Chapter
5

# Underwriting; Development of the Restructuring Plan

## Executive Summary

Section 5-1

This chapter describes the PAEs actions for financial underwriting of the M2M transaction and the development of the Restructuring Plan. The PAE will determine the project's rents, expenses, and deposits to the reserves under various scenarios. The PAE will then size the first and second mortgages, and third mortgage, if needed, and determine the amount of claim payable by FHA, as well as the sources and uses in the transaction, and the owner's financial return. The results of this underwriting, the due diligence described in Chapter 4, the tenant comments, and owner negotiations are consolidated in the draft Restructuring Plan Package submitted to the OAHP Preservation Office. The PAE should work cooperatively with the owner and lender as needed throughout this process.

## Underwriting Model

Section 5-2

A. **General**. OAHP has provided an Underwriting Model for use in completing the financial underwriting of M2M transactions. A copy of the Model is available on OAHP's Web site or can be obtained through the OAHP Preservation Office. Use of the Model is required and helps meet the unique requirements of this program that will not be present in other underwriting models. However, the Model is only an aid and may not be appropriate or complete for every case; the PAE remains responsible for its own conclusions, and for appropriately addressing unusual conditions that may not be fully considered by the model or this Guide.

B. **Using the Model**. PAEs are responsible for using the most recent, appropriate model and generally following the procedures reflected therein. Any changes should be identified and approved in advance. PAEs may wish to start initial inputs into the Model as early in the process as the information becomes available to expedite completion of the underwriting when all data is available. Since the Model provides space for comments, PAEs can save time and effort by including brief comments in the Model that do not have to be duplicated in narrative sections of the Restructuring Plan Package.

C. **Trend Factors**. The PAE is responsible for selecting trend factors for income, expenses, and other items in order to complete the model. The factors used should reflect long term operations, not short-term changes that may be reflected in the OCAF factor for a single year. The factor applied to income must never exceed the factor applied to expenses.

D. **MIS Input**. The Model creates an extract file that must be uploaded to the M2M MIS in order to complete the required electronic submissions to OAHP.

## Income

Section 5-3

A. **Estimate Gross Potential Rental Income Two Ways**.

1. Income Based on Comparable Market Rents. Estimate gross potential rental income by applying the market comparable rents to all units in the property, whether assisted or unassisted.

2. Income Based on Affordable (Tax Credit) Rents. Estimate an alternate income by applying one of the Low-Income Housing Tax Credit (LIHTC) standards below. Choose the LIHTC standard that the owner indicates he or she will select in the event that Section 8 is discontinued, either:

   a) 20% of units with rents equal to 30% times 50% of Area Median Income, or

   b) 40% of units with rents equal to 30% times 60% of Area Median Income.

B. **Commercial Income**. Estimate gross commercial income after a review of existing leases, market and other information supplied by the appraiser, and any other information available to the PAE. Show income from each commercial unit separately. If a current lease rent is less than market, use the current lease rent. PAEs should consider time remaining on any lease and the likelihood of continued occupancy. Do not include income from commercial space that has been standing vacant for any significant period of time.

C. **Other Income**. Estimate other income from such sources as laundry facilities, parking, cable TV, and washer/dryer rental. Use income from these sources only if it is common in the market and the project's operating statements demonstrate a history of consistent income that is likely to continue.

## Physical and Economic Vacancy

Section 5-4

A. **Residential Vacancy and Bad Debt/Collection Loss Factor**.

1. Analyze the project's historical occupancy performance and trends, market comparables, and other market information and trends, including the supply of competitive housing in the market.
2. If the RAAP determines that tenant-based assistance is appropriate, use a market vacancy rate and market bad debt factor.
3. If the RAAP determines that project-based assistance is appropriate, generally use the market rate. If using a market rate results in a major negative impact on HUD's cost, an exception may be considered. If the PAE determines that the property's historic vacancy has been significantly lower than the market, and that there is no reason to expect any change in that performance, the PAE may use a vacancy rate lower than market. Except in the case of the exceptions listed below, the PAE should not use less than the minimums below or less than the project's historical trend would dictate.
4. <u>Minimums</u>. For the first mortgage, the minimum residential physical vacancy rate is 5%. The minimum bad debt/collection loss factor is 2%. For the second mortgage, see Section 5-11 below.
5. <u>Exception to the Minimums</u>. For the first mortgage, if historic performance of the property has been significantly less than 5% combined (vacancy and bad debt) and that performance is expected to continue, PAEs may seek a waiver from OAHP Headquarters to reduce the combined factor to 5%. This waiver may only be requested where the market also shows performance at significantly less than 5% combined and that performance is expected to continue.

B. **Commercial Vacancy and Bad Debt/Collection Loss Factor**. Estimate separate physical and bad debt/collection loss factors for the commercial space based on historic performance, market information, and trends in the market. The minimum commercial physical vacancy rate is 10%. The minimum bad debt/collection loss factor is 5%.

