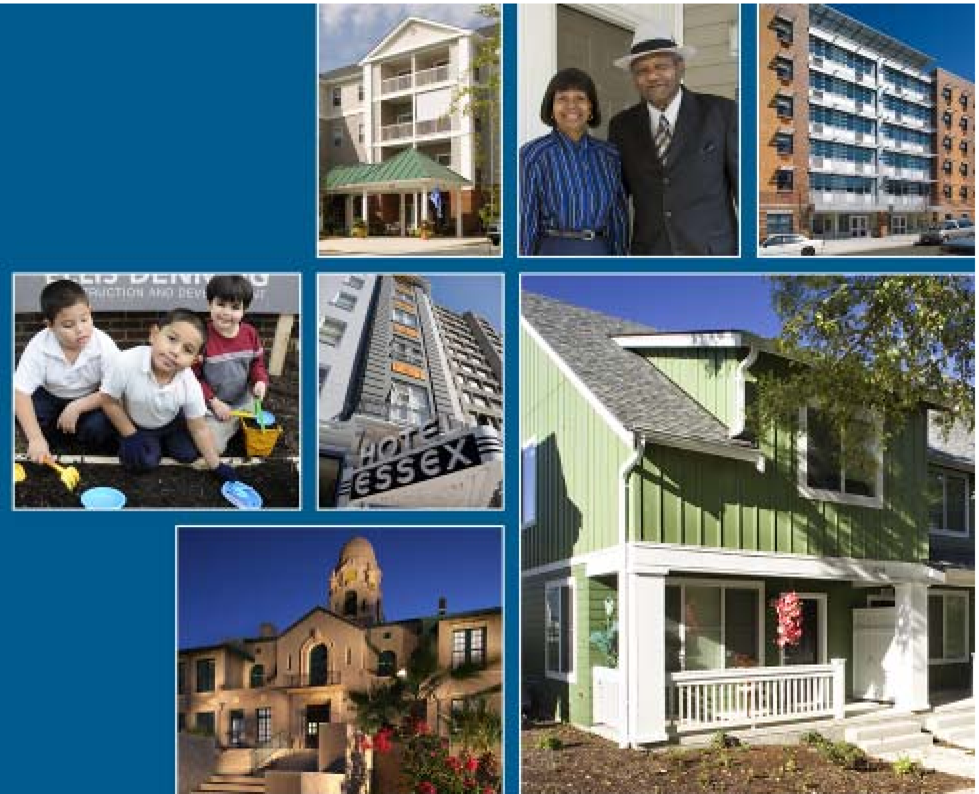
BASIC AFFORDABLE HOUSING FINANCE AND LOW-INCOME HOUSING TAX CREDITS



September 2012

With gratitude to Kathleen Foster

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Leading with Ideas

DEMONSTRATING THROUGH ACTION

Transforming with Capital

SUSTAINING THROUGH POLICIES AND PARTNERSHIP

Public Housing Finance Today

Conventional Public Housing Finance:

- Capital and operating fund based on formula
- Operating Fund is break-even, at-best
- Capital Fund supplements
- No NOI
- No ability to convert NOI into up-front debt
- Developments owned directly by PHA=syndication not possible
- Even with mixed-finance technique, no ability of PH units to support debt

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Why RAD?

RAD:

- Takes public housing units out of the operating and capital funding paradigm
- Converts both layers of subsidy into a single subsidy
- Ownership through single-purpose entities allows for TC syndication possible
- Positive NOI attainable, thus, project has ability to support debt
- PHA, as sponsor, can compete for other sources of funding, such as HOME, FHLB
- PHA has potential to earn developer fees and property management fees
- PHA can continue to control ownership of project

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Overview

- Private Finance Paradigm: The Affordable Housing Development as a Stand-alone Small Business
- Calculating Debt: Rental Income, Net Operating Income, and an Estimate of Debt
- LIHTC Program
- Calculating Equity
- Organizational Structure: Pass-through Entities, Roles and Responsibilities of Partners, Risk and Reward

