**U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

September 1, 2011

**MORTGAGEE LETTER 2011-32**

TO: All Multifamily Hub Directors
All Program Center Directors
All Project Managers
All Field Office Directors

SUBJECT: Underwriting Policies and Procedures for Commercial Space and Income in HUD-Insured Multifamily Projects

## I. Purpose

This Mortgagee Letter provides instructions and guidance pertaining to the recognition of commercial income in calculating the maximum insurable mortgage. This Mortgagee Letter is not applicable to the health care programs administered by the Office of Insured Healthcare Programs (Section 232, or refinancing of Section 232 pursuant to Sections 223(f) or 223(a)(vii)). The Mortgagee Letter will be effective pursuant to Section IX, below.

## II. Background

The largest portion of an insured project's gross income will come from the rental of apartments. However, there can also be significant ancillary income, commercial space and income, short term/premium leases and corporate leases. Together, these sources fall under the category of other income. The total amount of other income as a percentage of total gross income should not exceed what is prevalent in the subject's market area, as established by the appraisal and discussed in the underwriting summary. The Valuation and Underwriting of Commercial Space and Income is the subject of this Mortgagee Letter.

## III. Commercial Income – Space and Income Limitations

**A.** In accordance with 24 CFR 200.73, a project may include such commercial and community facilities as the Commissioner deems acceptable. The term "commercial" applies to any space within a multifamily property that is reserved for nonresidential use from which income is derived or anticipated. The term "community facilities" refers to project amenities, such as a pool, resident parking/parking garage, business center or fitness center that are predominantly used by residential tenants, with or without charging additional fees. Community facilities generally do not produce regular income and any intermittent revenue is to be included as ancillary income.

## B. Commercial Space and Income Limitations

The limitations on Commercial Space and Income are set forth below. Note that these commercial space limitations do not apply to community facilities. The Department is now specifying that uniform definitions of the limitations (i.e. percentage of net rentable area and percentage of effective gross income) be used for all programs. There is otherwise no change to the allowed percentages under the different programs.

**Commercial Space and Income Limitations**

| SOA | Allowable % of Total Net Rentable Area | Allowable % of Effective Gross Income |
|---|---|---|
| 221(d)(3)&(4) and 231 | 10% | 15% |
| 220 | 20% | 30% |
| 223(f) | 20% | 20% |

The percentage of Allowable Commercial Net Rentable Area is calculated by dividing Net Rentable Commercial Area[1] (Line C.35 of the form HUD-92264) by the sum of Net Rentable Residential Area[2] (Line C.34) and Net Rentable Commercial Area (Line C.35).

The percentage of Allowable Commercial Effective Gross Income (EGI) is calculated by dividing Effective Gross Commercial Income[3] (Line F.32c of the form HUD-92264) by the sum of Effective Gross Residential and Ancillary Income[4] (Line F.30d) and Effective Gross Commercial Income (Line F.32c).

## C. Parking

1. Parking income attributable to residential tenants is considered to be ancillary income and is not included in the limits contained in Section B, above. Commercial parking spaces reserved for use by motorists who are not property residents or are not parking to use the on-site commercial tenant's facilities, and the related non-tenant parking income, must be included in the Commercial Space and Income limitations, above. The income and space attributable to parking spaces reserved for non-residential or non-commercial tenants must be included in the limitations, based on applying the percentage of the total spaces that are reserved for non-tenant use. For existing properties that are to be acquired, refinanced or will undergo substantial rehabilitation, that provide parking for a

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[1] Net Rentable Commercial Area – the sum of all commercial areas within the exterior walls measured from the interior faces of exterior walls, corridor walls and partitions separating the area from other commercial and/or living areas.

[2] Net Rentable Residential Area – the total amount of living area for all residential units. "Living Area" is the area of a living unit measured from the inside faces of corridor and exterior walls and from the inside faces of partitions separating the living unit from other living units or commercial areas.

[3] Effective Gross Commercial Income – is Gross Commercial Income multiplied by the Commercial Occupancy Percentage.