## Operating Expenses

Section 5-5

A. **Estimate Operating Expenses**. Analyze operating expenses using the historical expenses from the property's audited financial statements, year-to-date expenses if helpful, the Limited Scope Appraisal, the underwriter's own sources of data, information from HUD, the owner, and other available and appropriate sources. Examples of appropriate sources include property management firms, utility companies, taxing bodies, and service providers.

B. **General Approach.**

1. Expense estimates should be made for two scenarios: project-based assistance and tenant-based assistance.
2. Expenses should be estimated by individual line item.
3. Expenses based on property history should be appropriately trended in the model.
4. Expense estimates should be based on the average of prior years only where trends are not apparent and the basis for annual increases or decreases cannot be ascertained.
5. Significant deviations from the expected trend in any individual line item should be analyzed and explained.
6. Expense estimates should be based on the stand-alone performance of the property, not any savings resulting from combined management or maintenance, identity of interest contracts, etc.
7. Comparison to industry averages for comparable market-rate projects should be addressed if the PAE considers it useful to the analysis. Information can be obtained from publications by such entities as local apartment owners associations, IREM, and Dollars and Cents. However, the expenses for any individual property should consider the specific performance of that property, and should not rely solely on an industry standard or rule of thumb.

C. **Guidance on Individual Expense Items**

1. <u>Capital Recovery Payment</u>. Calculate this payment based on the requirements in Chapter 3, Section 3-6 and include it as an "expense" in underwriting.
2. <u>Management Fees</u>. Determine a Management Fee for use in underwriting by obtaining information from management entities, appraisers, similar properties, or other sources, on fees currently paid in the market at comparable properties and adjust as necessary. The management fee should:

a) be based on the cost that a competent, independent, non-Identity of Interest management agent would bid;

b) assume an affordable property with project-based assistance or tenant-based assistance, as appropriate;

c) consider any range of fees that has been identified recently by the Multifamily Hub or Program Center. Identify the range and do not exceed the maximum;

d) not be set so low that only the largest and most cost-efficient agents, or agents unable to provide adequate services, could manage the property profitably; and

e) consider the size and type of the property relative to any comparables used.

3. Accounting/Bookkeeping. Properties with FHA insured loans are allowed to hire bookkeepers as part of the property's on-site staff, paid as a property expense, to perform accounting tasks. These expenses may be included in underwriting where FHA insurance is contemplated. These transactions may also have accounting functions performed centrally by the property management firm with the appropriate share charged back to the property (not to exceed a market cost). The local multifamily Hub or Program Center may have limits on the amount and types of fees, which can be charged, and the PAE should ensure underwritten amounts are acceptable to the appropriate office.

4. Payroll. Assume adequate but not excessive staffing. If current staffing is high, consider whether this is due to unusual needs at the property or whether the management should be required to reduce staffing expenses as a condition of the Restructuring Plan.

5. Non-Revenue Units. Include any non-revenue units that exist in the property and are appropriate for the size and type of property. (In some instances, this number may be higher than typical because lower occupancy makes it desirable to give discounted units in lieu of salary.) Assure that only units with rents included in the gross income estimate are expensed.

6. Turnover Expenses. Assure that the estimate of turnover expenses reflects anticipated turnover and vacancy assumptions.

7. Repair and Maintenance. Assure that these expenses are adequate to maintain the property (i.e., if the property was not properly maintained prior to M2M, the expense used in underwriting should be higher than historic). Assure that there is no duplication with items included in the Reserves for Replacements.

8. Utilities. Contact all utilities that provide significant service to the property to determine both future and historic increases or decreases in rates that should be considered in developing the underwriting conclusion.
9. Real Estate Taxes. Contact all taxing bodies to determine both future and historic increases or decreases in taxes that should be considered in developing the underwriting conclusion. Determine whether any underwriting feature, such as an increase in income or an improved property condition, will affect the tax estimate. Where PILOT (Payment in Lieu of Tax) agreements or abatement have been, or are expected to be, in place, the PAE must verify the basis for the PILOT or abatement, and determine whether it will continue to apply after the transaction is closed and for what term, and assure that any changes are addressed in the underwriting.
10. Hazard Insurance. Contact the owner's insurance agent and estimate insurance based on discussions with the agent of anticipated increases or decreases in premiums for insurance that meets the requirements herein. The owner is required to maintain a comprehensive policy of hazard insurance with claims payable on a replacement cost basis. The face amount of the policy must meet or exceed HUD's minimum coverage of no less than 80% (or a higher percentage required by the insurer's coinsurance clause) of the project's "Total (100%) Insurable Value", as defined below. The policy must also be subject to an agreed amount clause (insurer agrees on the replacement cost of the insured property).

    "Total (100%) Insurable Value" is the greatest of the following:

    a) A current replacement cost estimate of structures and equipment, if available (OAHP does not require development of replacement cost, but an estimate may be available from the owner, insurer or lender);

    b) The most recent replacement cost estimate of structures and equipment for the project on which required insurance coverage was based prior to the restructuring (obtain the latest updated HUD-92329 Property Insurance Schedule from the owner or from the HUD project files). If significant improvements affecting replacement cost are required as part of the restructuring (e.g., addition of central air conditioning if none before) add the cost of those items; or

    c) The total of all project debt resulting from the M2M full debt restructuring at closing.

