U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

OFFICE OF MULTIFAMILY HOUSING ASSISTANCE RESTRUCTURING

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MARK-TO-MARKET

POCKET GUIDE

U.S. Department of Housing and Urban Development

Office of Multifamily Housing Assistance Restructuring

physical needs; and there must be no health and safety, or UPCS violations.

⇨ *Project Management.* Evidence of competent management – the absence of serious financial or physical deficiencies in the property, review of tenant comments, and the completeness and thoroughness of the property's records. There are no unresolved HUD management review or audit findings based on a review of tenant comments.

Process. Owners who renew Section 8 contracts at market rents without debt restructuring must select that option in accordance with Housing Notice 98-34 or subsequent guidance, and must submit the required documents to the Multifamily Hub or Program Center no later than 90 days prior to contract expiration. Tenants and other interested parties may submit comments to the PAE within 30 days of receipt of this notice. The PAE must document and consider these comments, but no public meeting is required. Required documentation from the owner includes:

⇨ a comparable market rent analysis;
⇨ the most recent required fiscal year audited financial statements for the property;
⇨ an owner's evaluation of physical condition, as provided in Section 401.450 of the rule; and
⇨ other such documents as the PAE or HUD may require.

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X. Other Issues – OMHAR-Lites

OMHAR-Lites. Properties whose rents are currently above market and whose owners request to renew their Section 8 contracts at market rents without debt restructuring, will undergo an abbreviated review and approval process. Properties not undergoing mortgage debt restructuring are not required to execute Use Agreements and, therefore, are not subject to the Low-Income Housing Tax Credit (LIHTC) program's affordable rent limitations. The standard processing time to complete the review will be 60-90 days from the date the asset is assigned to the PAE.

Eligibility. Properties are eligible for an OMHAR-lite if they meet all of the criteria for participation in the Mark-to-Market program (see Chapter 10, Section 10-3 of the Operating Procedures Guide) **plus** the following additional criteria:

⇨ *Debt Service Coverage (DSC)*. Adequate DSC after rents have been adjusted down to market (generally, the DSC ratio is at least 1.2).

⇨ *Physical Condition and Reserves for Replacement*. In good physical condition, with sufficient Reserves for Replacement to maintain the long-term physical integrity of the property; an adequate balance in the Reserves for Replacement account to make the minimum market improvements, and to meet the property's other immediate and short-term

VIII. Post-Closing Document Distribution

Prior to closing, the servicer, asset manager on both the first and second mortgages, the escrow agent for managing the rehabilitation financing escrow account, the Section 8 HAP Contract Administrator, and the monitor of the Use Agreement will be identified. Each of these parties receives the appropriate closing documents necessary to fulfill their particular responsibilities. The PAE is responsible for coordinating document distribution and conversion. A Closing Docket Content Checklist is provided in Table 8-1 in Chapter 8 of the Operating Procedures Guide.

IX. Servicing

Servicing Responsibilities. The PAE will typically be responsible for administering the Rehabilitation Escrow (for short-term repair requirements).

Public PAEs will generally serve as the property's Section 8 administrator, and will be responsible for long term compliance monitoring of the terms of the Use Agreement. In addition, the PAE may be selected to service the second mortgage.

Introduction to the Mark-To-Market Program

The purpose of this Pocket Guide is to provide interested parties with a brief overview of the Mark-to-Market program. The Office of Multifamily Housing Assistance Restructuring (OMHAR) was established by the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA) to implement the Mark-to-Market program. The Mark-to-Market Program Operating Procedures Guide and the implementing forms can be found on OMHAR's web site at: http://www.hud.gov/omhar.

MAHRA establishes a process for restructuring multifamily properties insured by the Federal Housing Administration (FHA) and receiving rental subsidy assistance under the Department of Housing and Urban Development's (HUD's) Section 8 program. Many of the 10,000 expiring FHA-insured Section 8 project-based properties, housing 1.6 million tenants, are subsidized above market levels, while it is estimated that 15 percent of these properties are physically or financially distressed.

What's Inside? A brief description of:

- ⇨ owner eligibility
- ⇨ role of the PAEs
- ⇨ importance of preserving affordable multifamily housing
- ⇨ data collection and verification responsibilities
- ⇨ underwriting and financing alternatives
- ⇨ loan and funding approval
- ⇨ closing and post-closing documentation
- ⇨ servicing
- ⇨ other issues

VII. Closing Documents

Within 60 days of the execution of the Restructuring Commitment by the owner, the PAE and the PAE's attorney should complete all closing documents and prepare their distribution. The PAE, OMHAR Field Office, and Multifamily Hub or Program Center must work together to ensure the Mark-to-Market closing process is effective. Chapter 7, Section 7-3 in the Operating Procedures Guide delineates the responsibilities for each party in the closing process. In addition, Form 7.2 in Appendix D provides a closing documents checklist.