[4] Effective Gross Residential and Ancillary Income – is the sum of the Annual Estimated Residential Income and Estimated Ancillary Income multiplied by the Residential Occupancy Percentage.

monthly fee, the lender must identify the percentage of monthly parkers who are non-tenants so as to include these in the commercial income limitations, above. The maximum occupancy factor to be applied to the parking income attributable to parkers who are not associated with either the project's residential or commercial tenants shall be the lower of:

a. The amount indicated by the market and by the historic performance of the subject, or

b. 50 percent.

NOTE: For proposed construction, or where new commercial parking facilities are to be constructed, the demand for this parking must be addressed in the market study, appraisal and underwriter's narrative.

2. If the borrower operates a parking facility that provides parking for residential or commercial tenants of the property, the lender must determine underwritten parking income based on an analysis of the past 3 years of operation and the trailing 12 month period prior to application.

3. If the parking facility is operated by a third-party, the lender may use the amount of income collected under the contract if it is a fixed monthly payment. Parking contracts that specify a percentage rent in addition to or in place of a fixed rent are not permitted without a waiver in compliance with Section V.F, below.

## IV. Limited Waiver of Commercial Income and Space Limits

A. Commercial Income Limits. Hub Directors may not issue waivers of the commercial income limits in Section III B, above, for any programs. Any waivers must be recommended by the Hub Director to Headquarters (HQ) and reviewed by HQ staff, with the final waiver determination made by the Deputy Assistant Secretary (DAS) for Multifamily Housing. The Hub Director's recommendation should demonstrate that the project's commercial component will contribute to meeting the Department's Strategic Plan Goals, including promoting sustainable communities or supporting transit-oriented development. If a waiver of the commercial income limits is requested, a credit analysis of all existing or pre-leased commercial tenants may be required at the discretion of the DAS.

Waivers will be granted where there are clear mitigating circumstances that justify such a waiver. Examples include but are not limited to:

1. A long-term lease with a credit-worthy tenant, such as a government agency;

2. A multi-tenant commercial space where most of the tenants have a long history of occupancy (5 or more years) and full occupancy of this space is not needed to provide a break-even cash flow for the project; or

3. There is substantial borrower equity and/or local government funds that mitigate risk.

B. Commercial Space Limits. Hub Directors may issue waivers to exceed the commercial space limits in Section III B, above, without the approval of HQ. Documentation supporting the space limit waiver must include:

1. Demonstration that the additional space will not negatively impact on the use of the project by its residential tenants and will not create a nuisance to the surrounding community;

2. There is ample market support to assure occupancy of the space within the projected absorption period; and

3. Any issues involving easements, liability insurance, parking and zoning must be resolved prior to granting the waiver.

## V. <u>Appraisal and Market Study Requirements for Projects With Commercial Space</u>

A. When a project contains commercial space, both the Appraisal and Market Study must be prepared by individuals who have experience in the appraisal and analysis of the specific type(s) of commercial space present in the project. The market study or appraisal report must contain separate residential and commercial sections.

In general, the current guidance for residential market studies should be followed with regard to format and content, recognizing that the commercial component of a project is a different market segment than the residential component, and that the commercial component may comprise more than one market segment depending on the type of commercial space, e.g., office or retail. Retail space may be further segmented into certain types such as convenience stores, restaurants, retail, bank branches, etc., each of which may have different characteristics in terms of lease structures, marketing requirements and absorption periods. Commercial market studies can vary greatly in complexity since there may be a need for expanded market delineation and a demand/supply analysis.

B. For substantial rehabilitation projects, when an "as is" value is required, the appraisal report must include a discussion of the capital costs that must be included in the development budget to achieve lease-up of the commercial space.

C. Commercial Initial Operating Deficit (IOD). For new construction and substantial rehabilitation projects, when determining the amount of the commercial IOD, a separate analysis of the commercial lease up portion of the project is required. More specific Valuation Instructions are contained in Chapter 7 of the MAP Guide. The market analysis must clearly demonstrate that the commercial space can be leased to the forecasted occupancy percentage (see VI.D, below) within the maximum 18 month absorption period permitted by the program.