11. Security/Protection Expenses. Include security expenses to the extent that such costs are reasonably necessary for a competent agent to operate the property at the level of comparable market expenses. These expenses may be higher or lower than historical expenses.

12. Neighborhood Networks and Other Non-Housing Service Costs. Include appropriate costs taking into account such factors as the current and anticipated resident profile. The costs should be discussed with the appropriate Multifamily office. All new services should also be discussed with Multifamily. In the underwriting, include any impact on expenses (such as an increase in insurance, utilities, supplies, cleaning or other operating expenses) that may result from the addition of the Neighborhood Network.

D. **Expenses for Tenant-based Properties**. In developing alternative expenses as a tenant-based property, base the expenses on similar market-rate properties. Especially consider whether changes are likely in advertising/marketing expenses and in management and administrative fees.

## Net Operating Income (NOI) for Calculating the First Mortgage

Section 5-6

A. **Net Operating Income (NOI)**. The PAE will determine the NOI using the model. In the model, NOI reflects deductions for expenses as indicated below:

1. Tenant-based Assistance. Where the RAAP (see Section 4-13) determines that project-based assistance should not continue, NOI should always be determined using

   a) the lower of market rents or affordable rents and

   b) tenant-based expenses.

2. Project-based Assistance. Where the RAAP (see Section 4-13) determines that project-based assistance is appropriate, NOI should be determined using

   a) the lower of market rents or affordable rents and

   b) project-based expenses.

3. Deposits to Replacement Reserves. In all cases, treat the annual deposit to the replacement reserve (see Section 4-11) as an expense in determining NOI.

4. Capital Recovery Payment. In all cases, treat the Capital Recovery Payment (see Section 4-11) as an expense in determining NOI.

B. **Analyze the Resulting NOI**.

1. Positive NOI. If the NOI is positive, the PAE should use the NOI determined above to size the first mortgage. Note that a different NOI may be used to size the second mortgage in some cases (see Section 5-10 below).

2. Inadequate or Negative NOI. If, with a full payment of claim, NOI is negative (income less than expenses), or proves insufficient to support financing for rehabilitation costs (resulting in a shortfall in transaction sources), or if NOI is positive but provides an insufficient 2nd mortgage debt service coverage for the specific circumstances of the property, the underwriter may consider exception rents (see Section 5-12 below) or rejection of the restructuring plan (see Chapter 6).

## General Considerations in Structuring the Mortgages

Section 5-7

The PAE should use its best judgment in developing the restructuring plan to balance the following overall objectives:

A. To establish a supportable first mortgage with a reasonably low likelihood of future default considering the property's market, condition, competition, and the resources of the owner.

B. To provide a modest but reasonable return to the owner, sufficient to maintain interest in operating a sound, decent property without excess return regardless of past levels of return.

C. To establish a second mortgage that is reasonably repayable (as defined below) with the most favorable terms for the government that do not imperil the first mortgage or cause owner disinterest in the property.

## First Mortgage

Section 5-8

A. **Determine the First Mortgage**. The first mortgage should be sized assuming the NOI determined by the PAE above (Section 5-6) and the limitations or considerations discussed in this section.

B. **Terms**. PAE should assume full amortization and fixed monthly payments based on competitive terms. As soon as a lender is identified, the PAE should get the likely rate and terms from the lender and document that the terms are competitive. The amortization period should generally not be less than 30 years. A shorter term may be chosen by the PAE if it determines that (1) the difference in cost to the government of using a shorter period is minimal, or (2) obtaining needed approval to extend a partnership to allow a 30-year term is unreasonable, or (3) a real estate tax abatement or PILOT agreement expires in less than 30 years, and the transaction cannot be reasonably underwritten to ensure that the future estimated tax burden can be absorbed by the property.

C. **Debt Service Coverage**. The PAE should generally select a Debt Service Coverage Ratio (DSCR) between 1.2 and 1.4.

1. The 1st mortgage DSCR should be adjusted upward, if necessary, so that the 2nd mortgage pro forma underwriting permits payment of the full Incentive Performance Fee (see Chapter 3-6 B) in the initial year.

2. In selecting a DSCR, the PAE should consider the following and may make adjustments accordingly:

   a) Because of the small size of the new loan in some M2M transactions, a special factor must be considered in establishing the DSCR. The 1st mortgage DSCR should be set so as to allow an adequate 2nd mortgage "cushion" in each transaction. The cushion is the amount of funds remaining when expenses, deposits to reserves, CRP, and debt are paid. (The cushion, therefore, is the amount of the IPF plus HUD's and the owner's shares of cash flow.) The cushion should generally be between 7-10% of expenses. The lower figure is more appropriate for larger or less volatile transactions or where the tenants pay all, or nearly all, utilities. The larger figure is more appropriate for smaller properties, those in volatile markets, or those where the owner pays for all, or nearly all, of the utilities.

   b) The smaller the dollar amount of net operating income, the higher the DSCR that may be appropriate in order to provide adequate cash flow to cover contingencies.

   c) Where the RAAP has determined that project-based assistance is appropriate, and the affordable rents are lower than the market rents, it may be appropriate to adjust the DSCR downward to account for the fact that market rents will be paid under project-based assistance, at least initially. The DSCR must never be lower than would allow minimal coverage in the event that Section 8 payments became unavailable (generally no lower than 1.05 DSCR).

   d) The PAE should consider the strength and depth of the market, the competition the project currently faces, the probability of increased competition from new projects, and the owner's motivation and ability (including liquidity) to finance necessary repairs, replacements and major maintenance items in case the reserves are depleted.

