Rental Assistance Demonstration (RAD)- Overview, Financing & Case Study

Conference: HUD Region III & IV, Mixed Finance and RAD Conference

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VISION KNOWLEDGE PEOPLE

Roles: Joint Venture Opportunities- Examples of Partnering

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- Turnkey Developer
- Significant Development Partner
- Management & Maintenance

What PHA's Bring to the Table

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- Land
- Infrastructure
- Social Service Connection/Programs
- Goodwill in the community
- Public Housing Funding
- Leverage Financing of Capital Funds, Replacement Housing Factor Funds (RHF) and Operating Funds
- Other Capital - At conversion, RAD allows 1 x use of certain HA Capital Funds if needed to "close the gap"
- PHA capable of attracting other GAP loan funding or grants.

Overall Approach

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- A key goal of RAD is to leverage private capital to meet the physical needs of public housing
- Many RAD conversions will involve capitalization with conventional debt only, essentially by leveraging the Capital Fund portion of the existing funding level
- Other RAD conversions will benefit from one or more of the following financial tools:
  - 4% LIHTCs
  - 9% LIHTCs
  - Available public housing funding, including Operating Reserves and unobligated Capital Funds
  - CDBG funds
  - Other State and local subordinate financing
  - Federal Home Loan Bank AHP funds
- Key drivers determining which financing makes the most sense for any given project will be:
  - Level of rehab needed
  - Amount of supportable debt (key variables: contract rents, operating expenses)
- The following presentation explores different options and the pros and cons of each, using a case study approach.

DEBT: Most Likely HUD Programs

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- 221(d)(4): Construction and permanent financing for multi family properties – new construction or substantial rehabilitation.

- 223 (f): Refinancing or acquisition of existing multi family properties with moderate repairs.

- With RAD, either of the above programs are eligible for use under HUD LIHTC PILOT Program, which is designed to expedite processing to meet tight external deadlines imposed when using the LIHTC program. There are 20 approved MAP Lenders.

FHA Section 221(d)4 Loan Program Summary

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PURPOSE: Construction and permanent financing for new construction or substantial rehabilitation for multifamily and senior (without services) properties. Commercial space is permitted but may not exceed 10 percent of total square footage or 15 percent of gross income. If the site is located in a 220 eligible redevelopment zone, the commercial percentages can increase to 20 percent and 30 percent respectively.

- **Loan Term Amortization:** Construction period plus a 40-year fully amortizing permanent loan.
- **Note Rate:** Low rates as a result of a AAA rated credit, fixed at construction loan closing for life of the loan, based on market conditions. The interest rate is typically locked once a firm commitment issued by HUD is accepted by the borrower.
- **Loan Amount:** No maximum mortgage limitations other than those imposed by the underwriting standards.
- **Underwriting:** With 90% or greater RA= min. **DSCR** 1.11; and “affordable”= min. .1.15; (and market rate 1.20) . **LTV**= max. 90% and 87% (and 83.3%) respectively.

FHA Section 223(f) Loan Program Summary

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PURPOSE: Permanent financing for existing (at least three years old without a waiver) multifamily and seniors rental properties. Commercial space ≤ 10% of total SF or 15% of gross income.

- **Loan Term Amortization:** The lesser of 35 years or 75 percent of the remaining economic life of the property as determined by the appraiser.
- **Note Rate:** Taxable, low-interest GNMA mortgage-backed securities for permanent loans or may serve as credit enhancement for tax-exempt bonds. The interest rate is typically locked once a firm commitment issued by HUD is accepted by the borrower. However, advance/ early rate locks are available.
- **Loan Amount:** No maximum mortgage limitations other than those imposed by the underwriting standards.
- **Underwriting:** With 90% or greater RA= min. **DSCR** 1.15; and “affordable”= min. 1.176 (and market rate 1.20). **LTV**= max. 87% and 85% (and market rate 90%) respectively.

Gap Loan Sources

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- Housing Development Gap Financing: HFA's non-tax credit
- Housing Credit Assistance Program: HFA's- 9% only
- Multifamily Bond Gap Financing: HFA's- 4% only
- Housing Investment Fund: HFA- non tax credit.
- Local HOME: City or County programs generally reserved for tax credit projects.
- Federal Home Loan Bank: Affordable Housing Program – available for tax credit and non tax credit projects.
- Other Capital - At conversion, RAD allows 1 x use of certain HA Capital Funds if needed to "close the gap"
- PHA capable of attracting other GAP loan funding or grants.

