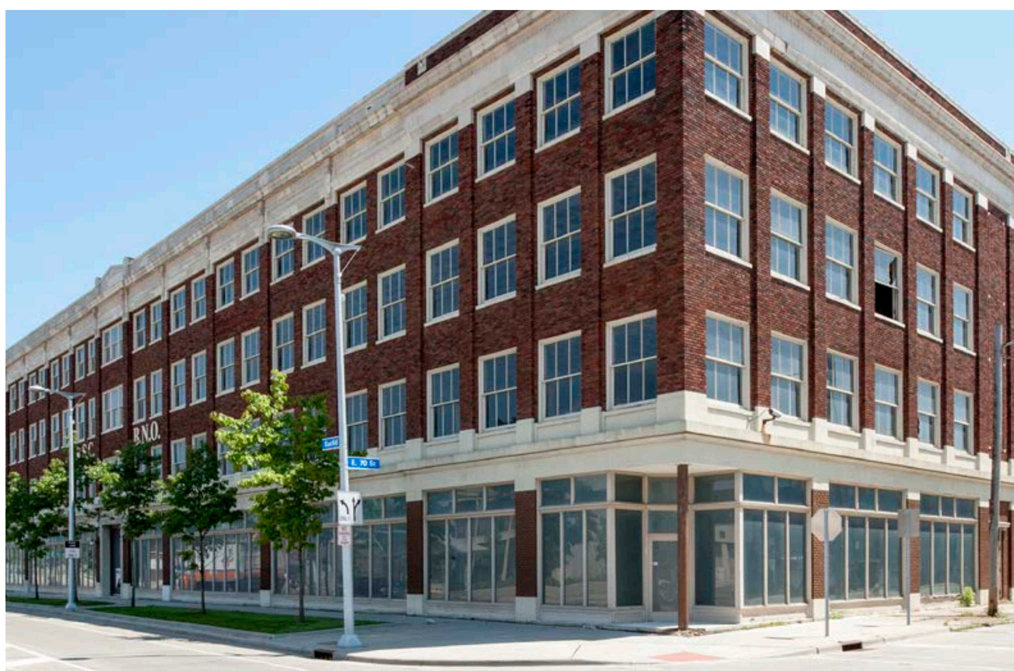
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

HUD Office of Community Planning and Development

Section 108 Underwriting Guidelines for Income-Producing Projects

2017



Including: Residential, Office, Retail, Industrial and Mixed-Use Real Estate Projects For Section 108 Loan Guarantee Recipients

COMMUNITY PLANNING DEVELOPMENT

EQUAL HOUSING OPPORTUNITY

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INTRODUCTION

Program Overview

Section 108 is the loan guarantee provision of the Community Development Block Grant (CDBG) Program. It provides CDBG grantees with a source of financing for economic development, housing rehabilitation, public facilities, and other large-scale physical development projects. This flexibility makes it one of the most potent and important public investment tools that HUD offers to states and local governments. **The Section 108 Loan Guarantee Program** provides state and local government grantees the ability to transform a small portion of their CDBG funds into federally guaranteed loans large enough to spur economic growth and jump-start community revitalization efforts. For more details, see the program's website at *https://www.hudexchange.info/section-108/*.

The guaranteed loans are made by investors who purchase "debt obligations" that are guaranteed by HUD. The debt obligations are promissory notes issued by states and local governments, or public agencies (such as redevelopment agencies and housing authorities) designated by a state or local government to be the issuer. Each issuer receives a loan guarantee from HUD and is referred to in this guide as a "**Recipient**[1]." A **Subrecipient** is a public or nonprofit agency, authority, organization, or for-profit entity authorized under 570.201(o) that is engaged by a CDBG grantee to receive a pass through of CDBG funds to undertake CDBG-eligible activities. For purposes of this guide, the purchaser of the HUD guaranteed debt obligations will be referred to as the "Investor."

The Section 108 Loan Guarantee Program provides state and local government grantees the ability to transform a small portion of their CDBG funds into federally guaranteed loans large enough to spur economic growth and jump-start community revitalization efforts.

A state or local government that is awarded a loan guarantee under the Section 108 program must pledge its current and future CDBG allocations as security for the guaranteed loan. Although HUD relies on this pledge of CDBG funds as security, it cannot assume that CDBG funds will always be available. **Thus, in order to receive a Section 108 loan guarantee, the Recipient must furnish additional collateral to ensure that the loan guaranteed by HUD is an acceptable credit risk.** Examples of additional collateral include liens on real property and pledges of tax increment revenue. This guide, however, focuses, on another category of additional collateral: third party loans.

[1] Recipient is a qualified state or local government that qualifies to receive CDBG funds from HUD, also known as "grantee." As noted above, they participate in either the Entitlement Program (for cities in metropolitan areas over 50,000 in population, designated principal cities of metropolitan statistical areas or urban counties with more than 200,000 people). Under the States and Small Cities Program, states receive funding directly from HUD and provide it to small cities (non-entitled communities), also referred to as units of general local government. https://www.hudexchange.info/resources/documents/Basically-CDBG-Chapter-1-Overview.pdf

A **third party loan** is originated when Section 108 guaranteed loan funds are used to make a loan to another entity (i.e., a **third party**). A typical example is a loan made by a Recipient to a for-profit business pursuant to 24 CFR 570.203(b), where the loan funds will be used to carry out an economic development project. Third party loans made with Section 108 guaranteed loan funds may also be used to finance other project types including, but not limited to: housing rehabilitation, public facilities and improvements (when carried out by a **subrecipient**)[2], and mixed-use development. HUD uses the term "**Third Party Borrower**" to refer to a third party (such as a for-profit business) that receives a loan from the Recipient.

Together with the pledge of CDBG funds, a third party loan may, in addition to serving as the source of repayment for the Section 108 funds, be sufficient to satisfy HUD's additional collateral requirements for the related Section 108 guaranteed loan. Consequently, proper underwriting of third party loans by the Recipient can substantially reduce the risk that CDBG funds will have to be used for repayment of the loan.

Purpose of This Underwriting Guide

HUD is providing the following guidelines to assist Section 108 recipients in underwriting third party loans that finance the development of income producing properties. Although compliance with these guidelines is not mandatory, HUD's acceptance of third party loans as collateral for Section 108 guaranteed loans will be facilitated if they meet these guidelines.

HUD is also providing a companion document, *HUD Section 108 Underwriting Guidelines for Business Loans*, which provides guidance for underwriting these loans along with assistance for underwriting startup ventures.

Acquisition and Rehabilitation of a Historic Building, Eugene, Oregon

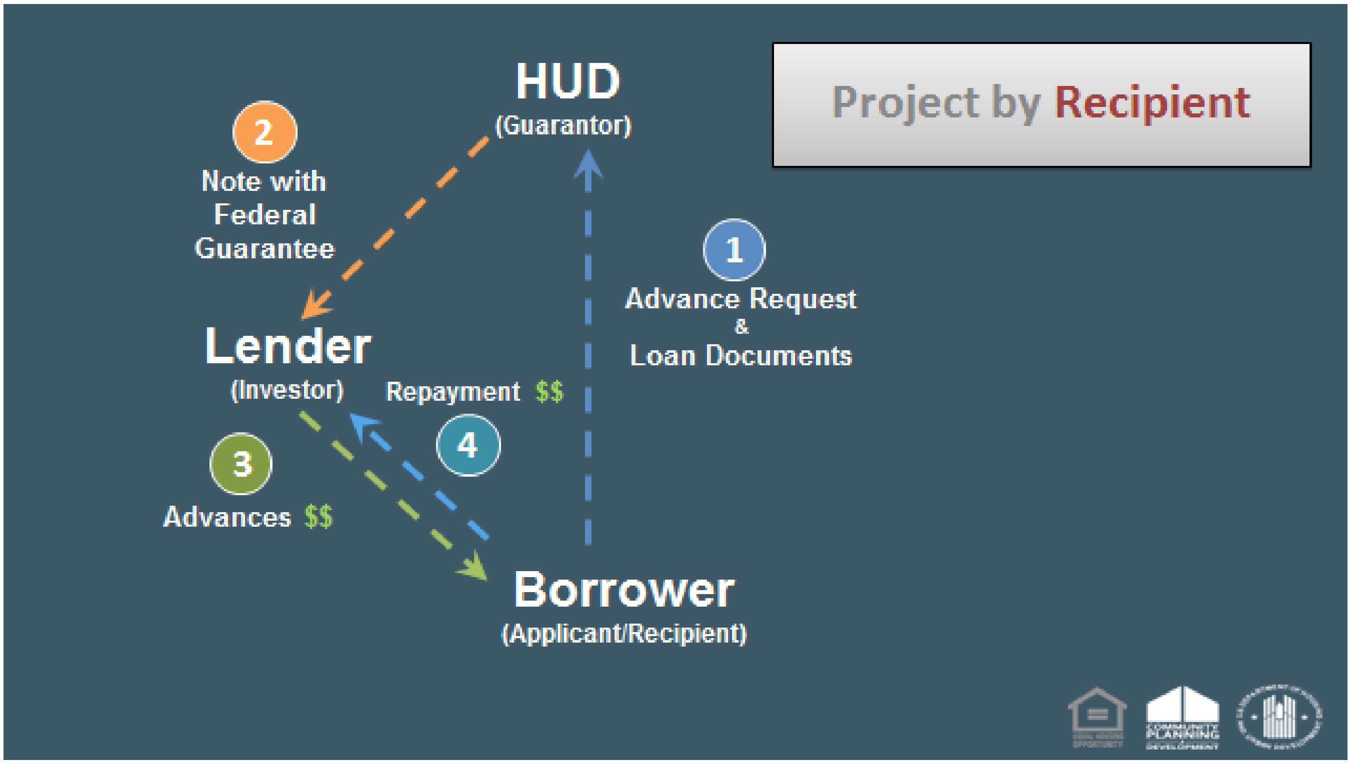
[2] A subrecipient, as per 24 CFR Part 570.500 (C) is a public or private nonprofit agency, authority, or organization, or a for-profit entity authorized under 24 CFR §570.201(o), receiving CDBG funds from the recipient or another subrecipient to undertake activities eligible for such assistance under 24 CFR 570 Subpart C, "Eligible Activities."
24 CFR §570.201(o) relates to how for-profit entities are eligible to serve as subrecipients when they use CDBG funds to provide credit to microenterprises.
The term excludes an entity receiving CDBG funds from the recipient under the authority of §570.204 (Special Activities by Community Based Development Organizations), unless the grantee explicitly designates it as a subrecipient. The term includes a public agency designated by a unit of general local government to receive a Section 108 loan guarantee, but does not include contractors providing supplies, equipment, construction, or services subject to the procurement requirements in 2 CFR part 200, subpart D.

Section 108 Project Financing Structures

There are two ways a Recipient can invest Section 108 guaranteed loan proceeds -either by a project that is undertaken by the Recipient or a project that is undertaken by a third party.