D. **Loan to Value**. The Loan to Value ratio may not exceed 100% without a waiver from OAHP Headquarters. The financing vehicle chosen may impose more stringent terms.

E. **Small Loans**. In cases where the supportable debt is less than $250,000, the PAE may consider foregoing the first mortgage thereby increasing the size of the “second” mortgage. This approach is likely to be appropriate where no cost effective sources are available for loans of this size and where the owner can reasonably fund 100% of transaction and rehabilitation escrow costs, and any IDRR shortfall. The PAE should provide support for such an approach and should consider an increase in the interest rate of the “second” mortgage. With an OPG waiver and appropriate support, the PAE may also propose this approach in cases where the supportable debt is larger than $250,000.

## Sizing the Partial Payment of Claim

Section 5-9

The claim must be the lesser of:

A. The unpaid principal balance (UPB) of an insured or HUD-held first mortgage prior to restructuring, or

B. The result of the following calculation:

1. the UPB on the existing first mortgage;
2. plus the rehabilitation costs approved by the PAE;
3. plus the Initial Deposit to the Reserve for Replacement;
4. plus the transaction costs approved by the PAE;
5. plus up to 10% of Excess Project Accounts (see Section 5-13, A.3) approved by the PAE for payment to the owner;
6. minus the restructured first mortgage (or supportable debt) determined by the PAE;
7. minus all contributions made by the owner (and the owner’s partners/investor) in connection with the restructuring, as determined by the PAE;
8. minus all Project Accounts (total account balances of the Reserve for Replacement, Residual Receipts and any other applicable accounts at the time of closing), as determined by the PAE. (See also Section 5-13.)

## Sizing the M2M Subordinate Debt

Section 5-10

A. **In General**. The total amount of M2M subordinate debt (2nd and, where applicable, 3rd mortgages) should be determined in accordance with this section. The M2M Underwriting Model (version 4.2 and higher) reflects the provisions of this section. The formula for total M2M subordinate debt varies depending on whether the property has an FHA-insured or HUD-Held mortgage, and whether residual receipts are used to help finance the restructuring.

B. **New Reg Residual Receipts**.

1. Definition. Some Section 8 New Construction / Substantial Rehabilitation properties, developed under the November 1979 "new" Section 8 regulations, have Section 8 HAP Contracts that impose distribution limitations and require that Surplus Cash over and above the limited distribution be deposited into a residual receipts account. 24 CFR 880.205(e) provides that those funds ("new reg residual receipts") belong to HUD at the end of the HAP Contract's term.

2. Use of New Reg Residual Receipts in M2M. In M2M transactions, HUD uses those "new reg residual receipts" funds to reduce the partial payment of claim that would otherwise have to be paid. Because these funds are HUD funds, they must be included in the M2M subordinate debt (that is, they are treated as if they were PPC funds).

3. Potential Owner Share. The amount of "new reg residual receipts" included in the M2M subordinate debt is the total amount, less any percentage paid to the owner in accordance with Section 5-14.B.4.

C. **Other Residual Receipts**. Residual receipts, other than "new reg" residual receipts, will also be used as a source of funds in the restructure (a portion may be released to the owner; see Section 5-14.B.4). However, these funds will not be included in the M2M subordinate debt.

D. **Restructures of FHA-Insured Mortgages**. The total amount of M2M subordinate debt is calculated as follows:

1. Partial payment of claim.

2. Plus any "new reg residual receipts" not distributed to the owner (see Section 5-14.B.4 regarding potential owner share).

E. **Restructures of HUD-Held Mortgages**. The total amount of M2M subordinate debt is calculated as follows:

1. Pre-M2M unpaid principal balance (including accrued interest and accrued Servicing Fees) of the HUD-Held mortgage loan.
2. Plus any "new reg residual receipts" not distributed to the owner (see Section 5-14.B.4 regarding potential owner share).
3. Minus (for transactions in which the HUD-Held loan is modified at the M2M closing) the principal amount of any modified HUD-Held 1st mortgage.
4. Minus any cash proceeds of closing paid to FHA. FHA will receive cash proceeds from the M2M closing whenever the take-out 1st mortgage (and other cash sources) exceed approved uses (such as HUD's share of the rehab escrow, IDRR and transaction costs).

