

PRACTical RAD - Capital Needs Assessments

00:00

Hello and welcome to this video in the “PRACTical RAD” Series on Capital Needs Assessments, or “CNAs.” This is one in a series of videos that provide practical guidance to owners of Section 202 properties with Project Rental Assistance Contracts. We refer to these properties as 202 PRACs.

This video will provide owners and other stakeholders with a general understanding of Capital Needs Assessments and what the assessment process entails.

00:29

After watching this video, the viewer will have a better idea of what goes into a CNA and why it is required. The viewer will also learn how to prepare for an assessment that meets HUD’s requirements and fits into the RAD conversion plan. Through this presentation, we will answer these questions to help you develop a fuller understanding of this critical element in the process.

00:54

The CNA is a physical inspection of a property and all its building systems and components. It determines a project’s short- and long-term repair needs, as well as their timing and costs. The CNA report identifies critical repair needs that address health and safety concerns or accessibility deficiencies.

The report will also provide a list of non-critical repairs or rehab needs, as well as replacements to be scheduled over time. These reflect all building components, some of which will be currently in good condition, some will be aged, and some may have already exceeded their useful life

1:35

A CNA is an essential part of the RAD conversion for two reasons.

First, assuming a limited scope rehab, determine the annual reserve for replacement deposits which would be required. This configuration will generally result in higher reserve deposits which can be used to justify a pre-conversion PRAC rent increase. This rent increase can be carried over into your conversion.

Second, assuming a more comprehensive rehab approach that will be undertaken as part of the conversion. From this determination, the ongoing monthly deposits to the reserve for replacement following a RAD conversion can be established.

The CNA provides the necessary information to properly size this ongoing deposit to the Replacement Reserve. This will directly impact the Section 8 contract rents available to the property through the RAD conversion.

2:29

Let’s look at the impact of the CNA on contract rent.

This first bar chart shows us that typical PRAC rents are based on a HUD-approved budget which is comprised largely of operating expenses, resident services, and replacement reserve deposits among other things (as found in the HUD Form 92547 A).

The second bar chart shows us that, prior to PRAC contract renewal, a project will commission a CNA if it believes there are changes in the level of services, equipment, or repairs needed at their project in the

short or long-term, which would result in increased replacement reserve deposits and service costs to justify a budget-based rent increase (otherwise known as “BBRI”) accordingly. Here, the goal is to maximize your rents regardless of whether you choose to pursue RAD or not.

When you convert to RAD, the same CNA used for your most recent BBRI or a new CNA will establish the baseline of minimum repairs that need to be addressed. Your rents alone may or may not be enough to support these repairs, let alone any additional ones not contemplated in the CNA but that should be completed as part of the conversion. Any additional design or improvements (such as, ADA, aging-in-place, energy efficiency retrofits, or other) may result in further scope of work and replacement reserve deposit increases.

In the third bar chart then, new financing is needed to address all the repairs, reducing the replacement reserve deposit, allowing the property to leverage new debt. The property’s Section 8 rental income is and must always be adequate to cover all conversion required repairs, the property’s operating expenses and services, as well as debt service and reserve.

4:14

All requests for budget-based rent adjustments for a PRAC are processed through your assigned Account Executive in the HUD field office. If an owner intends to convert the property through RAD, the account executive will coordinate with the Office of Recapitalization to review the CNA to make the appropriate adjustment to the Reserve for Replacement deposit amounts. Please note that a CNA would not need to be submitted if the owner’s requested change to Reserve deposits does not exceed \$250 per unit per year or represents no more than an OCAF increase from the prior year’s Reserve deposit

4:53

All properties converting through RAD are required to conduct a CNA and submit the CNA with their Conversion Plan. The CNA determines the minimum scope of work that must be completed as part of the conversion. An owner may choose to address additional discretionary work items as part of the RAD conversion. HUD also uses the CNA to establish the capital Replacement Reserve deposit levels the project requires once under a Section 8 contract.

Given that many properties will undertake rehab up front as part of the conversion, it will be very common for the ongoing monthly Reserve deposit levels to decrease following the conversion from the levels previously approved in the PRAC budget-based rent process. In many cases, this decrease will help create room in the project budget to support debt service. In cases where the repairs and deposits result in a cash flow deficit, a rent adjustment may be warranted.

5:56

A valid CNA must meet the requirements of Appendix 5 of the Multifamily Accelerated Processing Guide, commonly referred to as the ‘MAP Guide’ and must be no more than 18 months old from the date of the site inspection, with a desk update, or HUD requires a new site inspection and CNA.

A CNA is comprised of several parts, of which one of the most important is a narrative describing the project’s major building systems and components and their condition. Another important part of the CNA is a financial model containing a 20-year schedule that identifies the cost and timing of all projected repairs. The CNA will recommend deposit amounts for the property’s Reserve for Replacement account that will be sufficient to meet these costs as they occur.

