NSP Underwriting Principles Webinar

Tuesday, August 3, 2010

2 PM EDT

Speakers and Session Format

- Speakers
  - Paul Webster, HUD
  - Marsha Tonkovich, ICF
- How to ask questions
  - Change status in Live Meeting from green to purple
  - Press *1 to ask a question through Premiere Conference
    - ✓ Provide Name and Organization
    - ✓ If question already answered, press *2 to remove from queue
  - Change status back to green after question answered

Agenda

- Presentation on key topics:
  - NSP & rental housing summary
  - Multi-family underwriting basics
  - Using the HUD underwriting tool
  - Considerations when financing LH25 rental units
- Open time to take your questions!

NSP & Rental Housing

- Rental housing is common use of NSP $$$
  - ***Eligible Use A*** to finance rental development in foreclosed units
  - ***Eligible Use B*** to acquire and rehab foreclosed or abandoned units
  - ***Eligible Use E*** to acquire vacant land/property and:
    - ✓Construct new units
    - ✓Rehabilitate
    - ✓Reconstruct
    - ✓Convert non-residential to residential

Key NSP Rental Housing Requirements

1. Rents must be affordable
   - Defined in Action Plan
   - HOME is safe harbor

2. Rehabilitation must comply with grantee's standards & local codes/requirements for habitability, quality, safety

3. Households must meet income targeting
   - LMMH Housing National Objective
   - 25% low income set aside

4. Units must remain in compliance for affordability period

Key NSP Rental Housing Requirements – Income Targeting

- Needs to meet LMMH national objective
  - NSP currently requires that 100% of units be rented to households at or below 120% AMI
  - *Coming soon*: revised policy to allow for proportionate funding
    - ✓ Ensure that portion of NSP-assisted units ≥ portion of NSP funding
  - Some units may be counted toward LH25 and designated for households at or below 50% AMI

Key NSP Rental Housing Requirements – Affordability Period

- **Rents:** Must remain affordable during period
- **Incomes & Unit Mix**: Check income of new tenant at unit turn over
  - Unit originally occupied by household at 120% of median, new tenant at $\leq$ 120% of median
  - Unit originally designated for LH25, new tenant at 50% of median
  - Units could float so long as maintain proportion
- **Sales of property**: If assisted project sold, must continue income and rent restrictions for balance of affordability period

Key NSP Rental Housing Requirements – Implications for Underwriting

- Project must be maintained for affordability period
  - Rental income must be sufficient to operate property
    - Sufficient income to pay expenses & debt service
    - Sufficient income to save for reserves
  - Property manager must maintain proper number of NSP-assisted units and document tenant incomes
  - Grantee must have method of ensuring on-going compliance after subsequent sales
    - Deed restriction or land covenant
- Follow sustainable underwriting approach

HUD Underwriting Template

- Originally designed to underwrite HOME multi-family projects
  - Can easily be used for NSP
- Works with tutorial on underwriting basics and how to fill out template
- Can save Excel file for re-use, printing
- http://www.hud.gov/offices/cpd/affordablehousing/training/web/underwriting/

Market Rate Housing

Operating Budget		Development Budget	
Gross Potential Rent	$140,000	Hard Costs	$600,000
Vacancy Loss	($10,000)	Soft Costs	$100,000
Net Rent	$130,000	Other Costs	$50,000
Other Income	$5,000	TDC	$750,000
Effective Gross Income	$135,000	Maximum Loan	($704,000)
Operating Expenses	($60,000)	Equity	($46,000)
Net Operating Income	$75,000	Gap	$0
Debt Service	($65,000)		
Cash Flow	$10,000		

Affordable Housing

Operating Budget		Development Budget	
Gross Potential Rent	$100,000	Hard Costs	$600,000
Vacancy Loss	($10,000)	Soft Costs	$100,000
Net Rent	$90,000	Other Costs	$50,000
Other Income	$5,000	TDC	$750,000
Effective Gross Income	$95,000	Maximum Loan	($429,000)
Operating Expenses	($50,000)	Equity	($50,000)
Net Operating Income	$45,000	Gap	$271,000
Debt Service	($40,000)	Public Subsidy	($271,000)
Cash Flow	$5,000	Remaining Gap	$0

How Much Private Debt Can Be Supported?

