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Moderator: Marsha Tonkovich
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Operator: Good day and welcome to the NSP Underwriting Principles Webinar. Today's call is being recorded. And it's star 1 for questions at any point today.

Marsha Tonkovich: Good afternoon everybody. This is Marsha Tonkovich with ICF and I am joined here by Paul Webster, and I'll ask Paul to introduce himself in just a moment. And you are joining the NSP Webinar related to Underwriting of Multifamily Projects.

So a little bit about myself. I am with ICF and we're one of the TA providers with HUD, who are assisting on NSP Technical Assistance. And we've been doing a lot of work on various types of NSP programs. And also prior to that working on the CDBG Program and the HOME Program and other CPD programs. And so we're looking forward to sharing some underwriting information with you.

Paul, why don't you introduce yourself?

Paul Webster: Okay. Paul Webster - I'm the Director of the Financial Management Division here in HUD headquarters in the Office of Community Planning and Development. I've been working over the years on the CDBG program, really since its inception since 1974.

I've been working on the NSP program since it was implemented in 2008, and other responsibilities include section 108 Loan Guarantee Program. But today I'm going to be in the background as much as I can, and we'll rely on Marsha Tonkovich to lead the presentation. Marsha?

Marsha Tonkovich: Thanks, Paul. So we’re going to walk through a series of PowerPoints. So this one - if you've been on any of the other Webinars you'll know that most of them were predominantly Q&A, with a moderate amount of PowerPoint.

This one, because we’re covering a technical topic and we’re going to show you a tool that’s available to you to use to do some underwriting, we’re going to work through the PowerPoints first.

And then I'm going to show you the tool, and then we'll open up for questions. And depending on how much time it takes for us to get through the PowerPoint, I may also take some questions in the middle of the PowerPoint as well, just to give you guys a chance to chime in.

When you’re ready to ask a question, we’re going to ask you to do two things. First, we’re going to ask you to go to the top right-hand corner of your screen, where you'll see a header that says Feedback.

And you'll see there’s a green dot next to Feedback. See if you can go ahead and go on to that green dot. And if you can change it to purple for Question, we'll know that you have a question that you want to ask.

When you’re actually ready to ask that question and you want to go ahead and get in the queue, press star 1 on your phone. That will put you in the queue for the phone operator.

And then when we take our break and we're ready to answer questions, we'll take them in the time order that they are received. So the first person to press star 1 gets asked the first question and so forth.

And so we'll work through the questions as we go for our next two hours together. If somebody asks your question and you don't want to ask it anymore or you - we've moved on and you've figured it out, feel free to press star 2 and that will take you back out of the queue. And you'll no longer be called upon to ask your question.

Do make sure that when you have had your question answered or if you've taken yourself out of the queue, go ahead and change your dot back to green so that we know that we no longer have a question from you.

We'll try to track the number of purple dots that we have so that we can keep a good pace and get through all of everybody's questions within the two hours that we have, until - from now till 4 o'clock.

Normally underwriting, as many of you probably know, is taught over multiple days and sometimes even multiple weeks. We're going to boil it down into a very short presentation within two hours. So we're going to go through the PowerPoints very quickly, just hitting the high points.

The PowerPoints themselves will be available on the Web site - on the NSPTA Web site, as will the Excel templates that we're going to share with you. And so, you know, if you have questions, if we've gone through it a little bit too quickly, please feel free to reference the Web site and reference the recording of this session as well.

So let me give you a quick overview of our agenda. We're going to start with a quick summary of how and when you can do rental housing under NSP, and what's eligible and what's not. And I'll probably take a quick break after that for questions, because folks may have some questions about that.

We'll then get into very basics of underwriting. How present lenders set the amount of money they're going to be willing to lend in a multifamily deal, and how you as grantees or as developers will look at the rents that you can charge and the incomes of the households that are going to be in our units, and how to look at the feasibility of some of the projects and build in some sustainability into those projects.

I will then show you the HUD underwriting tool, which is a tool that's been out there on the HUD Web site for a long time. But it's really a fantastic tool, and it's a great resource for looking at assisted housing and looking at how to look at the financials of a project with subsidized rents.

And then finally we're going to talk a little about when you're underwriting LH25 or the 25% Set Aside projects, what are some key questions that you should ask yourself?

We are going to focus predominantly on multifamily housing, not single family housing. However, if you have any single family questions we can of course take them. But as you'll see this is predominantly focused on rental housing.

So that's our agenda for today. As I said, we will periodically pause to answer your questions. So, NSP and rental housing. There are many different ways to do rental housing under NSP. And so a quick summary of those - and many of you have probably already been through this.

Under eligible use A, you can use the financing mechanisms eligibility category to provide financial assistance or financial mechanisms to develop rental housing when the units are foreclosed or were foreclosed.

Under eligible use B, we can acquire, rehab and either resell to another developer or owner or acquire, rehab and own rental housing where the property was formerly foreclosed or abandoned. We're not doing new construction there; we're just predominantly acquisition or acquisition with rehab under eligible use B.

Then under eligible use E, we can acquire vacant land and property and use that to - that vacant land or property - to construct new rental units. So unlike ((inaudible)), we have difficulty in doing new construction, under NSP it's perfectly eligible under eligible use E.

We can also rehabilitate. So we could acquire and rehabilitate existing vacant land or property. We can reconstruct. So reconstruct is to take an existing structure and demolish it - or it could have formerly been demolished - and again, that structure has to be vacant because it's under eligible use E - and then we will rebuild a similarly sized project on the site.

So if it's single family, we'll go back to single family. If it's multifamily, we'll build back the same number of dwelling units, although not necessarily the same number of bedrooms, but the same number of dwelling units - back on the project site.

It does not have to be on the same foundation. It could be located somewhere else on the site, but it does have to be back on the same project site. And that is reconstruction and is eligible under NSP eligible use E.

Finally we can do conversion. So we could acquire vacant non-residential structures. So an old school, an old hotel, an old office building. And we could convert those non-residential structures into residential units. As long as we remain within the building envelope, the existing four walls of the building, that would be considered to be rehabilitation.

If we decide to go beyond that and expand the size of the structure and add additional units on or additional size of the structure, that would then be new construction and again, eligible under eligible use E.

So key things about NSP rental units that you need to know as you're thinking about underwriting at the very beginning. First is that your rents do have to be affordable. And that's going to be defined in the action plan.

So if you're a developer and I do have some of the ask-a-questions that are on the NSPTA Web site, and we've recently had some questions about what an affordable rent is, or how it's defined.

You want to go back and look at the action plan that the grantee submitted to HUD. And within that action plan they will have defined what an affordable rent or how they're going to look at affordable rent within your community.

What the notice - the NSP initial notice said was that the HOME rent structure - so the high and low HOME rents, which are published on an annual basis for the HOME program - were a safe harbor.

And so many jurisdictions elected to adopt the HOME rents as their affordable rent. Some jurisdictions chose other options, but HOME is the most common. So when we look at our underwriting, we have to make sure that we're underwriting at an affordable rent.

Secondly, we need to look at what scope of rehabilitation we're going to do. And we have to make sure that at the end of the day when we're done doing rehabilitation or if it's reconstruction, reconstruction, has to comply with the grantee standards and codes. So we do have to make sure that we're following our own local laws relating to that.

Third, the households that we assist must meet the national objective for NSP that that will typically be occupancy in these units by households who are at or below 120% of area median income or the low middle income housing national objective.

So 120% of median and below for most of these units. And we do have to document the income of those households who are occupying the NSP assisted unit.

Or we may have some of the units - and in some cases all of the units - that we have counted toward the 25% set-aside. So we've counted the expenditure toward the LH25 Set Aside, where those units are targeted at households who are at zero to 50% of median.

So we may have a mix of 120 and zero to 50 or you may have entirely 50. And we also have market rate units in there as well that are unassisted. So we may have a mix of any of those combinations.

One of the questions that we've had from folks recently having to do with unit mix - we'll talk about in just a moment how many units have to be NSP assisted.

Finally the units have to remain in compliance with these requirements - and we'll talk about which specific ones - during the entirety of the affordability period. So unlike CDBG, which doesn't really have an affordability period, NSP requires that we establish an affordability period based upon our amount of investment and our type of activity at the site.

And it could be anywhere from 5 to 20 years, depending on whether we did rehab or did construction and depending on our level of investments. And we have to record that affordability period and then comply for that entire affordability period with the rents and with the rules about occupancy that we'll talk about in just a moment.

And we're required to make sure we have an ability to enforce that, that we have a way of enforcing those requirements.

So in terms of the income targeting mentioned earlier, there was an FAQ that came out about two years ago that let people know very early in the program - that let people know that you could do a proportionate funding.

In other words, if you funded 30% of the units with NSP or 30% of the money with NSP, we wanted 30% of the units. Similarly, if you did 30% of the units, you could put 30% of the money in. So it's proportionate, which is different than the way that CDBG works; however, there's a little bit of confusion around that policy. And so just know there will be some clarification coming out about that to make it clear how that is eligible and when it is eligible.

So if you're doing something where you're doing mixed income or mixed use and you want to look at proportionate funding, watch for a new notice coming out about that in the next month or so.

In addition as I mentioned earlier - in addition to the 120% targeting, we may have some units which we have counted toward the LH25 targeting and who are occupied or which are occupied by households of zero to 50% of median, you will see that you have to maintain that designation throughout the affordability period. And we'll talk about how that works in just a moment.

So things to know during the affordability period. First, the rents do need to remain affordable as defined by the grantee. So if you've deferred to the HOME rents and the HOME rents go up during the affordability period, you will continue to monitor that project during the 15 or 20 or however long your affordability period is. You'll continue to monitor that project and ensure that the owner is charging those affordable rents on an annual basis throughout the affordability period.

Secondly, you need to look at the unit mix and so one of the ways that NSP is different than either CDBG or HOME is that you're going to look at the income of tenants at the point of unit turnover.

In other words, if someone is living in the unit and they haven't moved out and they're there continually throughout the affordability period, you're going to check their income when they first move in. But you don't have to check them - you don't have to recertify them on an annual basis.

However, if that existing household moves out during the affordability period and a new household moves in, that new tenant you - there will be a requirement that the owner or the grantee on behalf of the owner - check the income of the new tenant.

And depending on whether that tenant is in a unit that was designated for households at 120% of median, they'll have to be at that income interval or below. Or if that tenant was moving into a unit that was designated for LH25, that new tenant will have to be at 50% of median and below.

So the income targeting - 120% targeting and the 50% targeting - remain throughout the affordability period. Units can float in a way that HOME allows units to flow, where one unit might be at 25 or 120% unit today and then if the person moves out maybe you're short on the 50% units, and so you designate it as a 50% unit tomorrow.