Lastly, the recommendations in the CNA must comply with applicable federal, state, and local building codes, and other rules related to construction, rehabilitation, and accessibility for persons with disabilities.

The CNA provided as part of RAD Conversion Plan submission must be consistent with the CNA an owner may have provided as part of a PRAC budget-based rent adjustment. In other words, HUD expects the two CNAs' depiction of the property's condition to be consistent with one another. Most owners will procure a MAP-compliant CNA for the purposes of a PRAC budget-based rent adjustment and then subsequently update the CNA in the RAD conversion plan to reflect "time passed" as well as the rehab that the property may undertake through the RAD conversion.

7:40

HUD created the CNA e-Tool to provide a common format and standard for CNAs.

Originally designed as an Excel spreadsheet and web portal, the e-Tool is now a single web application that walks CNA preparers – usually Needs Assessors - and submitters – usually lenders - through the online inspection, reporting, and submission process. HUD reviews the submitted CNA within the same web-app, which generates various reports used to review and analyze the CNA. HUD may approve or comment on the Needs Assessor's and Lender's recommendations through the e-Tool as well.

The use of the CNA e-Tool is optional for 202 PRACs; however, its use and format is recommended to facilitate HUD's review of the CNA, and use of the CNA e-Tool format complies with Appendix 5G of the MAP Guide. Use of the CNA e-Tool reduces the time it takes for HUD to review the RAD Conversion Plan.

8:40

In RAD conversions, when possible, project owners are expected to add energy efficient upgrades and adhere to green standards that make economic sense.

As such, the CNA must also identify water and energy saving solutions and green improvements that are cost-effective over the long-term.

Specifically, for 202 PRACs, HUD also encourages owners to include additional items in their scope of work that anticipate the needs of elderly residents, and that will improve their quality of life and help them age in place, including enhancements to improve accessibility.

9:18

The ideal time to get a CNA is well in advance of your annual PRAC renewal, so that the CNA may be used to justify an increase to the Reserve for Replacement deposits in your budget-based rent adjustment. The owner can then re-use the CNA in its RAD conversion plan. The owner would work with the CNA preparer to perform a desk-update of the CNA to reflect the rehab that the owner will undertake as part of the conversion and update any building component ages if time has elapsed.

To begin, you'll need to make sure you find a Needs assessor that meets the MAP requirements. To support a good assessment, provide solid information about your property's capital needs, including data on what building systems are in place, what you've replaced and when, and what those replacements have cost. Other information useful to the assessor include property occupancy reports and rates of turnover.

It's best to have this information ready for the Needs Assessor's review. As a percentage of unit interiors must be inspected, be sure to notify residents in writing well in advance of the inspection date.

10:26

Very much like an HQS or REAC inspection, a Capital Needs Assessment will include an inspection of all unit types, common areas, and building exteriors, as well as sites and structures. The requirements are driven by a building's age.

10:45

With respect to the RAD conversion, the CNA results will inform the minimum required scope of work that HUD will require to be completed as part of the conversion. The owner will need to demonstrate that it can arrange the financing – through existing Reserves, debt, tax credit equity, or other sources – to address those rehab needs and any further improvements the owner elects. The CNA will also be used to appropriately size Replacement Reserve deposits for the property, once converted. There are two key tools to making sure your Reserve for Replacement account is adequately funded over the term of the HAP contract. In the first, funds are deposited up front at the closing of the RAD conversion from development sources (such as new mortgage proceeds) or transferred over from an existing Reserve account. This up-front deposit effectively seeds the account and gives it a starting balance that reduces the amount of on-going deposits. This up-front deposit is called the Initial Deposit to the Replacement Reserve, or I.D.R.R. The second approach is through on-going deposits from operations, which are called Annual Deposits to the Replacement Reserve, or A.D.R.R.

Properties with extensive replacement needs in the first few years of the CNA period will require a higher I.D.R.R, so that there are sufficient funds in the Reserve account to pay for these capital improvements, sooner rather than later. Properties that will have more substantial physical needs in later years can generally rely on annual deposits from operations – or A.D.R.R. - to accrue over time to meet those costs when they occur.

In general, the CNA Needs Assessor and/or lender will provide recommendations for a balanced I.D.R.R. and A.D.R.R. to cover all property needs over the 20-year CNA period. Owners may modify the recommended amounts with HUD's approval, if the proposed funding levels result in Reserve balances that meet or exceed the minimum balance requirements, as stated in the MAP Guide, Appendix 5G.

12:54

This video and all other videos in the PRACTical RAD Series can be accessed through the RAD Resource Desk as they are published. Your HUD transaction manager, who is assigned once you have created a RAD resource desk account and made an initial submission of interest, is ready to assist you. If you have not yet been assigned a transaction manager, email your questions to the general mailbox, RAD2@hud.gov. Technical assistance is also available for owners who would benefit from more specific guidance during different phases of the RAD conversion process, to enable them to move forward with their RAD transaction. Thank you for your interest in RAD for Section 202 PRAC properties. We look forward to hearing from you.