U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF MULTIFAMILY HOUSING ASSISTANCE RESTRUCTURING

DATE: May 15, 2002

MEMORANDUM FOR: PAEs, All OMHAR Staff

FROM: April LeClair Chang, Director, Underwriting and Finance

SUBJECT: UNDERWRITING ISSUES

As a result of quality control reviews conducted in the last four months, we have identified a number of underwriting issues that require some clarification and additional guidance. We are providing the following information on these issues to assist PAEs and OMHAR underwriters in structuring transactions. **Nothing here is intended to imply that there is only one appropriate answer in a given case** and PAEs and OMHAR staff should continue to recognize the significant range of transactions and issues that we must address.

RETURN TO THE OWNER

The IPF is a minimum level of return for retaining owner interest in the property. It is not the "maximum allowable" nor do we consider a higher return to be excessive in terms of program goals. Indeed, the statute requires setting the rents to market with the intent that the property, in the absence of Section 8, would operate like other market rate properties that clearly operate *without limitations* on the return.

Nevertheless, in many cases, HUD will be making partial payments of claim that will not be fully recaptured. In these cases, it is appropriate to consider methods of increasing the return to HUD *so long as* owner returns are not reduced unduly.

The approaches being discussed in this section relate to transactions where the cash flow with standard underwriting is already greater than needed for IPF and cushion. ***In no case*** should debt service coverage (DSC), or exception rents, be increased solely to increase return to the owner except, as stated in current policy, where necessary to cover the first year's IPF or to provide for adequate cushion.

When is it appropriate to consider changing the cash flow split from the minimum 75/25 split (75% to HUD, 25% to the owner) that is required by the statute?

It is appropriate to consider increasing HUD's percentage of the split whenever there has been a partial payment of claim, the incentive to the owner is fully adequate, and second and third mortgages are *not* being paid off in full at the maximum allowable interest rate. In other words, an increase of the percentage split to HUD *may* be appropriate to increase the payback of the claim in any case where owner return is adequate and HUD recapture has not been maximized.

Please note:

1. *Any increase in split has the potential to reduce owner interest in decreasing expenses and improving cash flow. As the owner's share decreases, the benefit the owner gets from making changes that increase cash flow becomes progressively smaller. If the marginal benefit to the owner is very small, the owner's interest in operating the property efficiently may be greatly lowered. The lowered interest may result in indifferent operations that reduce the overall cash flow. The result is that the return to HUD, through its 75% (or greater) share of that cash flow, actually becomes lower than if the owner's share, and thus the owner's interest, were greater.*

2. *CRP will not normally play a role in this discussion. Its purpose is the return of funds invested as part of the M2M process. While proper management is encouraged during the term of the CRP (or the owner won't receive it), the CRP term is limited and the CRP will not provide owner incentive in the out years. (When considering owner return after the CRP term, it is technically appropriate to include a percentage of the amount that was paid as CRP. However, the practical difficulty of making estimates so far in the future makes it unnecessary to include this amount in our considerations unless the amount is very large.)*

When is the incentive to the owner fully adequate?

The purpose of the M2M program is to provide for financially sound transactions either with, or without, Section 8, that provide quality affordable housing for the next 30 years. Therefore, the incentive we provide to owners must be adequate to sustain the owner's continued interest in operating a well-run property in good condition over the term of the Use Agreement. In the past, consideration of the return would have included significant tax advantages in many properties as well as cash flow. Going forward, the tax advantages that have historically been present are not likely to be as significant in terms of return (and the PAE, therefore, need not consider them). In sum, cash flow, plus any fees from management in identity-of-interest management cases, is the principal motivator for owners. We do not want to encourage "excessive" return; however, failure to provide adequate, and market comparable returns will result in some properties deteriorating. This deterioration will result in substantial financial and administrative cost to HUD and potential detriment to tenants.

Generally speaking, a reasonably expected level of return on similar conventional transactions would be $300 to $400 per unit per annum, or approximately $25-33 per unit per month. (Note that this range is based in part on review of the net cash flow of a large group of 221(d)(4) unassisted properties that were analyzed.) It is not unreasonable for a well-run M2M transaction to anticipate such returns, ***including*** the IPF. Generally, the higher return (up to $33 per unit per month) might be appropriate where the transaction is more difficult (e.g., volatile, in need of substantial owner intervention, etc.) and entails more risk. The lower level of return may be more appropriate where the property's performance is expected to be more stable over time. In any instance in which the return to the owner appears to exceed these levels, an effort to increase recapture may be appropriate.

Assuming acceptable management, no distinction should be made between identity of interest management and third party management. The restructuring should not reduce the ability to make future transfers or changes in management.

When is it appropriate to increase the interest rate on the second and third mortgages?

It is appropriate in some cases to increase the interest rate on the second above the 1% minimum prescribed in the statute in order to increase the recovery to HUD. (The rate may not be increased above the AFR.) This approach will not reduce the cash flow to the owner (since the payment to the second is defined as a percentage of the cash flow rather than a scheduled payment) but it can reduce the owner's overall returns. If you assume the same sized payments to a second mortgage, a higher interest rate will result in the need to make such payments for a longer period of time. This longer time period results in (1) later pay-off of any second or third, (with the result that the owner doesn't have as lengthy a period when HUD takes *no share* of the cash flow) and/or (2) reduced proceeds from a sale or refinancing at the end of the term.

An increase in the interest rate on the second should generally be considered where (1) the second pays off before or at the same time as the first or (2) the residual value at maturity greatly exceeds the amount of the second outstanding at that point. "Greatly exceeds" might be defined as where a second with an increase in the interest rate of one whole percentage point can still be comfortably paid.