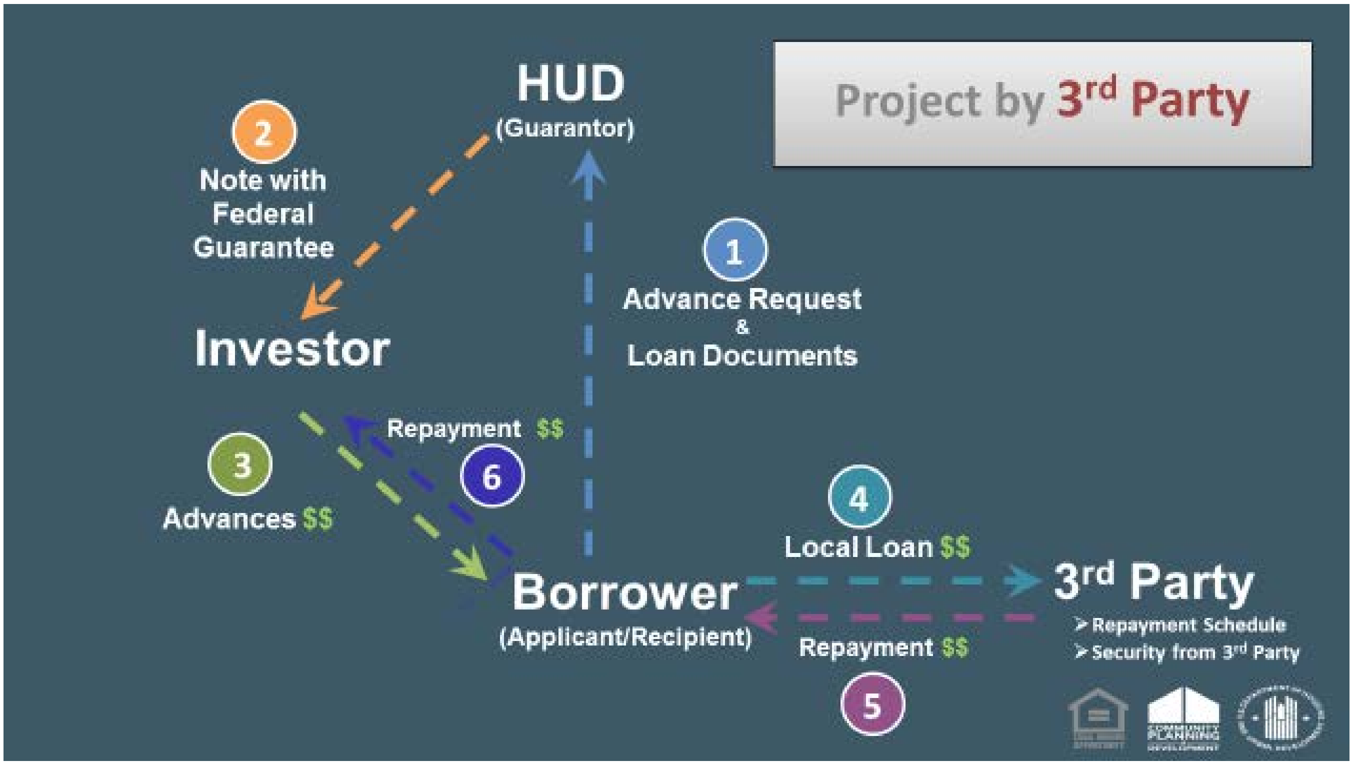
Project Undertaken by Recipient

The Recipient can directly use proceeds from a Section 108 guaranteed loan to implement eligible housing or community and economic development activities on their own. Under this structure, the Recipient assumes all repayment and guarantee obligations directly. (See graphic below.)



Project Undertaken by a Third Party

In many instances, however, the Recipient re-lends the Section 108 guaranteed loan funds to a third party or to multiple third parties (for example if the Recipient had established a loan fund with Section 108 financing). (See graphic below.)



Context for Underwriting 108-Funded Projects

The first step in making a third party loan is to evaluate the proposed project for compliance with Section 108 program and cross cutting Federal requirements. A third party loan may meet the underwriting guidelines described below but may still be ineligible for funding under Section 108 because it does not meet Section 108 program eligibility requirements such as compliance with CDBG national objectives criteria (NOTE: most CDBG requirements also apply to use of Section 108 guaranteed loan funds). The Recipient must therefore treat compliance with the program requirements as an initial threshold step in the underwriting process or determine compliance prior to the underwriting stage.

Additionally, the Recipient should incorporate guidance from **"24 CFR Part 570, Appendix A to Part 570 - Guidelines and Objectives for Evaluating Project Costs and Financial Requirements"** when using guaranteed loan funds to carry out economic development projects (See ***Exhibit A***). This underwriting guide incorporates the HUD guidance in Appendix A.

Third Party Loan Underwriting is the process of evaluating the creditworthiness or risk of providing financing to a specific borrower for a specific project. The underwriting process evaluates both the financial feasibility and the risks of making a loan to a third party. The objectives of these underwriting guidelines are to ensure:

- ✓ Borrower has the experience and capacity to undertake the project starting with the financing phase and continuing through to development and then to project operations.
- ✓ Borrower has a successful accomplishment record of developing and operating similar projects.
- ✓ Market conditions support the revenue, expense, and occupancy projections.
- ✓ Project development costs are accurately projected.
- ✓ Cash flow will be adequate to cover the debt service on the loan with a reasonable cushion.
- ✓ Collateral value is sufficient to cover loan loss in the case of non-payment.

Execution of Underwriting Function

The Recipient should utilize a qualified underwriter, either in-house or via a contracted services agreement. The term "**Underwriter**" refers to the person or entity that acts on behalf of the Recipient and is responsible for determining the financial feasibility of and assessing the risk associated with making a third party loan.

Section 108 recipients may elect to carry out the underwriting function in a variety of ways, including:

- In-house staff underwriting
- Contracted underwriting services with an outside entity
- Combination of in-house and contracted underwriting services.

The loan underwriting guidance that follows is intended to be of assistance to the community regardless of whether the underwriting will be conducted by in-house staff or by engaging outside professional assistance.

If the Recipient plans to operate one or more loan programs with a significant loan volume, it may make sense to develop internal staff capacity. On the other hand, if the Recipient plans to make only a small number of loans or just a single loan, it could be more cost-effective to use outside expertise.

Recipients that do not have the in-house capacity to underwrite loans may pursue a variety of options, including:

- Use the expertise of another department or agency such as an economic development department, public housing authority, or a redevelopment authority that has experience financing income-producing real estate projects.

- Work with a qualified outside source such as a Community Development Financial Institution (CDFI), a Community Development Entity (CDE), a credit union, or a firm that specializes in underwriting commercial real estate loans.
- Engage a banker, former banker or other expert as an underwriting consultant.

Some communities employ a hybrid model where staff members review the loan applications against certain criteria while outside experts also prepare a credit analysis report or serve on a loan review committee. In some cases, outside assistance could be used to set-up systems, policies, and procedures to assist staff through the first few loans while training them to take over the function. In the case of particularly large and/or complex Section 108 projects, even when the community has staff members capable of conducting the underwriting, it may be wise to obtain outside assistance for an additional review.

The underwriting function typically requires someone with direct underwriting experience. The duties of the loan underwriter typically include, but are not limited to:

- Assess creditworthiness of prospective borrowers by completing review of company and personal financial statements;
- Evaluate historical trends, financial statements, cash flow projections, management performance, market and industry conditions, capital structure and collateral analysis;
- Order and analyze reports (credit, environmental, appraisal, and property evaluations);
- Prepare Credit Memo which provides summary of underwriting, risks and mitigating factors and proposed loan terms and conditions for Credit Committee and
- Perform other various functions such as loan covenant monitoring, annual review of loan client financial statements and risk rating.

Exhibit B "Sample Scope of Work for Section 108 Loan Underwriter" of these guidelines includes additional information on the duties and recommended skill set of staff performing the underwriting function.

GENERAL CONSIDERATIONS

As noted earlier in this guidance, the project to be financed with the third party loan must satisfy HUD program requirements (e.g., CDBG national objectives criteria) and demonstrate consistency with the Recipient's community development objectives and program design.

Therefore, before investing its time and resources to underwrite a third party loan request in depth, the Recipient should perform a threshold review that identifies whether the proposed project meets Section 108 program requirements and Recipient program criteria , as follows:

- ✓ Proposed use of the Section 108 guaranteed loan funds complies with Section 108 requirements (national objectives criteria, public benefit standards, etc.)
- ✓ Proposed loan amount falls within any loan amount range established by the Recipient
- ✓ Proposed use of funds by the Third Party Borrower meets the Recipient's community development objectives and satisfies other program criteria (e.g., project located in target geographical areas)

A thorough and complete underwriting conclusion must include an assessment of the components described in the following sections of this guide.

- ✓ Project Feasibility and Readiness
- ✓ Borrower Experience and Management Capacity
- ✓ Borrower Financial Capacity and Creditworthiness
- ✓ Project Financial Analysis
- ✓ Collateral and Loan Repayment Guarantees

Affordable Housing Project, Los Angeles County, California

PROJECT FEASIBILITY AND READINESS

If the threshold review indicates the processing of Third Party's loan request may proceed, the next step would be for an underwriter to assess the proposed project to ensure it is feasible and ready to move forward into the development stage.

Market Analysis

The performance of income-producing real estate depends largely on local factors and economic conditions that may affect the supply and demand for the income-producing real estate project for which funds are being requested. Performing this analysis will assist in defining the project's market area and assessing the current market conditions, as well as how the particular market where the development is proposed will respond to the project. The entity conducting the market analysis must be knowledgeable about the local real estate market conditions including:

- Market rent levels
- Occupancy rates
- Terms of tenant improvements and/or leasing concessions
- Management fees
- Property taxes
- **Operating expenses** for comparable properties
- Market competition (existing and planned developments of similar type in market area)

Each market analysis must contain a precise, data-driven evaluation of the project's feasibility including the prospect for long-term performance of the property given demographic trends and economic factors. For example, for office and retail development, the statement must include an estimate of the demand for each type of space in the expected year of market entry. For residential developments, this analysis must analyze whether sufficient demand exists in the market for the type of units proposed as well as affordability analysis on the rents proposed.

Due to the need for specialized knowledge, lenders typically engage an outside firm to conduct market analyses. While the lender identifies and hires the firm, the Third Party Borrower is typically required to pay for the analysis. Therefore, in the case of a Section 108 guaranteed loan application, the Recipient should look to select a firm that specializes in conducting market analyses for the specific type of project, which is being considered for a loan. Most lenders, including banks, credit unions, and CDFIs commission market studies for projects that may be applying for 108 financing. If available, the Recipient may also consider using such a market study.

Property Appraisal

The underwriter must select a qualified, licensed, and/or certified **appraiser** that has expertise and experience with current market conditions to complete a property valuation in accordance with loan underwriting standards.

The Underwriter will review the appraiser's qualifications and technical sufficiency including the verification of a current certification and license number for the state where the property is located. The appraiser must have experience appraising similar type properties to those that he or she will appraise for the Recipient's Section 108 loan guaranteed loans. The Recipient should reserve the right to reject an appraiser.

The appraisal must include the current or "as-is" market value of the project property, as well as the **prospective** or "as-completed" market value. Market values for proposed construction or renovation, partially leased or vacant buildings, non-market lease terms, and other developments with unsold units must include appropriate deductions and discounts.

It is a generally accepted industry practice that the appraisal must be completed not more than six (6) months prior to the loan closing. After the borrower satisfies all Section 108 underwriting and compliance considerations, the lender will set a date for Loan Closing whereby the loan is recorded, all loan documentation is executed, and loan funds are released per the terms and conditions of the note and security agreement.

Project Readiness

Zoning, Permits and Licenses

Prior to closing on a Section 108 guaranteed loan, the Recipient's Underwriter must have confirmation that the Third Party Borrower's project property meets all zoning requirements and is classified as either a legal conforming or a legal non-conforming use under local zoning requirements. This is necessary to ensure that no impediments exist that prevent the Third Party Borrower's project moving forward as proposed.

Staff from the jurisdiction in which the proposed project is located must provide this information. The staff must certify that the local government in which they work has vested in them the authority to verify consistency with local land use regulations and the zoning designation.

How successfully can this project be completed, accounting for various environmental, legal, and market factors that will affect it? Is it shovel-ready? Is there a market?

The local jurisdiction staff must provide the zoning designation and certify that the building(s) as proposed and the intended use(s) are consistent with the referenced zoning designation and current land use regulations. If the proposed project includes rehabilitation, the staff must certify that the proposed project is a legal non-conforming use, if applicable.

The staff should also certify that, to the best of their knowledge, there are no additional land use regulation hearings or approvals required to obtain the zoning classification, building size or density for the proposed project. The staff should also certify that there are no known conditions that would preclude construction or rehabilitation (as the case may be) of the referenced project on the proposed site.

The required Environmental Review will determine whether the development triggers compliance with the requirements of 24 CFR § 58.6, which include the Flood Disaster Protection Act; the Coastal Barriers Resources Act; and HUD's requirement for disclosure of properties located in airport runway clear zones. If the property does trigger any of these requirements, the Underwriter must ensure that any additional costs are included in the total development costs as well as on-going operations.