## Second Mortgage (Mortgage Restructuring Note or MRN)

Section 5-11

A. **Terms**.

1. The interest rate on the second mortgage must be a minimum of 1%. The PAE may require a higher interest rate, whenever (a) both the 2nd and 3rd mortgages can be fully repaid, using no more than 80% of the property's estimated residual value (at the end of the term) and (b) no third mortgage is created by using the higher interest rate. When proposing a higher interest rate, the PAE should increase the interest rate in 0.50% increments. However, in no case can this rate exceed the Applicable Federal Rate, as published monthly by the Internal Revenue Service. (The Rate is available from the IRS monthly Bulletins and from several commercial web sites such as www.timevalue.com).
2. The term and maturity date of the second mortgage must be the same as the term and maturity date of the restructured first mortgage. If there is no first mortgage under the restructuring, the maximum second mortgage term is 30 years, but the second mortgage term may not exceed 75% of the remaining economic life of the property.
3. Note that the provisions for return to the owner in the form of the CRP and IPF are included in the documentation for the subordinate M2M debt. If there is no second or third mortgage, the CRP and IPF cannot be provided.

B. **Funds to Service the Second Mortgage**.

1. For underwriting purposes, at least 75% of NOI minus first mortgage debt service, and Incentive Performance Fee, must be applied toward the second mortgage. The remainder will go to the owner.
2. The PAE may increase the government's percentage applied to the second mortgage (the "split") if the PAE determines that the return to the owner is otherwise adequate. Generally, the PAE should consider reduction of the owner's share where the owner return per unit exceeds $25-$33 per unit per month. The lower figure is appropriate for less risky or difficult transactions such as housing for the elderly in a tight suburban market or lower cost area. The higher figure is more appropriate for family properties in difficult areas or higher cost areas.

C. **Sizing the Second Mortgage**: Restructures of FHA-Insured Mortgages. Except as provided in paragraph F below, the size of the second mortgage must equal the lesser of:

1. The total amount of M2M subordinate debt (see section 5-10).
2. The greater of the following:
    a) the Full or Partial Payment of Claim or
    b) the difference between the UPB of the existing insured mortgage immediately before restructuring and the UPB of the restructured or new first mortgage.
3. An amount the PAE determines the project can reasonably be expected to repay.

D. **Sizing the Second Mortgage: Restructures of HUD-Held Mortgages**. Except as provided in paragraph F below, the size of the second mortgage must equal the lesser of:

1. The total amount of M2M subordinate debt (see section 5-10).
2. The difference between the UPB of the existing HUD-Held mortgage immediately before restructuring and the UPB of the restructured or new first mortgage,
3. An amount the PAE determines the project can reasonably be expected to repay.

E. **Criteria for Determining the Amount "Reasonably Expected to be Repaid"**. The PAE will determine the amount that can reasonably be expected to be repaid after considering both:

1. <u>The amount that appears repayable in the model's second loan pro forma that uses</u>:
    a) the income and expenses actually expected to be incurred (e.g., if affordable rents are lower, but the project will

have project-based assistance, use the higher market-rate rents even if not used in determining the first mortgage);

b) any Capital Recovery Payment, and any Incentive Performance Fee used in sizing the first mortgage;

c) an annual adjustment to the rents and expenses. The PAE will determine the amount of the trend and may choose to apply the OCAF percentage. In no case will the trend applied to the income exceed the trend applied to the expenses;

d) a likely vacancy rate (including both physical vacancy and collection loss that reflects the property's projected vacancy rate supported appropriately) of no less than 3%, as determined appropriate by the PAE;

e) the percentage (split) of Net Cash Flow determined by the PAE in paragraph B. of this Section; and

f) the term of any first mortgage. And,

2. <u>The anticipated residual value/refinance potential of the project at the end of the term</u>. The residual value will be calculated by the model using the rents and expenses of the last year of the term (or, at the PAE's option, the year following the last year of the term) and a reasonable capitalization rate selected by the PAE. If the transaction requires exception rents, or if the model-based approach is not considered the best available, the PAE may develop an alternative approach to residual value that is supported by market history and trends and realistic expectations the PAE selects about the physical and financial position of the property.

F. **Qualified Non-profit Purchasers**. PAEs may recommend forgiving all or part of second mortgage requirements, or assigning the second mortgages to eligible entities, for all qualified, non-profit purchasers. See Appendix C for definitions, procedures, and requirements.

## Third Mortgage (Contingent Repayment Note or CRN)

Section 5-12

A. **When Appropriate**. If the total amount of M2M subordinate debt (see Section 5-10) exceeds the principal amount of the second mortgage, HUD may require a third mortgage in the full amount of the difference, or in a lesser amount. The PAE's recommendation for a third mortgage in a lesser amount, or for no third mortgage, must be documented and justified. (The PAE may provide the documentation in the underwriting model.)

B. **Terms**. Any third mortgage will be subordinate to other HUD-held mortgages, will bear interest at the same rate as the second mortgage and will require no payments until the second mortgage is paid in full. If reducing the interest rate on the second mortgage would result in the elimination of the third mortgage, the rate should be reduced.

