U.S. Department of Housing and Urban Development
Community Planning and Development

Special Attention of:

Notice: CPD 98-1

All Secretary's Representatives
All State/Area Coordinators
CPD Division Directors
All HOME Participating Jurisdictions
All HOME Coordinators

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Subject: Layering Guidance for HOME Participating Jurisdictions When Combining HOME Funds with Other Governmental Subsidies

I. PURPOSE

The purpose of this Notice is to provide guidance to participating jurisdictions (PJs) in their development of local guidelines to evaluate projects using HOME funds in combination with other governmental assistance to ensure that no more than the necessary amount of HOME Program funds are invested in any one project to provide affordable housing.

II. BACKGROUND

Both Section 212(f) of the Cranston-Gonzalez National Affordable Housing Act, as amended, and 24 CFR Part 91, the consolidated plan final rule, require a PJ to provide a certification with the consolidated plan. This certification asserts that prior to the commitment of funds to a project, the PJ will evaluate the project in ' accordance with the guidelines that it adopts for this purpose and will not invest any more HOME funds in combination with other governmental assistance than is necessary to provide affordable housing.

In developing these guidelines, CPD relied heavily on the experience of HUD and State tax credit allocation agencies, as well as the professionals experienced in evaluating housing project financing. This notice is designed to offer the experience and advice of those who have conducted project layering reviews.

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If a PJ uses these guidelines, or relies upon subsidy layering evaluations produced by HUD or State tax credit allocation agencies, as described below, HUD will consider the PJ to be in compliance with the statutory requirement. A PJ may, of course, develop its own guidelines for conducting subsidy layering evaluations. In this case it should ensure that its review process is consistent with the advice in this Notice.

III. DEFINITIONS

Governmental Assistance - Governmental assistance includes any loan, grant, (including Community Development Block Grant), guarantee, insurance, payment, rebate, subsidy, credit, tax benefit, or any other form of direct or indirect assistance from the Federal, State or local government for use in, or in connection with, a specific housing project.

Maximum Per Unit Subsidy Limits - The amount of HOME funds that a PJ may invest on a per-unit basis in affordable housing may not exceed the per unit dollar limits established under section 221(d)(3) of the National Housing Act for elevator-type projects, involving nonprofit mortgagors that apply to the area in which the housing is located. These limits are available from the Multifamily Housing Division in the HUD Field Office. If the participating jurisdiction's per unit subsidy amount has already been increased to 210% as permitted under section 221(d)(3)(ii) of the National Housing Act, upon request to the Field Office, HUD will allow the PJ's per unit subsidy amount to be increased on a program-wide basis to an amount up to 240% of the original per unit limits.

IV. USE OF THE GUIDELINES

Based on the certification contained in the annual submission of the consolidated plan and the subsidy layering provisions of §92.250(b) of the HOME final rule, a PJ must use the guidelines it has adopted to document that when HOME funds are used in combination with other governmental assistance, no more subsidy is invested than is necessary. The project file should contain the required evaluation. For example, if a project is using HOME funds in combination with local tax increment financing, the PJ would use the guidelines, evaluate the project, and document the evaluation.

While the evaluation requirement is predicated on the combination of HOME funds with other governmental assistance, it is recommended that the guidance in this notice should also be used when determining the level of HOME funds to be used in a project absent other governmental assistance. The evaluation may need to be updated if additional sources of funds, not originally contemplated, are added to the project. The evaluation and certification is the sole responsibility of the PJ.

However, the PJ may rely upon the guidelines developed and evaluation conducted by other agencies when the following governmental assistance is being used:

Low-Income Housing Tax Credits (LIHTC)

The PJ may rely upon the State tax credit allocating agency's evaluation (which is conducted to determine whether there are excess tax credits) to ensure that HUD subsidies are not greater than necessary to provide affordable housing when combining HOME assistance with the tax credits. Such State agencies have typically established project guidelines (based on project size, characteristics, location and risk factors) that determine appropriate project costs and developer fees. An acceptable State agency certification is done pursuant to either applicable HUD regulations or the Internal Revenue Code.

