CHAPTER 10. MANAGEMENT ANALYSIS

10-1. INTRODUCTION. Management analysis seeks to reach the conclusions and decisions listed below. This analysis is performed by reviewing materials submitted by the applicant and integrating this analysis with observations made during an on-site review of project conditions and management practices. The lender's Management Analyst must document in the application file the observations, analyses and conclusions developed at each step.

a. Identify any financial, physical and management problems and their causes and reach agreement with the owner as to how and when these problems will be corrected.

b. Determine the acceptability of the proposed management agent and the agent's proposed procedures for managing project operations.

c. Verify the appropriateness of the underwriting staff's assumptions and conclusions related to:

(1) repairs and replacements needed prior to endorsement;

(2) calculation of the initial deposit to the reserve for replacements;

(3) income and expense estimates; and

(4) calculation of any operating deficit escrow.

10-2. NEED FOR MANAGEMENT STAFF'S INPUT. The lender's property management/loan servicing staff must render Input on coinsurance applications at the firm commitment stage for the following reasons:

a. As loan servicers, they will have to live with the loan.

b. They will have experience in reviewing operating expense statements and will be able to assess reasonableness of expenses both in terms of conditions at the project and comparability with other projects' operating expenses.

c. Their knowledge of property management practices will enable them to identify operating deficiencies which could create project problems and/or defaults.

d. Their experience in property management and project oversight will enable them to determine the causes of project problems and to negotiate corrective actions with owners.

10-3. ANALYSIS OF PAST PROJECT PERFORMANCE. The first step in management analysis is to review the project's financial statements (which are submitted as Exhibit i or j of the application) and the reports on apartment unit vacancy, tenant turnover and tenant accounts receivable (which are submitted as Exhibits w and x of the application and are shown in Appendices 6 and 7 of this Handbook). During this step, the Management Analyst should identify any problem areas that may require corrective action. During the on-site review and subsequent discussions with the applicant, the Management Analyst should seek to determine the cause of these problems and the specific corrective actions needed. This analysis will also help to evaluate the appropriateness of operating procedures and the competence of the current management agent. When reviewing the project's financial statements and the occupancy and collections data submitted by the applicant, the Management Analyst should pay particular attention to the following areas.

a. Check Cash Throw-Off. Has project income been sufficient to support the project's debt service and operating expenses? Use the income and expense figures reported on the HUD-92410 or comparable Statement of Income and Expenses. To determine cash throw-off, make the following adjustments to the net operating profit/loss shown on the HUD-92410.

(1) Add depreciation and other "non cash" expenses to net operating profit/loss.

(2) From net operating profit/loss, deduct payments required to principal and deposits to the replacement reserve (or other project reserves). These cash payments are not reflected on the HUD-92410.

b. Check Liquity. Does the project have sufficient cash to meet accrued short-term obligations plus the next month's mortgage payment? A healthy project should be able to meet short-term payables plus the next month's mortgage payment without relying on the next month's rental receipts.

c. Evaluate Adequacy of Rent Collection Practices. Use the tenant accounts receivable information submitted as Exhibit w of the application. If accounts receivable are high, during the on-site review look at procedures for collecting rents, identifying and tracking delinquencies, following up on delinquent accounts and evicting delinquent tenants.

d. Review Past Trends in Vacancy and Turnover. If vacancy is high, during the on-site review look carefully at marketing procedures, procedures for readying units for occupancy following move-out and curb appeal. If turnover is high, look at tenant selection and screening, management's responsiveness to tenant complaints and repair requests, quality of maintenance, etc.

e. Evaluate Reasonableness of Project Expenses. Are expenses reasonable compared to similar projects in the same market area? Are increases in expenses reasonable in comparison with the inflation rates during the periods covered by the financial statements? Is the project operated as efficiently as possible? If expenses appear higher than need be, during the on-site the review the Management Analyst should check cost-control procedures (e.g., bulk purchasing, taking advantage of discounts, comparing prices, preparing budgets and monitoring actual expenses against budgeted amounts).

