Section II
Production

Appendix 2.1

Calculating the Initial Operating Deficit Escrow

A. **Format**. The Initial Operating Deficit (IOD) Escrow Calculation Template (Form HUD-91128-ORCF) has been developed for 232 applications. This is a template that incorporates the rules outlined herein and will aid the Lender in preparing an IOD calculation that is acceptable to ORCF. The IOD workbook will be a required exhibit whenever an IOD analysis is required (see above). The workbook ~~should~~must show the cash flows up to the period of stabilized occupancy, rather than stopping at the point when a positive cash flow is achieved. Except in unusual circumstances the IOD calculation will use constant dollars, leaving the income and expenses stable without adjusting for inflation. This means that the later periods of stabilized occupancy will exhibit incomes and expenses consistent with the underwritten assumptions.

The operating deficit represents the total of all cumulative monthly losses projected to occur until the project reaches breakeven operations and produces a consistently positive cash flow.

B. **Absorption Rate.** ~~The~~Estimate the rate that the project is able to fill beds/units ~~should be estimated~~ using a net monthly absorption rate. This rate ~~should~~must account for both move-ins and move-outs, which are part of any normal operation. ~~Preleases~~A conservative preleases can be considered, which will result in more move-ins the first month than the monthly average. The template will delay the reimbursements for the move-ins by two~~-~~-months to account for a payment lag~~.~~, for non-private pay residents. For Section 241(a) applications, existing operations can be represented within the prelease. We urge caution when forecasting or extracting absorption data from comparables~~—~~do not double count the preleases in the calculation of the monthly average. While no limit is being placed on the length of the absorption period, the viability of projects with unusually long absorption periods will be brought into question.

C. **Expenses**. At times, the expense conclusions of the Lender differ from those of the appraiser. That is because the appraiser is asked to use "market" expenses, and the Lender is asked to superimpose ORCF specific expense requirements over the appraiser's when calculating the maximum loan amount based on Debt Service. For purposes of the IOD calculation, it is the Lender's expense estimates that ~~should~~will be used, rather than the ~~appraiser's~~appraisers.

Because some expenses vary with level of occupancy and some do not, the expense estimate must be forecasted monthly by categories. Names of example categories are given on the IOD template. The names may be changed to correspond to the categories used by the appraiser, Borrower, or Lender. There are a few basic categories that should not be renamed in the template. These categories and the reasons to account for them separately are as follows:

1. **Ground Rent.** This expense will not be charged in Interval 1 (see below).

2. **Marketing & Promotion**. The estimated amount in this category is usually derived from comparables and generally only accounts for the amount needed to maintain stabilized occupancy. The IOD template will apply this expense at 200% of normal until the stabilized occupancy has been achieved. This category ~~may~~will not be blank.

3. **Insurance (property & liability).** This expense generally must be paid up front, therefore a year's worth of this expense will be paid at the end of construction (Interval 2 below). Following that, a monthly amount will be impounded so another full year's payout will not be necessary.

4. **Real Estate Taxes.** This fixed expense will generally be the same regardless of occupancy. For that reason, it is accounted for separately so it can be applied at 100%.

5. **Management Fee.** This expense ~~should~~will represent the particular arrangement defined in the management agreement. It is often calculated as a simple percentage of the Effective Gross Income once stabilized occupancy is achieved, but there are generally provisions for a different reimbursement arrangement during the initial lease-up period. The IOD worksheet ~~should~~will reflect those project-specific intricacies.

6. **Reserve for Replacement~~.~~ (R4R).** This expense category is constant regardless of occupancy and is not collected during Intervals 1&2 (see below).

7. **Expense Floors.** In conjunction with the concept that some expenses vary depending on the level of occupancy, the IOD worksheet ~~should~~will include expense floors. The floor is the level that a variable expense category cannot be expected to fall below. For example, the "Housekeeping & Laundry" expense may be quite low when a project is minimally occupied, but it would never be expected to fall to $0, since a minimum level of staff would need to be retained. The expense floors on the IOD template are to be entered as a percentage of the normal amount; the dollar amounts are calculated automatically. The percentages pre-entered in the IOD template represent ORCF's expectations for the example expense categories. Giving justification when departing from these expectations may serve to expedite the review process.

8. **Intervals.** A project will begin to incur expenses not covered by the loan upon receiving the certificate of occupancy. The monthly debt service payments start later, with interest only at first. Because these expenses phase in at different times there are three distinct expense intervals to consider when calculating the deficit.

   a. Interval 1 covers the period of time between certificate of occupancy and the end of the construction period/cost certification period (Note that the construction period is defined as construction time plus two months for cost certification purposes). Technically this is an optional interval, because some projects may have a similar certificate of occupancy date and construction completion date, and thus would not need an Interval 1. However, it is hard to predict if that will be the case when the IOD is being prepared, so the template is set up to assume that Interval 1 will consist of a 2-month period. When calculating expenses for this Interval, no debt service is to be included as an expense~~.~~, with the exception of existing debt service payments for Section 241(a) applications which must be an included expense in all three intervals. Mortgage interest for this interval is included in the loan amount, not the escrow. ~~Reserve for Replacement~~The R4R and ground rent are not to be included in Interval 1. Ground rent during the construction period is calculated into the loan amount. This interval will only include the underwritten estimate of all of the applicable operating and leasing expenses for each period (month).

   b. Interval 2 begins at the end of the construction period/cost certification process and ends at the beginning of loan principal amortization. This period can be no greater than 2~~-~~-months and is also technically an optional interval (Amortization must begin no later than 4~~-~~-months after construction completion for insurance of advances and first day of second month after final ~~endorsement~~closing for insurance of completion cases). Again, at the time the IOD calculation is made, the exact length of this period will not be known. For that reason, the IOD template utilizes a standardized 2-month period for Interval 2. Debt service in this interval will include payment of interest and MIP, but not principal payments because amortization signals the beginning of Interval 3. Ground rent must be included if the property is a leasehold since only ground rent during construction can be included in the loan, and this interval begins after construction completion. ~~Reserve for Replacement~~The R4R deposits are not included in Interval 2. This interval will include the underwritten estimate of applicable operating expenses for each month (period).

   c. Interval 3 begins at the start of amortization. Amortized debt service is a mandatory expense in this interval, and must include payment to principal, interest, and MIP. Ground rent, if applicable, and ~~reserve for replacement~~R4R deposits are also mandatory in Interval 3. This interval will include the underwritten estimate of applicable operating expenses for each month (period).

9. **Commercial Income.** Where commercial facilities are included in the project, a separate operating deficit estimate ~~should~~will be made. The Lender will ensure that expenses included in the residential deficit estimate are not duplicated in the commercial operating deficit estimate so as to unfairly penalize the property. The commercial space operating deficit is added to the residential operating income deficit to determine the total project escrow that will be necessary. Any positive income attributable to the commercial space during the deficit period will not offset the residential operating deficit requirements.