D. Commercial Income Estimates. For Section 223(f) properties containing commercial space, the appraiser must include a grid similar in format to the form HUD-92273, containing at least three commercial rental comparables, particularly focusing on those located in a portion of a comparable residential rental project. The grid must provide the name of the tenant, type of business, address, square feet, rent, vacancy, concessions and major lease terms for each commercial rental comparable.

E. Commercial Vacancy Rate/Lease Abstracts. The appraiser must provide data that supports the Property's commercial vacancy rate in relation to the overall market commercial vacancy rate, must review the lease rollover risk[5] and the cost of tenant improvements that may be needed to re-lease the space, and must prepare lease abstracts for each lease in effect. Lease abstracts must contain, at a minimum, the following:

1. Term
2. Lease commencement/expiration dates
3. Exact name of tenant
4. Base square footage
5. Scheduled rent increases or increases based on application of an index
6. Calculation of gross rent
7. Calculation of percentage rent
8. Calculation of expenses including expense escalators over a 3 year period
9. Expense pass throughs, plus any limits or caps
10. Expense reimbursements
11. Specific clauses, such as renewal, cancellation, or subordination
12. Landlord provided tenant finish included in the rent

NOTE - The appraiser must note the actual market derived commercial vacancy/occupancy rate in the appraisal report. However, the appraised value for acquisition/refinance or the underwritten net operating income (NOI) for new construction/substantial rehabilitation projects must assume either the lesser of what is indicated by market or the occupancy limitations shown in Section VI.E, below.

F. Percentage Leases. While percentage leases are generally permitted, recognition of percentage income from such leases requires a waiver from the Hub Director. The appraiser must assume a hypothetical condition and substitute for the percentage lease income an assumed comparable monthly fixed payment lease based on lease rates in the market as modified by the actual history of the percentage lease revenue, and as further limited by Section VI.B, below. A waiver of this policy is available only for Section 223(f), or for substantial rehabilitation cases without commercial tenant

[5] Lease rollover risk arises from the possibility that there may be difficulty renewing leases as they expire or in re-leasing space vacated by tenants upon early expiration of leases.

displacement, that have an existing commercial lease with a history of stable and predictable percentage payments. In substantial rehabilitation cases, the appraiser and underwriter must address any issues relating to potential reduction of the percentage lease revenue to the commercial tenant as a result of the nature and level of rehabilitation. A waiver of the requirement to recognize percentage lease revenue as if it were a fixed payment is not available for new construction cases.

G. Segregation of Income, Expenses, Vacancy and Replacement Reserve. The appraiser must segregate rental income, vacancy and collection loss, operating expenses and reserve for replacements attributed to both commercial and residential rental space, or indicate why this cannot be done, while still demonstrating a rational allocation of costs between the two sections of the project. The segregation may be based on separate metering of the commercial tenants or on applying the percentage of commercial space to the total project expenses. Income and expenses are already listed separately in Section F of the form HUD-92264, "Multifamily Summary Appraisal Report" for residential and commercial components. The commercial portion of the annual reserve for replacement deposit should be separately noted under remarks in Section O.

## VI. <u>Underwriting Requirements for Commercial Income</u>

A. Analysis of Commercial Income. Commercial facilities that are included in a residential project require a separate analysis of the effect that the commercial operation will have on the residential project operations. The lender must calculate income, vacancy and collection loss, operating expenses, and replacement reserves attributable to commercial space separately from the residential portion of the project. A separate analysis should be performed for each type of space using the form HUD-92273 or a similar format to summarize appropriate adjustments to actual and comparable data. These analyses must also be incorporated in the overall residential market study submitted at the pre-application or Firm Commitment stages, depending on the program requirements. In addition, a separate analysis of a commercial IOD must be made by the appraiser in accordance with paragraph G, below.

B. Valuation of Properties with Commercial Income. The programmatic limitations on commercial occupancy (contained in Section VI.D, below) and on recognition of commercial space and income (contained in Section III.B, above) should be applied to both the appraiser's determination of value under Criteria 3 and the determination of debt service coverage under Criteria 5.

C. Commercial Income in Existing Projects. For Section 223(f) properties, the lender must base the underwritten commercial rental revenue on the aggregate contractual monthly rental rate from the borrower's certified rent roll, multiplied by 12, using the vacancy assumption required by Section VI.D, below.