10-4. ON-SITE REVIEW OF PROJECT OPERATIONS AND CONDITIONS. The second step in management analysis is to conduct an on-site management review of the proposed project. The on-site review enables the Management Analyst to make a first-hand assessment of project conditions and the quality of project management. When integrated with the findings of the Management Analyst's desk reviews of the project's financial statements and occupancy data, the observations gained from this review will enable the Management Analyst to evaluate the adequacy of the agent's proposed management procedures and to identify any corrective actions which must be implemented before the mortgage is endorsed for insurance. In undertaking the on-site review, the Management Analyst should adhere to the steps discussed in paragraphs a through d below.

a. Preparing for the Review.

(1) Review the physical inspection report (list of required repairs/work write-up) prepared by the lender's architect.

(2) Review the proposed management procedures or plan submitted as Exhibit g of the application.

(3) From the analysis of past project performance (paragraph 10-3), identify any problem areas on which the review should focus.

(4) Determine the location of records to be reviewed (e.g., at the owner's or agent's office, at the project, etc.)

(5) Provide the owner and the current and proposed management agents sufficient advance notice so they can arrange for appropriate members of their staffs to be present and for all project records to be available for inspection.

b. Forms. The Management Analyst should use the form shown in Appendix 18 for preparing the Management Review Report. For gathering information needed for the Management Review Report, the Management Analyst may use the Management Review Worksheet shown in Appendix 19 or develop and use an alternative on-site inspection/interview form which is organized around the five categories of management operations on the Management Review Report.

c. Conducting the On-Site Review.

(1) Entrance Conference. Upon arrival at the project, the Management Analyst should meet with the owner and the current and proposed management agents to explain the purpose of the visit, outline the scope of the review, determine the location of pertinent project records, determine when staff will be available to answer questions, and set an appropriate time for the close-out conference.

(2) Inspections/Interviews. HUD does not prescribe a specific number of units to be inspected, files to be reviewed, or exactly how to obtain information (interview vs. file review). The Management Analyst should examine sufficient documents and units and ask sufficient questions to determine if the agent is adequately performing the tasks listed on the Management Review Report, to determine the cause and scope of any problems noted during desk reviews or the on-site review, and to negotiate corrective actions. Pay particular attention to repairs and replacements proposed to be completed prior to endorsement and to any problems identified in desk reviews completed pursuant to paragraph 10-3. For example, if the project has an unusually high vacancy rate, carefully evaluate the adequacy of current and/or proposed marketing techniques and look at the time required and procedures used to prepare vacant units for occupancy.

(3) Close-Out Conference. At the conclusion of the on-site visit, the owner and agent should be afforded an opportunity to discuss the results prior to the issuance of the report. During the meeting the Management Analyst should discuss review observations and conclusions (both positive and negative) and allow the owner and agent an opportunity to explain their opinion of the causes of any problems and their recommendations for corrective actions. The Management Analyst should discuss any suggestions he/she may have on the operating procedures proposed by the applicant in Exhibit g of the application for Coinsurance. The Management Analyst should attempt to reach agreement

with the owner and the proposed agent on the causes of the problems, the corrective actions needed and target completion dates. The Management Analyst must document conclusions and agreements reached at the conference.

d. Preparation of the Management Review Report. The Management Analyst should use the format shown in Appendix 18 to report the results of the on-site review. This should be done as follows:

(1) For each line item reviewed, check the appropriate code column: "A" - Acceptable, No Action Needed; "P" - Procedure and/or Management Plan Change Needed; C - Corrective Action Needed.

(2) For any line noted "C" or "P" , prepare on the Continuation Sheet of the Management Review Report a narrative Statement of Findings and Recommended or Required Actions.

(3) Suggest Target Completion Dates for major action items.

(4) On Line 39, rate the overall quality of the management operations. On Lines 10, 20, 27, 31 and 38, rate the quality of the management operations in each of the five categories - maintenance and security; financial management; leasing and occupancy; tenant/management relations; and general management practices.