Evidence of Site Control

The Third Party Borrower must provide evidence of site control to the Underwriter to demonstrate project readiness. If the Borrower does not have site control or a clear path to site control, there could be unexpected, and often costly, delays or unexpected impediments to project implementation. Evidence of site control include the following:

- Sales or Purchase Agreement with assignments and addendums
- Recorded Deed or Certificate of Title
- Lease or Ground Lease, including all attachments and addendums

Title Insurance

An American Land Title Association (ALTA) lender's **title insurance policy** must be required by the Recipient's Underwriter and based on the latest Minimum Standard Detail Requirements for ALTA/American Congress on Surveying and Mapping (ACSM) land title surveys including the following endorsements or their equivalent if available in the applicable jurisdiction:

- ALTA 8.2 commercial environmental
- CLTA 100 comprehensive endorsement
- CLTA 116 designation of improvements (in addition to any zoning endorsements that may be required, as discussed in the "zoning" section above)

If the project property is being pledged as collateral on the Section 108 guaranteed loan, the Recipient shall provide HUD with a standard title policy, naming the Recipient as the insured party. The policy must either include in the definition of the "insured" each successor in ownership of the indebtedness secured by a lien or be accompanied by an endorsement of the policy to the U.S. Department of Housing and Urban Development (HUD) Secretary.

Survey and Legal Description

A professional ALTA/ASCM Survey is required for verification of physical boundaries and any encumbrances on the property submitted as collateral. It is essential to use an experienced and reputable land surveying company that holds a valid license within the state in which the property is located. The survey must also be accompanied by legal description that defines the property boundaries and means of access.

Environmental Site Assessment

A **Phase I Environmental Site Assessment** is required and must be prepared by a qualified environmental engineer according to the current Phase I Environmental Standard E1527 established by ASTM International.

It is a general industry practice that the assessment must be completed not more than six (6) months prior to loan closing and must provide definitive conclusions as to the overall acceptability of the property.

Special note: A Phase II environmental investigation will be required if recommended by the Phase I environmental consultant.

Property Condition Assessment

If Section 108 guaranteed loan proceeds will be used to acquire an existing building, a physical property inspection known as a **Property Condition Assessment (PCA)**, also known as a Property Condition Report (PCR), of the subject premises is required. The PCA should be conducted by a registered architect or licensed engineer and submitted in conjunction with a Phase I Environmental Assessment.

The objective of the PCA is to identify any physical deficiencies of the property, estimate the remaining useful life of its various physical components, such as building systems, assess the adequacy of its condition, and identify items of deferred maintenance and the estimated cost of any needed repairs or improvements. A PCA will also provide cost estimates for long term maintenance.

The most important sections within the PCA are the "Immediate Repairs/Deferred Maintenance" and "**Replacement Reserves**" schedules. A Deferred Maintenance Holdback in the amount of 125% of the architect's or engineer's estimated cost to correct the deferred maintenance items should be established at loan closing by the Recipient.

Seismic Risk Assessment (if applicable)

If the Engineering Property Condition Assessment identifies the project property as being within a Seismic Zone of 3 or 4, i.e. zones with the highest probability of damaging ground motion, a Seismic Risk Assessment/Probable Maximum Loss (PML) Study should be conducted by a reputable engineering firm that is current with the latest ASTM E2026-99 standards regarding seismic risk assessment. The PML is a traditional measure of earthquake loss popularized by the insurance and seismic engineering industry in the 1980s. The Recipient and the Recipient's Underwriter should determine if additional property insurance is necessary based on the PML.

BORROWER EXPERIENCE AND MANAGEMENT CAPACITY

In addition to evaluating the project specifics noted above, the Recipient's Underwriter must also review the experience and financial soundness of the Third Party Borrower.

The primary objective of this step in the process is for the Underwriter to be able to identify what entity or person is ultimately responsible during all project stages and whether this responsible entity has the experience and capacity to ensure the project will be successful.

Ownership Type

Who is accountable? Do they have the experience and capacity to successfully implement the project?

The Third Party Borrower must provide the Underwriter with the identity of all parties/counterparties and entities or individuals involved in the organizational structure in order for the Underwriter to be able to determine ownership, financial strength and creditworthiness. A **Key Principal** is defined as an individual(s) or entity owning or controlling twenty-five percent (25%) or greater interest in the project. They must:

- Be legally authorized to do business in the United States and;
- Not appear on the HUD list of debarred contractors on the System for Award Management (SAM).[3]

The following table illustrates various ownership structures that may participate in a 108-funded project:

Borrower(s)	Key Principal(s) [4]
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)

3 http://portal.hud.gov/hudportal/HUD?src=/program_offices/enforcement/debarments.

4 This assumes a "Key Principal" is a "natural person," as opposed to a "legal person," which may be a private (i.e., business entity or non-governmental organization) or public (i.e., government) organization.

Third Party Borrower Experience - "Management Capacity"

The Underwriter shall also complete a sufficient due diligence review of the Third Party Borrower's ownership history, as well as management capacity, if the Third Party Borrower will also be managing the project. The underwriting report must detail the following components:

Borrower Information	Information for Credit Review Report
Borrower Legal Identity	Date and place of formation/incorporation
List of Principals	Name, role and contact information
Principals and Key Staff Qualifications	Resumes, Qualifications
Experience with Development & Property Management	Description of projects, dates completed, locations, sources of financing
Organization Chart	Key principals and staff roles and responsibilities
Development Team (e.g. architect, engineers, general contractor, lawyer, property manager)	Name, role, contact information resumes and qualifications of firms and their key principals
Organization Financial Statements	Balance sheet, income and expense, statement of cash flows, other real estate owned
Organization Tax Returns	From two most recent years
Personal Financial Statements from Key Principals and Guarantors	From two most recent years
Tax Returns from Key Principals and Guarantors	From two most recent years
Pending Litigation, Foreclosures or Mechanics Lien Claims	If applicable
Contingent Liabilities	If applicable

The Third Party Borrower and members of the development team should have recently completed at least one like-project of similar size and scope. If not, then Borrower must show how they will bring the experience and skills needed to bring the project to successful fruition, including additional staff or contractors.

Management Capacity

The Third Party Borrower must submit a narrative that details its organization and management capacity that includes the following:

- ✓ What is the history and background of the borrower as an entity and its principals?
- ✓ What factors of management experience and capacity will position the project for success?
- ✓ Who does what functions in the organization and related to the project that will be funded with Section 108 loan proceeds?
- ✓ What is the development experience of the borrower for income generating real estate development projects (e.g. types of projects, number of units/square footage, total cost of projects and financing sources)?
- ✓ What is the property management experience of the borrower?
- ✓ What has been the financial performance of the borrower over time that is an indication of acceptable management capacity?
- ✓ What, if any, is the pending litigation and foreclosures, mechanic's lien claims, or contingent liabilities of the borrower?

Historic Hotel, Cary, North Carolina

Property management is critical to the successful operation of the property and must be thoroughly considered by the Underwriter. The property manager must have at least a three (3) year record of managing similar type properties. If an external management company is used, the Third Party Borrower must have a written contract with the management company. The agreement must outline the plan for managing the property as well as include all contractual obligations of the Third Party Borrower and the management company. All management agreements must be subordinate to the mortgage.

Housing Development, High Point, North Carolina

The Underwriter will consider the size and complexity of the project when determining the adequacy of existing management (i.e., smaller properties may require different levels of management expertise than larger properties). The Underwriter will consider the following factors in determining the acceptability of external management companies:

- Record and reputation
- Types of properties managed
- Total number of units/square feet/facilities managed
- Location of the management company's main office with respect to the property
- Marketing and leasing plan
- Borrowers must disclose any and all judgments and contingent liabilities.

Property management is critical to the successful operation of the property and must be thoroughly considered by the Underwriter.

BORROWER'S FINANCIAL CAPACITY AND CREDITWORTHINESS

Financial Statements

How likely is it that the Third Party will repay the loan? Does it or its principals have the financial position to provide some level of assurance?

The Third Party Borrower must provide an overview of its financial position as well as that of any person or entity that will be providing a financial guarantee that the loan will be repaid in order to confirm that the guarantor has the financial capacity to guarantee 100% of the loan's principal balance, either individually and/or jointly (See "Evaluation of Guarantees" below.)

In cases where the Third Party Borrower may be a special purpose entity that is created solely for the assisted project, the Underwriter would require financial statements from the key principals of the special purpose entity and guarantors of the Section 108 loan since the Third Party Borrower itself would have no financial statements available nor would it be able to provide a guarantee.

The Underwriter will review three years of **audited financial statements** and current interim statements for the borrowing entity, general partners, and guarantors. The Recipient should require that the Third Party Borrower submit the following financial documents:

- ✓ Balance sheet for the past three years identifying contingent liabilities
- ✓ **Income and expense statement** for the past three years
- ✓ Statement of cash flows
- ✓ Contingent liabilities and a statement concerning their amount, nature and path towards resolution
- ✓ Detailed schedule of other real estate holdings
- ✓ Tax returns for the past three years
- ✓ Bank statements for the past 6 months
- ✓ Authorization to pull credit reports, as specified by the Recipient and
- ✓ Any notes from Third Party Borrower that can provide explanation and/or rationale for any information that Underwriter may perceive as a credit and/or capacity issue.

The financial statements must also include any other factors that might affect the financial condition of the Third Party Borrower or Key Principal(s).

The Underwriter must consider the Third Party Borrower's financial condition and resources. This includes the financial capacity of any key principal(s), the value of any underlying collateral, and the Third Party Borrower's character and credit history to repay as agreed. Third

Party Borrowers must demonstrate the capacity to meet a realistic repayment plan from available cash flow and liquidity. Liquidity measures ability to convert assets to cash. Cash is the most liquid asset for paying off debt.

The Recipient and its Underwriter should establish project evaluation criteria that addresses the following questions for the following components of the financial statements:

Balance Sheet

- ✓ What is the ratio of current assets to total assets? How has this changed over time?
- ✓ How much debt does the Borrower currently have on its books?
- ✓ What is the ratio of debt to equity?

The balance sheet presents a "snapshot" of a Third Party Borrower's financial position at a specified date or point in time. For example, the amounts reported on a balance sheet dated December 31, 2015 reflect that instant when all the transactions *through December 31* have been recorded. The balance sheet informs the reader of the entity's or individual's financial position as of one moment in time. It helps the lender see what an entity or individual ***owns*** as well as what it ***owes*** to other parties.[5] The following are commonly used (but not an exhaustive list) ratios to evaluate the condition of a borrower's balance sheet.

[6]

Financial Ratio	Definition	
Working Capital	**Current Assets - Current Liabilities = Working Capital**	
	Does the borrower have sufficient working capital to meets its current obligations? The greater the amount of working capital, the greater the likelihood the borrower can meet its current financial obligations.	
	Current Assets:	$100,000
	less Current Liabilities:	$75,000
	***equals* Working Capital:**	**$25,000**
Current Ratio	**Current Assets ÷ Current Liabilities = Current Ratio**	
	The current ratio is a liquidity ratio that measures a borrower's ability to pay short-term and long-term obligations. To gauge this ability, the current ratio considers the current total assets of a borrower (both liquid and illiquid) relative to that borrower's current total liabilities.	
	Current Assets:	$100,000
	divided by Current Liabilities:	$75,000
	***equals* Current Ratio:**	**1.33**
Debt to Equity	**Total Liabilities ÷ Owners' Equity = Debt to Equity Ratio**	
	Debt/Equity Ratio is a debt ratio used to measure a borrower's financial leverage, calculated by dividing a company's total liabilities by its stockholders' equity. The D/E ratio indicates how much debt a borrower is using to finance its assets relative to the amount of value represented in shareholders' equity.	
	current liabilities	$75,000
	long term liabilities	$300,000
	equals **Total Liabilities:**	**$375,000**
	Total Liabilities	$375,000
	divided by Owners' Equity	$250,000
	equals **Debt to Equity Ratio:**	**1.50**

[5] http://www.accountingcoach.com/balance-sheet/explanation

[6] http://www.investopedia.com and www.accountingcoach.com for basic financial analysis terms

Income and Expense Statement

- ✓ Does the Third Party Borrower generate sufficient and steady income to meet its financial obligations? How has this changed over time?
- ✓ Is this individual or this entity profitable?

The income statement is also referred to as the profit and loss statement, P&L, statement of income, and the statement of operations. It reports the revenues, gains, expenses, losses, net income and other totals for the period of time shown in the heading of the statement.[7]

While reviewing the income and expense statement it is important that the borrower clearly states whether or not they present this report on a "Cash" or "Accrual" accounting basis.