LAYING THE GROUNDWORK FOR FINANCING: Initial Project Budget -- What Costs to Include

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- Costs that will apply in all cases
  - Basic due diligence: capital needs assessment, environmental assessment, appraisal, market study
  - Basic closing costs: survey, title & recording, legal fees
- Costs that will vary by rehab needs
  - Hard rehab costs, contingency
  - Architect, engineering
  - Building permits
  - Temporary relocation
- Costs that will vary by financial structure
  - "Acquisition" costs
  - Developer fee
  - Operating reserve
  - Capitalized replacement reserve
  - Financing fees, including bond issuance costs
  - Legal fees
  - LIHTC application/allocation fees
  - Audit and cost certification

Operating Income

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- Determining Contract Rents
  - "Current funding level"—but:
    - PBRA: contract rents can't exceed 120% of FMR if above market, 150% of FMR if below market
    - PBV: rents can't exceed "reasonable" (market) rent
  - LIHTC and HOME considerations
- Other income
  - Historic vs. potential additional post conversion
- Vacancy and bad debt assumptions
- Utility allowances

Operating Expenses

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- Understanding current/historical expenses
  - Distinguishing between capital and operating expenses
- Real estate taxes/PILOTs
- Third party management options
- Achieving greater efficiencies under PHA management
  - Admin staffing
  - Maintenance staffing and contracts
  - Additional items PHA may currently be charging as expenses which can instead be recovered from available cash flow: asset management fees, accounting, IT fees
- Effect of planned rehabilitation on operating expenses
  - Replacement of major systems may reduce some maintenance costs
  - Green retrofits, conversion to tenant-paid utilities, etc.
- Other ideas to bring down operating costs?

When to Consider LIHTCs

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- When rehab needs are higher than can be handled by debt-only financing
  - LIHTC investors typically require a minimum of $25k-30k per unit in rehab to be completed upfront.
- When ability of project to carry must-pay debt is limited due to high expense ratio
  - LIHTC investor will require that must-pay debt is sized to achieve a minimum debt coverage ratio for the 15 year compliance period
- Additional considerations
  - LIHTC project will allow a larger developer fee to be paid
  - LIHTC Investor will require an operating reserve equal to six months operating expenses and debt service
  - Unlike FHA lenders, LIHTC investors will underwrite to lower of Section 8, LIHTC max, or market rents. However, in most cases Section 8 rent levels under RAD wouldn't result in additional "loss run" reserves.

LIHTC Options

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- 4% LIHTCs paired with tax exempt bonds are easier to obtain, but provide fewer dollars for the same deal, and there are added transaction costs in a bond financing

- 9% LIHTCs provide significantly more dollars for rehab and other costs, but are much more competitive

ISSUES: High Expense Ratio and Capital Needs . Convert w/4% or 9% Tax Credits

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Sample Case Study:

- Assume need for $27.5K-$33K/unit in rehab up-front
- Project can support less debt due to operating expenses of over $5,530/unit and expense ratio of 80.6% (and trending vs. 223f)
- 4% LIHTC/tax exempt bond structure, with FHA 221(d)(4) permanent debt would require substantial additional capital or "soft monies" of $1.064 million, or $5,700+/unit
- 9% LIHTC structure eliminates need for additional capital, plus provides $1.4 million for further rehab or other uses

Scenario #1: Convert with 221(d)4 and 4% LIHTC/Bonds

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- Utilize tax-exempt bonds/taxable FHA structure to take advantage of low taxable GNMA rates- use bonds proceeds that are then reimbursed from FHA taxable (GNMA) perm loan. Assume 3% rate, 40 years term & amort.
- Assume FHA 221(d)4 financing: 3.00% rate, 40 year term & amortization.
- LIHTC enables significant up-front rehab (*assumed 25k/unit net of contingency).
- Added acquisition cost to generate acquisition basis, matched with a seller loan (a wash).
- Added developer fee, operating reserve, typical soft costs, including relocation.
- Reduced annual replacement reserves contributions to $400 pupa given higher up-front rehab.
- Additional capital contribution is assumed in this case (HA Funds?).

Sources & Uses 4% LIHTC/Bonds with FHA 221(d)4 Loan

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Sources		**per unit**
FHA 221(d)4 Loan	3,200,000	17,297
Seller Note	3,290,000	17,782
Deferred Dev Fee	462,000	2,500
LIHTC Equity	2,933,000	15,854
Other Capital	1,064,000	5,752
Total:	10,949,000	59,185
Uses		
Acquisition	3,290,000	17,782
Rehabilitation	5,088,000	27,500
Soft Costs	414,000	2,239
Financing Fees	652,000	3,527
Development Fee	925,000	5000
Operating Reserve	580,000	3,137
Total:	10,949,000	59,185

How Could a Deal Work Better With 4% LIHTCs

If a different project had contract rents that were just **$25** higher ($615 instead of $590):

Sources	**was:**	**now is:**
FHA 221(d)(4) Loan	3,200,000	4,735,000
Seller Note	3,290,000	3,993,000
Deferred Dev Fee	462,000	0
LIHTC Equity	2,933,000	3,084,000
Other Capital	1,064,000	0
Total:	10,949,000	11,812,000