As long as you're maintaining your proportion of 50% units and 120% units, they can float among the various units in the project. But the key is that you have to maintain this income targeting throughout the affordability period and document that throughout the affordability period.

Finally, the third key thing during the affordability period is you have to look at the sale of the property. The grantee is required or the developer is required that if they're selling the property during the affordability period that secondary purchaser must continue the income and the rent restrictions for the entirely of the affordability period - for the balance of the affordability period.

But just because there's been a sales transaction doesn't wipe out the requirement. And so we recommend to folks that they have a land covenant or a deed restriction or some other way of enforcing at the time of sale the grantee is notified if in fact this transaction is occurring and can therefore ensure that the secondary owner understands the requirements that they're buying when they buy this property.

Okay, before we move on to implications for underwriting, Paul, anything to add about the NSP role that we've covered so far?

Paul Webster: No. I think that you've covered it very well.

Marsha Tonkovich: Okay, great. All right, so let's talk about what all that means as you're - if you're underwriting a rental housing deal. First thing is that if your rents are going to be constrained at the affordable rents, however that has been defined by the grantee, then you need to make sure that that rental income, whatever it is, is sufficient to pay for the expenses and the debt service on the property throughout the balance of the affordability period.

In other words, are they going to have enough cash flow to be able to operate this property during the affordability period, because we have requirements that we have due again continue to operate these rents, continue to operate for this income targeting.

And so we need to look not only at the initial occupancy, but is the project feasible over the entire affordability period? So, that rent constraint will have a significant impact on our underwriting.

The second thing is, you know, is there enough income in addition to paying our expenses and our debt service to save enough money to keep the units maintained and at a reasonable quality throughout the affordability period, so that we don't end up having lots of vacancies and people moving out because the units are substandard. So do we have enough income to save for reserves in order to be able to maintain these units and to repair them if we need to?

Secondly, we do need to have a property manager who understands the unit mix that they've signed up for on the NSP assisted project. And they understand how many of the 120% they have and how many at the 50% of income they have, and how to maintain that mix over the full affordability period and how to document the income of tenants whenever we have that unit turnover.

Finally, as I mentioned, we do have to have a way of ensuring that subsequent sales follow the rules. And I mentioned that we would look to see a deed restriction or a land covenant in order to record that requirement.

So as you think about all these things, what we’re really suggesting is that you need to think about underwriting as being sustainable. But do we have a sustainable project which will be able to be healthy and financially viable throughout the affordability period? And we’re going to share with you some tips and techniques for how to think about that.

Okay, so before I move on to the HUD underwriting template, I'm going to ask if we have any questions. So skimming the list here, I don't see any purple buttons yet. But I'll go ahead and ask our operator - do we have anybody in the queue, Robbie?

Operator: We currently don't have anybody in the queue. Again, it is star 1 if you have phone questions.

Marsha Tonkovich: Okay, so we'll give it just a moment if anybody would like to get in the queue to ask any questions on what we've covered so far. Robbie, anybody?

Operator: We do have a question from Patricia Jones with NENA.

Marsha Tonkovich: Hi, Patricia.

Patricia Jones: Hi. So I have just a logistics question. Are we going to be able to get this PowerPoint? It’s a lot of information to - I guess are you going to provide that in any kind of way?

Marsha Tonkovich: Yes, absolutely. It’s actually going to be in the NSPTA Web site along with the recording, and the Excel templates as well.

Patricia Jones: Okay, great. Thank you.

Marsha Tonkovich: No worries.

Patricia Jones: Okay.

Marsha Tonkovich: That was an easy one.

Operator: You have another question.

Marsha Tonkovich: Okay.

Operator: You do have another one from Chris Dettling with PPL.

Marsha Tonkovich: Hi, Chris.

Chris Dettling: Hi, I just wanted to follow up on a comment on the availability of the PowerPoint.

Marsha Tonkovich: Yes.

Chris Dettling: What I - on the bottom of the screen when you print it - you can choose to print it and then you can save the file.

Marsha Tonkovich: Yes, yes.

Chris Dettling: Unless you want to save it now instead of waiting for it to be online.

Marsha Tonkovich: Thank you Chris. That's a great suggestion. Okay, anybody else?

Operator: We do have a follow-up from Patricia Jones.

Marsha Tonkovich: Okay.

Patricia Jones: I apologize; I thought I was coming out of the queue first.

Marsha Tonkovich: No problem, Patricia.

Patricia Jones: Thank you.

Marsha Tonkovich: Okay. All right, so what I would like to do now is show you a template that exists on the HUD Web site right now that you can download. It's in Excel. It was designed originally for the HOME Program.

But as you - as I just mentioned, the HOME rules on - are referenced in the NSP rules periodically. And so the template really works for both programs and I've actually used it for NSP. It really proves to be an excellent way of looking at multifamily deals.

So I'm going to show you where it is on the HUD Web site, and I'm going to walk you through because it's a little bit varied on the HUD Web site. And then we're going to come back to it as we get to the end of the call. And I'm going to show you a couple of sample projects and how it might be used.

So with that I'm going to try to see if I can share my screen with everybody. Okay, so everybody should be seeing the HUD Web site. Paul, are you seeing the HUD Web site?

Paul Webster: I am.

Marsha Tonkovich: Okay, terrific. All right, so let me walk you guys through where to find this template. And as I mentioned it is a little varied. You're going to go to hud.gov, which is HUD's official Web site.

And then you're going to go to Program Offices and you're going to go down to Community Planning and Development, which is a part of HUD where NSP lives and where CDBG and HOME are housed.

And so now you'll be at Community Planning and Development, and there's Secretary Márquez. Now let me go down -hold on for just a second. There we go, just moving a little bit slowly. Okay, let me try to go back - there we go.

Okay, so we're going to go down under Community Planning Development, and we're going to go to the HOME Program. Under the HOME Program you're going to want to go to HOME Training on the right-hand side.

And then you're going to want to go to Web Based Training HOME Front. And then finally you're going to go to the bottom of the page and you'll see it says Underwriting Multifamily.

And so here you have a Web-based tutorial that'll do a lot more detail on everything that we're talking about today - rents, development costs, operating costs and so forth.

And as a part of that if you look at where it says "About the HOME Multifamily Integrating Template and Getting Started," there is a way we could go through this module. It will allow you to download the Excel document, which is the underwriting template that this Web module coordinates with.

So there's both text to teach you more about underwriting as well as an Excel document that I will show you here in just a moment. That is a multi-faceted underwriting template. So that's where you find it.

So that's where the template is. We'll take an actual look at it in just a few moments, but I did want to let you guys know that it was there and where to find it. And then you have the Web site here on the PowerPoint as well if you want to go to the exact address.

So let's jump in a little bit and talk about underwriting and some key underwriting principles. So one of the things that I think if you come from a perspective is difficult to kind of put together is why is it that we end up having a gap in the public projects, but particularly in the public multifamily projects that we do?

Why is it that we as public agencies have to invest in affordable housing? And the reason is pretty clear when you look at the numbers. If you look at a typical market rate deal - and you'll see as an example of one here. And if you look at the rent that is being charged and the expenses and so forth, the way that private lenders think about how much money they’re willing to lend on a deal like this is based upon the cash flow.

In other words, how much income - how much net operating income is there that’s available to pay for debt service? Do they have enough money to pay me back is the bottom line. And based upon that debt service, they will then establish a maximum loan that they are willing to lend.

And so in this example, given rents of $140,000, this project can afford a loan of $704,000 from the lender. However, if you look at an affordable deal, where when you think about what you’re doing in an affordable deal, what you’re doing is you’re constraining the rent.

You’re saying, "We’re not going to allow anybody to charge any more than x amount for rent." That in turn constrains the income to the project. And so even if you keep everything else constant, if you use same vacancy loss as a percentage, same expenses and so forth, and solely all that we do is that we say, "Okay, we’re not going to allow you to charge the market rent. We’re going to charge an affordable rent."

What that does is it affects the net operating income in the project. It says once we've paid all those constant expenses and all those other (head) vacancy and so forth. The cash that I have left over to pay for debt service if you look in my example is now down to $45,000 which supports debt service of $40,000 - they want to have a cushion there.

And so a debt service of $40,000 - this is a maximum loan of $429,000. So when we constrain the rent, the lender is willing to lend less because there is less income, and therefore we end up getting a gap in the project where when we look at all the costs and we look at how much the private lender is willing to lend, we have an amount that is not covered.

And so our job as a public lender is to look at ways to fill that gap and so that's the reason why we're looking at gap financing when we talk about affordable lending.

So how much is the private lender going to be willing to lend? That's one of the - as you're looking at underwriting of these multifamily NSP deals, that is one of the first questions you have to ask yourself. How much leverage - how much other funds can I get in this deal before I decide how much NSP money to put in?

So the private lender is going to look at the lower of the loan by loans value - in other words, what the property is worth and my loan against that value - and the loan versus the cash flow that we just looked at at that coverage ratio.

Well, I'll talk about or calculate those in just a moment. The reason for that is that the lender's perspective on this - the private lender's perspective - is that they want to make sure they're going to get made whole.

And so loan to loan - loan by loan to value says I'm only going to lend a portion of the value of the property so that if we have to go to foreclosure I can get my money back, because I'm not - I haven't put the full amount of debt on the property.

And as you can imagine in recent years, that loan to value ratio has begun to come down. The loan by debt coverage ratio says, okay, but do they have enough cash to pay me back? And so we're going to have a cushion in that as well.

NSP is then the source that’s in the middle to make up that gap. So the loan to loan value says, okay, most lenders are going to set a loan to value ratio which says, "I'm not going to lend 100% of the value based upon an appraisal, but rather I'll lend somewhere between 60% and 80% of the value." And as you can probably guess, these days we’re more toward the lower number than the higher number.

And that will establish how much I'm willing to lend so that I can make myself whole in the case of the sale of the property or foreclosure of the property.

Fair market value is typically determined by an appraiser and the appraisal and there are lots of different ways they do that. And I'll get back because many of you in NSP have looked at appraisals many, many times over the last couple of months.

So loan to value ratio is then calculated as the loan amount over the value. And that creates a ratio. And so we can solve - if we know the ratio we can solve for the loan amount. If we know the loan amount we can figure out what the loan to value ratio is. We can solve either way.

But that will constrain how much the lender is willing to lend. But what if we have more than one loan? So for example, let’s say we have a second position loan which has an equal claim on the property in the event of a foreclosure.

Well, then we’re going to add both loans together over the fair market value and that will help to create the loan to value ratio. And so you can see the more debt you put against that property value, the higher that loan to value ratio goes.