The *cash basis of accounting* recognizes revenues when cash is received and expenses when they are paid; however, this method does not recognize accounts receivable or accounts payable. Many smaller businesses opt to use the cash basis of accounting because it is simple to maintain. The cash accounting method does not track receivables or payables. The cash method is beneficial in terms of tracking how much cash the business actually has at any given time. Transactions are not recorded until the cash is received or paid.

Under the accrual basis, revenues and expenses are recorded when they are earned, regardless of when the money is actually received or paid. This method is more commonly used than the cash method, especially for larger corporations. The accrual basis of accounting gives a more realistic idea of income and expenses during a period of time, therefore providing a long-term picture of the business that cash accounting cannot provide. The downside is that accrual accounting does not provide any awareness of cash flow; a business can appear to be very profitable while in reality it has empty bank accounts. Accrual based accounting without careful monitoring of cash flow can have potentially negative consequences.[8]

If a Third Party Borrower submits financial statements on a 'cash basis', the Underwriter should request recent accounts receivable and accounts payable reports. Most small business computerized accounting systems can switch between cash and accrual accounting for reporting purposes.

How well do the key principals manage cash to meet financial obligations?

[7] http://www.accountingcoach.com/financial-statements/explanation/3

[8] https://bench.co/syllabus/accounting/cash-accounting-vs-accrual-accounting/

Statement of Cash Flows

The **cash flow statement** reports the cash generated and used during the time interval specified in its heading. The period of time that the statement covers is chosen by the Third Party Borrower. For example, the heading may state "For the Three Months Ended December 31, 2015" or "The Fiscal Year Ended September 30, 2015."

Cash flow statement reports cash generated and used in the 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**[9]

Contingent Liabilities statement concerning their amount, nature and path towards resolution

A contingent liability is a potential liability that may occur, depending on the outcome of an uncertain future event. A contingent liability is recorded in the accounting records if the contingency is probable and the amount of the liability can be reasonably estimated. If the contingent liability is probable, but the amount cannot be reasonably estimated, the contingency should be reported in the footnotes that accompany the financial statements.

Contingent liabilities can include:

- Outstanding lawsuits
- Claims against the company not acknowledged as debts
- Legal liability
- Liquidated damages
- Tort
- Unliquidated damages
- Destruction by disaster such as storm or flood
- Product warranty
- Disputed Taxes
- Financial guarantees given

Schedule of Real Estate Holdings

The Underwriter will examine the Schedule of Other Real Estate Holdings to determine the Third Party Borrower's and Key Principal(s) financial exposure to other properties and clearly note any assumptions regarding capitalization rates and/or gross income multipliers utilized in determining the value for other real estate owned.

Please see **Exhibit C** for a sample template of a Schedule of Real Estate Owned that reflects what the Recipient should require from its Third Party Borrowers.

[9] http://www.accountingcoach.com/cash-flow-statement/explanation

A key question that the Recipient needs to address when analyzing the schedule of other real estate owned by a Third Party Borrower is:

- ✓ How well are current real estate properties owned by the Third Party Borrower performing?
- ✓ How may the performance of other real estate owned by the borrower provide insight to the Third Party Borrower's development and management capacity?

Tax Returns

If applicable, Federal income tax returns for the previous two (2) years are required from the Third Party Borrower and/or identified Key Principal(s).

- ✓ Does information in the financial statements tie to the information stated in the tax returns? If not then the Borrower needs to provide an explanation to satisfy discrepancies.

Bank Statements

The Underwriter must review the Third Party Borrower's bank statements for the most recent three (3) months. The bank statements must verify the collection of monthly rental and other income (if applicable) attributable to leases in place at the time of underwriting.

- ✓ How well do bank statements provide a window to verify cash on hand as stated in most recent financial statements?

Creditworthiness

In addition to financial statements and verification of bank accounts, the underwriter determines a recommendation of "Creditworthiness" based on an evaluation of credit reports and credit scores, verification of employment, and past bankruptcies.

Personal Credit Reports

Personal credit reports are required for the Third Party Borrower, Key Principal(s) or others owning or controlling a twenty-five percent (25%) or greater interest in the borrowing entity. Experian, Transunion, and Equifax are the three primary reporting agencies that keep track of and evaluate the personal credit histories for most individuals. Credit reports must be dated within sixty (60) days prior to the issuance of the Section 108 Loan Guarantee Commitment.

Business Credit Reports

A report from an established business credit-reporting agency (such as the Dun & Bradstreet "Business Information Report") or other acceptable commercial credit report for business entities is required. If not using D&B, an acceptable commercial credit report must include the following:

- Public filings that includes suits, liens, judgments, bankruptcies and federal debt;
- Uniform Commercial Code (UCC) filings;
- Credit payment history;
- Industry standards showing how the facility compares in the areas of financial stress and payment trends; and
- A credit payment delinquency risk score over a 12-month period.

A general industry practice requires acceptable credit reports to be no more than 60 days old at the time of application for funding and no older than 120- days at the closing of the loan.

The Recipient should order all credit reports directly after the Third Party Borrower signs an authorization and release.

Credit Scores

The Underwriter is responsible for obtaining credit scores for each individual Third Party Borrower(s) and Key Principal(s) (those owning or controlling a twenty-five percent (25%) or greater interest in the borrowing entity). The credit score primarily referred to in this document is FICO® Score developed by the Fair Isaac Corporation (FICO).

If the underwriter identifies issues related to credit scores and/or credit reports, the underwriter may consider requesting from the Third Party Borrower a Credit Explanation Statement that addresses each issue identified in the credit report. A satisfactory Credit Explanation Statement should include:

1. Clarity that the borrower understands and takes responsibility for each negative event and
2. The steps the borrower took and/or is taking to remedy the negative credit event and resolve the issue.

The Recipient and the Underwriter are looking specifically for a pattern of pro-active responsibility and accountability for meeting all financial obligations. Mistakes can happen.

✓ How well did or does the borrower take responsibility and action to remedy a credit related issue?

Minimum Credit Score Requirement

All credit-scoring models rank individual consumers by their relative credit risk. That is, a score represents a borrower's likelihood of becoming delinquent on a loan. In most cases, for Section 108 loans HUD recommends that individual Third Party Borrowers and Key Principal(s) have a minimum qualifying credit score of 700. For those individual Third Party Borrowers and/or Key Principal(s) with credit scores below 700, exceptions can be considered on a case-by-case basis with compensating factors.

Past Bankruptcies

The Underwriter must evaluate such applications on a case-by-case basis. The Third Party Borrower and any Key Principal(s) in a limited partnership must sign a detailed Credit Explanation Letter, Certified Ownership, and Loan History Statement. The explanation must describe the following:

- Pending or current litigation, judgments, or public records
- Any delinquencies, defaults, foreclosures, or deeds-in-lieu of foreclosure, which occurred during the last seven (7) years
- Any bankruptcy which occurred within the last ten (10) years

The underwriter can require the borrower to include in their Credit Explanation Statement an explanation concerning low credit scores and/or bankruptcy.

✓ What factors contributed to low credit scores and/or bankruptcy and what did the borrower do to remedy and resolve the issue and over what time period?

Grocery, Philadelphia, Pennsylvania

PROJECT FINANCIAL ANALYSIS

Overview

If the Third Party Borrower and its principals satisfy the criteria for the Underwriter to recommend them as a good credit risk, then the underwriter can proceed to conduct financial analysis of the proposed project.

The objective of this next step in the process will be to assist the Underwriter to understand whether all of the financial resources have been committed to the project for every stage of development and through operations as well as whether it will generate sufficient revenue to be able to service the Section 108 debt obligation.

Project Financial Analysis should include the following components:

- Sources and Uses Schedule
- Rent Roll
- Project Capital Development Budget
- Operating Income and Expense Budget
- Cash Flow Analysis
- Loan Sizing (Determining the Loan Amount)
- Construction Loan Proposed Draw Schedule
- Loan Amortization Schedule
- Equity Contribution

Taken all together many developers and lenders call the sum of the schedules listed above to be the *"Project Development Pro Forma."* A *pro forma* that is thoroughly researched, verified, and detailed serves as an outline to tell the story of how the project will be funded, developed, and operated. The Underwriter's job is to test the majority of the assumptions in the project development *pro forma* and compare it with other similar projects in the market to determine whether the factors critical for success are present in the project proposal.

In addition to project financial feasibility, the Underwriter and Recipient need to review all project costs to satisfy cost reasonableness standards so that no party in a project funded with HUD Section 108 financing benefits from undue enrichment.[10]

The Third Party Borrower must sign and date a certification that states all information in the submitted pro forma is accurate, true, and correct.

Is there adequate funding for the development and continued operations of the project? Will the project generate sufficient revenue to cover debt service?

[10] "Appendix A to Part 570—Guidelines and Objectives for Evaluating Project Costs and Financial Requirements." https://www.gpo.gov/fdsys/pkg/CFR-2014-title24-vol3/pdf/CFR-2014-title24-vol3-part570-appA.pdf

Sources and Uses Schedule

The Underwriter will analyze the development costs of the potential project (the "uses"), how much capital, debt, equity and/or grants are needed to bring the project to fruition (the "sources"), and whether the project will produce sufficient income to repay a loan over the loan's term (revenue that can be used as debt service).

The Underwriter will review the construction and long term permanent funding sources and uses for completeness, which occurs through an analysis of a **Sources and Uses Statement.**

- ✓ Do the Sources equal the Uses for both construction and/or permanent financing?
- ✓ What are the terms and conditions of each Source, equity, grant, first mortgage debt, subordinate debt?
- ✓ What is the evidence of commitment of Sources?

In all cases, Sources must equal Uses. In reviewing a project's budget, the Underwriter must receive verification that all other funding sources are firmly committed unless other sources are contingent on the approval of the Section 108 guaranteed loan.

If applicable, the Third Party Borrower must provide a copy of an executed first mortgage loan commitment outlining the terms of financing. The Third Party Borrower must also provide a schedule of proposed secondary financing or grants, if any, supported by commitment letters. The Third Party Borrower must provide information on all repayment terms for all committed sources.

The Underwriter will review to ensure that to the extent practicable, Section 108 financing is not substituted for non-Federal financial support. The Underwriter will ensure that the project's line-item costs are reasonable and consistent with the local market. If another entity is engaged to determine cost reasonableness, the Underwriter will select the firm. The Third Party Borrower shall pay for the fee for the selected firm. In determining cost reasonableness, the Underwriter will utilize the guidance provided for in 24 CFR 570 Appendix A.

Rent Roll

The Rent Roll shows current and/or a projection of the sources of revenue for a project and sources of revenue for debt service.

- ✓ How reliable are the tenants in the proposed unit mix and rent roll?
- ✓ What is the minimum occupancy necessary to make debt service payments?
- ✓ How much is the proposed annual increase in rents and how does that projected increase align with current market conditions?

The Third Party Borrower must provide a schedule of proposed rents and any other projected income tied to the real estate that serves as collateral for the HUD 108 financing. Supporting documentation must include the following:

- Rents including any schedule for annual increases in rents
- Sources and amount of other income (such as parking, electric vehicle charging station)
- Tenant-paid utilities
- Tenant paid operating expenses
- Projected vacancy levels

Lease Documentation

The Third Party Borrower must provide supporting documentation to evidence lease commitments within the Third Party Borrower's project. A minimum of 20% of the leasing space must be committed prior to loan approval. The Underwriter will review the proposed terms of the standard lease.

The rent roll must include the following information:

- Tenant's name (or if appropriate indicate "Vacant"), tenant location within the site (i.e.- unit, suite or parcel number)
- Monthly rent indicated on the lease (asking rent on vacant units)
- Type of lease (gross, semi-gross, net), with terms spelled out regarding what expenses the tenant will pay and what expenses are the responsibility of the Third Party Borrower
- Square feet area related to each leased space
- Lease start date
- Lease expiration date
- Renewal and termination options
- Current or future leasing concessions and/or tenant improvements
- Other conditions such as co-tenancy provisions

Existing projects must provide a current rent roll. The rent roll must include unit number or identification, tenant's name, unit type, monthly rent, concessions, rebates or discounts given, lease commencement date, lease expiration date, arrearages owed, if any, and amount of security deposit(s) held.

