NSP Rental Basics:

A Primer on Using Rental Projects to Meet NSP Obligation and 25% Set-Aside Requirement

About this Tool

Description:

This tool is intended for NSP grantees and their partners seeking guidance on using NSP funds to develop a rental project. It is geared toward projects involving a straightforward acquisition of an existing multifamily structure using NSP funds only or NSP funds plus a standard commercial first mortgage. It includes information on first steps in the RFP and application process, strategies for evaluating project and developer potential, and guidance on project financing.

A related document, the NSP Rental Budget Analysis Worksheet, is also part of the NSP Toolkits on the NSP Resource Exchange.

Source of Document:

This document was adapted for NSP grantees from various ICF International training materials used in the field of rental development.

Disclaimer:

This document is not an official HUD document and has not been reviewed by HUD counsel. It is provided for informational purposes only. Any binding agreement should be reviewed by attorneys for the parties to the agreement and must conform to state and local laws.

This resource is part of the NSP Toolkits. Additional toolkit resources may be found at www.hud.gov/nspta

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Introduction

The Neighborhood Stabilization Program requires grantees to expend no less than 25 percent of their grant award for activities addressing foreclosed units sold or rented to households with income at or below 50 percent of Area Median Income. Using NSP funds to fund a rental project can be a good strategy for meeting this requirement. As there is no subsidy limit, grantees can develop projects that target households at the lowest incomes and require high levels of subsidy.

This primer provides tools and information for grantees and their partners who are new to affordable rental projects. The information and tools here are the basic materials needed to implement a straightforward rental project. The tools are merely simplified versions of what one might use for a more complex project. NSP grantees should use this material when:

- The grantee does not already have a good system in place for identifying, selecting and funding rental projects;
- The project is a straightforward acquisition of an existing multifamily structure which will be rehabilitated and rented to tenants with income mostly or entirely at or below 50% area median income[1]; and
- A primary goal of the project is to utilize NSP funding to meet the 25% set-aside.

Users of this primer might also want to review the full set of Multifamily Rental Toolkit items available, as some of those are likely to be useful. Tools available include:

- Creating an NSP-Eligible Rental Project. Guidance on packaging a rental project that meets NSP eligibility criteria.
- Multifamily Rental RFPs. A sample of a project specific RFP and a non-project specific RFP.
- Multifamily Rental Legal Documents. These include a sample loan agreement, note, mortgage, NSP regulatory agreement, operating deficit guarantee, completion guarantee, subordination agreement, and intercreditor agreement.
- Multifamily Rental Written Agreements. Sample agreements between the grantee and the developer, one project specific and one non-project specific.
- Multifamily Underwriting Template. An Excel workbook that grantees and developers can use to evaluate the feasibility (sources and uses) and viability (cash flow) of a proposed NSP multifamily rental project. A simpler alternative is the budget spreadsheet found as an Attachment to this primer.
- Guidance for Multifamily Developers. Guidance to help identify and fix potential NSP compliance problems when developers have already identified sites prior to receiving the NSP award.

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[1] Grantees should note that a project with 100 percent of units restricted at 50 percent AMI may or may not have enough rental income to be viable long-term, even with no mortgage payment. Projects with a high percentage of 50 percent AMI units should be carefully evaluated for long-term viability.

- Application Processing Guide. Guidance for Evaluating NSP Multifamily Rental Proposals From Developers

The toolkit also includes a number of other resources applicable to NSP funded projects including guidance on:

- Property Acquisition, including a sample property acquisition checklist
- Tenant Protection, Environmental Review and Other Federal Requirements
- Rehabilitation and construction, including performance standards, specifications, and sample contracts
- Tenant documentation including a sample tenant application form, guidance on Income qualification, and a sample lease agreement

These reference documents are available in the Multifamily Rental Toolkit on the NSP Resource Exchange along with other helpful resources. The documents can be easily found on the website using search terms that include key terms in the name and "multifamily toolkit".