The PAE is responsible for coordinating closing of the Mark-to-Market restructuring transaction. See the Table at the end of Section 7-3, Chapter 7 of the Operating Procedures Guide for a brief summary of the responsibilities for closing by type of financing alternative.

<u>Execution By Owner</u>. The OMHAR Field Office approves or rejects the Restructuring Plan package, as submitted by the PAE.

Plan approved: If approved, the owner has 30 days to accept or reject the (OMHAR-executed) Restructuring Commitment from the PAE.

Plan rejected: The owner has 10 days after rejecting the Restructuring Commitment to appeal to the PAE for a hearing.

I. Owner Eligibility for Participation

Each year HUD issues a Housing Notice that explains the procedures for owners to renew their Section 8 contracts. As explained in Housing Notice 98-34 and subsequent guidance, the owner requests rent and debt restructuring under the Mark-to-Market Program. HUD and the PAEs screen and confirm a property's eligibility.

<u>Process</u>. The process for preparing and executing Section 8 contracts under the Mark-to Market program for eligible properties begins when the owner files a notice with the HUD Multifamily Hub or Program Center, declaring an intent to:

- ⇨ renew Section 8 with mortgage debt restructuring;
- ⇨ renew Section 8 without mortgage debt restructuring (see Section X); or
- ⇨ opt out of the Section 8 program.

The Multifamily Hub or Program Center makes an initial determination of eligibility (e.g., ensures programmatic eligibility, and that the owner has not been suspended or debarred). If eligible, OMHAR assigns the asset to a PAE. The PAE completes the market rental analysis, affirms owner eligibility, and coordinates Section 8 contract renewal with or without mortgage debt restructuring.

Eligible for Mark-to-Market with Debt Restructuring. Properties are eligible to renew their Section 8 contracts at market rents and restructure their mortgage debts if they meet **all** of the following criteria:

- ⇨ multifamily housing (more than four dwelling units)
- ⇨ one or more FHA-insured or HUD-held mortgages (except Section 202 or if financed by state/local government)
- ⇨ receives project-based assistance (Section 8 contract)
- ⇨ project-based rents exceed comparable market rents
- ⇨ owner must be in good standing

Eligible for Mark-to-Market Section 8 Rent Reduction without Mortgage Debt Restructuring (*OMHAR-Lites*). Properties are eligible to renew their Section 8 contracts at market rents without mortgage debt restructuring or a Use Agreement as long as OMHAR agrees that the long-term physical and financial integrity of the property will not be jeopardized. (See Section X of this document and Chapter 10, Section 10-4 of the Operating Procedures Guide for further discussion of OMHAR-Lites).

Opt-Out. Properties may opt-out of the program, provided tenants and HUD receive proper notification.

OMHAR Review. If the Restructuring Plan package is conforming, the OMHAR Field Office performs an administrative review of the Restructuring Plan (within 15 calendar days of submission of a complete Restructuring Plan package). If the transaction is non-conforming, the OMHAR Field Office performs a technical review (within 30 calendar days of submission of a complete Restructuring Plan package). See Chapter 5, Section 5-6 C of the Operating Procedures Guide for an explanation of conforming versus non-conforming transactions.

The OMHAR Field Office reviews the draft Restructuring Commitment to confirm its consistency with the Case Memorandum and HUD’s guidelines. The review confirms that the draft Restructuring Commitment encompasses all the terms and conditions developed in the proposed Restructuring Plan, including the terms of the new Section 8 project-based HAP contract, as applicable.

OMHAR alerts the Multifamily Hub or Program Center, and the Public Housing Division when there is a pending conversion to tenant-based assistance.

VI. Loan and Funding Approval Process

Prior to obtaining loan/funding approval, the underwriter reviews data for completeness and accuracy; determines property ownership structure; identifies and evaluates compliance with HUD guidelines; and verifies financial statements and other owner-provided information.

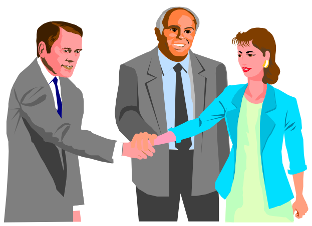
Review of Restructuring Plan. The PAE conducts an internal review of the underwriter's Restructuring Plan (and the "fast-track" mortgage request, if applicable). The PAE ensures that the draft Restructuring Plan incorporates all required documents, is consistent both internally and with the terms of the new financing, and complies with the underwriting standards in the Operating Procedures Guide (see Chapter 5, Section 5-6 and Form 5.2 in the Operating Procedures Guide).