Prominent Tenants

The Underwriter will review copies of financial statements and credit reports for any major tenant occupying 20% or more of subject project's space. The Underwriter will review the tenant's business history over the past two years (2) to determine the tenant's creditworthiness and capacity to make its lease payments to the Third Party Borrower who depends on such revenues to repay the loan.

Any significant discrepancies uncovered during the analysis must be identified and resolved prior to loan approval. Receipts, correspondence, and/or other data provided to support or reconcile cash flow information must be submitted to the Underwriter by the borrower.

Project Capital Development Budget

Below is a sample of line items that may be included in a Development Budget for a project that would represent all of the “Uses” for a Sources & Uses schedule:

Acquisition Costs	Land & Building
	Realtor/Finder Fees
	Title & Recording, Transfer Taxes and Settlement Fees
Soft Costs	**Predevelopment**
	Environmental Testing and Assessments
	As-Is and As-Completed Appraisal & Market Research
	Zoning and Permit Fees
	Geotechnical
	Survey
	Carrying Costs
	Utilities
	Real Estate Taxes
	Fencing & Security
	Insurance: Builder's Risk, Fire, General Liability
	Professional Services
	Legal
	Architect
	Engineers: Civil, Structural, Mechanical
	Renewable Energy Consultant
	Marketing / Advertising
	Financing Fees
	Appraisal
	Lender Legal & Title
	Loan Processing & Origination Fee
	HUD 108 Credit Subsidy Fee
	Construction Financing Interest
	Lease Up and Operating Reserve
	Soft Cost Contingency
	Developer Fee
Hard Construction Costs	All line-items in the scope of work for general contractor and their sub-contractors and all purchase of materials and equipment to support construction
	Infrastructure
	Building Renovation and/or New Construction
	Hard Cost Contingency

The Third Party Borrower must provide a detailed description of assumptions and/or calculations related to each project cost line item for acquisition, soft, and hard construction costs (including contingencies, general requirements, and all overhead and profit figures).

This development budget should include a detailed calculation of interest reserves, operating and working capital reserves, and builder's fees.

- ✓ How do budget line items align with local market conditions for similar projects?
- ✓ What happens if the project costs substantially more than the budget amount proposed by the Third Party Borrower?
- ✓ What are the terms and conditions of the construction contract with general contractor and subcontractors to prevent cost overruns?
- ✓ What will Third Party Borrower do to resolve cost issues without putting 108 financing at risk?

The underwriter should challenge the Third Party Borrower to provide quotes and/or contracted costs for each line item. If they are not available, the Third Party Borrower needs to show the assumptions and methodology for how they arrived at the amounts in each line item. The underwriter will review this to verify the amount aligns with local market conditions.

HUD Section 108 Credit Subsidy Fee

The Underwriter must clearly understand how the Third Party Borrower plans to pay for the HUD Section 108 Financing Fee, which is set annually by HUD.[11]

The Third Party Borrower can pay the credit subsidy fee from grant, equity, and/or loan sources. It can also be included in the Section 108 loan and amortized over the loan term.

Operating Income and Expense Budget

Stability of rental income is a core component of underwriting to determine the likelihood of stable debt service payments over the loan term. If the Third Party Borrower submits an income and expenses budget where expenses are projected too low than actual and income is projected too high than actual, then that results in a decrease in actual **Net Operating Income** (NOI). A decrease in NOI often results in decreased funds available for debt service payments, which puts the HUD 108 at greater risk.

Net Operating Income (NOI) is the result of income less vacancy, less collection loss, and less operating expenses. Capital expenses such as principal and interest payments included in debt service are NOT included. NOI is integral for determining maximum amount a project can support in debt service payments.

[11] Please see https://www.hudexchange.info/resources/documents/Section-108-Financing-Fee-FAQs.pdf and https://www.federalregister.gov/documents/2015/11/03/2015-28002/section-108-loan-guarantee-program-announcement-of-fee-to-cover-credit-subsidy-costs .

The Third Party Borrower must submit NOI projections that at least equal the term of the HUD 108 financing. For example, if the loan term is for 15 years, the operating and expense budget must be for 15 years. The underwriter must confirm that the assumptions in the statement are supportable and that the project can maintain no less than a 1.2 debt coverage ratio. (See loan sizing section)

For existing developments, the borrower must submit the actual Income and Expense Statements on the property for the current year-to-date, and the year-end statements for the previous two (2) years (certified by the Applicant). Please see Rent Roll section for discussion of review of projected revenue sources.

For projected expenses for operation of income generating real estate, a developer and its property manager should submit an operating budget that, at a minimum, includes the following line items:

- Property Management Fee
- Administration & Overhead
- Accounting Fee
- Marketing
- Legal
- Insurance
- Real Estate Taxes
- Licenses, Permits and Fees
- Utilities (Electric Meter Fee & Water Use)
- Maintenance:
  Service Contracts such as Elevator, HVAC Cleaning and Unit Turnover Refresh
- Repairs
- Landscaping & Snow Removal
- Replacement Reserves

The borrower should show how they arrived at each line item either based on:

- Quotes or experience with similar projects in the local market
- % of Effective Gross Income, income after accounting for vacancy (e.g. property management fee can be calculated at 7% of Effective Gross Income)
- Per Unit or Square Feet benchmark (e.g. contribution to replacement reserve equal to $350 per residential unit per year).

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

The following can serve as a guide to determine criteria for budgeting acceptable ranges of projected annual increases in income with projected annual increases in expenses:

Projected Annual Increases	Prudent	Acceptable	Not Acceptable
Income	1.5%	3.0%	3.0%
Expenses	3.0%	3.0%	1.5%

For pro forma budgeting purposes, income should not be set to increase annually at a rate greater than expenses. This may position the loan to be too high to be paid down by actual net income.

The underwriter should calculate expenses ÷ effective gross income. If expenses are less than 20% of EGI or more than 50% of EGI, then borrower should provide an explanation.

Replacement Reserves

Replacement reserves must be included in the operating expenses and replacement of capital items. For new construction, the Underwriter shall confirm that the amount included is consistent with industry standards. For existing developments, a replacement reserve analysis will be in the Property Condition Analysis. An initial deposit to the replacement reserve may be required for existing properties depending upon the property condition assessment and the level of on-going contributions to replacement reserves. All borrowers will be required to enter into a Replacement Reserve Agreement for the purpose of establishing and funding a replacement reserve escrow account.

Cash Flow Analysis

Cash Flow analysis starts after the calculation of Net Operating Income (NOI), which is Gross Effective Income less Operating Expenses.

Rental Income			
	Residential Units		$360,000
plus	Commercial Units		$312,500
	Gross Rental Income		$672,500
less	Vacancy	5.00%	$33,625
equals	**Effective Gross Income**		**$638,875**
	Effective Gross Income		$638,875
less	Operating Expenses		$211,098
less	Capital Replacement Reserves		$12,778
equals	**Net Operating Income**		**$415,000**

- ✓ Is there enough NOI to cover debt service on requested loan amount(s)?
- ✓ Is the sufficient net cash flow after debt service payments for developer and its investors to earn enough income to be motivated to continue to manage successful operations of the project?

The property's cash flow is the primary indicator as to whether a proposed loan's debt service can be paid. The Underwriter will review the operating pro forma provided by the borrower. The Underwriter will compare the provided assumptions with the rents and occupancy rates for similar properties in the surrounding area identified in the market study. The Underwriter will ensure consistency between the developer's income and expense projections and the projections contained in the appraisal.

The Underwriter will analyze the pro forma's operating expenses for consistency with similar developments in the local market. The appraisal and market analysis can provide useful data for comparable properties.

For existing properties, two years (2) prior operating statements (actual vs. budget) must be analyzed in addition to fifteen (15) years of future cash flow projections. For new developments, the borrower must supply a 15-year operating pro forma.

The Underwriter will review the projected cash flow and confirm that to the extent practicable, the return on the Third Party Borrower's equity investment will not be unreasonably high. Please see Appendix A for "24 CFR Part 570, Appendix A to Part 570 - Guidelines and Objectives for Evaluating Project Costs and Financial Requirements."

Loan Sizing

The process for determining the maximum amount of a third party loan for an income generating real estate project involves taking the lesser amount of the following calculations:

- ✓ **Debt Service Coverage Ratio**
- ✓ **Loan To Value Ratio**

And for special economic development projects,

- ✓ CDBG Public Benefit for special economic development projects and/or public facilities and improvements projects undertaken for economic development purposes must meet a minimum level of public benefit (see Public Benefit section below).

To illustrate this process, below is a summary for a redevelopment project that will rehabilitate a mixed-use property into 24 two-bedroom apartments and re-purpose 25,000 square feet of commercial space for retail and studio uses.

Rent Roll	Units / Sq. Ft.	Rent / Unit or Sq. Ft.
Residential Two Bedroom Units	24	$1,250
Commercial Retail & Office	25,000	$12.50
Total Gross Rental Income:		

Debt Service Coverage Ratio (DSCR)

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Operating Income}}{\text{Debt Service Payment}}$$

Commercial lenders use the DSCR to analyze how large of a commercial loan can be supported by the cash flow generated from the property, or to determine how much income coverage there is at a certain loan amount. The debt service payment amount is incorporated into the formula that includes interest rate and loan amortization terms to determine maximum loan amount based on rental income. The DSCR makes sure that there is a surplus of net income after debt service payments for retained earnings and/or distribution to owners.

Unless the borrower can provide compelling compensating factors, the Recipient should impose a policy that Debt Service Coverage Ratio should be no less than 1.2, which is a commonly used ratio for commercial properties. The higher the DSCR, the more net cash flow is available for retained earnings and/or distribution to owners.

For projects that include commercial real estate tenants, other than traditional residential, the underwriter can calculate DSCR by using Net Cash Flow divided by Debt Service Payment. A property's Net Cash Flow is determined after subtracting tenant improvement allowances (if applicable) and leasing commission allowances from the property's Net Operating Income. Net Operating Income is net of replacement reserves.

	Effective Gross Income	$638,875
less	Operating Expenses (including Replacement Reserves)	$223,875
equals	**Net Operating Income**	**$415,000**
less	Tenant Improvements Allowance (If applicable)	$12,000
less	Leasing Commissions	$3,000
equals	**Net Cash Flow**	**$400,000**

For 100% residential rental projects, DSCR remains NOI ÷ Debt Service.

Individual loan amount will be the lesser of the minimum DSCR or the maximum loan to value (LTV) ratio. The DSCR loan sizing is based upon the underwritten net cash flow (NCF).

What is the maximum loan amount based on DEBT SERVICE COVERAGE Ratio?				
	Pro Forma Net Operating Income	$415,000		
	Pro Forma Net Cash Flow	$400,000		
	Minimum Debt Coverage Ratio	1.25		
	Interest Rate	6.00%		
	Term (years)	20		
				$400,000
Answer:	Net Cash Flow ÷ Minimum DCR = **Maximum Annual Debt Service:**	**$320,000**	=	1.25

Once you have calculated the maximum annual debt service, use the @PV formula in Excel to calculate the maximum loan amount

Note: To accurately calculate the loan amount (*PV*), convert the rate, term (*nper*) and payment (*pmt*) into monthly amounts by dividing each number by 12.
*=PV(0.065/12,20*12,-52000/12)*

	Annual		Monthly
Maximum Debt Service Payment	$320,000		$26,666.67
Interest Rate	6.00%		0.5000%
Term	20		240
	Maximum Loan Amount Based on DSCR:	**=**	**$3,722,000**

Loan to Value Ratio (LTV)

The **Loan to Value ratio** calculates the maximum loan amount based on the appraised market value of the property multiplied by a percentage set by the lender. For HUD Section 108 guaranteed loans, Recipients are encouraged not to exceed 80% of appraised value. There is flexibility to go above 80%. However, the underwriter needs to see material compensating factors that justify higher risk in a higher loan amount compared to the property's market value.

What is the maximum loan amount based on LOAN TO VALUE Ratio?		
Appraised Value		$5,000,000
Loan to Value Ratio:	*times*	80.00%
Maximum Loan Amount Based on Loan to Value:	**=**	**$4,000,000**

To reduce exposure to risk, most lenders would choose the lesser loan amount. In the example above the lender would select the **$3,722,000 loan amount based on the DSCR**, which is the lesser of $4,000,000 based on the LTV ratio.

However, with HUD Section 108 financing, specifically for economic development projects there is the CDBG Public Benefit minimum requirement that can impact the loan amount.