In 1993, the National Council of State Housing Agencies (NCSHA) adopted a set of standards for use by State agencies that administer the LIHTC. The standards cover the specific areas related to the administration of LIHTC programs, including per unit cost, developer fees, consultant fees, verification of expenditures, compliance monitoring and net proceeds from tax credits. Participating jurisdictions may find these standards useful in conducting subsidy layering reviews of HOME projects, regardless of whether LIHTCs are used. The standards can be obtained from the NCSHA.

Other HUD Program Funding

The PJ may rely upon HUD's evaluation (conducted in accordance with Section 102(d) of the HUD Reform Act) for projects funded by HUD's Office of Housing (for example, FHA Mortgage Insurance) and Office of Public and Indian Housing and other HUD offices which are required to provide this kind of evaluation. A HUD review is required in these cases because the Department is directly making funds available for these projects. This is not the case for the HOME Program where the PJ receives a formula-based allocation and subsequently selects and underwrites HOME projects.

V. PROJECT EVALUATION

Before a PJ invests HOME funds in a project, it must assess if other governmental assistance has been, or is expected to be, made available to that project.

In performing this evaluation, the PJ should consider the aggregate amount of assistance from HUD and from other sources that is necessary to ensure the feasibility of the assisted project. The PJ should take into account all the factors relevant to feasibility, which may include, but are not limited to, past rates of returns (in that area for that type of project) to owners, sponsors, investors; the long-term needs of the project and its tenants; and the usual and customary fees in the development of the project.

In addition, the PJ should consider the population that is being served when conducting the layering review. For instance, if the targeted population is 60 percent of median income for the area, that results in one level of assistance; if the targeted population is very low-income, e.g., below 30 percent of area median income, that will result in an increased level of HOME or other assistance.

Sources & Uses of the Funds Statement

As part of the application process, the PJ should have the applicant submit a Sources/Uses of Funds statement for the project. The Sources/Uses of Funds statement should reflect the project development budget and should list:

1) all proposed sources (both private and public) of funds and the dollar amount(s) for each respective source, and

2) all uses of funds (including acquisition costs, rehabilitation/or construction costs, financing costs and professional fees) associated with the project.

The PJ should identify the types of documentation necessary to verify the sources and uses of funds indicated in the statement. The listing of documentation should be provided to the applicant so that the documentation may be submitted along with the Sources/Uses of Funds statement in the application for HOME funds.

Sources of Funds: The PJ should request the following: (1) commitment letters with all terms and conditions for all mortgages, grants, subordination agreements, bridge (interim) loans and investment tax credits (historical, low-income, if applicable) and (2) if the applicant is a partnership, a copy of the partnership agreement, which will indicate the cash contributions by the general partner(s) and/or limited partner(s).

Uses of Funds: The PJ should request the following: (1) earnest money agreement, option or closing statement for land and/or building(s); (2) construction cost estimate; (3) construction contract or preliminary bid(s); (4) agreements governing the various reserves which are capitalized at closing (to verify that the reserves cannot be withdrawn later as fees or distributions); (5) appraisal (to substantiate the value of the land and the value of the property after rehabilitation or the structure being built); and (6) if low-income housing tax credits are utilized, documentation on the syndication costs (legal, accounting, tax opinion, etc.) from the organization/individual who will syndicate and sell the offering to ensure that the project can support the fees necessary to syndicate/fund the project. All assumptions in the offering should be verified in the supporting documentation.

The applicant should also provide supporting documentation for all other costs as specified in the Sources/Uses of Funds statement. If the documentation is not adequate and does not support the costs as stated, the PJ should request additional documentation, a second opinion and/or reference from the appropriate source (i.e. another construction cost estimator, another architect or lawyer), or deny the project HOME funding. It should be noted that for projects with tax credits to be sold, the proceeds from the sale of these credits must be identified as a source of funding.

KEY EVALUATION POINT

Certification of Federal Assistance

The PJ should obtain a formal certification from the applicant(s) concerning the governmental assistance provided or to be provided to a project. If no such governmental assistance is to be provided at the time of the application or in the future, the applicant(s) should certify to that fact. The applicant(s) should also certify that should other governmental assistance be sought in the future, the PJ will be notified promptly. These assurances may take the form of a certification.

Review of the Project Development Budget

The PJ should review the project development budget to determine whether the development costs are necessary and reasonable, taking into consideration the long-term needs of the project as well as the objectives of the HOME Program and the PJ.

