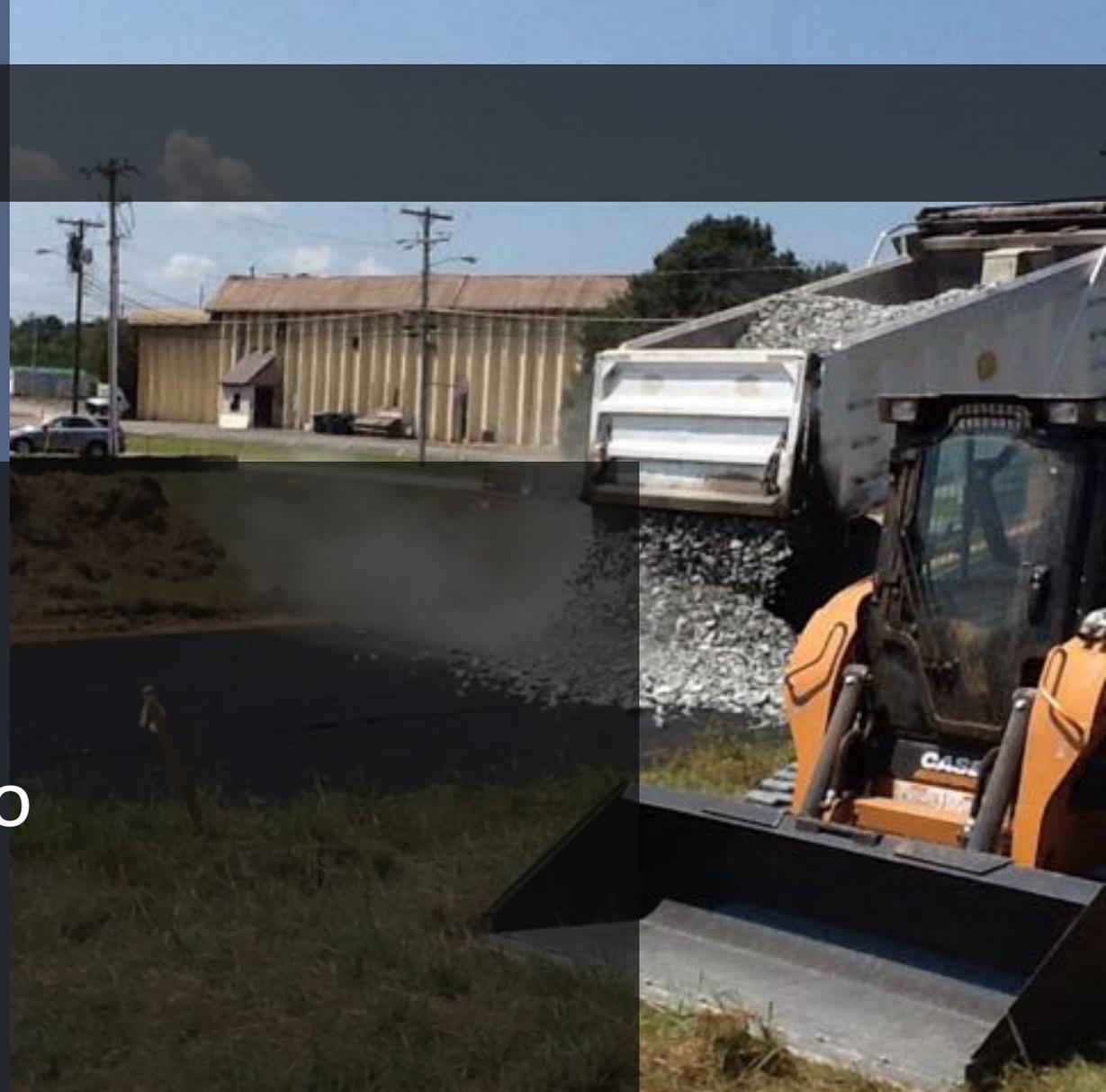
When will the project begin and be completed? What could adversely impact the projected timelines?

Key Components:

- Zoning, Permits, Licenses
- Evidence of Site Control
- Title Insurance
- Survey and Legal Description
- Environmental Site Assessment

Types:

- Sales or Purchase Agreement
- Recorded Deed or Certificate of Title
- Lease or Ground Lease



Legal Structure/Ownership

Borrower Experience &
Management Capacity

Who or what entity is responsible during all project stages?

Borrower(s)	Key Principal(s)
General or Limited Partnership	General Partner(s)
Limited Liability Company (LLC)	Managing Member(s)
Corporation (for profit and non-profit)	Controlling Shareholder(s)
Trust	Controlling Party(ies)
Individual(s)	Individual(s)

Management Capacity

Borrower Experience &
Management Capacity

Does Borrower have the experience and capacity to successfully implement the project?

Key Information	Documentation
Legal Identity	Date and place of formation/incorporation
List of Principals	Name, role, contact information
Principals & Key Staff Qualifications	Resumes, Qualifications
Organization Chart	Key principals and staff roles and responsibilities
Development Team	Name, role, contact information resumes and qualifications of firms and their key principals

How likely is the Borrower to repay the loan?