Public Benefit

Projects funded with Section 108 loans must meet a minimum level of public benefit when used for special economic development projects and when used for public facilities and improvement projects undertaken for economic development purposes. The public benefit standards have two levels:

Individual Activities

An individual activity is considered by HUD to provide insufficient public benefit and cannot be assisted with a Section 108 loan if the amount of CDBG assistance exceeds $50,000 per full-time equivalent (FTE), permanent job (created or retained) or $1,000 per LMI person to which goods and services are provided by the activity.

Aggregate Activities

Activities, when assessed in the aggregate for all the activities within a specific grant year, must either:

- ✓ Create or retain at least one FTE, permanent job per $35,000 of CDBG funds used;

or

- ✓ Provide goods and services to an area where the number of LMI persons served by the assisted business amounts to at least one LMI person per $350 of CDBG funds used.
- ✓ The Recipient may choose to impose a standard for each project to be financed with a third party loan that is stricter than the individual standard to ensure that it will be able to meet the aggregate standard. The public benefit standard selected will require a minimum number of jobs or LMI persons served and, at the same time, establish a maximum third party loan amount depending on the public benefit standard used.

Public Benefit and Loan Sizing-Example

Minimum # New Jobs Created from HUD 108 Financing			
106	=	$3,722,000	Maximum HUD 108 Loan Amount
		$35,000	One (1) FTE job for every $35,000 in HUD 108 Financing

If the project does not generate 75 new FTE jobs, then either the amount of Section 108 financing needs to be modified and/or the project needs to be modified to serve a different public benefit standard.

Proposed Construction Loan Draw Schedule

The Underwriter shall review the proposed construction loan draw schedule to confirm that any interest reserve is sufficient to cover the cost of financing until closing on the permanent loan.

To the extent practicable, Section 108 funds should be disbursed on a pro rata basis with other funding sources.

Proposed Amortization Schedule

The Underwriter shall review the proposed amortization schedule submitted by the borrower and include the terms in the credit memo.

If the loan is not fully amortized from project cash flow by the end of the loan term, the credit must clearly explain how the "balloon balance" will be paid and why the source of funds is expected to be available.

Equity Contribution

NOTE: The Recipient or another lender can require that the Third Party Borrower provide **equity** in an amount equal to a specific percentage of the total development cost. In some cases, the Recipient will allow this requirement to be met with subordinate debt or subsidy. The language below can be used in loan documents if the lender's policies call for such a contribution. The percentage of the total development cost that is required to come from the Third Party Borrower is at the lender's discretion.

For example, the following language could be included in a Recipient's Underwriting Policy:

> "The Third Party Borrower must contribute equity in an amount equal to at least ten (10) percent of the total development cost as defined in the sources and uses statement. Subordinate debt and/or subsidy is acceptable for meeting this requirement. If subordinate debt is used, the Combined Loan to Value cannot exceed 100 percent and the combined Debt Coverage Ratio cannot be less than 1.20."

Community-Owned Grocer, Burlington, Vermont

COLLATERAL AND LOAN REPAYMENT GUARANTEES

An Underwriter's assessment of collateral available to secure the loan is the final essential element in the loan decision process. By ensuring that adequate collateral exists to secure the repayment of the loan, the Recipient will significantly reduce the risk that CDBG funds will have to be used if the project does not come to fruition or is not successful in generating revenue sufficient to repay the loan.

Acceptable Types of Collateral

In addition to real estate, as discussed in earlier sections of this manual, the examples below can also be used as collateral —provided that they can easily be converted to cash:

- Cash
- Equity
- Letters of Credit
- Real Estate
- Corporate and Personal Guarantees
- Machinery and equipment
- Accounts Receivable
- Pledges (debt service, management, & developer fees)

Evaluation of Guarantees

The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation. The attributes of a financially responsible guarantor include the following:

- Guarantor has both the financial capacity and willingness to provide support for the loan;
- Guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term;
- Guarantee is written and legally enforceable.

The Recipient or its Underwriter should have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. This assessment includes consideration of the total number and amount of guarantees currently extended by a guarantor in order to assess whether the guarantor has the financial capacity to fulfill the contingent claims that exist.

Is there sufficient collateral to ensure the loan will be repaid in full if the project does not generate sufficient cash flow?

The Underwriter should consider whether a guarantor has demonstrated its willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. An important consideration is whether previously required performance under guarantees was voluntary or the result of legal or other actions by a lender to enforce the guarantee.

Completion Guarantee/Performance Bonds

The Recipient is highly exposed until the Third Party Borrower's project is completed according to its plans and specifications. In order to ensure that the Third Party Borrower's project is completed and constitutes a sufficient collateral asset for the loan, the Underwriter will:

- Require the Third Party Borrower to engage a qualified general contractor and require the general contractor to obtain either a payment and **performance bond** from a properly licensed surety, which bond and surety shall be acceptable to the lender; or a letter of credit, acceptable to the lender, and;
- Require the Third Party Borrower to provide a **completion guarantee** agreement, from a creditworthy guarantor, promising to complete construction if the general contractor fails to do so, and promising to pay any costs in excess of budget, including any costs due to change orders. Such completion Guarantee, and guarantor, shall be acceptable to the lender's sole and absolute discretion.

Multiple Sources of Financing / Inter-Creditor Agreements

Development projects often have multiple sources of financing. Along with the Third Party Loan, the other types of financing are debt financing, equity investments, or other types of financial assistance (e.g., local/state grants, charitable contributions). The Recipient should seek a lien position on collateral that is senior to all other financing sources if possible. However, the Third Party Borrower may request the Recipient to subordinate its lien for various reasons (e.g., another lender refuses to accept a subordinate lien position and the project will not go forward unless the Recipient agrees to subordinate, etc.).

The senior lender on a loan may insist that the Recipient (and any other subordinate lenders) enter into an "**Inter-creditor Agreement**" (or the equivalent). These types of agreements can sometimes be disadvantageous to the subordinate lender, which may be the Section 108 Recipient (e.g., by imposing restrictions on the subordinate lender's ability to take action on collateral). Should this happen, and to ensure that its collateral is not compromised, the Recipient should carefully review the Inter-creditor Agreement and take steps to protect itself in the event of a default (e.g., advance notification of actions by the senior lender and an opportunity to cure default).

SAMPLE OUTLINE FOR CREDIT MEMO

The Underwriter will submit a report (Credit Memo) to the credit committee and/or designated officials of the Recipient. The Credit Memo is the primary deliverable of the Underwriter and provides the record of analysis and recommendation for how to proceed with the Section 108 financing request. The Credit Memo should include:

Cover Sheet

Applicant

Project Name:

Requested Loan Amount:

Project Description:

Location:

Collateral:

Target Closing Date:

Analysis

A. Project Description

B. Section 108 Program Compliance

1. Section 108 eligible activity under 24 CFR 570.703
2. National objectives criteria under 24 CFR 570.208
3. Public benefit standard as required for projects qualifying under 570.703(i) and 570.203 or 570.204 activities.
4. Environmental review

C. Evaluation of Compliance with Underwriting Guidelines

1. Project Feasibility and Readiness
2. Experience and Management Capacity
3. Borrower Financial Capacity and Creditworthiness
4. Project Financial Analysis
5. Collateral (including any Loan Repayment Guarantees)

D. Risks and Mitigating Factors

Conclusion and Recommendation

A. Recomendation and rationale for approval/disapproval
If recommendation is approval, provide the following information:

B. Loan Amount

C. Primary & Secondary Collateral

D. Recommended Conditions:

- ✓ Receipt of commitment approval documentation from other funding sources
- ✓ Satisfaction of insurance requirements, General Liability, Builder's Risk and Property
- ✓ Receipt of an updated lender's Title Policy in favor of the Recipient
- ✓ HUD release of funds from environmental condition
- ✓ Approval and execution of construction contract
- ✓ Confirmation of lien and judgment-free status (search) prior to closing
- ✓ Receipt of approval from HUD
- ✓ Receipt and execution of loan documents from HUD
- ✓ Receipt of updated documents from third party borrower (budgets, contracts, other documents) as requested

E. Schedule for Repayment of Section 108 Loan

F. Third Party Loan Terms:

- ✓ Interest rate: (should be pegged to rate on Section 108 loan)
- ✓ Term:
- ✓ Payment frequency (monthly or quarterly):
- ✓ Special provisions: (e.g., principal amortization deferral, balloon payment)

CREDIT MEMO Exhibits:

1. Detailed Sources & Uses and Analysis of Cash Flow
2. Property Appraisal – Executive Summary
3. Site Plan & Schematics

Exhibit A. Appendix A To Part 570—Guidelines And Objectives For Evaluating Project Costs And Financial Requirements

Volume: 3
Date: 2012-04-01
Original Date: 2012-04-01
Title: **Appendix A to Part 570 - Guidelines and Objectives for Evaluating Project Costs and Financial Requirements**
Context: Title 24 - Housing and Urban Development. Subtitle B - Regulations Relating to Housing and Urban Development (Continued). CHAPTER V - OFFICE OF ASSISTANT SECRETARY FOR COMMUNITY PLANNING AND DEVELOPMENT, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT. SUBCHAPTER C - COMMUNITY FACILITIES. PART 570 - COMMUNITY DEVELOPMENT BLOCK GRANTS.

Pt. 570, App. A

Appendix A to Part 570—Guidelines and Objectives for Evaluating Project Costs and Financial Requirements

I. *Guidelines and Objectives for Evaluating Project Costs and Financial Requirements.* HUD has developed the following guidelines that are designed to provide the recipient with a framework for financially underwriting and selecting CDBG-assisted economic development projects which are financially viable and will make the most effective use of the CDBG funds. *The use of these underwriting guidelines as published by HUD is not mandatory.* However, grantees electing not to use these underwriting guidelines would be expected to conduct basic financial underwriting prior to the provision of CDBG financial assistance to a for-profit business. States electing not to use these underwriting guidelines would be expected to ensure that the state or units of general local government conduct basic financial underwriting prior to the provision of CDBG financial assistance to a for-profit business.

II. Where appropriate, HUD's underwriting guidelines recognize that different levels of review are appropriate to take into account differences in the size and scope of a proposed project, and in the case of a microenterprise or other small business to take into account the differences in the capacity and level of sophistication among businesses of differing sizes.

III. Recipients are encouraged, when they develop their own programs and underwriting criteria, to also take these factors into account. For example, a recipient administering a program providing only technical assistance to small businesses might choose to apply underwriting guidelines to the technical assistance program as a whole, rather than to each instance of assistance to a business. Given the nature and dollar value of such a program, a recipient might choose to limit its evaluation to factors such as the extent of need for this type of assistance by the target group of businesses and the extent to which this type of assistance is already available.

IV. The objectives of the underwriting guidelines are to ensure:

(1) that project costs are reasonable;

(2) that all sources of project financing are committed;

(3) that to the extent practicable, CDBG funds are not substituted for non-Federal financial support;

(4) that the project is financially feasible;

(5) that to the extent practicable, the return on the owner's equity investment will not be unreasonably high; and

(6) that to the extent practicable, CDBG funds are disbursed on a pro rata basis with other finances provided to the project.

i. Project costs are reasonable. i. Reviewing costs for reasonableness is important. It will help the recipient avoid providing either too much or too little CDBG assistance for the proposed project. Therefore, it is suggested that the grantee obtain a breakdown of all project costs and that each cost element making up the project be reviewed for reasonableness. The amount of time and resources the recipient expends evaluating the reasonableness of a cost element should be commensurate with its cost. For example, it would be appropriate for an experienced reviewer looking at a cost element of less than $10,000 to judge the reasonableness of that cost based upon his or her knowledge and common sense. For a cost element in excess of $10,000, it would be more appropriate for the reviewer to compare the cost element with a third-party, fair-market price quotation for that cost element. Third-party price quotations may also be used by a reviewer to help determine the reasonableness of cost elements below $10,000 when the reviewer evaluates projects infrequently or if the reviewer is less experienced in cost estimations. If a recipient does not use third-party price quotations to verify cost elements, then the recipient would need to conduct its own cost analysis using appropriate cost estimating manuals or services.

ii. The recipient should pay particular attention to any cost element of the project that will be carried out through a non-arms-length transaction. A non-arms-length transaction occurs when the entity implementing the CDBG assisted activity procures goods or services from itself or from another party with whom there is a financial interest or family relationship. If abused, non-arms-length transactions misrepresent the true cost of the project.