As in the Sources/Uses of Funds statement, the budget should include all costs associated with the development of the project regardless of the funding sources. The budget line items may include, but should not be limited to: construction "hard" costs, soft costs (architectural, engineering, legal and appraisal fees), marketing costs, construction loan interest, developer fees, real estate taxes, insurance, all loan fees, building permits, relocation and consultant fees. The project development budget should reflect the total costs as in the "uses" section of the Sources and Uses of Funds statement.

The PJ should also review to ensure that the costs being funded by the HOME Program are eligible and the HOME funds per unit do not exceed the maximum per-unit subsidy limits.

The PJ's review guidelines should focus on the project's quality, and construction costs, architectural and engineering fees and consulting fees. The PJ should determine what costs are necessary depending on the type of development activity (new construction vs. rehabilitation, occupied vs. unoccupied). The determination of "reasonableness" of the costs should be based on all of the following factors: (1) costs of comparable projects in the same geographical area; (2) the qualifications of the costs estimators for the various budget line items and (3) comparable costs published by recognized industry cost index services.

KEY EVALUATION POINT

Rate of Return on Equity Investment

The PJ should require the applicant to furnish a proforma (project income and expense statement) which should include achievable rent levels, market vacancies and operating expenses and also specify the consequences of tax benefits, if any, and any other assumptions used in calculating the project cash flow to determine the reasonableness of the rate of return on the equity investment. The proforma should represent, at a minimum, the term of the HOME affordability requirements, but longer if applicable (e.g., 15 years for low-income housing tax credit projects). It is imperative that the PJ scrutinize the proforma to ensure the cash flow projections are reasonable in light of the present economic conditions since the rate of return on the investment is partially predicated on the cash flow. The cash flow projections should neither be unduly conservative nor overly optimistic.

The proforma should adhere to guidelines established by the PJ. However, there are some basic industry standards that may be implemented as guidelines, such as those presented in TABLE 1.

TABLE 1: Basic Proforma Industry Standards

INCOME

* All income should be included in the proforma (commercial, residential, laundry, etc.).

* All additional equity contributions to the operating budget (e.g., staged tax credit equity payments, funds to cover anticipated initial operating deficit) should be shown as income.

* The rate of increase for income should be no higher than 3 percent per year for the average project.

OPERATING EXPENSES

* All cash expenses should be included and reflect the project's type (rental, cooperative, condominium), size (number of units), services and costs provided by the locality (garbage collection, tax abatements, water and sewer charges) and type of mechanical systems (electric vs. gas).

* Expenses should always be trended higher than income on an annual basis, e.g., increases of 4 to 4.5 percent per year (as compared to 3 percent for income).

* Operating expenses tend to be generally 30-40 percent of gross rents for a market rental project (varies depending on many factors including the limitation on gross rents that can be obtained in a HOME subsidized project vs. a market rate project which has no such limitations). The operating expenses of comparable rent controlled projects should also be examined to determine a percentage for the project.

* The vacancy rate should be a minimum of 5 percent on an annual basis (regardless of project type, size or market conditions).

* Property management fees should be approximately 5-7 percent of gross rents. Please note that the 5-7 percent range is based solely on the managing agent's property management responsibilities. If social services are included in the rent and the managing agent has the responsibility to coordinate/provide such services, the fee may be higher based on additional responsibilities.

EXPENSES

* All partnership distributions (surplus cash) should be included as expenses.

* All debt service should be included in the cash flow projections.

* All non-cash expenses should be included such as depreciation, amortization of fees and amortization of principal.

If the income/expense statement does not meet the guidelines and/or the supporting documentation presented is not adequate to justify the projections in the proforma, the income/expense analysis in the appraisal should be reviewed for consistency and/or verification. The expense sources (property management firm, tax authority, water/sewer department) should be contacted for verification of the costs.

The project cash flow shall be defined as: the spendable cash generated annually (at the end of the yearly period) after all operating expenses and debt service payments have been deducted from the gross revenues of the property. The determination of a reasonable rate of return on the equity investment will be based on an evaluation of the individual project as it compares to market standards for similar investments. Using data contained in the project application, the PJ may evaluate several factors (e.g., cash on cash return, the internal rate of return, net equity) in determining a "reasonable" rate of return for the project.