Now, the second method that the lender’s going to look at. The private lender is going to say, "Okay, but how much cash is covering my debt?" And so we’re going to take the net operating income or that's rent minus expenses, that cash that's left over and I'm going to divide that by the debt service to give me something called the debt coverage ratio.

In other words, how much cushion do I have between the income and the amount of money I have to pay to pay off the lender to pay the debt service? Lenders obviously always want more than one, right, because they want to have more income than I have due in terms of the debt service payment.

These days a typical cushion is around 120%. We've heard people even going up as high as 130% so if you see lender that's in that range it's not uncommon these days because they want that extra cushion. How that's calculated - so you take the NOI and you divide it by the debt service and that gives you the debt coverage ratio.

Similarly if we have two different loans - in other words we have two different claims on that net operating income - we both are going to get paid, then we're going to add together those loans to create the ratio.

So the net operating income over loan one plus loan two will give us what is the riskiness of paying back both of these loans. And again some of this the way the lender will look at it will depend upon the lien positions and the claims against, you know, who has a right to claim that income.

So the maximum loan then that a lender will be willing to lend is going to be a function of the debt service, the term and the rate. But they're going to look at the net operating income divided by the debt coverage ratio to tell me what is the maximum debt service that this property can support.

Once I know the debt service I can back into the loan. So that's kind of the private lender's perspective and it'll constrain how much they're willing to lend.

Now let's talk about it from the public perspective. So from the public perspective you're going to want to get a couple of different things from your partners. From your private lender you're going to want to get copies of that analysis that I just looked at and how did they decide, what are - what is their debt coverage ratio, what is their loan to value ratio, how are they constraining, how much they're willing to lend as well as the appraisal that backs that up.

From your developer you're going to want to get a copy their development budget. So the development budget is the list of all of the construction and acquisition costs - all the costs to develop the property. So it'll include both hard costs and soft costs to develop the property.

You're also going to want to get a Sources and Uses Statement. So the Sources and Uses Statement takes the development budget - all of those costs and then it says okay, well how am I going to pay for those? What are my sources of funds to cover my development costs? And hopefully those two things even out.

Thirdly, you're going to want to get an operating budget or otherwise known as a pro forma. That operating budget is a projection of the expenses and income over a certain period of time and we'll talk about what those time frames are.

So if I'm a grantee on an NSP and I'm working with a developer I want to be requesting all of this information as a part of my review of their proposal, review of their application packet and so forth.

So let's talk about the development budget first. So the development budget classifies costs into specific line items. So there are costs for the acquisition, and the site preparation, and the roof and so forth as well as all of the associated soft costs and the fees that are being charged by the developer.

So we'll have on there the construction profits, the construction overhead for the construction contractor as well as the developer's fee and his associated costs.

And you're going to add all those up and that'll give you the total development costs for the project. You will - you as the grantee will review that and say, okay well does this make sense, are all - is it financially viable, are all the costs eligible, are they in compliance with the circulars in terms of reasonableness and the other associated rules.

So here's an example - this is just an extract, this isn't the - obviously you can tell it doesn't have all the different types of construction costs but an extract of what a development budget might look like.

So all the different types of cost categories and the cost - and sometimes you see these also - some of these line items will either be divided out by square footage or sometimes as a per unit cost with a total cost as well.

So then you're going to look at that and you're going to look not only for eligibility but cost reasonableness and say, okay well does that development budget make sense given what is reasonable and customary in my community?

And you're - and you're going to look to - OMB Circular 87 which specifies some things that are reasonable and some things that are never reasonable in a federally assisted project.

And then you're also going to look at what are the common costs in my region, how much do these things typically cost in order to do roofs or sidewalks or whatever it might be in your community.

One of the things that we get a lot when we talk about NSP and when we talk about looking at costs is well what is a reasonable developer fee? How do I determine what the right fee is?

And there is no one right answer. It's going to depend upon your market and what's reasonable and customary in your market but it's also going to depend up the project itself. How risky is it?

Is it a complicated multi-layered financing deal serving a very difficult to house population - in which case perhaps the fee will be higher? Is it a very simple fourplex, you know, done a thousand times by this same developer - very routine? Perhaps then the fee will be lower.

So the grantee is going to have to come up with some guidelines about what is a reasonable cost and what a reasonable fee is and then develop some policies and procedures around that for reviewing deals.

We also do recommend that you consider creating a review team of non-conflicted - so you wouldn't choose anybody who's developing a deal - but non-conflicted parties in the community.

So lenders who aren't lending on your NSP deals, or appraisers aren't approving your NSP deals, or if you have anybody from the state who lives in your community or sophisticated non-profit developers creating your project review team to give input to the grantee about here's some concerns about this deal or these costs don't look right or whatever it might be.

NSP doesn't require that after the end of the day when the construction's done and when you're looking at the cost estimate and then the conclusion of the cost that you do a cost certification.

In other words an audit of the construction costs. However, many projects do - particularly larger projects do a cost certification where you have an auditor go out at the end of the construction period and look at all the bills that were charged and say yea indeed these costs were in fact eligible - they were in fact anticipated based upon the original development budget.

If you're a grantee who's listening in you may want to consider requiring a cost certification as a part of your construction process so that you ensure that the bills you paid and the cost that you paid for things are what you expected to be able to pay at the beginning of the project. So that's the development budget.

Let's move on to the Sources and Uses Statement and then we'll go ahead and take a break for questions. So the Sources and Uses Statement is similar to the development budget.

It takes the development budget but what it does is then says, okay given these costs to develop this - the total development costs of the deal - what are the sources of financing I have in order to cover those costs and what are the timing of those?

In other words I might have costs that I have to incur up front like acquisition or appraisals or so forth. And the question is: when is the money available to me? Is it available at the beginning of construction or maybe it is tax credit equity that doesn't come in until later. And so you want to look at the timing of that money as well as the amount of that money.

And so here's an example of a Sources and Uses - again a subset of the Sources and Uses Statement. So you have some uses here and you'll see that you have the amount of the use and then the month that cost is going to be incurred.

So for example, you might have a very large acquisition cost at the beginning or a very large demolition cost at the beginning. You need to make sure that you understand the inflow and outflow of money.

So here's again an example of the second part of the Sources and Uses which is the sources and so you have both the interim financing, the construction financing and then the permanent financing. And obviously you would have had all the other costs previously described.

And so you can look at that month by month and for total what is my cash position? In other words how much do I have available to pay for costs and what are the costs likely to be for that month?

And so we do recommend if you're - if you're doing a large development deal that you not only do a Sources and Uses Statement at the point in time which most people do but that you actually do look at it over time to make sure that the developer won't be short on bills in a particular month.

So before we get into operating budget I want to open up to some questions or - first I'm going to start with Paul. Paul, anything you want to add to what I've done so far?

Paul Webster: No, again I'm just enjoying your presentation.

Marsha Tonkovich: Okay. All right so...

Paul Webster: So far, I really don't have anything to add yet.

Marsha Tonkovich: Okay, all right, perfect. So Robbie, do we have any questions in the queue?

Operator: Yes, we do. First we'll go to Melissa Ehlinger with New Orleans Redevelopment Authority.

Marsha Tonkovich: Okay. Hi, Melissa.

Lois Colson: Hi, actually it's Lois Colson with Melissa. I'm having Melissa put it in now so you guys will take my questions. So I'm just kidding. Question about the last couple of slides and ineligible costs versus - I guess well to be very specific.

Developer fees is an ineligible cost in the budget entirely or could you elaborate on for example this situation where you mentioned the tax equity and a lot of these multifamily projects especially will have the low-income housing tax credits and that - those budgets for the tax equity allow for a developer fee, I mean in fact they - I think they actually would rather have development fee - developer fees than all of it broken out into these little pieces.

Marsha Tonkovich: Yes.

Lois Colson: How are you guys addressing that? Because we're coming into a bit of a challenge. If we're not paying for the developer fee with NSP2, would it be allowed?

Marsha Tonkovich: It is allowed. And developer fees are perfectly eligible under both those ((inaudible)).

Lois Colson: Oh, wait, wait, wait. Let me stop you. I'm sorry, because there's a huge - there's a huge stickler here. This is our consortium member who is the developer.

Marsha Tonkovich: Ah. Okay.

Lois Colson: Yes, sorry.

Marsha Tonkovich: Okay, that adds a twist. So let me answer the question generically for everybody else who's on the phone.

Lois Colson: Okay.

Marsha Tonkovich: And then let's talk about NSP2. So for everybody who's on the phone - there has been a misunderstanding about developer fees, thinking that they're somehow ineligible because they're profit to the developer.

Developer fees are perfectly eligible. If you have an arm's length developer or a non-union developer and the development fee that you're paying them is reasonable, as I mentioned given what's customary in the community and the difficulty of the project and all that good stuff, developer fees are perfectly reasonable.

They're typically not paid out until the construction is completed, sometimes even after that point, depending on the cash flow of the project and so forth. And you need to negotiate that with the developer.

But developer fees are perfectly eligible as they are reasonable. The issue with NSP that I think New Orleans is raising has to do with consortium. And what happens in consortium is that we have some consortium with our developers who are members of the consortia.

And so that developer was part of the applicant to HUD for NSP2. And when NSP2 was awarded to the consortium, the developer was therefore an awardee as part of the consortium award.

And so the policy that HUD came out with at that point was, okay, well if they were part of the original applicant for the funding and they were part of the group that won the funding, then they are not a separate arm's length developer but rather they are a part of the grantee.

And so as a part of the grantee they are treated as the grantee and technically not as a developer, even though they might- that might be what they do all day long some other place, they cannot earn a developer fee.

They cannot make a profit, because they are the grantee and as you - as many of you on the phone know, grantees and sub recipients are not allowed to earn a developer fee. They're not allowed to earn a profit.

They get their costs fully covered, but they don't earn a developer fee. And so a developer who's a member of the consortium isn't really a developer. They are in fact the consortium. And therefore there is no developer fee for that member. So I think that's the issue you guys are getting at, right.

Lois Colson: Yes, exactly.

Marsha Tonkovich: Okay. So what's - so what do you guys want to be able to do?

Lois Colson: Well, they are - it's pretty much what you said. I mean, they are technically a consortium member but they haven't given up their developer role. I mean they're not going to go out and hire a developer, because that's what they do.

Marsha Tonkovich: Okay.

Lois Colson: So they - it's misleading, misunderstanding at the very beginning of what it would mean to us to have them be a consortium member.

Marsha Tonkovich: Yes.

Lois Colson: So now we're in a position - we'll be - we don't even know how to break out that development fee into something that is...

Marsha Tonkovich: I think...

Lois Colson: Sorry, I didn't want to break the line (tech) equity into the deal so they want to charge a developer fee on that portion.