2. *Commitment of all project sources of financing.* The recipient should review all projected sources of financing necessary to carry out the economic development project. This is to ensure that time and effort is not wasted on assessing a proposal that is not able to proceed. To the extent practicable, prior to the commitment of CDBG funds to the project, the recipient should verify that: sufficient sources of funds have been identified to finance the project; all participating parties providing those funds have affirmed their intention to make the funds available; and the participating parties have the financial capacity to provide the funds.

3. *Avoid substitution of CDBG funds for non-Federal financial support.* i. The recipient should review the economic development project to ensure that, to the extent practicable, CDBG funds will not be used to substantially reduce the amount of non-Federal financial support for the activity. This will help the recipient to make the most efficient use of its CDBG funds for economic development. To reach this determination, the recipient's reviewer would conduct a financial underwriting analysis of the project, including reviews of appropriate projections of revenues, expenses, debt service and returns on equity investments in the project. The extent of this review should be appropriate for the size and complexity of the project and should use industry standards for similar projects, taking into account the unique factors of the project such as risk and location.

ii. Because of the high cost of underwriting and processing loans, many private financial lenders do not finance commercial projects that are less than $100,000. A recipient should familiarize itself with the lending practices of the financial institutions in its community. If the project's total cost is one that would normally fall within the range that financial institutions participate, then the recipient should normally determine the following:

A. *Private debt financing*—whether or not the participating private, for-profit business (or other entity having an equity interest) has applied for private debt financing from a commercial lending institution and whether that institution has completed all of its financial underwriting and loan approval actions resulting in either a firm commitment of its funds or a decision not to participate in the project; and

B. *Equity participation*—whether or not the degree of equity participation is reasonable given general industry standards for rates of return on equity for similar projects with similar risks and given the financial capacity of the entrepreneur(s) to make additional financial investments.

iii. If the recipient is assisting a microenterprise owned by a low- or moderate-income person(s), in conducting its review under this paragraph, the recipient might only need to determine that non-Federal sources of financing are not available (at terms appropriate for such financing) in the community to serve the low- or moderate-income entrepreneur.

4. *Financial feasibility of the project.* i. The public benefit a grantee expects to derive from the CDBG assisted project (the subject of separate regulatory standards) will not materialize if the project is not financially feasible. To determine if there is a reasonable chance for the project's success, the recipient should evaluate the financial viability of the project. A project would be considered financially viable if all of the assumptions about the project's market share, sales levels, growth potential, projections of revenue, project expenses and debt service (including repayment of the CDBG assistance if appropriate) were determined to be realistic and met the project's break-even point (which is generally the point at which all revenues are equal to all expenses). Generally speaking, an economic development project that does not reach this break-even point over time is not financially feasible. The following should be noted in this regard:

A. some projects make provisions for a negative cash flow in the early years of the project while space is being leased up or sales volume built up, but the project's projections should take these factors into account and provide sources of financing for such negative cash flow; and

B. it is expected that a financially viable project will also project sufficient revenues to provide a reasonable return on equity investment. The recipient should carefully examine any project that is not economically able to provide a reasonable return on equity investment. Under such circumstances, a business may be overstating its real equity investment (actual costs of the project may be overstated as well), or it may be overstating some of the project's operating expenses in the expectation that the difference will be taken out as profits, or the business may be overly pessimistic in its market share and revenue projections and has downplayed its profits.

ii. In addition to the financial underwriting reviews carried out earlier, the recipient should evaluate the experience and capacity of the assisted business owners to manage an assisted business to achieve the projections. Based upon its analysis of these factors, the recipient should identify those elements, if any, that pose the greatest risks contributing to the project's lack of financial feasibility.

5. *Return on equity investment.* To the extent practicable, the CDBG assisted activity should provide not more than a reasonable return on investment to the owner of the assisted activity. This will help ensure that the grantee is able to maximize the use of its CDBG funds for its economic development objectives. However, care should also be taken to avoid the situation where the owner is likely to receive too small a return on his/her investment, so that his/her motivation remains high to pursue the business with vigor. The amount, type and terms of the CDBG assistance should be adjusted to allow the owner a reasonable return on his/her investment given industry rates of return for that investment, local conditions and the risk of the project.

6. *Disbursement of CDBG funds on a pro rata basis.* To the extent practicable, CDBG funds used to finance economic development activities should be disbursed on a pro rata basis with other funding sources. Recipients should be guided by the principle of not placing CDBG funds at significantly greater risk than non-CDBG funds. This will help avoid the situation where it is learned that a problem has developed that will block the completion of the project, even though all or most of the CDBG funds going in to the project have already been expended. When this happens, a recipient may be put in a position of having to provide additional financing to complete the project or watch the potential loss of its funds if the project is not able to be completed. When the recipient determines that it is not practicable to disburse CDBG funds on a pro rata basis, the recipient should consider taking other steps to safeguard CDBG funds in the event of a default, such as insisting on securitizing assets of the project.

EXHIBIT B SECTION 108 LOAN PROGRAM

Sample Scope of Work for Loan Underwriting and Servicing for Section 108 Loan Guarantee Program for Income Producing Real Estate Projects

EXHIBIT B TABLE OF CONTENTS

Summary

The following scope of work for an Underwriter will be included in an agreement with a contracted agency with the capacity to support the success for the Grantee's HUD 108 Loan Program. This scope of work covers underwriting and loan servicing. The underwriting scope includes due diligence, settlements, inspections, draws and budget to actual record keeping and accounting. The servicing scope includes receipt and remittance of loan payments and reporting.

The Grantee has final loan decision-making authority. The contracted Underwriter shall make recommendations and propose terms for HUD 108 loans and follow through with getting them to settlement, funded and serviced.

Underwriting

Compliance with CDBG Regulations and Underwriting Policies

1. The underwriter shall follow underwriting guidelines approved by the grantee for all HUD 108 loan requests. Underwriter may propose modifications to underwriting guidelines subject to written approval by the grantee after the grantee has confirmed acceptance of these changes with HUD.

2. Credit underwriting must comply with the Grantee's Section 108 Underwriting Guidelines and 24 CFR Part 570 and all other applicable Federal, state and local regulations. The Underwriter shall confirm that the proposed activity funded by the Section 108 loan meets a CDBG National Objective and that each proposed loan will serve CDBG eligible uses, activities, and target areas.

3. The proposed use of Section 108 loan funds must provide a minimum level of public benefit for special economic development activities. The underwriter must confirm that the funded activity will:

    Create or retain as a minimum, at least one full-time equivalent permanent job per $35,000 of Section 108 loan funds. On a case-by-case basis the grantee may approve loans that create at least one full-time equivalent permanent job per $50,000 of Section 108 loan funds

    or

Provide goods or services to residents of the area, such that as a minimum at least one low-and moderate-income resident of the area benefits from each $350 of Section 108 loan funds expended.

Site and Development Analysis

With respect to the proposed development, the Underwriter shall conduct the tasks outlined in each section below.

Market Analysis

a. Review the qualifications of professional economic and market consultants who provide the market study. The Grantee reserves the right to reject a market study.

b. Review and verify the market study report to make a recommendation as to whether the market exists to support the development. (The market study may be a separate report from the appraisal.)

c. Confirm that the market study is certified and prepared for the Underwriter as an agent for the Grantee.

Site Analysis

a. Confirm accessibility-ingress, egress, utilities, and infrastructure availability.

b. Confirm Zoning and land use requirements compared to the Development and verify conforming use.

c. Review the Phase I Environmental Report and, if necessary, a Phase II Environmental Report, Asbestos Survey and Lead-Based Paint Report.

d. Confirm local Government approval of preliminary plans and specifications.

e. Obtain and review, including a comparison to the application, a plan and cost review (preconstruction analysis) and, where applicable, a capital needs assessment, for the Development.

f. Review the cost estimates and certifications from the Borrower's contractors, architect, engineer, or other professionals.

Appraisal

a. Review the appraiser's qualifications and technical sufficiency including the verification of current State certification and license number. The Grantee reserves the right to reject an appraiser.

b. Review the appraiser's valuation approach and provide an opinion as to the validity of the technique and value conclusion.

c. Review appraisal to determine whether the value of the land and the improvements to be acquired supports the acquisition cost.

d. Review appraisal to determine whether the value of completed or rehabilitated properties supports the proposed sales price of the homes.

e. Confirm that the appraisal is certified and prepared for the Underwriter as an agent for the Grantee or meets the Grantee's requirements for accepting an appraisal prepared for another lender.

Economic Feasibility

a. Review all project development pro-forma financial feasibility documents such as development budget, rent roll, sources and uses of funds, operating budget, cash flow projection and loan amortization schedule to make sure that the Borrower has the resources to fund the cost of the Development and to cover the debt service requirements.

b. Identify and verify sources of loan repayment should financial objectives not come to fruition.

Development Team and Credit Analysis

With respect to the Development team, the Underwriter shall:

1. Conduct financial credit analysis of all borrowers and guarantors who sign note, mortgage, and credit agreements for HUD 108 financing.

2. Review, verify and document executed certification forms and experience of Borrowers, general contractors, management companies, confirming that the minimum requirements of the Application have been met.

3. Review Developments constructed and/or currently owned by Borrower to determine that Developments are in good financial standing and, where applicable, in compliance with applicable statutes, rules, and regulations. If it is identified by the Underwriter that the Borrower's principals have other loans with Grantee County, or other lenders, that are out of compliance, in default or non-performing, the loan recommendation shall include a summary of the problems.

4. Verify and document that the Certificate of Good Standing for the applicant entity through the Secretary of State is current during credit underwriting.

5. Evaluate Borrower's, Guarantor's, and general contractor's ability to complete a Development, based on their financial capability and stability as well as contingent liabilities for the Borrower and Guarantors.

6. If applicable, evaluate financial capacity and stability of any syndicators and credit enhancers or bond purchasers. This shall include the review of the commitments from credit enhancers or bond purchasers, and housing tax credit syndicators.
7. Perform a credit analysis, for principals, guarantors, general contractor, applicant, and general partner (i.e., credit reports, bank references, trade references, written financial statements analysis, tax returns, bank deposit verification, etc.).
8. Review, verify, and document executed certification forms and experience of general contractors.
9. Verify and document that architect/engineer has a valid state license and carries Errors and Omissions insurance in an amount equal to the greater of HUD 108 loan guidelines.
10. Review the management agreement between the Management Company and the Borrower and obtain an executed agreement prior to or at loan closing.
11. Verify and document the adequacy of the general contractor and owner's insurance policies as to dollar amount and types of coverage, and ensure that the Grantee is named as loss payee, mortgagee, and additional insured, as applicable.

Credit Memo and Recommendations for Loan Review Committee

Underwriter / Servicer shall prepare a loan credit memo and recommendations for the Loan Committee to review as part of their loan approval process. Credit memo shall include:

1. Summary of key credit issues and underwriting considerations, and risks and proposed mitigating measures
2. Project Development Pro Forma
3. Summary of Credit and Financial Status of Borrower and Guarantors
4. Recommendations, which shall include:
   a. If Affirmative, proposed terms for HUD Loan approval or
   b. If Subject to Issue Resolution, list issues to resolve for loan application re-submission or
   c. If Denial, list reasons for denial of loan request
   d. Provide a draft of the credit memo to the Grantee prior to providing it to the Loan Review Committee.

Loan Settlement

The Underwriter shall:

1. Prepare the Commitment Letter with all terms and conditions for proceeding to settlement for HUD 108 financing. The Commitment Letter shall include:

    a. Loan approval terms and conditions

    b. Loan **covenants**

    c. Checklist of tasks to be completed and/or documents required proceed to settlement

2. Prepare all documentation required for settlement such as but not limited to Note, Mortgage, Credit Security Agreement, Guarantee and related HUD compliance documentation.

3. Coordinate preparations for settlement with the Grantee and legal counsel and attend settlement.

4. Retain all documents from settlement, organize in loan file, and proceed with setting up loan for disbursement per terms and conditions of loan and HUD Section 108 program rules.

Permanent Loan Servicing

The Underwriter shall provide the following services for all recipients of Permanent Loans, as applicable, pursuant to the loan documents:

1. Establish separate loan servicing files for each Development, which shall contain copies of all closing documents pertaining to the Development.