C. **Qualified Non-profit Purchasers**. PAEs may recommend forgiving all or part of the third mortgage requirements, or assigning the third mortgages to eligible entities, for all qualified, non-profit purchasers. See Appendix C for definitions, procedures, and requirements.

## Exception Rents

Section 5-13

A. **General**. Exception rents (available only for full restructuring transactions) are:

1. rents that are greater than comparable market rents; and
2. are within the limitations described in Section E below.

B. **Exception Rent Recommendation**. A PAE may recommend exception rents if

1. the PAE determines that the loss of the project would seriously and adversely impact the tenants and the community, for example, by displacing tenants who would have serious difficulty finding comparable housing (see MAHRA §514.g.2.a.i), and
2. the project's NOI is insufficient to support:
   a) reasonable and necessary operating expenses,
   b) adequate annual deposit to the Reserves for Replacement,
   c) an adequate operating expense cushion on the 2nd loan proforma,
   d) debt service on any new rehabilitation loan,
   e) the required full IPF, and
   f) a reasonable return to the owner. (See Sections 3-5 and 5-11 for a discussion of the owner's reasonable financial return.) The Underwriting Model supplies a reasonable method for calculating a possible return to the owner in these cases.

C. **Sizing Exception Rents**. Exception rents should not exceed the amount necessary to

1. cover the items in paragraph B. 2. above, and

2. provide a debt coverage ratio which the PAE determines provides a reasonable cushion for future operations.

D. **Recommendation Against Exception Rents**. The PAE should not recommend exception rents if it determines that:

1. continuation of the project would have an irreversible detrimental impact on the community; or
2. the project is in poor physical condition that cannot be remedied cost-effectively; or
3. the project's owner has been confirmed to be ineligible for restructuring.

E. **Exception Rent Limitations**.

1. Generally, the PAE may not use exception rents on more than 20% of all units in properties accepted in any one year, per PRA. PAEs should analyze their portfolio periodically to determine if the number of units that have been or will be approved will exceed 20% of the units accepted. If the percentage is expected to exceed 20% for that fiscal year, the PAE must request a waiver using Form 5.1.
2. Generally exception rents may not exceed 120% of the FMR. If required, the PAE's Case Memorandum should clearly state why Exception Rents over 120% of FMR are appropriate. The OAHP Preservation Office will review the request and submit its recommendation to OAHP HQ in the case of exception rents exceeding 120% of the FMR.
3. The authority to waive the 120% cap is limited to no more than 5% of the units (nationwide) assigned to PAEs under PRAs.

## Sources and Uses

Section 5-14

A. **Sources**. Sources may include any combination of the following:

1. <u>Proceeds of any new loan</u>.
2. <u>Partial or Full payment of claim</u>.
3. <u>Cash contributions from the owner (partners/investors) toward transaction costs</u>. See Section B-5. (b) below.
4. <u>Cash contributions from the owner (partners/investors) toward the cost of rehabilitation</u>. With two exceptions noted below, owners are required to contribute, in cash, at least 20% of the cost of items in the Rehabilitation Escrow. Of the owner's contribution, three percent (3%) of the cost of items in the Rehabilitation Escrow must come from non-government sources.

PAEs should confirm the amount and source of the owner's contribution of non-project funds to the Rehabilitation Escrow. (Note that syndication proceeds from LIHTC awards would not be considered a governmental source and may be used to meet the owner's contribution requirement.)

The two exceptions are: (a) non-profit cooperatives are exempt from this requirement and (b) where the Rehabilitation Escrow includes Significant Additions. Significant Additions are items that are new (not replacements or repairs) and that are determined necessary improvements to tenant living conditions by the PAE. They are generally limited to air conditioning, elevators, and new community space. Considering the structure of the transaction, the PAE will generally reduce the owner contribution for the cost of the Significant Additions to 3%. (The contribution may never exceed 20% of the cost of such items.)

5. Excess Project Account Balance. Any Excess Project Account Balance is determined by subtracting the Reserves for Replacement account balance required after closing from the total account balances of the Reserve for Replacement, Residual Receipts and any other applicable accounts, at the time of closing.

   a) 100% of the Excess Project Accounts Balances should be used as a Source.

   b) If 90% of the Excess Project Account Balance is so large as to remove the need for a partial payment of claim, the transaction will still be processed as a Full and the other requirements of the Restructuring Plan must be met, including a Use Agreement and a Rider to the Section 8 contract. Any funds remaining will be recaptured by HUD.

B. **Uses**. Funds may be used in any combination of the following for the benefit of the project:

1. Pay-down or pay-off of the original UPB.
2. Repair/Rehabilitation escrow.
3. Initial Deposit to the Reserves for Replacement (including the balance prior to closing plus any additional amount that is required under the Restructuring Plan).
4. Up to 10% of the Excess Project Account Balance provided to the owner if part of the Restructuring Plan. Excess Project Account Balances can only be distributed after all required rehabilitation work has been completed satisfactorily, unless the owner applies such funds to owner-paid transaction costs.