Marsha Tonkovich: Ah. Okay. So what they want to do is proportion the total development cost so that we can say, okay, 50% of it is NSP - just to make up a number - and 50% of it is tax credit. And therefore I can get a fee on the tax credit portion but not on the NSP portion. Is that what they’re saying?

Lois Colson: Yes, I mean I think that they'd like to get whatever they would have gotten under the tax - if the NSP money wasn't in it.

Marsha Tonkovich: Yes.

Lois Colson: They were just doing the tax credit deal, they want to be able to charge the developer fee that they would have charged except for NSP. And so they’re wanting - NSP money is not used to pay it, is it okay?

Marsha Tonkovich: No, it’s not a matter of whether NSP is used to pay it or not. It’s a matter of whether they can earn it or not on the NSP unit. So for the NSP portion of the project - so forget the tax credit portion for a second.

For the portion of the development cost which is attributable to NSP, they cannot earn a fee. It doesn't matter who - whether they pay it out of tax credits or you pay it out of CDBG or HOME or whatever - they cannot earn it on the NSP portion of the deal.

Lois Colson: Okay.

Marsha Tonkovich: So they're not going to be able to earn what they would have earned if it had, you know, if it had been a pure tax credit deal, because a portion of the total development cost is being paid for by NSP and that...

Lois Colson: But they could - they could pull out whatever portion is earned on the tax credit fees and have it be paid under that?

Marsha Tonkovich: Yes, but I'm going to let Paul jump in here, because we did have a series of questions about this, Paul, a couple of months ago. And I believe that is the answer that HUD has given.

Paul Webster: Well, I wasn't involved in that exchange, so I'm not quite sure what the answers were, quite frankly. But it really gets down to which entity is carrying out the actual work - which entity is developing the property.

If it is a part of a grantee, then that entity is subject to the cost principals under the applicable OMB circular which in most cases would be A-122.

And that circular authorizes the recovery of all costs associated with a project like this, including indirect costs. But it does not provide for any increment above cost which would be the profit associated with a transaction.

So if an entity that is carrying out the work with NSP funds is part of the grantee then it simply is not permitted to earn a profit or charge that profit to the NSP Program.

If there's a - another contributor to the project - and I'm trying to grasp exactly how this - the ownership structure would look in a situation like this - then that entity, if it's not part of the grantee, if it's a - if it's not a sub recipient, if it is a developer in the sense that we're talking now then yes, it can earn a fee on whatever it's doing with non-NSP funds. So that's - if that's - I believe that's what you were getting at, Marsha.

Marsha Tonkovich: Yes, that's consistent with what we said before.

Paul Webster: Right.

Marsha Tonkovich: Does that make sense to you guys in New Orleans?

Lois Colson: Yes. It's a...

Paul Webster: But it seems to me that...

Lois Colson: But it doesn't help, but certainty helps, but...

Paul Webster: It's not the answer you wanted to hear, obviously, and I understand that. We actually sympathize with you on that point but there's not much we can do.

Lois Colson: But the other advice would be then to just break out that developer fee into every little piece. And imagine for indirect costs and profits associated with it and costs.

Paul Webster: Yes, that's - to me that's...

Lois Colson: These are not fees, but whatever we can think of to call it and sort of break it out with a description.

Marsha Tonkovich: Well, I'd be careful because you have to have an actual cost backup.

Lois Colson: Right.

Marsha Tonkovich: So usually things like fees don't have a bill from somebody. You don't have a contractor that you're paying for that. So you don't have a roofer or something you're paying. So you know, I think spreading it among the line items isn't going to help you.

I think what helps you is to look at the total development cost and look at the portion of the total development cost that is being paid for by somebody else - tax credits, CDBG, you know, whatever.

And pay the portion of the fee that would be attributable to that total - that part of the total development cost. And unfortunately, your partner is going to have to forego the fee on the part that's attributable to NSP.

Lois Colson: Okay. But they could have costs associated with those other funds.

Marsha Tonkovich: Yes, well, and assuming the other programs allow it. Whatever they'll - you know, eligible under those other programs, obviously.

Lois Colson: Right. All right.

Marsha Tonkovich: And again, you know, your developer colleague can get all their costs paid for, as Paul just said. So they can have all their fees and all of their, you know, staff who work on this and this project and everything else can all get paid for. It's just that profit that's the problem.

Lois Colson: Right, okay.

Marsha Tonkovich: All right?

Lois Colson: Thanks.

Female: Thanks.

Marsha Tonkovich: No problem. So Robbie, do we have anyone else on hold?

Operator: Yes, we do. Harry Islas with San Joaquin County.

Marsha Tonkovich: Okay. Harry?

Harry Islas: Yes, thank you for taking my call. Is it customary to include the acquisition costs in calculation of the developer fee for a multifamily complex?

Marsha Tonkovich: I think it would typically depend upon how the deal is being structured. I've seen some deals where there are two different entities involved, and one’s acquiring it and one’s developing it. And so in those kinds of strange situations I would say no.

But in a situation where it’s an acquisition rehab deal, you’re typically looking at the total - at a reasonable fee on the total development cost which would be inclusive of acquisition in my experience at least - I don't know. Paul, what do you think?

Paul Webster: Yes, I agree. You have to look at each individual deal separately. But from what I've been able to - my research on this - the source for a lot - for the best information can be on how to charge a developer’s fee. What the base would be for applying the percentage is through the policies that housing finance agencies have adopted.

Because they have - they deal with these kinds of projects all the time and they have developed some fairly sophisticated ways of dealing with developers' fees.

So you might want to - in the state where you're located you just might want to check the housing finance agency's policies on developers' fees. And they typically have, you know, fairly sophisticated ways of allocating those fees. So something you might want to look at.

Harry Islas: Yes. We're kind of at an impasse here. We're told that it is customary to include in this case. But it's the developer using NSP funds from the grantee who acquired and will rehabilitate and then operate a multi unit project for the 25% Aside tenants.

And their position is that the acquisition cost is included in calculation of the developer fee. This is our first project and we were uncertain. It seemed to us that if NSP funds were given to them to take ownership then there's - then there's no development in assuming ownership if the development fee would be based on the rehabilitation and operation.

Marsha Tonkovich: Well, you could certainly have that as a policy. There would be nothing inappropriate with that as a policy. The - from the developer's perspective, I think they would say that they're taking on the risk of the entire development process, from acquisition all the way on to lease up and everything else in between.

And so, you know, it - acquisition is only one step in that process. And so I think there's a - you could reasonably say it's fair to look at the developer fee for the entire, you know, cycle of the acquisition. But that fee should be a reasonable percentage.

And again, I agree with Paul. I think I would talk to my state FHA as well as some other jurisdictions around me to see what is customary in your market, because it may be in your market it's not customarily added in. But I would - you know, I would check around and see what's customary around you.

Harry Islas: Okay. I have another question regarding reserves.

Marsha Tonkovich: Sure.

Harry Islas: This may be part of the pro forma. Is it permissible to use NSP funds to establish a multipurpose reserve for say capital and operating improvements at the beginning of the project?

Marsha Tonkovich: It is permissible if the private lender has dictated that such a reserve shall exist. So what the NSP rule has come out and said is if the private lender on the project has said in order for me to be willing to lend whatever amount on this deal the developer has to put up or the owner has to put up a reserve of this amount as an upfront deposit, then I wouldn't probably mush together operating reserve and reserve for replacement. I would separate those out.

But whichever one the developer has - the lender has required, NSP will allow you to introduce a reasonable deposit to either one of those or both of those if dictated by the private lender.

Harry Islas: Okay, there is no private lender involved here. So as long as it's reasonable then NSP funds can be used for separate reserve accounts?

Marsha Tonkovich: Unfortunately - and I'm going to let Paul at this point - you know, Paul is with HUD - give the official policy on this. But what the Q&As have said about that is unfortunately if there is no private lender who is dictating the deposit to the operating reserve, then there is no requirement that you do it and therefore you cannot do it under NSP. Is that still policy, Paul?

Paul Webster: Yes, that's what we've said in response to these questions. But again you have to differentiate operating reserves and other kinds of reserves.

Harry Islas: Capital improvements?

Paul Webster: Capital improvement reserves typically for - if you're talking about the grantee or sub recipient owned projects, they would be funded from annual cash flows - the project. But - and I can't remember actually whether we've responded to a question on capital reserves specifically on this.

Marsha Tonkovich: You have not yet.

Paul Webster: Yes. But normally that would be something that would be funded from annual cash flows. And I think the presentation that Marsha is giving talks about what we'll give - what we'll continue on - talks about those kinds of contributions being permissible in ordinary - certainly for developer-owned projects. And also I think for the grantee-owned projects.

But I think that if - the burden would be on somebody who's coming to us with a question as to why it is necessary if you don't have a lender involved, why it's necessary up front to establish a reserve when you can fund that from annual cash flow.

Harry Islas: Okay, now in a situation where say there are less than 50% of the units occupied and the entire complex needs to be rehabilitated, there's going to be, you know, very low rents. And so in this - these will all be for 50% AMI or less - the tenants.

Paul Webster: Yes.

Harry Islas: So my question is how do we go about using NSP funds to get this project up and running on a revenue stream until it can reach full occupancy? Do you have any suggestions?

Marsha Tonkovich: I do, and we actually have - thank you for asking that question. We actually have some slides that are going to cover that very topic. So let me go ahead and get into those, and then if we don't answer your question, jump back in and we'll talk about it some more.

Harry Islas: Thanks for your time.

Marsha Tonkovich: Sure. So with that, let me go ahead and keep going. And I know we have some questions that are pending, so we'll do those after the next chunk.

So operating budgets. We've talked about sources and uses. We've talked about development budgets. Operating budgets are pro formas - are that projection of income and that projection of expenses over a specified period of time.

And that period of time is typically at least as long as the affordability period or the loan period, if there's a - sometimes the loan period is longer - the financing period is longer than the affordability period. So you might have a 10- year affordability period but a 30-year loan. And so you're going to look at the longer of those two periods.

You are also going to look at both lease up and stabilize. And I think the question you just asked gets to this point, that if we have a property that is vacant, that we're doing rehabilitation or new construction, we're going to have a period of time where we have to complete the units and then get them rented.

And so our income will be reduced in that initial period, that lease-up period, because we're trying to lease the units. And then we'll get to a stabilized period where we have reached full occupancy or virtually full occupancy and then we'll just have typical turnover. So we need to look at both the lease-up period and a stabilized period.

And I will tell you, having looked across the country at troubled rental projects, troubled assisted rental projects, one of the ways the projects get in trouble is they don't look at that lease-up period, and they lose money the first year or so when they operate because they haven't fully leased-up or they had overly rosy expectations of how quickly they would lease-up.

And they never get back out of the hole because they never - they, you know, they're behind on what they have to pay. So we do need to think about building in a cushion for that lease-up period.