KEY EVALUATION POINT

The simplest evaluation is the cash flow return on the investment. A PJ may find the cash on cash return analysis adequate for purposes of the review and it is calculated as illustrated in TABLE 2. In other cases, tax benefits and potential appreciation will be significant sources of return to investors.

There are more refined and comprehensive approaches to determine rates of return on the investment which can be undertaken, including net equity, internal rate of return. These types of reviews might be especially beneficial if HOME funds are used in conjunction with projects funded through the FHA program and low-income

housing tax credits. The PJ should not allow an excessive gain/profit to be derived from the project, in part due to the financing (low-income housing tax credits, low interest loans, grants, tax abatements, etc.). The PJ should establish specific standards for reasonable rates of return on the invested equity based on the project.

Cash On Cash Analysis

The cash flow (Cash on Cash) return is calculated by dividing the cash flow by the equity invested. It is calculated as follows:

Step 1. Determination of Net Operating Income

Gross Annual Income - Vacancy Loss (Rate x Rental Income) = Effective Gross Income (EGI)

EGI - Operating Expenses = Net Operating Income (NOI)

Step 2. Compute Cash on Cash Return

NOI - Debt Service Cost (Sources other than owner equity (loans, grants, donated land, etc.)) = Cash Flow = Cash on Cash Return
Equity

Notes: 1. Equity can be determined by reviewing the partnership documents.

2. Since cash flows tend to change over time and be lower in the early years of a project, cash flows should be averaged at a minimum over the term of the affordability period to gain a realistic picture of an owner's return.

Table 2: Simple, Single-Year
Cash on Cash Illustration

Assumptions:

Cost: (total investment)	$ 1,000,000.
Less: First Loan (9.5% 30 yrs)	($ 650,000.)
Less: Second Loan (8% interest only)*	($ 150,000.)
Cash (equity) required	$ 200,000.

Step 1. Determine the Net Operating Income

Gross rental income	$ 175,000.
Less: Vacancy (5%)	($ 8,000.)
Effective Gross Income (EGI)	$ 166,200.
Less: Operating Expenses	($ 67,000.)
Net operating income (NOI)	$ 99,200.

Step 2. Compute Cash on Cash Return

Net Operating Income			$ 99,200.
Debt Service (First Loan)	$ 65,586.		
Debt Service (Second Loan)	$ 12,000.		
Total Debt Service		$ 77,586.	
Cash Flow		$ 21,614.	

Cash Flow = $ 21,614. = Cash on Cash Return = 11%
Equity $ 200,000.

Notes: The cash on cash return in based on an annual pre-tax cash flow which excludes non-case expenses such as depreciation.

* Form of subordinate government assistance that is grant or loan does not alter the above evaluation.

Since cash flows tend to change over time and be lower in the early years, cash flows should be averaged at a minimum over the term of the affordability period to gain a realistic picture of an owner's return.

Overall Evaluation

If the Participating Jurisdiction determines that the total amount of HOME assistance and other governmental assistance exceeds the amount that the PJ determines is necessary to make the project feasible due to the unreasonableness of the costs and/or the projected rate of return, the PJ can consider several options:

1) Reduce the amount of HOME assistance through reducing the development budget accordingly or increasing the non-public funding of the project;

2) Make other adjustments to the project, such as lower the rents to be charged, reduce the term of the loan in order to lower the rate of return; or

3) Deny HOME assistance if the applicant refuses to make reasonable adjustments or to limit its return/costs.

VI. SINGLE-FAMILY RENTAL HOUSING (1-4 units)

The concepts contained in all subparts of Section V above pertain to single-family rental housing of 1 to 4 units as well as multi-family rental housing (for example, income/expense, cash on cash, and net operating income analyses). However, there are two questions a PJ must consider before applying these concepts: 1) is the rental project owner-occupied? and 2) is the owner-occupied unit being rehabilitated with Federal funds?

If the answer to both questions is YES, the rental income for the owner's unit (had the project not been owner-occupied) must be excluded from the income analysis of the proforma. For example, in a four unit owner-occupied project, only the expected income of the three rental units are included in the income analysis. Similarly, expenses associated with the rehabilitated owner's unit must also be excluded from the proforma. The exclusion of income and expenses of the owner's unit not only affects the net operating income and the cash on cash analyses, but also influences the results of the proforma.