5. Transaction Costs.

   a) PAEs should determine the reasonable, necessary and customary, transaction costs for each transaction. These include, but are not limited to:

      i. Title search
      ii. Site Survey (if needed)
      iii. Recordation, transfer taxes and similar costs
      iv. Prepayment penalties
      v. Owner's counsel's fees
      vi. First mortgage transaction fees
      vii. Closing Escrow Agent's fees
      viii. Rehab escrow administrator's and inspector's fees, if any
      ix. Plans and specifications if needed for items in the Rehab Escrow
      x. Operating deficit escrow, if necessary
      xi. New tax and insurance escrows
      xii. Up to $15,000 of the purchaser's costs for a market study, PCA, environmental study, and other purchase due diligence
      xiii. Accounts Payable. All operating accounts payable as defined in Form 5.3 must be cleared prior to or at closing. Owners must submit the appropriate certification(s) as required by the PAE. All such payables must be reviewed and approved by Multifamily in accordance with their policy on M2M payables.
      xiv. Purchaser's legal costs for TPA, partnership agreement, closing, etc.

   b) In general, the owner/borrower will be responsible for paying at least 20% of the transaction costs (or 100% of the transaction costs where there is a modification of the existing loan or where there is no new 1st mortgage).

C. The owner/borrower may finance the remainder of the transaction costs through the new first mortgage, provided the mortgage remains within the limits of HUD guidelines, where FHA insurance is being used.

## Subsidy Layering Review

Section 5-15

A. **Overview**. A subsidy layering review is a review to determine that multiple funding sources on a transaction do not overlap. The purpose is to ensure the efficient allocation of scarce governmental subsidy resources so that no project receives more subsidy dollars than necessary. The PAE will do the subsidy layering reviews for the M2M program and certify to OAHP that every Restructuring Plan submitted for approval meets HUD's "subsidy layering" requirements. In general, completion of the Restructuring Plan in accordance with the M2M program standards assures such overlaps do not occur.

B. **Potential Overlapping Funding Sources**. Funding and subsidy sources with potential overlaps include:

1. Claims paid in Mark-to-Market restructurings;
2. IRP rehabilitation loans or grants (under section 531 of MAHRA);
3. FHA-insured loans;
4. Low-income housing tax credits;
5. Project-based Section 8 subsidies;
6. State and local tax-exempt bond financing; and
7. Other public funds.

C. **Requirements for Owners**. Owners are required to disclose assistance from other government sources and the financial interests of persons involved in the project. The statement of the sources and uses of funding attached to the Restructuring Commitment must reflect all such sources.

D. **Requirements for PAEs**. In determining compliance with HUD's subsidy layering requirements, the PAE should:

1. use the comprehensive sources and uses of funding statement as the basis for the subsidy layering review; and
2. limit project uses in accordance with the guidelines noted in HUD Notice 95-4; and
3. if necessary, adjust project sources to balance with project uses; and
4. develop and use subsidy layering review procedures and standard subsidy layering review certifications that have been reviewed and approved by OAHP. The OAHP website contains an acceptable example of subsidy layering review procedures developed from a "best practices" review of existing PAE

procedures. OPG Forms 5.4 and 5.5 were similarly developed from a "best practices" review. Use of these forms satisfies the PAE's certification obligations. A PAE may use alternate procedures and certification forms if they have been reviewed and approved by OAHP.

## Restructuring Plan and Commitment

Section 5-16

A. **Owner And Lender Input During Underwriting**. The PAE is expected to work with the owner and lender throughout the process of developing the Draft Restructuring Plan. (See Chapter 6-2 for more detailed information on owner involvement in the restructuring process.)

B. **Draft Restructuring Plan**. When underwriting and all other due diligence are complete and a viable Restructuring Plan can be prepared, the PAE will complete a Draft Restructuring Plan Package (see Appendix L). The PAE must ensure that the draft Restructuring Plan incorporates all necessary support, and generally complies with the underwriting standards of this Guide, including Appendix V, or the PAE has obtained appropriate waivers.

C. **Completion of Underwriting and Due Diligence**. The PAE may request that OAHP review of the Draft Restructuring Plan occur before presenting the Draft Restructuring Plan to the owner and/or tenants.

D. **Second Tenant Meeting**. A second tenant meeting must be held no later than 10 days prior to submission of the Plan in order to allow the PAE 10 days to address tenant concerns prior to submission (or resubmission) of the Plan to OAHP. See Chapter 3 regarding timing, notices, and provision of materials.

E. **Submission to OAHP for Approval**. The PAE will submit the Restructuring Plan to the OAHP Preservation Office for approval. At the time of the submission, the PAE must "submit" the Form 5.2 electronically to the M2M MIS system.

## Operating Deficit Escrows

Section 5-17

A. **When Underwriting Differs from Property Performance at Closing**. In some transactions, the underwriting reflects financial circumstances that the property will not achieve for some period of time after closing. For example:

1. Occupancy may be below the occupancy contemplated in underwriting and the property will not achieve the higher occupancy until repairs are completed; or
2. Occupancy may be reduced during rehabilitation or repairs; or,
3. Significant improvements, such as installation of energy efficient systems, may be required to reduce expenses sufficiently to achieve the expense levels contemplated in underwriting.