2. Furnish billing statements to the Borrower with amount of payments due to Grantee.

3. Collect loan payments and allocate funds to the appropriate servicing accounts and make all appropriate remittances to the Grantee within 20 Days of collection. For remittances not received by Grantee within 20 Days of the date received by the Underwriter, the Underwriter may be subject to a late charge of 5% of the remittance amount, at the sole discretion of the Grantee.

4. Maintain all accounts held on behalf of the Borrower or the Grantee in FDIC insured custodial or trust accounts for The Grantee and, where applicable, the mortgagors. If at any time the amounts in the accounts exceed the maximum limits of the insurance provided by FDIC, the Underwriter shall transmit an amount due to The Grantee to reduce the account under the maximum limits of the insurance.

5. Service delinquent accounts of Borrowers, including, but not limited to, sending notices as required by the loan documents and implementing all appropriate collection procedures. Collection procedures should include, for accounts over 30 days past due, a phone call with the Borrower. The Underwriter may retain late fees collected, after Grantee's interest, principal and other applicable fees, if any, have been paid. However, late fees retained by the Underwriter shall not include late filing fees assessed to and collected from Borrowers for failure to submit audited financial statements by the required deadline. These late fees shall be remitted to The Grantee.

6. Establish escrow accounts replacement reserves, or any other accounts specified in the closing documents, if not held by the first mortgagee. Review all escrow accounts annually for adjustments. Accounts shall be set up as follows:

   - Individual accounts for replacement reserve escrow;
   - Two signatories for all withdrawals/payments;
   - Monthly reconciliation performed by someone other than the individual who prepares deposits or withdrawals; and
   - Determination of adequacy after each disbursement.

7. If escrow accounts for replacement reserves are held by the first mortgagee, where applicable, these accounts shall be verified monthly with the holder of the account to ensure that scheduled payments have been received.

8. On an annual basis, provide a reconciliation of the escrow accounts relating to replacement reserves, real estate taxes, and property insurance, to include, at a minimum, the beginning balance, debits, credits and ending balance.

9. Upon request by Grantee, perform analysis of disbursements from any escrow account.

10. Annually prepare IRS Form 1098 for each real estate borrower by January 31st of each year, itemizing the total interest paid for the previous year.

11. The Underwriter shall ensure that at all times during the existence of the loan all buildings and improvements making up the Development are insured as required by the loan documents for the benefit of The Grantee against loss or damage by fire and from such other insurable risks and hazards all as more specifically set forth in the mortgage and other loan documents. In the event the Borrower fails to maintain such insurance in full force and effect, and upon the written authorization of The Grantee, such insurance shall be maintained by the Underwriter, subject to payment by the Grantee, which shall advance necessary loan funds to the Underwriter, upon request from the Underwriter. The Underwriter shall retain and safely store, service and continually maintain all such policies and documents related thereto as required herein.

12. Review any amendment to, or renewal of, property insurance policies, to include but not limited to general liability, flood (if applicable), and replacement cost hazard insurance, with special attention to exclusions of coverage, including mold, sinkholes, and windstorms. All exclusions, or in the case of an amendment to or renewal of an existing policy, any changes from the original policy shall be immediately reported, in writing, to the Grantee Loan Servicing staff to include an assessment of the effect that such change or inclusions have on the overall transaction.

13. Provide loan servicing reports in writing to the Grantee pursuant to the schedule of report dates provided by the Grantee at the beginning of each year and as amended from time to time which identify all delinquent accounts, and/or default issues. The Grantee's approved format, which may be amended from time to time, for the loan servicing reports is provided as Exhibit B.

14. Provide loan servicing reports in writing to the Grantee pursuant to the schedule of report dates provided by the Grantee at the beginning of each year, and as amended from time to time, which identify all delinquent insurance issues. New non-compliance issues will be reported with the past dues for three consecutive months and then moved to the annual report. All issues that deal with a total lapse in coverage should be reported monthly until coverage is secured. The Grantee's approved format, which may be amended from time to time, for the loan servicing reports is provided as Exhibit C.

15. Provide quarterly (March, June, September, December) Trial Balances to the Grantee on the last day of the month following the end of the quarter (4/30, 7/31, 10/31 and 1/31) for each Section 108 loan, identifying the current loan balances and accrued and unpaid interest of all Section 108 loans in the Underwriter's portfolio being serviced on behalf of the Grantee.

EXHIBIT C. SAMPLE SCHEDULE OF OTHER REAL ESTATE OWNED

Schedule of Real Estate Owned: List all real estate holdings of Borrowing Entity and key principals of Borrowing Entity (include real estate that is owned "free and clear", funded by other lenders and/or funded by any company).

Borrowing Entity & Property Address	Ownership %	Property Type (C, I, MU, MF, VL)	Acquisition Date	Acquisition Cost	Present Market Value	Amount of Mortgages 1st and 2nd	Lender	Loan Number	(1) Gross Income	(2) Maintenance & Operating Expenses	(3) Net Operating Income	(4) Mortgage Payments	**(5) Net Cash Flow**
				TOTAL:	$0	$0			$0	$0	$0	$0	**$0**

Schedule of Other Loans Applied For or Made by any financial Company: List all non real estate debt funded or to be funded by any financial company.

Borrowing Entity & Property Address	Lender	Loan Number	Original Amount	Current Balance	Maturity Date

C:	Commercial
I:	Industrial / Warehouse
MU:	Mixed-Use
MF:	Multifamily
SF:	Single-Family
VL:	Vacant Land

If none, Initial this box: ☐

By signing below, the Applicant certifies and represents to and its successors and assigns, that the information provided in this Schedule of Real Estate and Other Loans is complete, true and correct

Applicant Signature: ______________________ Date: __________ Co-Applicant Signature: ______________________ Date: __________

NOTE: Borrowers may attach a pre -prepared financial statement including a schedule of real estate: 0 Check box if pre-prepared financial statement and schedule of real estate is attached and sign above.

DEFINITION OF TERMS

Appraiser
A professional who, through specialized training and experience, is able to provide an opinion of the market value of a specific property.

Audited Financial Statements
A company's financial statements which have been prepared and certified by a Certified Public Accountant that the financial statements meet the requirements of the Generally Accepted Accounting Principles (GAAP).

Balance Sheet
A statement of the assets, liabilities and capital of a business at a particular point in time.

Cash Flow Statement
A report that shows the cash generated and used by a company over a specific timeframe. While similar to the income statement, the cash flow statement does not include non-cash items, such as depreciation.

Collateral
Property or another asset pledged as security for repayment of a loan, to be forfeited in the event of a default.

Completion Guarantee
A common part of the documentation for a construction mortgage loan. In a Guarantee of completion, a creditworthy principal or affiliate of the borrower guarantees that construction being financed will be completed, even if the borrower defaults.

Covenants
Affirmative covenants are conditions in which a lender will require a borrower to comply with such as inform lender of litigation, maintain financial records, maintain insurance, pay taxes, and so on. Negative covenants are conditions is in which the borrower will not do, without permission of the lender, such as incur indebtedness, discontinue operations, or otherwise obligate the property subject to the mortgage.

Current Liabilities
Debts that are due in one year or less. Examples include accounts payable, taxes payable, accrued expenses, short term loans.

Current Market Value

Often referred to as the "as is" value of the property), which reflects the property's actual physical condition, use, and zoning designation as of a current effective date of the appraisal. If the highest and best use of the property is for redevelopment to a different use, the cost of demolition and site preparation should be considered in the analysis.

Debt Service Coverage Ratio (DSCR)

Net operating income divided by debt service (principal and interest) yields the Debt Service Coverage Ratio (DSCR). DSCR should be at least 1.25.

Depreciation

The decrease in value of capital assets used to generate income. It is also used as the basis for a tax deduction and an indicator of the flow of money into new capital.

Income and Expense Statement

A financial statement that measures a company's financial performance over a specific accounting period. The Income Statement shows what has happened in the business over a period of time.

Inter-creditor Agreements

An agreement among creditors that sets forth the various lien positions and the rights and liabilities of each creditor and its impact on the other creditors.

Key Principal

Generally identified as an individual(s) or an entity(ies) owning or controlling twenty-five percent (25%) or greater interest in the project as being legally authorized to do business in the United States; and as having the financial capacity to guarantee 100% of the loan's principal balance.

Lender

A unit of general local government (e.g., City, County, Municipality), a public agency designated by such entity, or a subrecipient, that intends to relend the proceeds of a Section 108 guaranteed loan to third party borrowers.

Liquidity

A measure of the extent to which a third party borrower has cash or assets that can be quickly converted to cash, to meet immediate and short-term obligations.

Loan to Value Ratio (LTV)

The Loan Amount divided by the Appraised Value of the property. A maximum LTV in the 108 program is suggested at 80%.

Net Operating Income (NOI)

For income producing properties, total income from the property, less vacancy, less collection loss and less operating expenses. Capital expenses such as principal and interest payments included in debt service are NOT included when calculating NOI.

Operating Expenses

All overhead and labor expenses associated with the operation of the business.

Performance Bond

A surety bond issued by an insurance company or a bank to guarantee satisfactory completion of a project by a contractor.

Phase I Environmental Site Assessment

A report prepared for a specific property that identifies potential or existing environmental contamination liabilities. A Phase I involves a review of records, a site inspection, and interviews with owners, occupants, neighbors and local government officials.

Property Appraisal

Professional judgments of the market value of real property based on a variety of market factors. A property valuation must be completed by a licensed or certified appraiser in good standing. The appraiser must have experience appraising similar type properties that he or she will be asked to appraise for the Section 108 loan guarantee program.

Property Condition Assessment (PCA)

A PCA provides an extensive analysis of building systems, recommendations for specific repairs or improvements, and funding estimates for long term maintenance. The PCA shall be conducted by a registered architect or licensed engineer and submitted in conjunction with a Phase 1 Environmental Assessment. The objective of the PCA is to identify any physical deficiencies of the property, estimate the remaining useful life of its various physical components, assess the adequacy of its condition and identify items of deferred maintenance and the estimated cost of any needed repairs.

Recipient

As used in this Underwriting Guide, a qualified state or local government that qualifies to receive CDBG funds from HUD, also known as a “grantee.”

Replacement Reserve

The replacement reserve is a method of setting aside funds in a bank account to cover a rental property’s anticipated inevitable future capital improvement expenses. This data can be found in the Engineering Summary Section within a Property Condition Analysis.

Section 108 Loan Guarantee Program

Section 108 of the Housing and Community Development Act of 1974 provides for a loan guarantee component of the Community Development Block Grant (CDBG) Program. The Section 108 Loan Guarantee Program (Section 108) provides communities with a source of financing for economic development, housing rehabilitation, public facilities, and other physical development projects, including improvements to increase their resilience against natural disasters.

Sources and Uses Statement

An important step in the loan underwriting process is a review of construction sources and uses. In all cases, Sources must equal Uses.

Subrecipient

As per 24 CFR Part 570.500 (C), a public or private nonprofit agency, authority, or organization, or a for-profit entity authorized under 24 CFR §570.201(o), receiving CDBG funds from the recipient or another subrecipient to undertake activities eligible for such assistance under 24 CFR 570 Subpart C, "Eligible Activities". The term excludes an entity receiving CDBG funds from the recipient under the authority of §570.204 (Special Activities by Community Based Development Organizations), unless the grantee explicitly designates it as a subrecipient. The term includes a public agency designated by a unit of general local government to receive a Section 108 loan guarantee, but does not include contractors providing supplies, equipment, construction, or services subject to the procurement requirements in 2 CFR part 200, subpart D.

Third Party Borrower

An entity, such as a for-profit business, that receives a Section 108 loan from the Recipient

Third Party Loan

A loan made by a public agency to a third party that will carry out the Section 108 financed project activities.

Third Party Loan Underwriting

The process of evaluating the creditworthiness or risk of providing financing to a specific borrower for a specific project. The underwriting process evaluates both the financial feasibility and the risks of making a loan to a third party.

Title Insurance Policy

An insurance policy that protects real estate owners and lenders against any property loss or damage they might experience because of liens, encumbrances or defects in the title to the property.

Underwriter

The person or entity that acts on behalf of the Recipient and is responsible for determining the financial feasibility of and assessing the risk associated with making a third party loan.