So here's a very simple example, most operating budgets are much more complicated than this, but of a lease-up and then a stabilized budget and you'll see some key elements here that we want to look at.

So the rent, the growth that - which gives us the effective growth income - we'll talk about rent loss - and then the expenses. And what's left over is that net operating income and we'll talk more about that in just a moment.

Out of that operating income is - I'd have to pay my debt service and that - what's left over gives me my cash flow. And so you'll see that that lease-up period, my debt service hasn't changed.

I still have to pay my debt, even though I'm not fully leased-up, but my income is reduced because I have rent loss. I have vacancy. And so I have to think about how I'm going to deal with the fact that I have that loss in that lease-up period.

So income - we have lots of different kinds of income, the biggest of which, of course, is the rent. We might have other kinds of income like laundry or parking and so forth. So gross potential rent that you'll see on an operating statement is if everybody pays their rent all the time and every unit was occupied, that would be the max rent that you could get.

But in the real world, of course, we know that we - that’s not going to happen. And so we’re going to have vacancy loss. And so that’s going to be, you know, we’re going to be related to a couple different things - the vacancy, that there’s people moving in, people moving out, you know, units that are vacant.

We’re also going to have - we might have concessions where we write off rents, you know, where we - 10 months for - or 12 months for the price of 10. You know, those sorts of things.

And then finally we might have bad debt where people, you know, tenant accounts receivable or people don't pay their rent and so they’re still in occupancy but they’re not paying their rent. And so we have to reduce our gross potential rent for those kinds of deductions.

Expenses are then all of our costs to operate the property, not including debt service, so things like the heating in the common areas and the property manager and the mowing of the grass and the maintenance of the units and all those kinds of things would be operating expenses.

Typically when I look at pro formas - and I've seen many, many across the country that do this - they'll estimate those operating expenses based upon some nationwide rule of thumb. You know, 250 per unit per year or some number like that.

The issue with those sorts of things is that it doesn't take into account regional differences or the specific type of project you are managing or, you know, specific types of utilities and other kinds of things at the project.

And so we do recommend doing a benchmarking process where you look at similar projects in the community. Or if you don't have any other projects similar in the community across the lease in your state, then you look at what those projects cost to operate and you use those real operating expenses to help predict what you're going to get in your project.

We do not recommend using X units per unit - X dollars per unit per year because it often always proves to be unreliable. If you don't know that and you don't know how to benchmark your property against, you know, comparable properties in the community, try talking to your housing finance agency at your state.

Many HFAs keep data on their tax - on their tax credit projects, which may or may not look like the one you're doing with NSP but at least it's a starting point.

And they'll have it down to the county level or sometimes the town or the zip code level and they'll keep that operating data, they'll keep the information about those actual properties they have funded and most states are willing to share that kind of data.

So it's worth it to talk to them to try to get a, you know, real honest data about operating expenses. Because my hint to you guys would be getting this wrong, you know, getting the operating expenses wrong on the pro forma is one of the most common ways of getting in trouble.

People often are very rosy and hopeful about what the expenses will be and lately that hasn't - it hasn't proven to be true. They've been - tended to be higher than people have predicted. So we have a lot of different types of operating expenses and I won't go through all of them. They're fairly self-evident, but there's a list on your slides.

You'll see that there's a bunch of them and I'm going to back up here, but you'll see there's a whole range of different kinds of expenses that you might have on the pro forma that would be part of the operating.

You want to look at all of these typical - all these typical expenses and make sure you've accounted for and planned for being able to pay them, including the taxes and the insurance.

So reserve accounts - we've mentioned this earlier but just to recap, so there are two typical kinds, operating and replacement. Operating reserve accounts are for gaps in income. In other words, I have a dip in the rents or uptick in the expenses and, therefore, I don't have enough money to pay my ongoing bills. So that's operating reserve.

And then reserve for replacement is capital repairs. So it's when the roof needs to get replaced or the windows need to be replaced, that sort of thing. And you need to save for that to be able to pay for it.

As Paul said, typically both of these reserves come out of the cash flow of the project. So the amount of money that's left over, we typically then - after we've paid our expenses and we've paid off our debt, we set aside some funds as an operating savings account and as a reserve for replacement. And then we dip into those when we need them.

However, in most affordable rental projects, that is not the case because we, you know, we have difficult - we have difficulty doing it because our income is so constrained, our cash flow is constrained.

It is very, very common to see affordable rental projects where the reserves are sorely underfunded and it causes significant problems down the road. So we need to be thinking about what we can do at the beginning of the project to try to avoid that problem if we can.

And so one of the ways that we just mentioned was if you have a lender who has required you to have an initial deposit to reserve for replacement, which is the most common. And I think also perhaps for an operating reserve, Paul, if a lender has dictated thou shalt - the developer shalt deposit X amount of money in an account to be held for that rainy day, then you can draw down that fund out of NSP and put it in, you know, put the developer’s - or put that amount in an account that the developer can tap.

Now a couple of things about that - one is it does have to be reasonable. So if a lender said to you, "I want $10 million in a reserve account," probably not reasonable. So you need to look at what the likely replacement or likely operating costs of the project are over time.

And then number 2, we as the grantee probably want to have some leverage over when they get to dip into that account and what they get to use it for. So they can't use it to go buy a new car, but they can use it to replace the roof or whatever it might be.

So we might want to have a way of having required grantee sign-off on dipping into that account that I paid for out of NSP as an up-front deposit. Now, under NSP, we can't pay for either of these items, operating reserves or reserves for replacement, as an ongoing project-based expense.

So we’re going to - if the lender requires that we can do it as an up-front deposit, a one-time lump sum deposit, that is a development cost, but we’re not going to draw out of it every month or every six months or every year to make up gaps down the road. That is not an eligible NSP expense. So that’s reserve accounts. Paul, anything you want to add on that?

Paul Webster: No, no.

Marsha Tonkovich: Okay. All right, so within operating income in addition to paying for all the stuff we've already talked about also has to pay the debt service. So obviously the amount of the interest rate and the term will affect how much of the NOI can be paid or how much debt can be covered by this project, so it’s both the principal and the interest and obviously the lender will be very concerned about this, as will you if you’re making a second loan.

So the pro forma will have an initial lease-up period. It'll have a stabilized year and then it will go out for a certain number of years, typically somewhere between 15 and 30, depending on the length of the financing and the length of the affordability period.

And that means that you’re going to have to trend the rent, the - and the other kinds of income and the expenses over that 15- to 30-year period. So you’re going to have to grow them at a particular rate.

One of the most common things that we see the people do wrong is they either assume an equal growth rate, in other words the rents and the expenses are going to grow at the same percentage, the same rate, or they’re overly rosy about how quickly rents are going to grow and how little expenses are going to grow.

And so very often I'll look and I'll see a pro forma where rents are estimated to grow at 5% and expenses at 3%. And in the real world it just doesn't work that way, particularly for the rents in affordable deals where the rents are published by HUD on an annual basis, if you’re going back to the HOME rents as your basis or if you’re looking at the tax credit rents or any of the other rent.

And most of those rents are either pegged to the FMR or to the area median income, neither of which grow at a very fast rate. And so in the real world if you look at assisted rent and use HOME as an example, in most parts, but not all parts of the country, those rents have grown by 1% or 1 1/2% or in some cases 1/2 a percent.

So as you look at the trending of your rent, you want to go back and you can pull up, if you're using HOME as your model for the rent or you can use a tax credit rent, go back and pull up the rent history and look at how they have grown over the last five or ten years for your community and look at the real growth rate of those rents, not sort of the overly rosy one.

And then similarly for expenses, people have said, "Oh, we're not, you know, we're going to make sure that they don't grow." Well, after 911, with growth in insurance rates as well as the utility costs that have gone significantly up, expenses have far outpaced the growth of rent and so we'll talk a little bit more a little later about other ways of looking at trending expenses.

So you do want to make sure that there's enough income to cover all of the expenses and that there's a margin in there and that you've got a plan if there are any balloon payments - you know, if it's a loan that's going to come due in the middle of the affordability period and that you're saving enough of those reserves to keep the units standard.

So how developers make money - one of the things you're going to want to look at as you - because we talked about reasonable returns for developers, you're going to want to look at the entirety of the way a developer makes money, not just their developer fee. That's one way that your developer's going to make money.

But oftentimes, what we see is that the construction company is a subsidiary of the developer. And so - and that's perfectly legitimate. There's nothing wrong with that as long as costs are reasonable and everything else.

But what typically happens in those cases is they're earning a profit on the construction as a construction contractor and then they're earning a developer fee on top of that. And so you need to look at whether that's, you know, what is a reasonable level of return.

Similarly, we often have developers who become the property owners and who run the property management firm at the projects and again are making money off the property management fees.

And then finally they might be getting cash flow and other benefits from property ownership and so you want to look at all of those returns for the developer in deciding what a reasonable level of return is.

Identities of interest or conflicts are - you are allowed to have an identity of interest or relationship between a developer and the contractor, let’s say, or developer and the plumber, as long as they are indeed qualified and what they’re charging is cost reasonable.

So before we get into sustainability, anything you want to add, Paul, to what we've talked about?

Paul Webster: No, no.

Marsha Tonkovich: Okay. All right, so a couple things with sustainability and then we'll take some questions. So the concept of sustainability is to underwrite in a conservative way that enables the project to be feasible over the long term. So it’s not just feasible the day we open the door, but rather it’s going to be able to operate throughout the whole affordability period.

And so there are a couple key questions you want to ask, you know, you want to ask yourself as you look at the pro forma and as you look at the development budget and the sources and uses, can the project survive moderate shocks?

In other words, something happens in the community and maybe you’re a military community and there’s been a deployment or maybe a factory has shut down or maybe unemployment has just spiked up in your community, whatever it might be.

Can - does the property have enough of a cushion, not for a disaster scenario - you don't want to underwrite for the disaster, you know, every business in town shuts down - but at least a moderate shock to the rent. Do we have a little bit of a cushion in there that we can still survive?

Furthermore, on expenses, you know, do we, even if we underwrote at 4% or 5% increase in expenses, can we live if they go up to 6% increase? Do we have enough of a cushion so that we can, you know, if utilities - if it’s a bad year for utilities, we can survive.

Finally are - is there enough money to be able to fund our capital repairs? Do we have enough cash flow coming off of this deal that we can save for those replacements and we can actually plan to keep the units standard for the whole affordability period?

So some tips that we learned - and just as an aside where this all came from, ICF worked with HUD to do a study of troubled projects across the country under the HOME program and found some lessons learned about what did and didn't work.

So it - and it’s true for really underwriting it. It was true for the tax credit units that were HOME and tax credits. So the broader lessons will apply to NSP as well.