In each of these cases, the Net Operating Income anticipated in underwriting will not be achieved for some time after closing. Where the shortfall is significant, the property will need an Operating Deficit Escrow.

B. **Operating Deficit Escrow**. An Operating Deficit Escrow consists of funds set aside to bridge an estimated shortfall in cash flow between the cash flow at closing and the cash flow anticipated in underwriting. The escrow provides a source of funds to pay obligations until property operations are stabilized at the underwritten levels. In this way, the property can be underwritten at stabilized income and expenses without accruing payables or risking mortgage default during the first months after closing.

C. **Applicability of requirements.** The following requirements apply to transactions with M2M first mortgages under 223(a)(7). Requirements for other cases are addressed in paragraph G below.

D. **Documentation.** The ODE Agreement is Form HUD-92476-A, Escrow Agreement, Additional Contribution by Sponsors. The parties to the Agreement are the Depository (generally the lender) and the owner. Two items in this form must be amended for M2M.

1. Item 2 of the Form must be amended to clarify that the Capital Recovery Payment, normally due the owner, and any debt service subordinate to the first mortgage will not be included in calculating the cash deficit.
2. Item 4 of the Form must be amended to provide that unused funds will be used as a lump-sum payment against the principal of the Mortgage Restructuring Note. Unused funds may not be returned to the owner.

In addition, the RC must contain a requirement that the owner submit monthly accountings (Forms HUD-93479, 80 and 81) to the Depository and the Multifamily HUB.

Form HUD-92476-A is a required document in the M2M docket

E. **Time Covered by the Escrow**. The time period of the escrow may not exceed 18 months starting with the first month after closing. This approach is not appropriate if the property cannot achieve stabilized operations within 18 months. In exceptional circumstances, the Preservation Office may consider waivers for brief extensions.

F. **Amount Required**.

1. The base amount required for the Operating Deficit Escrow is the sum of the monthly differences between expected net operating income starting at closing and the underwritten (stabilized) net operating income.
2. In addition, each escrow must have a cushion of 10%. The underwriter may increase the cushion to a maximum of 20%, where needed to address a significant chance of delays or costs beyond the owner's control.
3. Regardless of the adequacy of the escrow, the owner must pay the mortgage and maintain and operate the property in a safe and sound manner.

G. **Estimating the Amount Required**. Model 4.35 (or Model 4.45) or later provides an excel format to use in calculating the monthly difference between the projected and underwritten operating income. In completing the format, the PAE must consider the effect of all applicable factors. Two or more factors on a single property may exist for different time periods. Examples include:

1. If the shortfall stems from low initial occupancy, the PAE must consider the vacancy rate at closing, the monthly schedule of unit or other repair completions, existing turnover and absorption rates, and any rent concessions which may be used to rent up more quickly.
2. If the shortfall will result from vacancies due to rehab or repairs, the PAE must consider the date the work will begin, the duration of the work, the length and cost of any temporary relocation (if not considered elsewhere), and the cost of marketing, in addition to existing turnover and absorption rates.
3. If the shortfall results from the need to await installation of replacement equipment, the PAE must consider the time from closing until the completion of the work (including any seasonality factors) and the resulting impact upon service billing.

H. **Source of Funds and Administration.** The Operating Deficit Escrow funds, including appropriate fees, should be included as transaction costs and entered in the Sources and Uses. HUD requires that the new lender be responsible for managing the operating deficit escrow, but the lender may arrange for certain duties to be performed by others.

The PAE must review and approve the fee for reasonableness (except see below if the PAE is the depository). Historically, depositories have done this for no fee, but are not required to pay interest on the escrow. Fees charged may vary based on the interest rate environment. Where the escrow is managed by a depository with no responsibility for inspections and no independent verification, any fee should be modest since the role is simple.

I. **Transactions that do NOT have 223 (a) (7) mortgages.**

1. In the case of a new 223(f) or a 221(d)(4) first mortgage processed by Multifamily Housing, Multifamily will dictate terms of, and controls over, the escrow(s).
2. In the case of a conventional first mortgage with an expected operating deficit, the terms and conditions of the operating deficit escrow will generally be worked out between the lender and the owner. The PAE must share any estimate it has made of a deficit with other entities. The PAE should share any concerns about the size of escrow estimates with OAHP.
3. Where the restructuring results in a HUD-Held first mortgage (MRN), there is no new lender. If the PAE has required an escrow, the PAE may arrange for escrow administration in a manner similar to the arrangements made for a Rehab Escrow Administrator; or, the PAE may administer escrows themselves with OAHP approval of the arrangement and fee.

J. **Transmission Memorandum.** Information on the Operating Deficit Escrow must be included by the Debt Restructuring Specialist in the Transmission Memorandum under Other Special Conditions or Issues.

## Business Forms

Section 5-18

5.1 Waiver Request - Exception Rents - 20% of Annual PRA Limitation

5.2 Case Memorandum Term Sheet