Please note: NSP grantees can request help in evaluating and implementing projects through the NSP Resource Exchange, at www.hud.gov/nspta. Please use this technical assistance as a resource if you need it. And before you do, use the tools here to gather the information that any professional underwriter will need in order to evaluate your project.

With these other resources in mind, the following sections provide an overview of the basics involved in executing a simple multifamily rental development project.

1. Identify Good Projects and Developers

To find projects and developers, grantees should use their existing process for issuing Requests for Proposals (RFPs) / Requests for Qualifications (RFQs). Grantees are advised to review similar documents published by other communities as well as any samples on the NSP Resource Exchange. Basic recommendations for this process include the following:

- Seek first, and/or give priority to, those developers who have access to NSP set-aside eligible projects, i.e. foreclosed properties.

- Seek also developers who may not already have projects, but are interested and have demonstrated capacity.

- In all cases, seek only those developers that show the capacity to work in a regulated affordable housing framework, i.e., rent and income limits and other Federal regulations.

- Share information early and often with developers and other partners regarding the rules related to NSP projects.

- Require a good application and proposal format to enable your reviewers to effectively evaluate the developer and any project brought forward.

It is permissible for grantees and developers to expend program delivery funds for the work of identifying projects and carrying out feasibility analysis. So, don't hesitate to recruit developers and give them incentives to bring in a workable project. See the Multifamily Rental Toolkit Non-Project Specific RFQ for two methods of helping developers to package NSP-compliant rental projects.

There are many examples of NSP RFPs available to grantees.[2] The Economic Development Corporation of Kansas City, Missouri, successfully recruited a number of developers to go out and find projects by using an open-ended RFP where the only criteria were developer capacity and commitment. Note that for developers recruited this way, the grantee may need to execute two kinds of agreements with them – one to govern their up-front work of identifying projects,[3] and another to govern each project once it has been approved by the grantee.[4]

2. Evaluate Developer and Project Information

Grantees are advised to review responses to their RFP/RFQ thoroughly to ensure completeness and compliance. Incomplete applications should be rejected. Key questions for review are listed below. The "Application Processing Guide" provided in the Multifamily Rental Toolkit can also serve as a resource.

<u>Evaluate the key elements of developer capacity</u>
Consider the developer organization's capability to carry out the NSP project. The organization's capacity level may be determined by asking the following questions:

- ❑ Are there qualified and ready-to-work team members for all roles listed on the sample application?
- ❑ Is knowledge of NSP rules and federal regulations indicated by a correct application and a project plan that reflects full understanding of NSP, environmental review, relocation and other Federal requirements?

<u>Readiness for NSP investment</u>
Assess the appropriateness of the property for NSP use. Appropriateness may be determined by asking the following questions:

- ❑ Is it an NSP qualified project? (Use the "Creating an NSP Eligible Project" from the Multifamily Rental Toolkit as a resource.)
- ❑ Will the grantee be able to generate an "obligation" (i.e. executed developer agreement with amounts based on a specific property development budget and an executed offer to purchase) by the grantee's obligation deadline and complete the project by the expenditure deadline?
- ❑ Is the project suitable for renting to households with income <50% AMI?

[2] See the NSP Multifamily Rental Toolkit "Project Specific RFP" and "Non Project Specific RFQ".
[3] For example, see the NSP Multifamily Rental Toolkit documents titled "Letter of Intent" and "Predevelopment Grant Agreement".
[4] For example, see the NSP Multifamily Rental Toolkit "Project Specific Award Acceptance Agreement".

Market Viability

Determine whether the proposed project has the potential to be viable in its market area. Making such a determination may call for a market study to evaluate supply and demand in the surrounding area. Market viability may be assessed by asking the following questions:

- ❑ Are developer's projections for rent, vacancy, and unit quality consistent with market study or known market information?
- ❑ Are market analysis conclusions supported by the evidence presented with regard to area rents and vacancy rates?
- ❑ Are the properties used as market comparables truly comparable in location, unit size, and amenities, and/or are differences adequately adjusted for?