So for rent, you want to think about not trying to max out the rent that you could charge. So if you've capped the rent at - tax credit rents or HOME rents or whatever’s affordable, you might want to think about backing off of that, perhaps to 95, you know, to a lower number so that you have a little bit of a cushion that you can raise rents if you have to.

The idea is that the lower the rent, the higher the occupancy because the more the demand for the units. So you might want to look at setting the rent in a way that will achieve that maximum occupancy.

Similarly on rent loss or vacancy, you know, we see projects where they just say, "Oh, it's always 5%. It's 5% vacancy." Well that might be true in some communities but not true in many, many markets.

And so we're recommending that people take a look at the market in your community - 5% of the bottom benchmark and long-term average loss in your community for rents - and really be conservative about what you think that number is.

Don't use 5% just off the bat. Use what is reasonable for your community. And typically in these kinds of deals we're seeing - we actually see vacancy rates that are much higher than 5%. We've seen many at between 7% and 10%.

Expenses - again, we, you know, we typically don't want to see people doing X dollars per unit per year. It doesn't turn out to be real. We really do want a benchmark to peer properties and look at what's happening there and then - and be able to survive sort of increases in expenses over time.

And then finally sustainable reserve deposit - we do recommend doing a capital needs assessment for larger projects to look at when those replacements are going to have to happen - of capital items - and think about whether there's budgeted enough money to be able to do it for the 20 years of capital needs or the affordability period as the case might be.

And then finally expenses and income trending - we do recommend that as you trend expenses, you should trend at least as high as inflation - in the - general inflation in the country or in your community if it's different and maybe even a little bit higher than that to build in that cushion.

Similarly rents, you want to trend way below inflation and typically, again, you want to look at what your HOME or your tax credit rents have changed over time and use that real rate. It'll probably be between 1% and 2%.

And then finally, you want to look at other kinds of trending assumptions related to what's reasonable in your community for incomes and the HUD-published FMRs and so forth.

Okay so before I get into LH25, I'm going to open it up for questions. So, Robbie, do we have questions on the line?

Operator: Yes, we do. We'll go to Anne Chaney with the state of Kentucky.

Marsha Tonkovich: Hi, Anne.

Anne Chaney: Hey, Marsha. Can you hear me okay?

Marsha Tonkovich: Yes, you sound great.

Anne Chaney: Oh, thank you. I've just got a couple of quick questions. I'm a little concerned. In Kentucky we require reserves for replacement and an operating deficit reserve and initial capitalization, okay?

Marsha Tonkovich: Yes.

Anne Chaney: And we are the first mortgage lender and that is our requirement and that is the industry standard for HOME, tax credits, risk sharing and so we said that's the requirement for NSP.

Marsha Tonkovich: And you're paying that with NSP, Anne?

Anne Chaney: We are and our rental projects were done deals with funding agreements prior to this guidance. We required it. We approved folks paying for it - the initial one, not the ongoing. We managed the reserve accounts. We set the amount of the deposit based on the project structure and we're the ones that approve disbursement so...

Marsha Tonkovich: So I'm going to let Paul jump in here on that one.

Anne Chaney: ...compliance with the available guidance and it also appears that we're a little too late to back up now.

Paul Webster: Who's the owner of the project?

Anne Chaney: We've got several. It's our subgrantees, whether they be subrecipients or developers, Paul.

Paul Webster: Well I think it would be one thing for a developer, private entity - who's requiring the reserves? Where is that coming from?

Anne Chaney: We are.

Paul Webster: We being?

Marsha Tonkovich: The state, Paul.

Paul Webster: Pardon?

Marsha Tonkovich: The state.

Anne Chaney: We, the state. I'm sorry. We, the state of Kentucky, in our underwriting criteria we require a reserve for replacement and an operating deficit reserve. We do allow the initial capitalization to be with NSP and we are also the first mortgage lender in these deals.

And one of the main reasons we're the first mortgage lender is because of HUD's parallel guidance officially - and this applies to subrecipients and not developers - that net operating income equals program income.

And so at that point, you can't really have other debt, because NOI is program income and debt service, according to HUD guidance, is cost of capital and reduction of liability.

So what we did was we structured our NSP assistance. We are the lender. We're making a loan so that whether it's a residual receipt or actual amortization, you know, that payment to us is program income any way you cut it so that we meet, you know, both sets of HUD guidance. And it feels like we're a little far down the road to back up on that.

Paul Webster: So you're making loans to - again, you're making loans with NSP funds to developers and you're making loans to subrecipients, is that correct?

Anne Chaney: We are.

Paul Webster: With NSP funds?

Anne Chaney: We are.

Marsha Tonkovich: And they're - and I don't think they're developers, Paul. I think they're both ((inaudible)).

Paul Webster: Yes. Well the challenge is to find - when you're dealing with - when you're dealing with grantee-owned or subrecipient-owned projects, the challenge is to find an authorization for payment of these kinds of costs.

But it is a - it is something that I think we might take a look at, frankly, because I - particularly as - if it deals with projects where there's a limitation on the rents and the - particularly during the lease-up period, it would make more sense to have at least the operating reserve established.

So HUD will take a look at that and we'll look at the guidance we've issued previously and then we'll see whether there needs to be a change. We'll have to discuss it with our attorneys because we have to find a legal basis for permitting these kinds of reserves to be established, but it's something we'll take a look at.

Anne Chaney: Okay.

Marsha Tonkovich: And Paul, would it be helpful for you if Anne wrote in a question to the Ask-A-Question with some examples so you could use that for talking to the attorneys?

Paul Webster: That would be helpful and when you do that, reference this Webinar and your discussions with me.

Anne Chaney: Okay thank you, Paul.

Paul Webster: NSP staff will know to come looking for me.

Anne Chaney: Okay, all right. Thanks much.

Marsha Tonkovich: Thanks, Anne. Okay, do we have any more questions, Robbie?

Operator: Yes, we do. We'll go next to Karen Ledet with National Community Stabilization Trust.

Marsha Tonkovich: Hi, Karen.

Karen Ledet: Hi, how are you?

Marsha Tonkovich: Good.

Karen Ledet: Two quick questions - if a project is being funded with HOME and CDBG funds already, can NSP funds also be used to bridge the financing gap?

Marsha Tonkovich: Yes. Yes, there’s no problem with putting NSP together with HOME and CDBG. However, when you do that, you will trigger the requirement for a subsidy layering analysis because of HOME. And so you do need to make sure that you’re not over-subsidizing.

So what subsidy layering would say is look at all those different sources, make sure there is in fact a gap that you are filling and that the project really needs that level of investment across all those sources and that you’re not over-enriching the developer. And then that’s an analysis the grantee will do.

Paul Webster: And wouldn't you also trigger the HOME program requirements in connection with the project. So you want to make sure that you don't inadvertently take a project that has some more flexibility and - under NSP and subject it to the more stringent requirements. That would also be the case with CDBG - regular CDBG funds if you were to use those in concert with NSP.

Karen Ledet: Okay, thank you. And question number 2 real quick, if a recipient - NSP recipient, already owns vacant residential land, can they develop that with NSP money?

Marsha Tonkovich: Yes. It's vacant land that an NSP grantee owns, I assume is what you're saying?

Karen Ledet: Yes.

Marsha Tonkovich: Okay. So it's vacant land. So under Eligible Use E, you could use then - assuming it's vacant and, you know, that there's no occupants on there, you could go ahead and you could use NSP funds to develop it under Eligible Use E. The key thing would be to make sure you're not paying yourself for the acquisition. So you couldn't - if you already own it, you couldn't pay yourself back, but taking out the acquisition and paying for the constructions costs and whatnot would be fine.

Karen Ledet: Okay and one more quick thing, I'm sorry. Can a project be mixed use, residential and say commercial on the first floor where you would allocate the NSP money only towards the residential?

Marsha Tonkovich: Yes. So you could - you can do mixed use with NSP, but you'd need to make sure you only pay for the parts that are eligible. So as you said, you would do an allocation and you would look at the actual costs.

So what you'd really do is you'd say, "Okay, what are the actual costs of building out the commercial on the first floor? And then what are the actual costs of building out the residential on the second floor?" And you'd attribute the actual costs of the residential to NSP and then you'd prorate some share of the common costs, like the roof.

Karen Ledet: Okay. Great, those are the answers I wanted. Thank you.

Marsha Tonkovich: Sure. All right, Robbie, who's next?

Operator: We'll go next to Erick Schmieder with New Mexico Mortgage Finance Authority.

Marsha Tonkovich: Great, okay. Hi, Erick.

Erick Schmieder: Hi. How are you doing?

Marsha Tonkovich: Great.

Erick Schmieder: You know, we - well we've been assuming we can fund this up-front cap replacement reserve because it's absolutely required by our underwriting and I guess a couple questions. I mean, so we're a quasi-state - well, we're a quasi-state agency. We're not...

Marsha Tonkovich: You guys are an HFA, right?

Erick Schmieder: That's right.

Marsha Tonkovich: Yes.

Erick Schmieder: Does that make us a private lender?

Marsha Tonkovich: Paul, I'm going to turn that one over to you.

Paul Webster: Okay. Well give me a little bit more information. What is the - give me an example of a use of funds by your...

Erick Schmieder: Well we got a - we got a CNA and we've done a bunch of cash flow analysis and pro formas and it’s pretty obvious from the information to date that in order for this thing to succeed over the 20-year period, we’re going to have to put some up-front funding for the reserves.

Paul Webster: Yes. And where are you making - where are you getting the money to make the loan to...

Erick Schmieder: NSP funds.

Paul Webster: Solely NSP?

Erick Schmieder: Right.

Paul Webster: All right, well this goes into that category then that I was discussing earlier, I think with the state of Kentucky, that we'll take a look at that again.

Erick Schmieder: But right now you’re saying go somewhere on your Web site?

Paul Webster: Well what we've - what we said is that where a lender requires a - and I'm talking about a private lender or at least a non - a lender who’s making a loan with funds other than NSP, let me put it that way.

Whether they require - where they require a reserve to be established as a part of their requirements as a condition to making the loan, then the NSP funds could be used to fund the reserves as a financing mechanism under eligible use A.

Now, where there is no private lender involved and NSP funds themselves are being used and presumably there’s no debt service required, then the - there is no - you have to find an authority for using NSP funds to fund the cost of operating a unit.

So what we would have to be able to say, I think, is that this is a capitalized cost, that this is something that is really part of the development costs of the project.

So that would be what we would have to, I think, ultimately arrive - conclude in order to permit this to be - the reserves to be established. And I want to take a look at it to be - I mean to be fair to those entities that are carrying out the development that are not either the grantee or some recipient of the grantee.