1. Rent Step-ups and Tax Escalations. If contractual rent step-ups occur during the first year of the commercial lease, the lender may recognize the extra income for the

applicable number of months that it will be collected.  The lender must underwrite future escalations for tax and operating expenses over the term of the lease by:

a. Averaging the last 3 years of collected expense reimbursements, and

b. Preparing an average projection of scheduled tax and expense increases over the next 3 years of the lease term and applying the average to the first year total expense, so as to reduce the first year net income.

2. Vacant Commercial Space.  The lender may not assign rent to vacant commercial space when determining the underwritten property NOI, even if the space has been vacated recently.  The appraiser may not assign rental revenue to vacant commercial space when determining the property value.  A waiver of this prohibition is not available.

D. Lease Analysis.  If lease income from any single commercial tenant accounts for 5 percent or more of the property's total EGI, the lender must conduct a lease analysis for risks and mitigants based on the lease abstracts and verification of the terms and conditions of the lease(s).  Lease analyses are not required for commercial tenants where the commercial EGI is less than 5 percent of the property's total EGI. However, lease analyses are required for commercial tenants where the commercial income is needed to achieve break-even cash flow for the project.

E. Commercial Occupancy Rates.  For all programs except Section 223(f), the maximum underwritten commercial occupancy rate shall be the lesser of: a) that indicated by the market, or b) 80 percent.  For Section 223(f), the maximum underwritten commercial occupancy rate shall be the lesser of: a) that indicated by the market, b) what is the actual occupancy rate of the subject, or c) 90 percent.  NOTE- Refer to Section III.C.1 for special instructions related to the maximum underwritten occupancy rate for non-tenant parking income.

F. Credit Analysis of Commercial Tenants.  The lender must perform a credit analysis of any commercial tenant that provides lease revenue that exceeds 5 percent of a property's EGI.  This credit analysis must include a thorough discussion, as applicable, of the commercial tenant's:

1. Historical operating performance in other leased properties;

2. Historical operating performance at the project's location;

3. Financial statements for the past 3 years; and

4. The adaptability of the commercial space for other uses in the event of a default by the tenant under consideration.

In the event that the tenant credit review is not satisfactory, a reserve equal to 6 months rent must be established and held by the lender for the term of the commercial lease.

G. Commercial IOD. For new construction and substantial rehabilitation projects, the commercial portion of the IOD provides funding for operating expenses and debt service when commercial net income is not available to support the loan during the initial lease-up period. This escrow is not mortgagable and the unused portion will be returned to the borrower. Although the lender will hold only one IOD escrow, separate calculations must be made of the residential and commercial portions of the escrow. The minimum requirement for the total amount of the IOD shall comply with the requirements of Mortgagee Letter 10-21, "Multifamily Risk Mitigation".

NOTE: A separate estimate of commercial IOD is not required when commercial EGI is less than 5 percent of total property EGI.

HUD will consider lender requests for IOD draws related to commercial space during lease-up. Lender requests must be accompanied by: a) a review and analysis of the monthly accounting reports detailing progress on commercial lease-up as compared to the lease-up projections used in underwriting, and, b) an updated calculation of the sufficiency of the escrow. This analysis and calculation is particularly important if the project is experiencing substantial variations from its commercial lease-up projections. HUD Mortgage Credit staff will consult with Asset Management staff prior to approving the release. Unused amounts will be released upon the lender's request at the later of 12 months after Final Endorsement or when the project has demonstrated to the HUD Field office's satisfaction that the project has achieved 6 consecutive months of break-even occupancy on the portion of the debt that is supported by the commercial income. The lender is responsible for insuring that funds from the IOD escrow are released solely for project operating needs.

NOTE: The funding of project expenses during the commercial lease up period are to be paid first out of the commercial portion of the IOD escrow followed by the debt service reserve, if necessary.