What are the financial strengths and weaknesses of the Borrower?

Key elements:

- Balance Sheet (for past 3 years)
- Income & Expense Statement (for past 3 years)
- Statement of cash flows
- Real estate holdings
- Bank statements (for the past 6 months) & tax returns (for past 3 years)
- Creditworthiness

Balance Sheet

Borrower Financial Capacity
& Creditworthiness

Does Borrower have a positive net worth?

How liquid are their assets? Are there past due accounts?

<u>Assets</u>	<i>less</i>	<u>Liabilities</u>	<i>equals</i>	<u>Net Worth</u>
<ul style="list-style-type: none">• Cash• Accounts Receivable• Fixed Assets		<ul style="list-style-type: none">• Accounts Payable• Accrued Liabilities• Notes Payable• Taxes		

Balance Sheet *(Continued)*

Borrower Financial Capacity & Creditworthiness

Working Capital = Current Assets – Current Liabilities

- Should always be a positive number.

Current Ratio = Current Assets ÷ Current Liabilities

- Should always be greater than 1.0.

Debt to Equity Ratio = Total Liabilities ÷ Owner's Equity

- The higher the D/E , the higher the risk.

Income & Expense Statement

Borrower Financial Capacity
& Creditworthiness

Does Borrower have a track record of generating sufficient and steady income to meet its financial obligations?

REVENUES *less* EXPENSES *equals* PROFIT

- Rent/sales
- Interest

- Operating Expenses
- Depreciation
- Taxes

Income & Expense Statement

Borrower Financial Capacity
& Creditworthiness

- Does the business consistently make a profit?
- How well do the key principals manage cash to meet the financial obligations of the firm?
- Are the borrower's future projections logical and reasonable based on historical trends?

Cash Flow Statement

Borrower Financial Capacity & Creditworthiness

Reports cash generated and used in following categories:

- Operating activities within the income statement
- Investing activities such as purchase or sale of assets such as real estate and equipment
- Financing activities such as incurring and/or paying off debt as a borrower or providing debt as a lender

Contingent Liabilities

Borrower Financial Capacity
& Creditworthiness

What potential liabilities could affect the Borrower's capacity to carry out the project or repay the loan?

- Outstanding lawsuits
- Claims against the company not acknowledged as debts
- Legal liability
- Guarantees
- Disputed Taxes

Schedule of Other Real Estate Holdings

Borrower Financial Capacity
& Creditworthiness

*Do other real estate holdings
undermine financial strength or
bolster it?*

- Value
- Contingent Liabilities
- Liquidity



Bank Statements & Tax Returns

Borrower Financial Capacity
& Creditworthiness

Do these documents confirm the numbers in the financial statements?

- Bank statements → cash on hand
- Info in tax returns → income statements
 - If these do not match, the borrower should be able to provide an explanation.

Creditworthiness

Borrower Financial Capacity & Creditworthiness

Look for credit scores of 700+ and no bankruptcies past 7 years.

- Credit reports should be run on all key principals
- Credit reports should be no older than 120 days
- Check public records for bankruptcies and judgments

Overview

Project Financial Analysis

- Project Capital Development Budget
- Sources and Uses
- Project Operating Income & Expense Budget
- Construction Loan Draw Schedule
- Cash Flow Analysis
- Loan Sizing
- Loan Amortization Schedule
- Equity Contribution

Sources & Uses

Project Financial Analysis

SOURCES AND USES: BUSINESS EXPANSION LOAN

SOURCES

Bank Loan	\$500,000
Section 108 Loan	\$1,500,000
Third Party Borrower Equity	\$300,000
TOTAL SOURCES	\$2,300,000

USES

Acquisition	\$600,000
Construction	\$1,300,000
Soft Costs	\$400,000
TOTAL USES	\$2,300,000

TOTAL PROJECT COSTS = SOURCES OF FUNDS= USES OF FUNDS

*Do Sources equal Uses?
What Sources are
committed?
What are the terms
associated with these
Sources?*

Rent Rolls and Tenants

Project Financial Analysis

*How well do the rents align with the product and market conditions?
What is the minimum revenue needed to service the debt?*

- Rent Roll – shows current and/or a projection of the sources of revenue for a project and sources of revenue for debt service
- Lease Documentation – What evidence of lease commitments?
- Prominent tenants – Is there any major tenant(s) occupying 20% or more of subject project's space?

Capital Development Budget

Project Financial Analysis

How do budget line items align with local market conditions for similar projects?

- Provide detailed description of assumptions and/or calculations related to each project cost line item
- Includes acquisition as well as hard and soft construction costs
- For Section 108 projects, should include how the borrower will pay program's financing fee

Operating Income & Expense Budget

Project Financial Analysis

How much do the projected increases in rent compare to the projected increases in expenses each year?