I think it is an argument that somebody could - a valid argument to - or a valid question anyway to ask, well, if there's a reason why a private lender can do it, why isn't there a reason why we could require it? Why can't we be treated consistently?

So I'll - we'll take a look at that. And then if we conclude that there is a need for the cost and there is - these reserves and there is a legal basis for us to authorize it, then we'll do that.

Erick Schmieder: Thank you. I guess I just want one more really quick thing because it's got me confused sometimes. You talk about subrecipients again, we're basically looking at the third party here as a developer. Does that change anything?

Paul Webster: As it - only if the - if you're giving money to a developer under the current guidance that we've issued. If you're giving money to a developer who's receiving private financing, then - on the project, then - and the reserve is established, then that could be funded.

I guess, likewise, that would be true if a grantee itself or a subrecipient were carrying out the project and in order to finance a portion of the cost you're borrowing funds from a private lender that might require a reserve to be established. I think we would say yes on that as well.

Marsha Tonkovich: So it's really not a subrecipient/developer distinction for this particular question. The distinction is who is the lender?

If the lender is the grantee itself, that's the outstanding question that Paul is going to look into. If a private lender using private funds is demanding the reserve deposit, then HUD has said that is okay, whether it's going to a subrecipient or a developer who is doing - however you've set up that entity - who's doing the deal. On this particular question, the distinction is who is doing the lending.

Erick Schmieder: Okay.

Marsha Tonkovich: All righty?

Erick Schmieder: Thank you.

Marsha Tonkovich: Let's take one more question, then we're going to move on to LH25 and then I want to show you guys the template very quickly. So one more question, Robbie.

Operator: Okay. We're going to Alan Nazzaro with CRP.

Marsha Tonkovich: Hi, Alan.

Alan Nazzaro: Hi.

Alan Nazzaro: Hi, Paul. How are you?

Paul Webster: Good. How are you?

Alan Nazzaro: My question - I guess it's twofold. In your example, you were showing that there was debt service and that was causing the initial - part of the initial loss in the lease-up period.

Marsha Tonkovich: Yes.

Alan Nazzaro: And my question is, isn't debt service reserve allowed with NSP and couldn't that help get through the lease-up period if you had a debt service reserve that was paying that deficit?

Paul Webster: If a private lender requires the debt service reserve, then, yes, that would be a permissible reserve as well.

Alan Nazzaro: But in the case where it's just NSP, you wouldn't be able to do a debt service reserve?

Paul Webster: Well, where would the debt service...

Alan Nazzaro: Well I'm just saying, in some cases there - it's just a loan and there is minimal interest or - but there's payments to be made.

Paul Webster: There may be a payment that would be made - would be payable to you if you're the grantee making a loan to the developer from NSP funds, but you always have it within your control to - if there is a shortfall, to forgive that payment.

Alan Nazzaro: Okay.

Paul Webster: So that's how you would deal with a shortfall if you were the lender. So I, you know, it'd be hard for us to see a rationale for requiring - or for allowing NSP funds to fund a debt service reserve when the debt service reserve is to protect the grantee itself from - when it made the loan. That, you know, that - I don't think that would fly.

But I think it's a different situation with respect to a private lender because the - a developer would have to make a - would have to make a loan to a third party. And so in those situations if there is a projected lease-up shortfall, then a debt service reserve I think could be appropriate.

Alan Nazzaro: Okay. All right, thank you.

Marsha Tonkovich: Thank you. Okay, so let's talk about LH25 and we still have some calls on the line so we'll get through this quickly and then we'll show the template and then we'll take some more questions.

So one of the things that everybody knows is that we are required to spend 25% of our grant amount for - to house folks who are at 0 to 50% of median and that is an absolute requirement. I think you all have heard Assistant Secretary Márquez talk about the fact that HUD is very serious about that requirement and about enforcing it.

So what does that mean? That means you have to establish some portion of the units that you are developing, whether they're homebuyer units or rental units, for occupancy by people at 0 to 50% of median.

When we're talking about rental, that means you're going to have to establish a rent for those units that people of that income range can afford, because obviously someone at 0 to 50 can't afford the same affordable rent as someone at 0 to 120 can.

So what many jurisdictions have done is taken different approaches to setting the rent for the LH25 units as opposed to the rents for the other units that we might be developing.

And so for the LH25 units, we've seen a wide range of definitions for what is an affordable rent, but it’s ranged from the low HOME rent, so that’s the rent that the HOME program establishes for people at 0 to 50% of median and that’s the most common that I've seen.

Some folks have also used the tax credit rents that are established for people at 50% of median, uses a slightly different formula than HOME does. And then finally some people have said, we’re going to establish rents at 30% of adjusted monthly income and it'll vary by household.

And you could have taken - picked any one of those or any combination of those as your definition of affordable rent, or some other rent for that matter, for the LH25 unit.

We've been recommending folks think long and hard about whether the right answer is the 30% of adjusted monthly income and the reason for that is multiple.

One is that your income - as the developer, your income will adjust over time depending on who’s living there and that’s hard to predict and hard to manage. And two is it adds a layer of burden in terms of trying to figure out what the rent is for each individual household as the developer goes in and verifies their income every year.

So most folks have chosen an established rent in the ((inaudible)) to low HOME rents or the tax credit rents and so forth. What does that all mean in terms of using that abbreviated rent or that lower rent for underwriting?

Bottom line is that in many markets - and this would be true across most of the country - if you had a project that was 100% LH25, in other words 100% where the occupants are at 0 to 50% of median, and you’re going to charge an affordable rent, like a low HOME rent or a tax credit rent at 50% of median or even a 30% of income rent, in most markets that income is insufficient to pay expenses.

((Inaudible)) just the ratio of what a person at that income can afford and the cost of operating a rental project, which don't get any cheaper just because of who lives there, in most cases we see that we have an insufficient cash flow in those kinds of deals and so we have to think about how are we going to plug that cash flow.

And so a couple things to look at in terms of what to do - so as you're looking at the underwriting first, then we'll talk about how to plug that hole in just a moment, we want to make sure that the trending is in fact reasonable.

In other words, have I done a minimal growth of that LH25 rent over time, because it's highly likely that that rent is not going to grow very much. Does in fact cash flow become negative and in most of these LH25 projects that are 100% LH25, the cash flow becomes negative at, you know, some not very distant time in the future.

In other words, income minus expenses when you trend the income and expenses, the cash flow becomes negative, you know, year six, year seven, year 10.

You're not even very far through the affordability period and you need to look at that. Will there be enough cash flow to pay the expenses and is the return reasonable? So you want to look at all of that for an LH25 project.

So if indeed the project turns out to be infeasible because of these constrained rents, there are a couple different things that you can look at, some of which are easier to do and some of which are not.

First thing is can we go back and look at the development expenses, the development budget? Can we look at the size of the units that we're building, the amenities in those units? Can we adjust that downward so that our total development cost goes down and thus there's less debt to borrow on the property?

And the trade-off of that of course is the more you skimp on the development, the harder it is to market the units because there won't be those amenities to attract tenants. So you need to look at that trade-off and decide whether you can cut the development budget or not.

Can we look at the assumptions about the project in terms of the number of units in the deal or the square footage of those units? Can we make them smaller and still, you know, attractive in the marketplace?

I looked at an NSP deal last week where there was only I think three or four rental units in the project and so with only three or four rental units in the project, there wasn't enough income to spread the expenses across and so a small deal like that was infeasible. So maybe if it were bigger, maybe if it had ten units, it might be able to make it work.

Can we raise the rent? So can we in fact go above what we currently have defined as affordable? Can we change our action plan or do we have room within the rents we had in our action plan and yet remain affordable to the target market that we're trying to serve?

Can we get some of the expenses waived? This is one of the big areas where this is one of the ways an LH25 project can work. Can you go to your city or county council and get the taxes waived, get a pilot payment, a payment in lieu of taxes, which is a lower rate than the tax rate would be?

Are there are other kinds of fees that are in the development costs that you can get waived? Can you acquire the land and donate it rather than having a cost for the land? So look at some things that you can get waived.

Other ideas - can we look at the financing structure and reconfigure the financing structure, so if the NSP money was going to be a low interest rate loan or some sort of amortizing loan, can you turn it into a deferred loan only payable upon sale? Or in fact, even a grant, though under NSP you could grant the money to the project. You know, could you turn it into a grant?

Could you have a greater portion of the financing coming from NSP than from the private sources so there is less debt service the property has to pay? Is there other money out there that you can put in this deal, like tax credits or CDBG that might help?

And here’s a big ticket one that you want to - it’s like gold if you can find it - but this is the easier way to solve the LH25 issue with the income. Try to see if you can find some project-based assistance. So there isn't a lot out there. It is hard to find, but some local housing authorities do still have project-based assistance.

There are also state project-based assistance programs. Those programs are an ongoing operating subsidy to the project that help to make up the difference between the income and the expenses. Can you go out and get some of those dedicated to this deal?

And then finally, rethink the unit mix. I think one of the issues that we’re seeing on LH25 projects is 100% LH25 and all the rents are constrained. Well when you do that, there’s not enough income in order to do it and none of these techniques will fix that problem.

So go back and rethink whether or not it should be mixed income so that some of the units are at market rate, some of the units are at 120% and some of the units are LH25. And yes, that will mean you'll have to do more projects with LH25 units set aside within them, but each of those projects will probably be more feasible than a straight LH25 project in most markets.

Now if none of those work and you look at the pro forma and it’s still showing as negative and you’re still showing a loss, I would recommend going back and taking a look at whether this is a viable deal.

You know, we do have to obligate and expend toward the LH25, but it may be that that particular deal isn't going to work if none of these options will get you a deal that’s going to get in balance, that’s going to have a positive cash flow at least marginally.

And the reason for that is, you know, you don't want to have a project that, you know, upfront that in year four, five, six, seven is likely to fail and will come back into your lap again for two reasons. One, obviously you don't want to deal with that and you don't want to have to displace those families.

But secondly, if you do have a project that does not live out the affordability period, that goes belly up and doesn't maintain the units and maintain the households, HUD could ask for you to pay the money back because now you've got an ineligible project that didn't meet out the affordability period. So you don't want to invest in those kind of deals knowingly going in.

So those are some tips about LH25. Before I take some more questions, I did want to share with you guys a few Excel - the HOME Excel spreadsheet and how it works and then we'll take a few more questions to round out for today. So I'm going to share this spreadsheet with you guys.

So this first one I'm going to show you is a mixed income deal. So if you were to go to the HOME part of the Web site that we just looked at and you were to pull down the Excel template that I showed you, what you would see - and I'm going to start at the first tab - is some basic information about the project.

So this is a fake project but basic information about a - the deal and then you would add in data about some of the unit constraints and here you'll see that again it was designed for HOME, but it works just as well for NSP so you can enter in the rent constraints.