Property specific history – either now or during most recent occupancy

Assess the existing rental project's history. (This is only relevant when using NSP funds for an existing rental project, and would not be relevant for grantees using NSP funds to create new rental projects; e.g. from single family properties). By collecting and compiling details on an existing rental project's operating expenses history, grantees can learn from past oversights, successes, and mistakes.

- ❑ What were the rent rates?
- ❑ What was the vacancy rate?
- ❑ If the project has problems or shortcomings, does the developer have a plan for dealing with those issues that is plausible and that is adequately funded??

Financial Viability

Determine the long-term financial viability of the project given the conditions surrounding the project. An accurate judgment of the project's future finances may involve the following considerations:

- ❑ Budgeting for realistic property expenses (including quality property management, property maintenance, and sufficient replacement reserves) is essential to the long-term viability of the project.
- ❑ Given rent restrictions, cash flow may decline over time. A 20-year cash flow projection is important to identify potential shortfalls in future years.
- ❑ This primer includes a simple budgeting tool. You will also find a more developed Multifamily Underwriting Template in the Multifamily Rental Toolkit.

Rents & Tenants Under NSP

Consider affordable rent levels and eligible tenants. Once the project is ready for tenants to move in, grantees must consider the following NSP rules:

- ❑ Rents must not exceed the grantee's definition of "affordable rents" (as defined in the NSP Amendment to the Consolidated Plan) for the full term of the affordability period.
- ❑ Tenants must be income qualified at the time they move in, but do NOT have to be re-certified annually. A tenant's income may increase over time without displacement from the project, but any new tenant moving in to the project must be income qualified.

3. Take Critical First Steps to Comply with Federal Requirements

In addition to assuring that the project meets the basic criteria for NSP eligibility and readiness, there are other critical federal requirements that must be dealt with immediately on any project. Details for these first steps are available on the NSP Resource Exchange. Also see the "Creating an NSP Eligible Project" in the NSP Multifamily Rental Toolkit.

Tenant Protection and Uniform Relocation Act Requirements

Grantees must assure that the NSP Tenant Protections have been followed and that any current occupants of the project are identified. These occupants are entitled to advisory services, in the form of notices and counseling, and, possibly, assistance, under the Uniform Relocation Act. Be sure you know who these occupants are and maintain records from the inception of the project. Failure to do so can lead to unexpected and substantial costs and work later.

A variety of tenant protection tools and guidance documents are available on the NSP Resource Exchange. To browse through these resources, search keyword "tenant protection."

Environmental Review

Failure to follow the proper Environmental Review procedures can lead to the project later being deemed ineligible. Be sure that any contract includes the required clauses and that the proper steps are followed prior to the investment of NSP funds.

The Environmental Review process is the responsibility of the NSP grantee, however, the developer may be asked to provide information regarding specific features or characteristics regarding the property, including it s history, past uses and the scope of the proposed redevelopment, renovations or remodeling.

A variety of environmental review tools and guidance documents are available on the NSP Resource Exchange. To browse through these resources, search keyword "environmental review."

4. Structure Project Financing

Project financing must take into account the likely cash flow from the project and the ability to repay loans.

Simple Strategies

In most affordable housing scenarios, it is desirable for the developer to secure a conventional first mortgage in the greatest amount feasible; however, that is not necessarily the best strategy for NSP projects given the likely rents and the time pressures for obligating funds. The simplest strategy is for the Grantee to fully fund project costs with an NSP funded first mortgage that has no required payments except for a share of any positive cash flow[5]. Using NSP funds for the first mortgage can help with meeting the obligation requirement and avoid the project delay that may occur if the developer seeks conventional financing.

[5] For example, see the template loan agreement, note and mortgage in the NSP Multifamily Rental Toolkit.

