PRACtical RAD – Financial Strategies

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Hello and welcome to another video in the PRACtical RAD series. This series provides practical guidance to owners of Section 202 PRAC properties seeking to convert their rental assistance to the Section 8 platform through HUD's Rental Assistance Demonstration program, known as RAD.

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Other videos in this series include a RAD Program Overview, Conversion Milestones, and Capital Needs Assessments. Viewers may find it helpful to watch these videos before proceeding with this one.

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The RAD program enables owners of Section 202 Capital Advance properties with a one-year Project Rental Assistance Contract, or PRAC, to convert to a 20-year Section 8 Housing Assistance Payment, or HAP contract.

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One of the benefits of conversion is that a 20-year HAP contract can be leveraged to obtain a mortgage loan, if the property has rehabilitation needs that exceed funding available in the property's reserve for replacements account.

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To qualify for conversion, owners must submit a conversion plan that meets the requirements listed in Attachment 4A of the RAD Notice.

Components of a conversion plan include: a capital needs assessment, a financing plan that explains any loans or tax credits obtained by the property, an operating pro forma, and a development budget.

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After watching this video, PRAC owners will understand:

- How to create an operating pro forma,
- How to use a pro forma to forecast a project's future cash flow.
- Why positive cash flow is necessary for RAD conversion.
- When recapitalization is required, and
- The components of a development budget.

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For a RAD conversion plan to be eligible for approval by HUD, the conversion plan must demonstrate that the property will remain financially viable over the term of the new HAP contract.

“Financially viable” means that the property has adequate funding to address both its immediate rehab and its long-term capital replacement needs - as identified in the property’s capital needs assessment.

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If an owner is obtaining a mortgage loan to help pay for its capital replacement needs, the property must have an operating pro forma that forecasts cash flow sufficient to maintain a debt service coverage ratio or DSCR of 1.11 or higher for ten years.

Alternatively, if the owner is not obtaining a mortgage loan, the property must have an operating pro forma that forecasts cash flow of at least $12 per unit, per month.

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Let’s take a few minutes to talk about operating pro formas, cash flow, and debt service coverage ratios.

Operating cash flow is cash remaining after payment of property operating expenses, deposits to the reserve account, and any required loan payments.

An operating statement is used to show cash flow in the current year.

An operating pro forma is used to forecast cash flow in future years.

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Operating cash flow is calculated by taking gross potential rental income plus any laundry and vending machine income and then subtracting out, losses due to vacancy or bad debt, operating expenses, deposits to the reserve for replacement account, and any loan payments or debt service.

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Debt service coverage ratio or DSCR is a metric used to gauge whether a property will have sufficient cash to make required loan payments.

DSCR is calculated by taking net operating income and dividing it by the sum of the annual loan payments that a property is required to make.

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A DSCR of less than 1.0 indicates that the property may not have enough cash flow to make its mortgage payments, while a ratio of more than 1.0 indicates a cash flow cushion. Most mortgage lenders require a minimum DSCR of 1.10 to 1.20 over the term of the loan.

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For the purposes of RAD, the property owner must submit a pro forma which shows that the property will have a DSCR of at least 1.11 for the first ten years after conversion if the conversion includes mortgage loan financing.

If the conversion does not include a new mortgage loan, the operating pro forma must show that the property will have cash flow of at least $12 per unit per month.

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An operating pro forma is created in 3 steps:

The first step is to create an operating statement which shows current revenues, expenses, reserve deposits, and NOI.

The next step is to forecast revenues, expenses, and cash flow in future years. This is accomplished by assigning an annual inflation factor to revenues and expenses and the deposit to the R4R account, typically 2% for revenues and 3% for expenses.

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Creating a 20-year proforma in this manner provides insight on how NOI may change over time, and whether a property will be able to pay operating expenses, make deposits to the reserve account.

It is important to note that this pro forma is based on the property's pre-conversion revenues and expenses and thus is a forecast of future NOI in the event the property does not covert. This is known as a status quo pro forma.

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The third and final step is to carefully consider how revenues, expenses, and the deposit to the R4R account might change as a result of conversion and rehab of the property.

Upon conversion, the property's initial HAP contract rents will be the same as the property's pre-conversion PRAC rents. HAP contract rents can only be adjusted for inflation through annual OCAF adjustments. Therefore, it is important for owners seeking to convert to apply for a PRAC rent increase prior to conversion. PRAC rents are budget-based. If the CNA indicates that a higher deposit to the reserve account is warranted, this can be used to justify a request for a rent increase.

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The on-going deposit to the R4R account will also change at conversion to reflect the amount required by the CNA.