Restructuring Commitment. The PAE drafts a Restructuring Commitment, incorporating the conclusions of the Case Memorandum, underwriting determinations (e.g., first, second, and third mortgage, if applicable), PCA (i.e., rehabilitation needs), RAAP, Use Agreement, and other materials in the Restructuring Plan. The PAE provides certification of completion of the Restructuring Plan, and (along with the mortgagee) certification of the FHA underwriting to the OMHAR Field Office.

Out-Year Contracts. OMHAR may restructure properties prior to the Section 8 contract expiration. If some or all contracts, or stages, expire after FY 2001, see Chapter 1, Section 1-3 E. of the Operating Procedures Guide for guidance.

Ineligibility for Mark-to-Market. Some properties/owners are **"ineligible"** (e.g., non-FHA-insured or rents less than market), **"exempt"** (e.g., State and local and bond financed, Section 202 elderly/disabled, FmHA Section 515 and Section 8 SROs), or **"disqualified"** (e.g., owner referred for Enforcement Center review) from the Mark-to-Market restructuring options.

II. Role of the PAE in the Mark-to-Market Program



The hands-on restructuring responsibility is delegated to qualified Participating Administrative Entities (PAEs), chosen and supervised by HUD's Office of Multifamily Housing Assistance Restructuring (OMHAR):

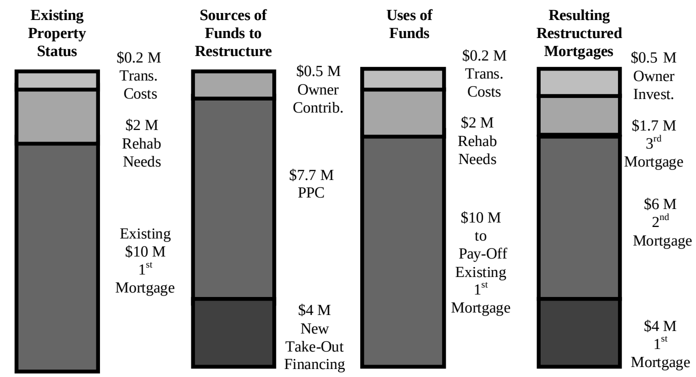
⇨ public agency (e.g., State and local HFAs)

⇨ where a public agency is not available, private entities can partner with public agencies (e.g., State and local HFAs, HUD)

PAE Responsibilities. Under the Portfolio Restructuring Agreement (PRA) signed with OMHAR, the PAE has a number of responsibilities:

⇨ review owner eligibility (i.e., verify owner/property not ineligible, exempt or disqualified)

Sample Transaction:
New Mortgage with PPC



Sources and Uses (in millions)

	PPC	New Debt	Owner Contributions	TOTAL USES
Satisfy outstanding debt	$7.7 M	$2.3 M	-0-	$10.0 M
Rehab. costs	-0-	$1.6 M	$0.4 M	$2.0 M
Transaction costs[4]	-0-	$0.1 M	$0.1 M	$0.2 M
TOTAL SOURCES	$7.7 M	$4.0 M	$0.5 M	**$12.2 M**

4 Owner-paid transaction costs include the mortgage insurance premium (MIP) on the new FHA-insured mortgage. Prepaid MIP on the existing FHA-insured mortgage cannot be netted against the new MIP due; however, the refund of prepaid MIP can be directed to the project reserve account post-closing.

Draft Restructuring Commitment. The PAE should draft the Restructuring Commitment after providing notice to and holding the required second meeting with tenants and local community groups, and should then forward a copy to the OMHAR Field Office for approval. Upon OMHAR approval, notice should be provided to every tenant, the owner, the mortgagee or loan servicer, and the chief executive officer of the affected unit of local government.

Conforming Versus Non-Conforming Transactions. The OMHAR Field Office will confirm whether the draft Restructuring Plan is conforming or non-conforming, as indicated by the PAE. The underwriter uses the criteria described in Chapter 5, Section 5-6 C of the Operating Procedures Guide to evaluate the Restructuring Plan transaction; OMHAR makes the final determination.

The following page illustrates the financing structure of a sample restructuring transaction. A larger version of this example also can be found in Chapter 5, Section 5-5 G of the Operating Procedures Guide.