And then you would enter in how many units you have of which various bedroom types, so one, two, three, four, five. And you're going to look at the rate of increase of those rents, both in the stabilized year and then the out years by unit type. And then you'll enter in your development budget, so you'll see here you have all of your various development costs.

And finally you're going to enter in your operating budget and it'll give you the stabilized year. It'll give you the operating expenses for the project. And you're going to enter in what are the financing sources.

So it'll - this will calculate for you the maximum first mortgage, the maximum private mortgage that this project can support and then you can put in and in this example you can see we have $2 million of NSP assistance and so you can put in the various financing sources.

And then finally it will show you a pro forma for the - once you've entered in all that data, it will show for you a pro forma of what that project looks like. So for this example, we have a mixed income project and you can see that we have - in year one, we have our income and our expenses and it takes you down and shows you the NOI that's here.

And so you can see that as we got leased-up and so forth we have our NOI. And what happens is you can tell in out years is the… starts to go down and the reason for that is because we're trending income at a slower pace than we're trending expenses.

And so what you want to do when you look at this sheet and when you look at any pro forma, is go out for all the years of the affordability period. Because what you can tell was happening here -

and this project I entered it as a 15-year affordability period - and so you can see that around about year 14, we're starting to lose money.

So we now - because of the trending of the rents and the expenses, we start to have a negative net operating income. And then what - you see what happens in year 16 - this has a 15-year affordability period - is that in year 16 it goes back up again and that's because it no longer has the affordability constraints on it. And so it presumes that those have ((inaudible)) and you're now back up at a market rate project.

And so this spreadsheet will give you good sense, good quick look at whether or not this project is feasible. And in this case you have two years of the affordability period where perhaps it's not so feasible.

And so you could go into the spreadsheet and you could say, "Okay, well what if I could go into my operating expenses and I could get my - maybe I could get my city council to offer us a pilot and have reduced taxes and maybe our taxes are only $10,000 a year instead of the $45,000 or whatever it was we had before."

And then you can go over to the pro forma and say, "Okay, well what effect did that have?" and lo and behold you can see that that one little change in the operating expenses had a significant effect on the feasibility of the project. Now this project is feasible throughout the whole affordability period so if they were able to get those taxes waived.

So you can play around with those inputs and you want to do it based upon facts of course to see what it would look like. And so there's an example of the spreadsheet filled out and we'll put that on the Web so you can see it. Don't use these numbers as good numbers. They're in there to show sort of some of the things that you can do with the data.

And then let's look at one that is actually for LH25 so you can see the difference. So notice before we leave this one, it has the same exact inputs as the LH25 one will have. And in the first year you have NOI of $80,000 and 101 as you go out years.

And now let's look at an LH25 one. So here's the same project before I had changed the taxes and you'll see now but look what's happening with the - let's ((inaudible)) right one ((inaudible)) right one. Nope, we're not on the right one. Hold on for just a second).

That wasn't – I'm pulling up the correct one so if you were to look at the one that was LH25, you would see that the NOI was negative rather than positive and that would be because the rent was constrained.

And so back on the previous sheets where you had the rent and income information, instead of having the market rate rents as we had here and this is the market rate sheet with the rent at 120% and at 50% and so forth, you would have the market rate units in the market one.

But in the LH25 you would show them all as low HOME or other units with a more constrained rent and you'll see that would affect the income and therefore the pro forma. So we'll have the LH25 one also on the Web site if you want to take a look at what that looks like and how that is different from the mixed income one that we're seeing here.

So with that, I'm going to go ahead and go back to the PowerPoint and then we'll take some more questions. Okay so, Robbie, can you go ahead and take our next question, please?

Operator: Once again, it is star 1 at this time if you'd like to ask a question over the phone; star 1 for questions.

Marsha Tonkovich: And do we have anybody in the queue?

Operator: Nobody in the queue currently. We do have Mary Click with the city of Phoenix.

Marsha Tonkovich: Okay. Hi, Mary.

Aaron Kimberlin: How are you doing? I'm not Mary Click. My name is Aaron Kimberlin with city of...

Marsha Tonkovich: Hi, Aaron.

Aaron Kimberlin: I had a question regarding this revised policy to allow for more proportionate funding similar to HOME. When is that going to be - could you give us a little preview of that? I understand it’s coming out in the next few weeks but...

Marsha Tonkovich: Yes. So here’s the - what happened was there was an FAQ that was out about - as I said about a year and a half ago, two years ago, that basically said that what you could do was if you assume you had a total development cost of $1 million and NSP was going to be 40%, so it was going to be $400,000 of the $1 million.

What the FAQ said was therefore you had to have 40% of the units in the project as NSP-assisted, but the balance of the units, the other 60% of the units, could be market rate, could be some other source, could be whatever. So it - so the amount of NSP-assisted units would be proportional to the NSP level of investment in the total development cost.

That was put out there as an FAQ as I said about a year and a half ago and it’s been the policy. There’s a legal issue with that that was raised by someone at OBGA. They just have to get cleaned up.

And so they're working at codifying that policy that I mentioned but making it official. Right now it's technically not the official policy because it's not technically allowed. But they're working at being able to explain how it will work, the proportionality, how it will work in NSP projects. Paul, is there - is that - anything else you'd add to that?

Aaron Kimberlin: Do you see a conflict when the 25% satisfied comes into play where you're having 50% of AMI individuals inside a property? I mean – I just wonder if you can develop some type of more explanation for that. I mean...

Marsha Tonkovich: Sure. Yes, I don't think it's going to affect it all because I think they're two different issues. So issue number 1 is what proportion of the total units must be designated as NSP assisted? Whether they're LH25 or up to 120% is irrelevant. What proportion of the total, at a minimum, must be (tainted) with the NSP rule?

So that's what we're trying - that's what this new notice is trying to resolve. Of that portion which is NSP assisted, you could have part be LH25, you could have all be LH25, you could have none be LH25.

So it's - I don't think it's going to affect the LH25 in any way, except to say what is the minimum number of total units which must be assisted, given how much money I put in the deal? Is that - and is that your understanding too, Paul?

Paul Webster: Yes, that's right.

Marsha Tonkovich: Okay.

Paul Webster: And I think that anybody who's relied on that FAQ previously in structuring a project is, you know, is safe. I don't - not going to be any penalty associated with that, but the policy has to be clarified or there has to be some action taken that would ratify the FAQ and it's - that's what's being worked on now.

Marsha Tonkovich: Thanks, Paul. Does that answer the question?

Aaron Kimberlin: Yes, it does.

Marsha Tonkovich: Okay, great. Robbie, do we have anybody else on the line?

Operator: We do have another line in queue and it's Pam Hallett with the Community Builders.

Marsha Tonkovich: Great. Hi, Pam.

Pam Hallett: Hi. How are you?

Marsha Tonkovich: Great.

Pam Hallett: I'm going to take you back to the (CUF reasonableness) you dealt with a while ago. Does HUD have any (CUF) threshold, like FHA or something like that, that would be easily used on a multifamily property?

Marsha Tonkovich: No, not really. I mean again, they're going to look for you to look to what is standard and customary in your market and that's going to vary from New York to Omaha. So there isn't really, you know, there isn't really any standardized list. I think what - they will look to you to look back to your procurement if you did procurement. They're going to look for you to have documented what similar deals cost, but there isn't any hard and fast, black and white rule on that. And, Paul, add anything to that.

Paul Webster: No, that's right and I would think that most grantees would be happy that there's no hard and fast rule, no rigid rule that would be - would work for grantees in some parts of the country and not for those in others.

So basically you have to go - if you're talking about - particularly if you're talking about the reasonableness of cost incurred by a developer as opposed to cost incurred by a grantee or a subrecipient, you want to look to see the - make sure - try to make sure that the - if there's been an analysis of the cost just to determine the reasonableness.

And I think that in most cases that's - provided that it was undertaken in good faith - that you're most of the way home. There is no - a developer, for example, is not required to follow the procurement rules.

So he wouldn't have that to fall back on for a developer, so you would look to see, again, what the cost - what is customary and reasonable for that kind of cost in the area where the project is being undertaken.

Pam Hallett: All right. So if we had three different general contractors, for instance, bidding as well as the one we chose was reasonably close to the others that would probably serve?

Paul Webster: Yes, I think so, particularly if you would pose that requirement that the developer have put things out - put these contracts out for bid.

Pam Hallet: Yes.

Paul Webster: Since they're not required - you're not required to require them to do that under the current rules, but if you do that, then you have a much stronger case and documentation for audit purposes and for monitoring purposes that the costs that were - that are incurred are reasonable for that project because you've gone through a competitive process.

Pam Hallett: Okay.

Marsha Tonkovich: And if you do choose someone who’s not the low-cost bidder, which they might, you know, a developer wasn't required to follow procurement so they might choose the non low-cost bidder, then do make sure they document why.

Pam Hallet: Well, sure. Sure. Okay, great. Thank you.

Marsha Tonkovich: Sure. Anybody else, Robbie, on the line?

Operator: And we have no further questions in queue at this time.

Marsha Tonkovich: Okay, great. Well so I'm going to just finish up then. So we do have some tools that are available to you to help and that you'll see the link here. There’s an NSP online toolkit that has sample agreements.

It also has some sample forms and things and it’s on the NSP Web site under Resources. So I recommend taking advantage of that. The HOME tool, this is the exact Web site of the HOME tool that we looked at.

And then finally there is technical assistance called FAST which is meant to be underwriting help and you can go on to the NSPTA Web site and request underwriting technical assistance and - via phone, excuse me, they’re - they are there to help you through deals and answer questions similar to what we've been talking about here on this Webinar.

So finally we hope that you'll give us your feedback. We hope this Webinar's been helpful to you. There is a SurveyMonkey link and it'll also come out to you as a thank you for attending. If you can click on it and give us your thoughts about what worked and what didn't or any other questions that you might have or other types of Webinars that you'd like to see HUD present.

So with that, Paul, anything to conclude?

Paul Webster: No other than to thank you, Marsha. It was a very good presentation and very clear and I think the main thing that - from HUD standpoint that comes out of this Webinar is our taking a look again at the issue of whether reserves can be established if they're not required by a lending institution.

So we'll be happy to take a look at that issue again. No promises, but we'll take a look at it and I do think it's, you know, there are arguments in favor of permitting NSP funds to be used to fund those reserves.

So we'll take a look at it against, you know, and we'll also have to take a look obviously at the law, at the regulations and our notice to see whether there's a legal basis for permitting something to be done.

Marsha Tonkovich: Thanks, Paul. All right, well thanks, everybody for attending. And I look forward to talking to you on a future Webinar. Bye-bye.

Paul Webster: Bye-bye.

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