- Private loan amount is <u>lower</u> of:
  - Loan by LTV (loan to value) and
  - Loan by DCR (debt coverage ratio)
- Loan by LTV = don’t loan more than lender could recover in foreclosure sale
- Loan by DCR = payments can’t be more than project can afford to pay
- NSP can fill the gap between private loan & project financial need

Loan by LTV

- Loan to value (LTV)
  - Loan amount ÷ fair market value
  - Usually no more than 60 -80%
    - Higher = larger loan amount (and less NSP $$$$ needed)
    - Lower = less risky

Fair Market Value

- Determined by an appraisal
- Evaluate the appraisal (Don’t just accept it as truth!)
  - Three approaches
    - Income
    - Comparable Sales
    - Replacements Cost
  - Ability of appraiser
  - Looking at comparables

LTV (1)

First position loans:

$$\text{LTV} = \frac{\text{LOAN AMOUNT}}{\text{FAIR MARKET VALUE}}$$

Example:

$$\text{LTV} = \frac{\$100{,}000}{\$140{,}000} = 71\%$$

Also:

$$80\% = \frac{\text{Loan Amount}}{\$140{,}000} \qquad \text{Loan} = \left(\begin{array}{l} \$140{,}000 \text{ x} \\ 80\% = \$112{,}000 \end{array}\right)$$

LTV (2) -- Also Known As "TLTV"

Second position loans:

$$\text{LTV} = \frac{\text{LOAN AMOUNT1 + LOAN AMOUNT 2}}{\text{FAIR MARKET VALUE}}$$

Example:

$$\text{LTV} = \frac{\$100{,}000 + \$25{,}000}{\$140{,}000} = 89\%$$

Also:

$$80\% = \frac{\$100{,}000 + 2^{nd}\ \text{Loan}}{\$140{,}000}$$

2^{nd} loan is \$12,000

Loan By DCR

Debt Coverage Ratio (DCR) =

Net Operating Income ÷ Debt Service

- Always > 1
- Lenders typically want 120% or more
  - Provides lender with cushion
- a.k.a. DSCR (debt service coverage ratio)

DCR (First Loan Only)

Example:

Net Operating Income	$11,000	= 1.22 DCR
÷ Debt Service	$9,000	

What if?

Net Operating Income	$100,000	= 1.01 DCR
÷ Debt Service	$99,000	

DCR (2)

Second position loans:

$$DCR = \frac{\text{NET OPERATING INCOME}}{\text{Debt Service (L1) + Debt Service (L2)}}$$

Example:

$$DCR\ \text{(L1 only)} = \frac{\$11{,}000}{\$9{,}000} = 1.22$$

Add 2nd Loan:

$$DCR\ \text{(L1+L2)} = \frac{\$11{,}000}{\$9{,}000 + \$1{,}500} = 1.05$$

Determining Maximum Loan By DCR

- Maximum Loan is a function of:
  - ✓ Maximum Debt Service
  - ✓ Available term
  - ✓ Available rate

Maximum Debt Service =

Net Operating Income ÷ Max DCR

Key Documents to Review

- From private lender:
  - Loan review/analysis
  - Appraisal
- From developer:
  - Development Budget
  - Sources and Uses Statement
  - Operating Budget (pro-forma)

Development Budget

- Classifies & estimates costs
  - Site acquisition & prep
  - Construction/rehab
  - Soft costs
  - Developer payment
- Helps determine if project concept makes sense
- Watch for ineligible costs
  - **Must** follow OMB circulars, in addition to NSP/CDBG rules

Development Budget (abbreviated example)

Development Costs	***Cost***
Concrete	$0
Masonry	$0
Rough Carpentry	$0
Finish Carpentry	$0
Roofing	$0
Sheet Metal	$0
Doors	$0
Windows	$0
Tile Work	$0
Cabinets	$0
Appliances	$0
Elevators	$0
Plumbing and Hot Water	$0
Heat and Ventilation	$0
Air Conditioning	$0
Electrical	$0
Site Utilities	$0
Roads and Walks	$0
Site Improvement	$0
Lawns and Planting	$0
General Requirements	*$0*
Building Permit	*$0*
Builder Overhead	$0
Builder's Profit	$0
Bond Premium	$0
Construction Contingency	$0
TOTAL COSTS	**$0**