H. Pre-Leasing Requirements for Commercial Space. For new construction and substantial rehabilitation projects, where any vacancy of the commercial units would prevent the project from achieving sustaining occupancy within the projected absorption period, a sufficient amount of commercial space must be pre-leased prior to Initial Endorsement, so sustaining occupancy can be achieved during project rent-up. Sustaining occupancy is defined as the project having sufficient residential income and income from the commercial portion of the project to pay its operating expenses, monthly debt service, escrow and reserve for replacement requirements for 3 consecutive months. In these cases, a pre-leasing requirement for that portion of the commercial space and income needed for the project to achieve break even occupancy must be included as a Firm Commitment condition.

The Hub Director may waive the preleasing requirement if it is impracticable to prelease the commercial space before construction has begun. In those cases, the borrower must be actively marketing the future commercial space prior to Initial Endorsement and during the construction period through a broker, and must have received expressions of interest as demonstrated by written records, inquiries and appointments to inspect the site where the commercial space will be offered.

The need for and amount of commercial pre-leasing is to be determined by subtracting the commercial NOI from the total NOI for the project. If the remainder is less than the amount required for sustaining occupancy, the pre-leasing requirement is applicable, per the example that follows.

| | |
|---|---|
| Project total NOI | $3,500,000 |
| Less Commercial NOI | ($990,000) |
| Residential & Ancillary NOI | $2,510,000 |
| Debt Service Including MIP | ($2,675,000) |
| If negative, this is the amount of required Commercial Pre-Leasing income | ($165,000) |

I. Lease Estoppel. All commercial tenants must provide a commercial Lease Estoppel certificate at the time of Final Endorsement, as requested by the lender or HUD.

J. Master Leases. The requirements contained in this Mortgagee Letter must be followed even if the sponsor will enter into a guarantee of or a master lease for the commercial space and income, and thus will be obligated to pay the commercial income even if commercial tenants do not enter into leases for the available space. The presence of a sponsor's guarantee or master lease of the commercial space should be disregarded when applying the requirements contained in this Mortgagee Letter.

## VII. IOD and Working Capital Reserves

For new construction and substantial rehabilitation projects, the minimum IOD and working capital reserves are to be established in accordance with program guidance and this Mortgagee Letter, amended as follows:

A. A funded commercial IOD for new construction or for existing vacant commercial space is required in all cases, even if the space is pre-leased or if there is a letter of intent to lease from a credit tenant. The commercial IOD will be released as soon as the pre-leased commercial space has been occupied and the first month's revenue has been received.

B. In addition, for any new construction and substantial rehabilitation projects that receive a DAS approved waiver for commercial income to exceed the program limitations, the minimum required total project IOD is 4 percent of the mortgage amount or 12 months debt service (whichever is greater) and for working capital is 3 percent of the mortgage amount or such higher amounts as are required by program guidance.

## VIII. Borrower Provided Tenant Finishes

Mortgagable costs may only include building out the commercial space to plain walls, lighting and HVAC, without the unique finishes required by certain commercial tenants. Borrower (landlord) provided commercial tenant finishes that are included in the tenant's base rent must be funded from the Borrower's equity and may not be funded from mortgage proceeds, without a waiver from the Multifamily DAS. In markets where landlords typically fund the costs of finishing space for commercial tenants, a separate escrow account funded in cash by the Borrower must be established and held by the lender to provide funds for tenant finishes until fully disbursed as underwritten.

## IX. Implementation

The policies established by this Mortgagee Letter shall be implemented immediately for all new or pending applications where an Invitation Letter or Firm Commitment has not been issued. Lenders with applications pending that have not yet received an Invitation Letter or Firm Commitment may withdraw the application and request a refund of the application fee in accordance with current departmental policies.

## X. Paperwork Reduction Act

The information collection requirements contained in this document have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB control number 2502-0029. In accordance with the Paperwork Reduction Act, HUD may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a currently valid OMB control number.

Any questions regarding this Mortgagee Letter should be directed to Joseph Sealey, Director, Technical Support Division at (202) 402-2559. Persons with hearing or speech impairments may access this number via TDD/TTY by calling the Federal Information Reply Service at (800) 877-8339).

/s/

Carol J. Galante
Acting Assistant Secretary for Housing –
Federal Housing Commissioner