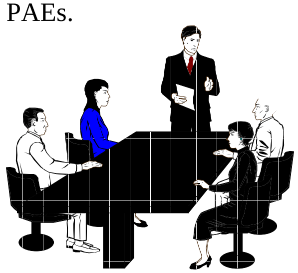
- ⇨ obtain public comments from tenants and community groups
- ⇨ collect and verify data (rents, expenses,etc.)
- ⇨ evaluate rehabilitation needs
- ⇨ determine type of Section 8 renewals (project-based or tenant-based assistance)
- ⇨ determine size/structure of new or modified mortgages
- ⇨ negotiate restructurings with the owner
- ⇨ assist the owners in loan/funding approval process
- ⇨ in certain cases, facilitate sale or transfer of properties
- ⇨ work with owners on closing
- ⇨ distribute closing documents

In addition, the PAE can be selected to service second mortgages, service Rehabilitation Escrow accounts, administer Section 8 contracts, and monitor compliance with Use Agreements

III. Preserving Affordable Housing

The goals of the Mark-to-Market program are:

- ⇨ Social: preserve affordable multifamily housing stock
- ⇨ Economic: reduce the cost of Section 8 subsidies and minimize FHA claims
- ⇨ Administrative: increase operating efficiency and ensure competent management with oversight delegated to a national network of decentralized PAEs.



The PAE plays a key role in achieving these goals, including:

- ⇨ working with tenants, local community groups, owners, OTAGs, ITAGs, Community Builders, and other parties to facilitate quality communication and manage competing public policy objectives.
- ⇨ developing a Restructuring Plan and a Rental Assistance Assessment Plan (RAAP)

One-time Distribution. The Restructuring Plan may also include a one-time distribution of up to 10 percent of the surplus project funds after the rehabilitation work is completed satisfactorily.

Draft Restructuring Plan. After all data collection and due diligence has been completed, the underwriter completes the draft Restructuring Plan by developing a Case Memorandum. The Case Memorandum explains the restructuring conclusions (i.e., NOI projections, sizing of the mortgages, rehabilitation needs, and the owner's estimated return).

The proposed Restructuring Plan should be available for inspection by tenant and community groups, and other interested parties no less than 20 days prior to submission of the Restructuring Plan for approval. Forms 5.2 and 10.1(a) in Appendix D of the Operating Procedures Guide provide a detailed list of the required elements for the Restructuring Plan.

The PAE certifies the Restructuring Plan and determines the affordability requirements in the Use Agreement.

<u>Estimating Rehabilitation Costs and Requirements for Reserves</u>. The underwriter determines both the Rehabilitation Escrow Account funding requirement and the size of the initial and annual/monthly deposits for the Reserves for Replacement Account. The PAE must require repairs (not maintenance items) due within 12 months to be escrowed (and obtain owner contribution from non-property resources) rather than deferred to be funded through monthly Reserves for Replacement deposits.

<u>Financial Return to Owner</u>. The Restructuring Plan may provide up to 25 percent of the net cash flow to be paid to an owner that meets management and quality standards.

Where exception rents are used, the underwriter should ensure a slightly positive NOI.

HUD will consider recognition of an asset management fee to the owner of up to $25 PUPM, provided the owner is amortizing the second mortgage on schedule. Further, the property must have received superior ratings from the Real Estate Assessment Center(REAC) in their most recent published ratings. This fee cannot accrue, and cannot be recognized if the project is receiving above-market exception rents.

- ⇨ verifying the affordability requirements through the enforcement of affordability and use restrictions if Section 8 funding ceases
- ⇨ monitoring Use Agreements
- ⇨ providing information through reporting requirements

<u>Tenants and Community Group Participation</u>. A minimum of two meetings will be held with tenants and community groups. The PAE (or owner) must notify and consult with tenants, local government officials, and other interested parties (consistent with Housing Notice 98-34, and subsequent guidance) when they select an option to restructure and when they complete a draft Restructuring Plan.

1. A consultation meeting is required within 20 to 40 days from the date of the notice to restructure, where tenants can comment on topics such as the physical condition of the building, rehabilitation and repairs, building management, and project-based or tenant-based assistance.

2. A second meeting will be held after the completion of the draft Restructuring Plan. The purpose of the meeting is to enable tenants and community groups to provide feedback prior to submission of the Restructuring Plan to OMHAR.

Other Tenant and Community Group Participation:

Intermediary Technical Assistance Grant Programs (ITAG). $9 million was allocated for Intermediaries to administer this technical assistance program around the country. Grants include Resident Capacity Grants, Predevelopment Grants, and Public Entity Grants. ITAG activities include, among others:

- ⇨ advertise funding availability for state-grouping;
- ⇨ produce and distribute grant application kits;
- ⇨ accept applications;
- ⇨ review and approve or reject applications; and
- ⇨ disburse grants to sub-recipients.

