CHAPTER 6. OPERATING EXPENSE ESTIMATES

6-1. ANALYSIS OF OPERATING EXPENSES. A determination is made of the portion of gross income which must be used to maintain, operate and repair the property and to defray the costs of ownership arising from it. Under proper management, these expenses are a first claim upon income and must be met if predicted gross income is to be realized. Accurate analysis of operating expense is essential to determining realistic net income.

6-2. EXPENSE DATA. Estimates of operating expenses can be made valid by comparison with operating expense developed by comparable properties situated in areas which are comparable with regard to climate, custom, labor and operating material costs, type and amount of services provided, and methods of operation and management. Differences in type of building materials, construction and design also must be considered in comparing operating costs. Estimates of operating costs made by engineers, cost estimators or other competent persons after study of project plans, specifications and locations also may be accepted. It is imperative that estimates be based on the project under consideration. The use of statistical average or formulae can be extremely misleading particularly if the project involved is markedly different in design or use of materials. Averages arrived at by the use of widely divergent or unverified data are of no value.

6-3. FILE DOCUMENTATION. Multifamily project expense data will be recorded on Valuation Data Sheets, Forms FHA-2275, 2276, 2277, and stored in the data bank. Comparable projects are selected from the bank and the amount of individual expenses from such projects, adjusted as necessary for significant differences, is utilized in processing. Where the sponsor's expense estimate is reasonable, his dollar amount should be used in processing to eliminate conflict over immaterial differences. Processing of Operating Expenses and Taxes on Form FHA-2274 must include the individual expense estimates for each component item listed. The expense estimates will be documented in the processing file by the inclusion of Form FHA-2274 which will contain the information for at least three similar projects and an explanation of the adjustments made to this operating experience in the development of the expense estimates.

    a. See Reference 2 of the Foreword for the Operating Analysis Worksheet, Form FHA-2274 to be used in the development of the expense estimates.

*(6-3)

   b. The appraiser must pay particular attention to the trending
       adjustment when analyzing the operating expenses and the
       rental estimate.

   c. Inadequacies in the expense estimate are often attributable
       to improper time and trend adjustments. The result is the
       necessity of increasing rents at the beginning of the first
       year of operation to offset the deficient expense estimate.

   d. The factor used as trend will consider past and anticipated
       economic climate and occupancy experience. Included in the
       analysis of data relating to past performance as a forecast
       of future performance, the appraiser must consider rates of
       change of various expense components and arrive at a component
       trend rate.

   e. Consideration must be given to the age of the data used; the
       time required for processing through the initial closing and
       the estimated construction time. For purpose of calculating
       trend, time of initial occupancy will be that time when
       construction of the project is estimated to be completed
       plus 2 months leeway normally allowed for the time between
       completion of construction to the time that cost certification
       occurs.

       (1) For example, assume an appraisal being made on 1/1/77
            using expense data recorded on Forms FHA-2275 or 2276
            showing a beginning date of the period of expense
            operation of 1/1/75. Further, assume a six month target
            date for initial closing and an estimated construction
            period of 10 months plus 2 months for purpose of
            calculating carrying charges. The operating expense data
            in this instance would be trended a total of 3 1/2 years
            from the beginning date of the expense data through
            construction time to the date of anticipated initial
            occupancy.

                 eg: 1/1/75 Date of data
                 To   1/1/77 Date of appraisal   = 2   years
                 To   6/1/77 Est. processing time   = 1/2 year
                 To   6/1/78 Est. const. time & 2 mos   = 1   year
                                                         _____
                      Total Time and Trend Period   3 1/2 years

            Note: Trend Factors for taxes may vary from other
                   trend factors.