10-5. DETERMINATION OF ACCEPTABILITY OF PROPOSED MANAGEMENT AGENT. The third step in management analysis is to determine whether the proposed management agent should be permitted to manage the project in question. To make this determination, the Management Analyst must consider both the conditions at the project and agent's abilities and past performance in managing this or similar projects. In evaluating the qualifications of the proposed management agent, the Management Analyst should take the steps listed below. When the lender determines that the proposed agent is acceptable, the agent must sign the Management Certification. Appendix 8a shows the Certification to be used for owner-managed projects; Appendix 8b shows the form to be used for projects with identity-of-interest or independent management agents.

a. Review Previous Participation Certifications. The mortgagee must secure and initiate processing of Previous Participation Certifications (Form HUD-2530) on the proposed management agent and all principals associated with the management entity. (Form HUD-2530 is shown in Appendix 23). These forms, like those submitted for the principals of the applicant entity, must be sent to the HUD Field Office for processing. When the

2530s are returned, they will indicate if the management agent or any of its principals has ever been associated with a HUD-insured or subsidized project which defaulted or was foreclosed. Additionally, the 2530s should show if the agent or any of its principals have ever received a "below average" or "unsatisfactory" rating on a HUD management review. If the proposed agent has a history of defaults and/or poor management ratings, HUD can withhold Previous Participation clearance. If HUD does so, the lender must require the applicant to propose a new agent.

b. Review the Management Agent Profile (Appendix 5). The Management Analyst should use the information on this suggested form to assist in determining the experience and capabilities of the proposed agent. To be considered acceptable, the agent should have both a track record of effectively managing this or comparable projects and demonstrate a capacity to provide effective management now, as evidenced by the strength of its professional staff, management procedures and support services. If the owner proposes to retain the current management agent, the Management Analyst should assess how the agent has performed in the past on this project. For example, has the agent promptly identified problems and shown ability to develop and implement solutions or has the agent's performance contributed to the project's problems? The proposed management agent must also demonstrate that it does not discriminate in hiring or marketing and that it can provide training to project staff on civil rights and fair housing law and practices.

c. Secure Supplementary Information on the Proposed Management Agent. The Management Analyst should use the HUD Field Office references in the Management Agent Profile to solicit additional information on the proposed management agent.

10-6. REVIEW OF PROPOSED REPAIRS, IMPROVEMENTS AND REPLACEMENTS. After completing the on-site management review, the Management Analyst should carefully review and comment on the conclusions developed by the architect and appraiser relating to repairs and replacements needed to be done before endorsement.

a. Verify the Adequacy of Proposed Front-End Physical Improvements. Review the list of required repairs/ work write-up prepared by the architect and evaluate its adequacy for correcting physical deficiencies and/or deferred maintenance observed during the on-site management review. If the Management Analyst believes that changes or additions are needed in the work write-up, the Management Analyst should provide the architect and cost estimator with a written list of the additional changes needed.

b. Verify the Assumptions Underlying the Required Initial Deposit to the Reserve for Replacements. Review the Estimate of Useful Life prepared by the architecture and the method used by the appraiser to calculate the Initial Deposit to the Reserve for Replacements. Determine if the assumptions were appropriate, in light of analysis of past project performance and observations made during the on-site management review. Useful life will vary according to the quality of maintenance provided and equipment purchased. The Management Analyst should discuss any recommended changes with the appraiser and the architect.

10-7. FORMULATION OF AGREEMENT WITH APPLICANT ON CORRECTIVE ACTIONS NEEDED. While only the repairs and replacements discussed in Chapters 6 and 7 will be considered in calculating the mortgage amount, other physical, financial or operating deficiencies may need to be corrected to assure that the project is an acceptable risk for mortgage coinsurance. For example, the owner may need to correct deferred maintenance items which are not included in the repairs to be covered by mortgage proceeds; reduce accounts payable; implement a rental increase; evict tenants who are delinquent on rent; or change past or proposed operating procedures, such as shopping and tightening cost controls, employing new marketing techniques, improving tenant selection and screening procedures, or using on-site rather than contract staff to get vacant units ready faster. The on-site review and analysis completed pursuant to paragraph 10-3 should enable the Management Analyst to identify financial or occupancy problems and deficiencies in operating procedures. If the problems or deficiencies are significant, the Management Analyst and the owner need to reach agreement as to what corrective actions will be taken, the time schedule for implementation and funding source (if other than recurring project income). Agreements must be documented in writing and attached to and incorporated in the firm commitment for mortgage insurance. Any corrective actions which can be completed before endorsement for mortgage insurance should be. Most changes in operating procedures can, for example hiring a new resident manager, implementing cost controls via new purchasing arrangements or scrutinizing monthly reports of actual vs. budgeted expenses, implementing new tenant screening, etc. If certain corrective actions cannot be completed before endorsement, the Management Analyst should establish deadline as tight as feasible. For example, if evictions are needed, specify dates for the filing of documents and follow-up. If serious corrective actions cannot be completed until after endorsement, the lender should obtain a signed letter of acknowledgement from the applicant that the Regulatory Agreement clause on management satisfactory to HUD includes completion of these items.