Outreach and Training Grants (OTAGs). Thirty-two (32) OTAG grantees were selected to organize and train tenants to participate meaningfully in the Mark-to-Market restructuring process. OTAG activities can include, among others:

- ⇨ identify residents and resident groups living in eligible Mark-to-Market properties;
- ⇨ provide outreach and training to such tenants, explain the Mark-to-Market program, educate tenants on possible financial changes and possible repairs;
- ⇨ organize residents; and
- ⇨ counsel residents to sound housing management, maintenance, and financial management.

To size the first mortgage, the underwriter considers the DSCR (generally between 1.2 and 1.4); the DSCR for a non-FHA insured take-out mortgage (no higher than 1.4); the DSCR for a modified loan or FHA-insured take-out mortgage (generally 1.2); amortization period and interest rate; transaction costs; other factors that demonstrate the likelihood of default (e.g., loan-to-value). See Chapter 5, Section 5-5C. of the Operating Procedures Guide.

Sizing the Second Mortgage. The subordinate mortgage is superior to all liens on the property, except the modified or new restructured first mortgage. The second mortgage is sized at the lesser of: (1) the difference between the unpaid principal balance before and after restructuring, or (2) an amount that the PAE determines the property can reasonably repay. (See Chapter 5, Section 5-5 D of the Operating Procedures Guide.)

Sizing the Third Mortgage. If the partial payment of claim is greater than the second mortgage, HUD will require a subordinate third mortgage. The third mortgage will bear interest at the same rate as the second mortgage, but will not require payment until the second mortgage is paid in full, at which point the borrower must pay the entire balance of the third mortgage. The PAE may negotiate forgiveness of a portion of this debt, up to 30 percent, to recognize imputed tax consequences of restructuring.

- ⇨ rent reduction to market levels with no partial payment of claim or mortgage modification, other than reamortization of the existing first mortgage. (Such a project would be processed as an OMHAR-Lite; see Chapter 10, Section 10-4 of the Operating Procedures Guide.)

If NOI is negative, or the NOI cannot support the cost of rehabilitation with a full pay-down of existing debt, recommend either:

- ⇨ approval of above market exception rents with a partial payment of claim (leaving only a nominal mortgage amount); or
- ⇨ rejection of the Restructuring Plan (and a recommendation to convert to tenant-based Section 8 assistance, provided it will not adversely impact tenants).

Sizing the First Mortgage. The underwriter should assume the first mortgage will be fully amortizing with fixed monthly payments on competitive terms. A waiver is required to use greater than 1.4 DSCR, unless it is necessary to constrain the LTV to less than 100%. The plan cannot produce a principal balance on the first mortgage that exceeds the existing unpaid principal balance of the first mortgage at the time of restructuring. The principal amount should be sustainable at rent levels that are the lower of: (1) Section 8 rents under Mark-to-Market, or (2) affordable rents allowed under the Use Agreement.

VISTA. HUD signed a Memorandum of Understanding with the Corporation for National and Community Service which included $1 million a year during each of the next three years to hire approximately 100 VISTA volunteers, annually, to help organize and train tenants in Mark-to-Market eligible properties.

Other Resources. Additional activities will include:

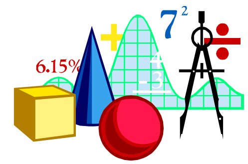
- ⇨ teleconferences broadcast to all HUD Field Offices for all Mark-to-Market stakeholders (tenant associations, non-profits, public entities, state or local government, PAEs, owners, etc.);
- ⇨ on-site two day conferences in states with the greatest number of eligible Mark-to-Market properties;
- ⇨ a national directory of all Mark-to-Market stakeholders;
- ⇨ a Technical Assistance Interactive web site; and
- ⇨ brochures to aid tenants, owners, and others in understanding the Mark-to-Market program.

RAAP. One of the key roles of the PAE is to use the Rental Assistance Assessment Plan (RAAP) to determine whether Section 8 assistance remains project-based or is converted to tenant-based assistance. The RAAP must assess the impact of converting to tenant-based assistance or extending project-based assistance. See Chapter 3, Section 3-5 C of the Operating Procedures Guide for more details.

A property receives <u>mandatory</u> project-based assistance if it is:

- ⇨ in a tight rental market (vacancy rates of 6 percent or below)
- ⇨ predominantly occupied by elderly or disabled families (at least 50 percent)
- ⇨ held by a nonprofit cooperative ownership housing corporation or a nonprofit cooperative housing trust.