       (2) The foregoing procedure results in income and expenses
            being trended to the same date.   *

*   f.   After completion of the worksheet the appraiser will enter
            in Section E of the Form FHA-2264 the total annual estimates
            for lines 21, 22, 28 and 29 properly updated to the time of
            initial occupancy. The individual expense items on the Form
            FHA-2264 will not be required. A complete expense analysis
            worksheet, Form FHA-2274 will be attached to the file copy
            of the Form FHA-2264 and included in the project binder in
            every case.   *

6-4.   DATA ANALYSIS.

       a.   Expense Estimates. The estimate of operating expense should
            reflect the needs of the income group to be served. In some
            cases the operating expense may be higher than the operating
            expense of other similarly constructed projects. Additional
            management expense may be incurred due to delay and effort
            required in collecting rents. These problems are most often
            found in those projects occupied by lower income tenants.

       b.   Maintenance Expense. The total estimate of maintenance expense
            should reflect the level of maintenance and repair costs which
            may be expected because of the intended occupants. Such costs
            may be higher because of tenant behavior in a lower income
            project and also because there may be more vandalism from
            the outside than is usually the case in similarly

            constructed but higher-income projects. In making
            comparisons with either higher or lower income projects, it is
            important that adjustments for the project in question be
            applied to individual amounts of operating, maintenance and
            repair expenses, rather than to an expense ratio. This is
            true of all expense estimates.

       c.   Reserve for Replacement. While processing requires utilizing
            expenses based on data, the reserve for replacement estimate
            must be identified as a specific dollar item for entry on
            the commitment. The reserve will in all instances be
            computed on a furnished factor times "total structures."
            This method recognizes that any laborious computation based
            on expected life of various building items is inaccurate at
            best and overlooks the various uses to which the reserve

account may be put. The reserve account may be considered
a contingency fund and as such need not specifically
identify the various items which will need replacement in
the life of the property.

    d. Estimate of Taxes. The methods of assessors in arriving
at the assessed value of real property vary so widely that
it is imperative that complete information be obtained in
order to make possible a fair estimate of future taxes. It
is necessary to become fully informed as to the various
practices and mechanics of assessing employed locally in
order to prepare a valid estimate of the probable real
estate taxes to be levied against a proposed project. It
will be necessary to compare the actual current tax on
competitive rental housing properties with the estimate for
the proposed project.

6-5. MARKET DATA. All offices must have a data bank containing
sufficient information to process cases. The data bank will
consist of not less than the following information:

    a. Absorption Data. FHA Form 184 will be maintained for each
HUD insured project. This data must also be maintained on
conventionally built rental projects. Each project binder
must contain absorption data to support conclusions reached
with respect to operating deficits. Where it is anticipated
that no deficit will occur, this must also be supported by
data.

(6-5) b. Data Forms FHA 2275 - (Rental). A Valuation Data Form will
be prepared at the conclusion of firm commitment processing
and thereafter maintained as annual operating statements are
received by the office. It is the responsibility of the
Field Office Director to see that copies of operating statements
(FHA Forms 2410, 92410, and 2474 or 9801) are provided
to the Multifamily Data Appraiser as soon as they are received
in the office. The Multifamily Data Appraiser must also
collect data and complete data forms on conventionally
financed projects.

    c. Rental Data. The rental and occupancy portion of the FHA
2275's must be kept current. This can be accomplished by
the processing appraiser when he uses a particular comparable
as well as the regular updating by the data appraiser.

    d. Land Sales Data. The land appraisal process is dependent upon
the collection, analysis and systematic recordation of current

land sales data. Land sales information shall be developed and maintained by the Multifamily Data Appraiser, with basic information required for proper determination of land values. This land sales data bank must be maintained on an active and continuing basis. The land sales data card should contain a sketch or photo of the site, information on any unusual site conditions, available utilities and distance to them, special appeal features, zoning, taxes, special assessments, and specific conditions of the sales transaction.

(1) Items which represent a cost to the purchaser, in addition to the sales price, should be noted. These may include off-site improvement cost, demolition cost, and any cost to bring the site to a usable condition.

(2) Five appropriate arms length land sales will be selected from the data bank, of which two must be conventional sales. A conventional land sale for this purpose is:

(a) A site on which a conventional (non-HUD insured) rental project is under construction or recently completed.

(b) A vacant site, whose sale has been closed, and has not been submitted to the Field Office for project mortgage insurance.

The appraiser will indicate the conventional sales by the letter "C" preceding the comparable number, on FHA Form 2264 Section J item number 8. The land sales cards selected will be reproduced and made a part of the processing package.   *

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