Uses		
Acquisition	3,290,000	3,993,000
Rehabilitation	5,088,000	5,088,000
Soft Costs	414,000	414,000
Financing Fees	652,000	779,000
Development Fee	925,000	925,000
Operating Reserve	580,000	613,000
Total:	10,949,000	11,812,000

Sources & Uses 9%% LIHTC with 221(d)4

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Sources		per unit
FHA 221(d)(4)	3,200,000	17,297
Seller Note	3,290,000	17,782
LIHTC Equity	6,717,000	36,308
Total:	13,207,000	71,387

Uses		
Acquisition	3,290,000	17,782
Rehabilitation	6,105,000	33,000
Soft Costs	409,000	2,212
Financing Fees	449,000	2,427
Development Fee	925,000	5,000
Operating Reserve	580,000	3,137
Total:	11,758,000	63,558
Excess Sources:	1,449,000	7,829

"RAD Place Apartments": Assumed Financial Basics and 223(f) Loan

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- Significant common area upgrades in 2009
- CNA identified capital needs as:
  - $828,000 in year 1 needs
  - $2.9 million NPV of needs over 20 years
  - $3.7 million total ($21k/unit total)
- Section 8 Rent per RAD Assessment Tool: $590 average.
- Other Income based on history (slightly higher than RAD Tool which provides a "plug" number)
- Operating expenses: $5,131 pupa net of repl reserve (per RAD Tool at 95% Formula Expenses).
- Year 1 expense ratio (including repl res) is 81.3%

Scenario #2: Convert with Straight FHA 223(f) Loan--no credits/bonds

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- 35 year term, assumed rate of 2.75% plus 0.45% MIP
- Capitalized Replacement Reserve of $2.9 million (+ annual ongoing of $450/unit)
- With high expense ratio and due to LIHTC requirements for Inc/Exp (2% & 3%) trending, the loan amount is higher as compared to the 4% LIHTC transaction.
- Up-front rehab covers immediate repairs/year 1 capital needs
- Substantial capitalized replacement reserve is assumed
- For properties in decent condition, using RR for repairs & replacements over time may be a better asset management approach
  - Risk is ongoing capital needs backlog, under-funding of ongoing replacement reserves
- Far less time and effort and lower transaction costs
- Developer fee opportunity if loan can support
- For projects with less than $25-$30k/unit in near-term rehab needs, 223(f) alone may be a better execution than LIHTCs

Sources & Uses Straight FHA 223(f) Loan

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Sources		**per unit**
FHA 223(f) Loan	4,000,100	21,622
Uses		
Repairs (critical + non-critical)	828,439	4,478
Capitalized Repl. Res.	2,935,710	15,868
Trans. Costs/Fin. Fees	236,038	1,276
Total Uses	4,000,187	21,622 (rd.)
Cash-to-Close	**(87)**	
Repair Escrow (20% x non-critical only)	120,708*	652*
Total Cash-to Close	120,795	653

*Refunded upon completion of Repairs

Financing RAD Conversions: Observations

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- Rates are low. SEIZE THE MOMENT
- Debt-only capitalization will work best when contract rents relative to operating expenses are relatively higher, up-front rehab needs are relatively modest
  - Lower transaction costs
  - Faster Execution
- LIHTCs structures are appropriate for substantial recapitalization/repositioning of public housing assets
  - Best where significant rehab work needs to be done upfront
  - Projects which convert with low contract rents/very high expense ratios may need to compete for 9% credits, as project will support little or no must-pay debt.
  - Scattered site projects can work, but raise other concerns (management, operating expenses, investor/lender appetite)

Financing RAD Conversions: Observations

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- Housing authorities should consider the benefits of competing for 9% LIHTC allocations, even in projects where 4% LIHTCs and/or a non-LIHTC debt execution might “work”:
  - Less soft costs and complexity than a bond deal
  - Less need for leverage, creating the opportunity for greater cash flow to the housing authority over time, and less vulnerability to Section 8 funding risk
  - More opportunity to earn a developer fee
- Post-conversion operating expenses, and ratio of expenses to Section 8 income, will be a critical financial feasibility issue.
  - Affects up-front debt sizing, as well as sustainability of operations over time, especially if expense increases outpace OCAF increases to Section 8 rent contracts
  - Housing Authorities participating in RAD should consider how they could operate RAD-converted properties more efficiently than in the past.

Contact For Follow Up

Bellwether Enterprise

- **Bellwether Enterprise Real Estate Capital:**
  Jeff Mion – Sr. Vice President, Agency & Commercial Mortgage Finance
  jmion@bellwetherenterprise.com

- **Enterprise Community Partners:**
  Meaghan Shannon-Vlkovic - Vice President & Market Leader Southeast
  mvlkovic@enterprisecommunity.org

- **Enterprise Community Investment:**
  Steve Gimilaro - Vice President Syndication
  sgimilaro@enterprisecommunity.com