Use Agreement. Every property that has debt restructured (i.e., in which a partial payment of claim is paid) will be subject to the affordability and use restrictions in a Use Agreement, which statutorily must be in effect for at least 30 years (e.g., preserve residential housing, ensure safety and health standards, document affordability requirements, provide enforcement rights, etc.).



NOI Recalculation. The underwriting concludes with the sizing of the first and second mortgages (and the third mortgage as needed), the determination of the Rehabilitation Escrow, and the deposits to the Reserves for Replacement. Before recommending the Restructuring Plan, the PAE should recalculate the NOI to assure consistency with the refinanced first mortgage terms, and to reflect changes dictated by the PAE's internal review process.

If <u>NOI is positive</u>, use one of the following restructuring approaches:

- ⇨ mortgage modification with a partial payment of claim (leaving at least a nominal mortgage amount);
- ⇨ new financing with a partial payment of claim (leaving at least a nominal mortgage amount); or

⇨ *Take-Out under Section 542(c) HFA Risk-Sharing or Section 542(b) GSE Risk-Sharing*. Will require a technical review by OMHAR if there is a conflict of interest.

⇨ *Take-Out with Full FHA Insurance*.

⇨ Section 223(a)(7) – limited for Mark-to-Market restructurings to no more than the amount of the current UPB and an amortization period equal to the remaining term (plus up to 12 years); requires a minimum DSCR of 1.2 (for Mark-to-Market restructurings)

⇨ Section 223(f) – requires Multifamily Hub or Program Center processing and approval, and requires the PAE to closely coordinate with FHA underwriters; limited to 85 percent of the appraised value or amount supportable by debt service; up to 35 year mortgage term; eligible for financing moderate but not substantial rehabilitation

⇨ Section 221(d)(4) – requires Multifamily Hub or Program Center processing and approval, and requires the PAE to closely coordinate with FHA underwriters; term of up to 40 years; eligible for substantial rehabilitation, but has LTV requirements of 90 percent.

<u>Timeline</u>. The following timeline reflects standard processing times:

Key Stages	Calendar days from Assignment to PAE	Calendar days form Section 8 Expiration
Owner Files H 98-34 Option		-90
Property Assigned to PAE	0	-45
Kick-Off Meeting	15	-30
Section 8 Contract Expries - Extension begins		
First Tenant Meeting[1]	45	0
Data Collection Completed	45	0
Due Diligence Completed	65	20
Second Tenant Meeting[2]	95	50
Underwriting Completed/ Restructuring Plan Drafted	105	60
Restructuring Commitment Issued[3]	120	75
Restructuring Commitment Executed	150	105
Closing Documents Prepared	195	150
Closing Document Executed	210	165

1 First tenant meeting held within 20-40 days of kick-off meeting. Thirty days is used in the above timeline.

2 Second tenant meeting may be held no later than 10 days prior to the submission of the draft Restructuring Plan to OMHAR for approval. Notice of available draft Restructuring Plan must be given no later than 20 days prior to submitting the draft Restructuring Plan to OMHAR for approval.

3 Restructuring Commitment allows 15 days for conforming transactions, or 30 days for non-conforming transactions, for approval. 15 days is used in the above timeline.

IV. Data Collection and Verification

In preparation for underwriting, the **owner** has 30 days after the kick-off meeting with the PAE to provide estimates of projected revenue, expenses, and rehabilitation needs. The following checklist includes required materials the owner must provide the PAE (see Section 4-4 and Form 4.3 in the Operating Procedures Guide for a complete list). PAEs may request additional information.

1. Documentation
   - ❑ Ownership documents
   - ❑ Location map
   - ❑ Related party agreements (if any)
   - ❑ Previous Participation Certificate(s) (HUD Form 2530) signed by each principal
   - ❑ Title Report or pro forma endorsement
   - ❑ Insurance policies (e.g., hazard, property, flood, casualty, etc.)
   - ❑ Easements and Joint Use Maintenance Agreements
   - ❑ Current rent roll

2. Financial Analyses and Projections
   - ❑ A one-year project rent and expense analysis to size the first mortgage
   - ❑ Optional: owners are invited to submit two 20-year pro formas (one with and one without Section 8 assistance), to size the second mortgage – assumptions for each may differ. The owner may request that the PAE develop the pro forma(s).