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Certain operating expenses may change as a result of RAD conversion. For example:

- If significant rehabilitation work is performed as part of the conversion, maintenance and repair expenses may decrease.
- If existing appliances and building systems are replaced with more energy efficient appliances and systems, owner-paid utility costs may also decrease.
- HUD requires owners to demonstrate that the service needs of residents are met through a service coordinator and/or the provision of supportive services that are funded through the property's operating budget, or through another arrangement. If services are added or enhanced, service costs may increase.

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As you can see, net operating income can be increased by increasing revenues and decreasing expenses. As NOI increases, so does the amount of debt that the property can support.

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Recall that HUD requires a DSCR of 1.11 or better in year ten. Now that we've created a post conversion pro forma, we can estimate the annual debt service that our property can support by taking year ten NOI and dividing it by 1.11. The size of the loan this amount of debt service can support depends on several variables determined by the mortgage lender, such as loan term, amortization period, and interest rate.

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The goal of a RAD conversion is to establish maximum rents, adjust operating expenses, properly size the reserve for replacement account, and set the property on a sure financial footing. If, after making these changes to the pro forma, projected cash flow is sufficient to maintain a 1.11 debt service coverage ratio for the first ten years after conversion or, if the property is not obtaining a mortgage loan, projected cash flow is at least $12 per unit per month, then the operating pro forma is acceptable to HUD for purposes of RAD conversion.

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Let's step away, for a moment, from our discussion about the pro forma and talk about the reserve for replacement account.

The R4R account is used to pay for capital replacements, such as the purchase of new appliances, windows, and roofs.

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The capital needs assessment, or CNA, estimates when capital replacements will need to be made and how much they will cost.

Owners converting to Section 8 rental assistance through the RAD program commit to making capital replacements generally in accordance with the schedule shown in the CNA.

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The cost of replacements can vary greatly from year to year. Therefore, the reserve account must be large enough each year to pay for these costs as they are anticipated to arise.

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The replacement reserve is funded through an initial deposit from the development budget, referred to as the IDRR, and annual deposits from the operating budget, known as ADRRs.

The ADRR can be reduced, to some extent, by increasing the IDRR. Decreasing the ADRR in the pro forma increases cash flow which, in turn, may increase the amount of money the property can borrow.

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If a property lacks resources needed to perform required rehab, as determined by the CNA, or to fund the IDRR, recapitalization of the property may be necessary to qualify for RAD conversion.

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Recapitalization is the process of adding new money to a property - such as a mortgage loan, soft loan, grant, or tax credit equity – to improve the property's financial stability.

If recapitalization is necessary, the conversion plan must include a detailed financing plan that identifies the types of funds being added to the property and the amounts and sources of those funds.

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If your property needs recapitalization, you may be wondering,"How much money does my property need?", or "How big a loan can my property support?"

Loan proceeds would need to be an amount that, when combined with any other new or existing property resources, will address the property's immediate rehab and capital replacement needs (as identified in the CNA), fund the IDRR, and maintain the required level of cash flow in the pro forma.

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The amount of debt a property can support is determined by NOI, the DSCR, the interest rate, and the term of the loan. In order to mazimize loan size, an owner should seek to maximize the NOI of their property.

If loan proceeds are insufficient, then owner will need to seek additional resources such as soft debt or tax credits.

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Whether or not a property is recapitalized, the RAD Conversion Plan must include a development budget.

A development budget has two parts: sources and uses.

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Sources are monies available to pay costs associated with the RAD conversion. Sources include existing property accounts such as the reserve for replacement account and residual receipts account, and any loans, grants, or tax credit equity obtained in conjunction with conversion.

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Uses are costs associated with the RAD conversion. Costs might include rehabilitation costs, construction contingencies, tenant relocation, the IDRR, an operating reserve, third party reports, legal fees, developer fees, and closing costs.

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The development budget must identify all sources and uses of funds associated with the RAD conversion, and most importantly, total sources must equal total uses.

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If your RAD conversion involves recapitalization, you will need a financing team.

The size of your team will depend on the complexity of your transaction, and might include a commercial mortgage lender, RAD consultant, tax credit syndicator, tax credit investor, lawyer, and title company.

Start thinking about who you might want on your team as early in the process as possible.

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Thank you for your interest in RAD for Section 202 PRAC properties. This concludes this PRACtical RAD video.

Your transaction manager is ready to further assist you. If a transaction manager has not yet been assigned to you, email the general mailbox at: rad2@hud.gov

For more information on HUD's Rental Assistance Demonstration program please see Section IV of HUD Notice H-2019-09 or visit hud.gov/rad and/or radresource.net.