10-8. FORMULATION OF AGREEMENT WITH APPLICANT ON ONGOING OPERATING PROCEDURES. The applicant will have submitted a description of proposed management procedures as Exhibit g of its application for Coinsurance. As part of the on-site review, the Management Analyst will have discussed these procedures and assessed their adequacy in light of his/her analysis of the project's past performance and current conditions. The Management Analyst should reach agreement with the applicant on what procedures will apply after the mortgage is endorsed for coinsurance and document what those procedures will be. The type of documentation required is at the discretion of the lender and will probably vary according to the management agent's past performance and quality of the management exhibits the applicant submitted with the application for coinsurance. If the description of proposed procedures covers all areas of concern to the lender and if these procedures are acceptable, the lender may decide that no more documentation is needed. If the description of procedures and/or manuals do not cover one or more management tasks of concern to the lender at this project, the lender may require the applicant to expand previous submissions to cover those management tasks. If the procedures proposed in the application need changes, (for instance, to incorporate corrective actions formulated pursuant to paragraph 10-7), the lender may either require Exhibit g to be rewritten to incorporate the revised procedures or may simply annotate the list of corrective actions to note that management procedures included in the list supercede the management procedures in Exhibit g.

10-9. REVIEW OF INCOME AND EXPENSE PROJECTIONS. The Management Analyst should review both the applicant's proposed budget and the appraiser's income and expense projections. The Management Analyst should determine if the appraiser's projections are appropriate in light of:

(a) observations made during the financial and occupancy analysis required by paragraph 10-3 and during the on-site review;

(b) corrective actions required per paragraph 10-7;

(c) operating procedures agreed to per paragraph 10-8; and

(d) repairs and replacements that will be made prior to endorsement for mortgage insurance.

The Management Analyst should pay particular attention to the amount of the management fee and to the line items related to problem areas noted during the desk reviews of mortgagor submissions or during the on-site review. For example, if increased marketing will be needed to overcome a vacancy problem, check the adequacy of the amount budgeted for advertising and other marketing costs. If the

Management Analyst believes changes are needed, these should be discussed with the appraiser and underwriter.

10-10. VERIFICATION OF ADEQUACY OF OPERATING DEFICIT ESCROW. If the applicant and the lender's mortgage credit staff have determined that an Operating Deficit Escrow will be needed, the amount and the assumptions employed in calculating it should be reviewed by the Management Analyst. The Management Analyst should review and comment on:

a. the date that full rent-up (sustaining occupancy) is expected to be achieved;

b. incremental progress toward that date;

c. the size of the deficit expected to be incurred during the period.

In doing this, the Management Analyst should consider the conclusions reached in the earlier steps of management analysis. The Management Analyst should make certain that assumptions underlying calculation of the deficit correspond with agreements reached on corrective management actions and ongoing operating procedures. For example, if the project needs stepped-up or different marketing, the Management Analyst should make sure that this is in the list of corrective actions needed. If the Management Analyst can demonstrate that the Operating Deficit Escrow should be increased, this should be relayed to the mortgage credit staff so that appropriate adjustments can be made.

10-11. PROJECT INFORMATION AVAILABLE FROM HUD FIELD OFFICES. If the project currently has an insured or HUD-held mortgage, the Management Analyst may want to discuss the project with the Loan Management staff in the HUD Field Office since HUD field staff have been analyzing monthly and/or annual financial statements, conducting on-site reviews, negotiating workouts of problems, and they may be able to provide valuable information regarding the project.