- ⇨ Ensure management has a fidelity bond in an amount equal to at least two months' potential rent collections per property
- ⇨ Review a sample of accounting and tenant files
- ⇨ Include Property Management Standards in the Restructuring Plan (these are summarized in Chapter 5, Section 5-3 I.7, of the Operating Procedures Guide).

First Mortgage Financing Alternatives. After completing the information analysis, the underwriter discusses preliminary findings with the owner and the existing mortgagee (for a loan modification), or the proposed new lender (for a take-out mortgage), as appropriate. The owner can obtain either a loan modification of the first mortgage or take-out loan (see Chapter 5, Section 5-4 in the Operating Procedures Guide).

- ⇨ *Loan Modification*. Only available with approval of the FHA-insured mortgagee, and cannot be used to finance rehabilitation or transaction costs. The owner will negotiate with the mortgagee for any combination of the following: interest rate reduction, principal write-down, or reamortization.
- ⇨ *Conventional Take-Out*. The owner should obtain evidence of loan commitment from a lender.

- ⇨ Estimated Rehabilitation Escrow based on the dollar amount of twelve-month physical needs (see Chapter 5, Section 5-3 H.4 of the Operating Procedures Guide for details);
- ⇨ Long-term capital needs to maintain physical integrity for next 20 years;
- ⇨ Reserves for Replacement (estimate initial and monthly deposits) – **do not double count** items in Rehabilitation Escrow in Reserves for Replacement;
- ⇨ Owner's contribution from "non-project" resources – confirm at least 20 percent of rehabilitation costs, with a minimum of 3 percent from non-governmental sources; and
- ⇨ Cost-benefit analysis for each major discretionary work item in the Restructuring Plan.

<u>Evaluation of Management and Other Issues</u>: The underwriter evaluates the property manager in accordance with industry norms and HUD guidelines.:

- ⇨ Identify type of management agent (*self-managed; identity-of-interest management agent; independent fee agent*)
- ⇨ Assess management through review of tenant and community comments, HUD Field Office comments and/or files, physical and financial condition of the property.

Use the following guidelines:

A. *Revenue Estimates -- using Comparable Market Rents*:

- ⇨ Calculate market rent based on three comparable, unsubsidized properties in same market area (use five comparables, where practicable).
- ⇨ If three or more comparable properties cannot be located in the same market area, consider non-comparable rental properties in the same area.
- ⇨ If three or more comparable properties cannot be located in the same market area, expand to neighboring areas.
- ⇨ Reflect the impact of rent control and zoning restrictions.
- ⇨ As a LAST RESORT, use the 90 percent of FMR standard.
- ⇨ Use lower of comparable market rent and affordable rent standard.
- ⇨ Identify the vacancy and bad debt assumptions.
- ⇨ Include revenue from commercial leases to the extent it is clearly reliable (i.e., a conservative estimate).
- ⇨ Specify market revenue trending assumptions.

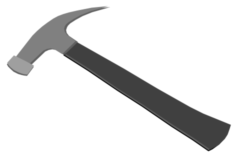
B. Operating Expense Estimates: Determine competitive market rate operating expenses and adjust for "other necessary" expenses for the property's operation as a subsidized property:

- ⇨ Identify management fees, salaries, benefits, and other management costs (e.g., rent-free units).
- ⇨ Analyze utility costs (e.g., if property-paid utility costs are not included in the comparable market properties, make an upward adjustment).
- ⇨ Show taxes, insurance and tax abatements, and explain.
- ⇨ Separate maintenance expenses from deposits made to the Reserves for Replacement account.
- ⇨ Specify market expense trending assumptions (pro formas only).
- ⇨ Explain other necessary expenses (e.g., costs that are not included in the comparable market properties).

C. *NOI Projections*: (from revenue and expense projections).

3 Physical Condition Assessment (PCA): The owner must provide an owner evaluation of physical condition (or an updated Capital Needs Assessment – CNA) which evaluates critical repair items, twelve-month physical needs, long-term physical needs, and an analysis of the Reserves for Replacement. The PAE engages a qualified physical inspector to develop an independent PCA. Note: If health and safety violations exist, the owner is in violation of the Section 8 HAP contract and the FHA Regulatory Agreement; all such work items must be corrected as soon as they are identified.

Exception Rents: If the adjusted NOI is negative, or if the cost of rehabilitation is greater than the debt supported by the NOI after restructuring, the underwriter may recommend exception rents. Exception rents are based on the projected costs of operation, assuming no first mortgage debt service, and using a reasonable allowance for second mortgage debt service coverage, and owner return. Exception rents may not exceed 120 percent of the area's FMR without a waiver from the OMHAR Field Office, and generally may not be used in more than 20 percent of the PAE's portfolio.