Cost Reasonableness

- Two tests
  1) OMB Circulars
  2) Prevailing costs in region
     - ✓ Use guides, local experts, comparable projects
     - ✓ Adjust benchmarks to your project
- Consider creating a review team
  - Local lenders, appraisers, architects, contractors, state HFA staff
- No cost certification required, but may make sense in larger project as verification

Sources And Uses Statement

- Costs and funds to complete the project
- Helps determine how much funding needed to develop property
- Sources = funds to pay costs
- Uses = one time costs

SOURCES = USES

Sources & Uses (partial example)

	Amount	Month
A. Acquisition Costs 1. Land 2. Existing Structures		
B. Site Work *(not included in construction contract)* 1. Demolition/Clearance 2. Site Remediation 3. Improvements		
C. Construction/Rehabilitation 1. Other Site Work 2. New Construction 3. Rehabilitation 4. General Requirements 5. Builder's Overhead 6. Builder Profit 7. Performance Bond Premium 8. Construction Contingency		

Sources & Uses (partial example - cont)

SOURCES	Amount	Month
M. Interim Funding Sources 1. Predevelopment Loan 2. Acquisition Loan 3. Construction Loan 4. Bridge Loan (for equity) 5. Grants		
N. TOTAL INTERIM SOURCES		
O. Permanent Funding Sources 1. Equity Pay-in 2. LIHTC Proceeds 3. Other Proceeds 4. Permanent Loan 1 5. Permanent Loan 2 6. Grants		
P. TOTAL PERMANENT SOURCES		
Q. Cumulative Difference (Cash Position)		

What Is An Operating Budget?

- Used to determine Net Operating Income (NOI)
- Assesses project feasibility over long run
  - Income
  - Expenses
- Projected at least as far as longer of:
  - Affordability period
  - Proposed financing term
  - Look at both lease-up & stabilized costs

Lease-up Vs. Stabilized Operating Budget (abbreviated example)

	Lease-Up	Stabilized
Gross Potential Rent	$ 180,000	$ 180,000
Rent Loss	$ (45,000)	$ (12,600)
Other Income	$ 900	$ 1,800
Effective Gross Income	$ 135,900	$ 169,200
Operating Costs	$ (100,000)	$ (111,402)
NOI	$ 35,900	$ 57,798
Debt Service	$ (50,259)	$ (50,259)
Asset Management	$ -	$ (3,000)
Cash-Flow	$ (14,359)	$ 4,539

Income

- **Income**:
  - **Rents** (paid by tenants)
  - **Other income** (laundry, parking, commercial, etc.)
- **Gross Potential Rent (GPR)**
  - Rent that *would be* collected if
    - All units are rented and
    - All residents pay their rent
- **Effective Gross Income (EGI)**
  - GPR + other income – uncollected rent

Rent Loss

- Adjust GPR due to:
  - Vacancy - look at current market & ten-year variation
  - Concessions
  - Bad Debt

Operating Expenses

- Covers all costs to operate property
  - Does not include debt service
  - Very common area where grantees under-estimate (both costs & escalation)
- Often estimated as $X per unit per year
  - Rules of thumb are usually unreliable
  - Best approach is to benchmark versus recent comparable actual results
  - Consult with state HFA for ideas on typical costs

Types of Operating Expenses

- Marketing
- Administrative & maintenance payroll
- Property management fee
- Utilities
- Services

Types of Operating Expenses (cont)

- Security
- Maintenance
- Real estate taxes
- Insurance
- Other expenses (office expenses, legal, training etc)

Reserve Accounts

- Two common types: operating and replacement
- Operating:
  - Initial reserve to typically help with lease-up
  - On-going reserve in case income shortfall
- Reserves for replacement:
  - Deposits for future capital expenditures
  - Grantees often use standard rule of thumb (e.g., $250 per unit)
    - Better to do property-specific capital needs assessment
- NSP allows initial deposit if required by lender

NOI Also Has To Cover ...