- Prudent to be cautious about projected increases in rent and expenses
- Need to test impact over time of scenarios if expenses increase at a higher rate than rents (e.g. 3% a year for expenses and 2% for rents).
- Must show that the project sustains comfortable debt service coverage ratio over the term of the loan

Does project operating budget show adequate Reserves?

- Capital Replacement
- Operating Capital
- Debt Service Reserve



Cash Flow Analysis

Project Financial Analysis

Can the project operate and have sufficient revenue for debt service?

- What is the Net Operating Income
- Is there sufficient revenue to cover operating expenses AND debt service?
- Consider other factors that influence net operating income- rent restrictions, other income, vacancy rates, tenant improvements and leasing commissions

Gross Rental Income

- Vacancy
- Operating Expenses

= Net Operating Income

Cash Flow Analysis

Project Financial Analysis

Are other cash expenditures considered in determining net cash flow available for debt service?

- Replacement reserves
- Tenant improvement allowance
- Leasing commissions

Debt Service

Project Financial Analysis

Is Net Operating Income sufficient to cover Debt Service Payments?

- Debt Service Coverage Ratio (DSCR) shows if there is sufficient income to make debt service payments.
- Typically 1.25 is considered an acceptable DSCR.
- DSCR less than 1.25 requires compensating factors and/or other sources of repayment.

$$\begin{aligned} & \text{Net Operating Income} \\ & \div \text{Debt Service Payments} \\ & = \text{Debt Service Coverage Ratio} \end{aligned}$$

Loan Sizing

Project Financial
Analysis

How do you determine the appropriate size of the loan?

Loan to Value Ratio $\leq 80\%$

Debt Coverage Ratio ≥ 1.25

- Use Loan to Value (LTV) based on real estate value
- Use Debt Service Coverage (DSC) ratio to determine maximum amount available for debt service.

Loan Sizing Based on Debt Service Coverage Ratio

*Based on Net Operating Income,
How Much Can we Afford to
Borrow?*

Project Financial
Analysis

Net Operating Income:	\$400,000
DSCR:	1.25
Maximum Annual Debt Service: (\$400,000/1.25)	\$320,000
Maximum Loan Amount 6.00% rate, 20 year term ("Present Value" Formula)	\$3,722,000

Loan Sizing Based on Loan to Value Ratio

Project Financial Analysis

Property Appraised Value	\$5,000,000
Loan to Value Ratio	<u>X 80%</u>
Maximum Loan Amount	\$4,000,000

Loan Sizing

Project Financial Analysis

How do you determine the appropriate size of the loan?

The lender will often choose the lesser result of the LTV and DSCR calculation methods.

Therefore the loan would be set at \$3,722,000, rather than \$4,000,000.

Collateral Examples

Collateral & Loan Repayment Guarantees



- Real property
- Personal property
- Debt service reserve
- Personal and/or corporate guaranty.

Need to underwrite the guarantee source as rigorously as the project.

Multiple Sources of Financing

Collateral & Loan Repayment Guarantees

- If projects that have multiple sources of financing, lenders may require an “Intercreditor Agreement” that establishes restrictions on subordinate lenders
- It is important to ensure that the Lender of the Section 108 guaranteed loan is sufficiently protected

Provides analysis of loan request and recommended terms and conditions for how to proceed.

- Project Summary
- CDBG Compliance Review
- Borrower Credit and Management Capacity
- Findings from Analyses
 - Market
 - Appraisal
 - Environmental
 - Management Review
- Risks and Mitigating Factors
- Recommended Loan Terms and Conditions

Closing Covenants - Affirmative

A list of all required actions to be taken by the borrower

- Inform lender of litigation or claims pending
- Maintain financial records in accordance with accepted accounting principles
- Maintain insurances- fire, liability, etc.
- Pay taxes and liens
- Perform and operate as promised

Closing Covenants - Negative

A list of what the borrower may not do:

- Take on other debts and liens without authority of lender
- Discontinue operations
- Make loans and guarantees that could obligate business

In Conclusion – the Big Picture

Rigorous and Robust Loan Underwriting

= Healthy Loan Portfolio

- Underwriting must take place for each and every loan
- Underwriters can be in-house staff or outsourced
- Underwriting evaluates the viability of a particular deal
- Underwriting evaluates the capacity of the borrower

In Conclusion – Add an Extra “C” to the Five Cs of Credit

- Capacity:** Cash to pay the loan as agreed
- Capital:** Borrower's investment in the project
- Collateral:** Real estate and/or other assets and guarantees to pay the loan if project cannot
- Conditions:** Project purpose and market in which it shall perform
- Character:** Experience and track record of performance of borrower and its team
- Compliance:** CDBG community impact by meeting a national objective

HUD's Section 10

Underwriting I

Quest



Thank You!

View or Download HUD Section 108 Underwriting Guidelines:

<https://www.hudexchange.info/resource/5284/section-108-underwriting-guidelines-for-incomeproducing-projects/>

For additional training materials on the 108 program visit:

<https://www.hudexchange.info/programs/section-108/>

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