- ❑ The NSP Rental Budget Analysis Spreadsheet, provided as an attachment to this primer can be populated with project data to calculate the size of a first mortgage that would be affordable in the private market at different interest rate and repayment schedules. The first mortgage should not be for an amount greater than the project can afford with sufficient cash flow to address unforeseen circumstances (i.e., no less than a 1.2 debt service coverage ratio).

- ❑ It should be noted that this spreadsheet is sufficient only for the most straightforward projects. The Multifamily Rental Toolkit contains an underwriting template with the functionality needed for more complex projects.

<u>Additional Subsidy</u>

If the first mortgage does not fully fund the project, grantees will typically put in place a second mortgage to fill the gap. This second mortgage may be interest-bearing, zero-interest, or forgivable, depending on the needs of the project. The NSP Rental Budget Analysis Spreadsheet (or the underwriting template) will help you determine the amount of that gap. NSP funds can be used to fund a second mortgage for the entire difference between the first mortgage and the post-renovation appraised value as long as all units meet NSP criteria.

<u>Payment Options</u>

The grantee should execute a note and a mortgage to secure repayment of their investment of NSP funds. There are three main options for repayment that a NSP grantee could use for a project: annual cash flow, required monthly, or fully forgivable/due on sale.

- Annual Cash Flow Payment
    - Grantee can require a percentage share of annual cash flow based on an annual project audit.
    - The two most likely options for sharing cash flow are:
        - One-third grantee and two-thirds owner
        - Half grantee and half owner
    - Such sharing is reasonable because it gives the developer some incentive to generate cash flow while still generating a potentially significant repayment to the grantee.
- Required Monthly Payments
    - The grantee can require monthly payments as done for conventional mortgages.
    - Monthly payments are not recommended on the second mortgage (it is a relatively large administrative burden for a relatively small return of funds); and
    - It is not recommended to require mandatory payments below 1.2 debt service coverage ratio (If there is a conventional first mortgage lender, there may be some debt service coverage left if first mortgage lender has underwritten at 1.25 or higher).
- Fully Forgivable/Due on Sale
    - NSP does not require the grantee to receive any repayment — the Grantee may choose to make the second mortgage fully forgivable over the term of the loan, with any remaining balance due if the property is sold before the end of the term or if the property fails to comply with NSP requirements.

- A typical forgiveness structure might involve no forgiveness for 10 years and then 10 percent per year for the following 10 years.

Interest Rate

The decision to charge interest should be based on a variety of factors. If the grantee plans to implement a forgiveness structure, then charging interest is probably unnecessary. If a grantee plans to require repayment, it might consider charging an interest rate that balances the need for program income, the capacity of the project to make payments, and the owner's need for a positive equity position.

Term of Affordability Commitment

NSP requires a term of affordability, commensurate with the amount of NSP subsidy per unit. For example, a renovation project with over $40,000 NSP subsidy per unit, the minimum term would be 15 years. The grantee is encouraged to set a longer term in order to get a longer term affordable housing resource for its investment of funds. The affordability commitment is separate from the term of the loan and should be recorded in a separate document that survives the repayment of the loan or foreclosure under the first mortgage.

5. Write Your Funding Agreement and Close the Deal

In addition to a standard mortgage and promissory note to secure repayment of the NSP funds, grantees will find it helpful to execute a funding agreement with all of the particulars of the specific project. A sample project-specific written agreement is available in the Multifamily Rental Toolkit as well as several sample legal documents. It is essential that the funding agreements and legal documents reflect all the performance and compliance requirements for your project, so that any meaningful change requires approval and all requirements are enforceable on the developer and/or the property, including but not limited to:

- Project budget
- Project description, unit type, design, construction standards
- Rent schedule
- Affordability requirements
- Lease requirements
- Tenant selection criteria
- Compliance with state and local tenant-landlord laws
- Conditions for faith-based organizations
- Lead-Based Paint requirements
- Fair housing and equal opportunity provisions
- Fund disbursement
- Record keeping and reporting provisions
- Enforcement provisions
- Procedures for securing rent increases
- Compliance requirements, including the monitoring checklist that will be used