- Debt service – the cost of borrowing money
  - The loan’s **interest rate** and **term** affect monthly debt payments
  - Debt payments include **principal** and **interest**

Looking Forward

- Usually 15 to 30 year pro forma period
- Need to trend income & expenses based on best estimate of actual growth
- Ensure:
  - Income is sufficient
  - Margin of safety
  - Project stays in balance
  - Plan for balloon payments
  - Reserves are adequate

How Developers Make Money

- Many sources of potential $$
  - Developer fees
  - Construction profit
  - Property management
  - Project ownership (equity)

- Watch for *Identities of Interest!*
  - OK for developer to fill multiple roles if:
    - ✓Qualified for task and
    - ✓Within market rates

Sustainability: Key Challenges

- **Can the property survive moderate "income shocks"?**
  - For example, 3% additional rent loss
- **Can the property survive moderate "expense shocks"?**
  - For example, a 7%-10% increase in operating expenses
- **Will the property be able to self-fund its long-term capital needs?**
  - From some combination of reserves, cash flow, and refinancing

Sustainable Rents

- **Start with the lower of:**
  - Maximum rents allowed under applicable affordability requirements
  - Comparable market rents
- **Then reduce to a level that will result in 95%+ occupancy**
  - So that there are enough target households to keep the property full
  - Probably at least 10% lower than indicated above

Sustainable Rent Loss

- Greater of:
  - Current market level of rent loss (current vacancy plus [1%] for bad debt)
  - 5%
  - Long-term cycle average rent loss
- Probably should underwrite at least 7% unless there is strong evidence that rents are well below market

Sustainable Expenses

- Traditional rules of thumb are not reliable. Maybe better would be:
  - Benchmarks based on “controllable” expenses instead of total expenses
  - “Peer properties” as benchmarks
- For sustainability, properties need to be able to survive a 7%-10% spike in operating expenses, for a year or two

Sustainable Reserve Deposit

- Reserve deposit that will be sufficient to cover 100% of 20-year capital needs in combination with:
  - Existing reserve balance
  - Reasonable interest earnings on reserve balances
  - Foreseeable excess cash flow
  - Foreseeable refinancing proceeds
- Consider requiring a capital needs assessment

Trending & Sustainability

- Expenses should trend at general inflation, or perhaps a bit higher
- Rents should trend below general inflation
- Rent trending assumptions should be reasonable in light of recent trends in rents, AMIs, and FMRs

Tips for Underwriting LH25 Projects

- Rents usually established at:
  - Low HOME rents
  - LIHTC rents
  - 30% of adjusted monthly income
- In many markets, reduced rent provides insufficient cash flow to cover expenses

Tips for Underwriting LH25 Projects (cont)

- Check project throughout affordability period
  - Is trending reasonable?
    - Minimal growth of rents over time
    - Expenses growing much faster
  - Does cash flow become negative?
  - Is there sufficient cash flow to pay expenses?
  - Is the return to the developer reasonable?

Tips for Underwriting LH25 Projects (cont)

- If project is initially infeasible:
  - Can assumptions be changed on development budget without affecting marketing?
  - Can assumptions be changed regarding project size (number or size of units)?
  - Can rents be raised and remain affordable?
  - Can expenses be waived (such as taxes)?

Tips for Underwriting LH25 Projects (cont)

- If project is initially infeasible – other ideas:
  - Can financing structure be changed (loans v. grants, more public assistance etc)?
  - Are Low Income Housing Tax Credits available?
  - Is project-based assistance available? (not from NSP)
  - Can the project become mixed income?
- What to do if none of these solutions work?

Available Tools

- NSP multi-family toolkit:
  - http://hudnsphelp.info/index.cfm?do=searchResourceKeywordFacets&topresourcetypeid=11^NSP%20Toolkits
- HOME underwriting tool:
  - http://www.hud.gov/offices/cpd/affordablehousing/training/web/underwriting/
- FAST TA:
  - http://hudnsphelp.info/index.cfm?do=viewTaRequest

Give us your Feedback

- Answer a few short questions
- Link: http://www.surveymonkey.com/s/underwrite