Determination of Rehabilitation Needs: The underwriter confirms the property's immediate deferred maintenance, market driven capital needs, and long-term capital needs to estimate the Rehabilitation Escrow and Reserves for Replacement by assessing:

- ⇨ Owner's evaluation of physical condition and PAE inspector's PCA report;
- ⇨ Uniform Physical Condition Standards – confirm there are no health and safety threats;
- ⇨ Twelve-month physical needs – confirm that restoration is to the non-luxury standard adequate for the market at the property's original purpose;

Calculation of Adjusted Net Operating Income (NOI):

Add the revenues:	+	Rental Income (comparable market rent data/affordable rent standard)
	+	Commercial Income (include in "other income")
	+	Other Income (e.g., laundry, parking, cable TV, etc.)
	-	Vacancy/Bad Debt Allowance (deduct from gross revenue potential)

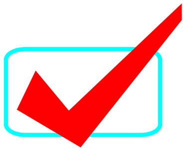
Subtract Operating Expenses:	-	Base Fees
	-	Controllable Expenses
	-	Other necessary expenses (e.g., Service Coordinators, security, tenant income verification, Neighborhood Networks (to extent included in the FHA approved Business Plan))
	-	Monthly deposits to Reserves for Replacement (treat the monthly deposits as an operating expense for underwriting purposes)

NOI	=	Total Revenues minus (-) Total Operating Expenses ⇒ if positive, underwriter determines sustainable first mortgage debt, generally using a 1.2 DSCR ⇒ if negative, underwriter may recommend exception rents

See Chapter 5, Section 5-3 G of the Operating Procedures Guide for more details

4. Financing plan. The owner may propose a plan for restructuring the property's mortgage debt and for refinancing rehabilitation costs.
5. Real Estate Appraisal. If the owner intends to apply for FHA mortgage insurance under Section 223(f), the mortgagee should submit a real estate appraisal from an approved appraiser.

The **PAE** verifies the information with independent data, qualified professionals, consultations with affected parties, **and field review of the subject property (and comparables)**. Use this due diligence checklist, where appropriate:



1. Documentation
   - ❑ Review Field Office records and certifications for the:
     - ⇨ project and property
     - ⇨ ownership and management
     - ⇨ security and assistance
     - ⇨ loan and other financial information
   - ❑ Review lender records (from mortgagee or loan servicer)
   - ❑ Review local government records (compliance issues), if available

2. Due Diligence for Revenue Projections
   - ❑ Procure a qualified appraiser
   - ❑ Set the scope and standards of the appraisal
   - ❑ Use standards of market-comparable improvements and appropriateness of comparable market rents

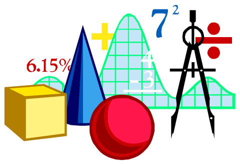
3. Due Diligence for Operating Expense Projections
   - ❑ Review expense data sources
   - ❑ Determine Reserve for Replacement deposit requirements
   - ❑ Determine other necessary expenses

4. Due Diligence for Rehabilitation Requirements
   - ❑ Consult with tenants and other interested parties
   - ❑ Establish scope of work, review, and revise PCA, in consultation with the property inspector
   - ❑ Estimate rehabilitation costs (using qualified inspector)

5. Environmental Evaluation (see Chapter 4, Section 4-5 K. of the Operating Procedures Guide)
   - ❑ Review the Environmental Restrictions Checklist (Form 4.4) and the PCA prepared by the PAE's physical inspector
   - ❑ Provide information to the OMHAR Field Office, which will review the Environmental Restrictions Checklist (Form 4.4), and complete the Environmental Assessment and Compliance Findings for the Related Laws (HUD 4128)

V. Underwriting and Financing Alternatives

Role of the Underwriter. The Underwriter uses the Limited Scope Appraisal (or full appraisal), financial statements, rent/expense analyses and pro formas, owner evaluation of physical condition, PCA, third-party expense information, management documents, and other available sources to: determine a property's rents, expenses and rehabilitation needs; recommend and justify exception rents if necessary; evaluate management; and recommend the size of the first mortgage, the second (cash flow) mortgage (and third mortgage if needed), the amount of claim payable by FHA, rehabilitation financing requirements, and the owner's estimated financial return.



The underwriter analyzes stabilized revenues/expenses to size the first mortgage, and develops a 20-year projection of revenues/expenses to size the second mortgage. The underwriter evaluates two scenarios: (1) project-based Section 8 is continued indefinitely at market rates, and (2) project-based Section 8 is discontinued.