No increase should be pursued if the increase causes the second to cease being reasonably repayable using both payments over the term and (usually 80% of) residual value at maturity of the first.

The rate on any third mortgage is automatically increased if the rate on the second is increased. The impact on the owner of a rate increase on the third may also be considered.

DEBT SERVICE COVERAGE WHERE AFFORDABLE RENTS ARE SUBSTANTIALLY LOWER THAN MARKET RENTS

In some areas, notably New York and eastern Pennsylvania, mortgages frequently must be determined using **substantially** lower, affordable rents rather than market rents. Where this occurs, and no compensating adjustment is made, two notable things result: (1) the partial payment of claim may be greatly increased (because the new lower mortgage is unable to support as much debt as a mortgage based on market rents), and (2) the cash flow is greatly increased (because, at least initially, the actual rents paid are the Section 8 rents that reflect market rents, not the lower, affordable rents).

In some cases, OMHAR has approved DSC in such circumstances as low as 1.0 (break-even at the affordable rents) in an effort to increase the supportable new debt and thereby reduce the partial payment of claim. However, because one of the basic tenets of the M2M program is recognition of the possibility of withdrawal of Section 8 subsidies, this issue has been reconsidered. Going forward, DSC will not be reduced below 1.05 to 1.10 coverage in such cases. We would expect the 1.05 coverage to be adequate only where there is additional cushion available as a result of using a 7% economic vacancy factor on the first mortgage in a transaction where (1) the historical vacancy has been notably lower and (2) anticipated vacancy, in the absence of Section 8, would likely be similar. The lower coverage may also be appropriate for housing for the elderly since the cessation of project-based Section 8 assistance to such transactions is less likely.

In no case should the mortgage be higher than would be allowed using a 1.2 DSC (or appropriately greater DSC) using ***market rents***.

We would normally expect such transactions to reflect the highest reasonable (and allowable) interest rate on the seconds. In addition, where other HUD debt is being deferred (such as flex sub loans), we would expect the loan documents to reflect reinstatement of the payments on the deferred debt as soon as any second is paid off.

Where owner return is higher than that described above, we would expect some increase in the cash flow split to HUD, but not so great an increase that owner return would be wholly inadequate if Section 8 subsidies were removed. In these cases, consideration of the amount of cash flow available after the pay off of the CRP may be appropriate.

On a second issue related to this type of project, we note that the affordable rents are sometimes inadequate to support required new debt and "exception rents" are needed. While these rents are not technically exception rents, since they do not exceed market rents, they should be determined using the same general standards. Specifically, need for the units should be addressed and the amount of the rent should be determined based on the expenses and new money (debt) needed for repairs, etc. These rents, unless they exceed market rents, need not be counted in figuring limitations on exception rents.

VACANCY RATES

We have noted recently that there has been reduced attention paid to physical vacancy issues in transactions where no RAAP is required either because of low statewide vacancy rates or because the transaction involves housing for the elderly.

Solid underwriting of any transaction, subsidized or not, requires full consideration of the economic (physical vacancy plus bad debt) vacancy rate of the property. The property's physical vacancy history should be compared to the comparables used, and the market area history and trends. The statewide rate may be 5%, but a particular area may have a vacancy rate that far exceeds 5% and there can still be questions of whether the property should continue to involve project-based Section 8. Further, just because a property provides housing for the elderly does not mean that it cannot be experiencing serious vacancies which need to be addressed. In all cases, the PAE should consider the impact if Section 8 is not available in the future.

PAEs and OMHAR staff should assure that complete current, historical, and predicted vacancy information is provided for each transaction. Even though a RAAP may not be required, in some transactions, especially those with exception rents, all of the issues normally considered in a RAAP must still be addressed in order to reach a reasonable conclusion.

A separate memo regarding RAAPs will be issued in the near future.

ECONOMIC VACANCY RATES IN EXCEPTION RENT TRANSACTIONS

Because of a red flag that appears in the model in the case of deals with exception rents, questions have been raised regarding the economic vacancy rates in such transactions.

Where exception rents are being used, vacancy rates on second mortgages should be determined in

exactly the same way as on non-exception rent transactions. If a reduction in the vacancy rate on the second would otherwise be appropriate, because historical vacancy rates have been low, the reduced vacancy rate would be appropriate in calculating the second.

In the very rare case where historical vacancy has been both very low and very consistent, and there are no market factors which would suggest any change in the future, the PAE could propose a modest reduction in the vacancy rate on the first (certainly no lower than 5%). This reduction would serve to reduce the exception rents needed and should be considered where appropriate. However, we expect that this will be approved by the OMHAR regions only in a very few, well-documented cases where cushion is clearly adequate.

Bear in mind that transactions with exception rents are transactions that we would not normally expect to survive in the event of the withdrawal of Section 8 subsidies in any case, so the reduction of a modest amount of "excess cushion" while the Section 8 ***is*** in place will not appreciably impact the transaction's chances of survival.

EXCESS PAYABLES

Some properties in M2M have delinquent accounts payable and the question has been raised how such accounts should be treated at closing.

First, all delinquent accounts should be paid off at closing. Second, our general policy is that if the property had sufficient funds to cover these payables and failed to do so, the owner should bring the accounts current with his or her own funds (out of pocket). On the other hand, if the property was unable to cover these accounts, the PAE may recommend that they be considered transaction costs with the owner paying 20%. In all cases, the appropriate HUD Multifamily HUB or Program Center should be involved in making this decision.

COMMERCIAL SPACE

We have noted several transactions recently that lacked the appropriate attention to commercial space. PAEs should identify the amount, type and history of the commercial space, analyze leases, and provide strong support for the commercial income and vacancy conclusions reached.