Private Finance Paradigm

Affordable Housing Financed Like a Small Business

- A stand-alone entity owns and operates a development
- Estimates of income based on market potential of the product (given its quality, location, and appeal), use restrictions, and/or long-term subsidies
- Operating expenses based on what it would take to operate the property according to contemporary professional property management standards without below-market participation from affiliated organizations (i.e., staffing budgets reflect actual cost for the number of FTE's needed, back-office expenses covered by management fee that aligns with market fees charged
- Ongoing replacement reserves deposits based on the greater of underwriting standards or a project's particular needs

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Private Finance Paradigm

Where does the money come from to develop the project?

- Must-pay debt
- Equity
- Soft debt (payable from cash flow or payable upon sale or refinance)

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Private Finance Paradigm

- Typical real estate (or a business, for that matter) is financed by capturing the flow of future cash flow and ownership benefits in the form of debt and equity
- Debt provider is in a less risky position: has a lien on property, lends only up to a certain percentage of the property's value, gets lower return compared to equity
- Equity provider is in a riskier position: no lien, gets paid only from net cash flow after payment of all other obligations, but expects a higher return, has a theoretically unlimited return and gets an ownership interest in the company (some control)

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Private Finance Paradigm

- How much debt can my project support?
  - Use Estimates of income and expenses to calculate Net Operating Income ("NOI")
  - Divide NOI by a cushion (Debt Coverage Ratio)
  - Use result to determine loan payment amount
  - Loan payment supports a certain amount of debt

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Private Finance Paradigm

- How much equity will a partner invest?
  - Private equity based on expectation of cash flow after payment of all project obligations, expectation of sales proceeds, and perhaps tax benefits
  - Since no lien, equity will usually have some control over ownership to maximize the likelihood that it will get its expected benefits
  - Private equity expects a risk premium compared to debt

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Private Finance Paradigm

- How does this apply to privately financed Affordable Rental Housing?
  - Debt is calculated similarly to typical real estate, except that use restrictions have the effect of reducing NOI and subsidies often increase NOI compared to a market scenario
  - Equity usually driven by tax benefits to the investor: Low-income Housing Tax Credits (LIHTC), tax losses, and Historic Tax Credit; some states have state tax credits as well

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Calculating Debt

- Net Operating Income (NOI) is the engine supporting debt
  - NOI equals gross income minus operating expenses minus other obligations, such as replacement reserves (reserves set aside for future replacement of property components that will wear-out over time, such as appliances or building systems)
  - Supportable debt equals NOI divided by “debt coverage ratio,” a factor intended to provide for a cushion in case NOI is lower than expected at various points in time

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Calculating Debt

- Example:
  - 50-unit development with rent of $600 per unit per month
  - 7% vacancy
  - Operating expenses of $4500 per unit per year
  - Required replacement reserve deposit of $350 per unit per year
  - Assume 1.20 debt coverage ratio
  - Assume first mortgage interest rate of 6.0% with 30 year amortization

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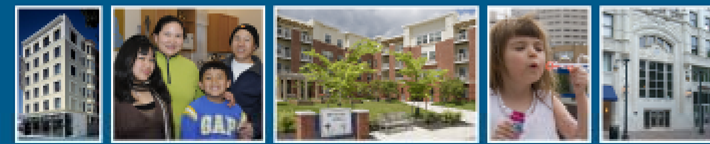
Calculating Debt



- Gross Income:
  - $600 x 50 units x 12 months=$360,000
  - Vacancy of 7%=$25,200
  - Gross income=$334,800
- Expenses and Replacement Reserves:
  - Operating expenses=$4500 x 50 units=$225,000
  - Replacement reserve=$17,500
- Net Operating Income
  - Gross income – expenses and operating reserves
  - NOI=$334,800-$225,000-$17,500=$92,300

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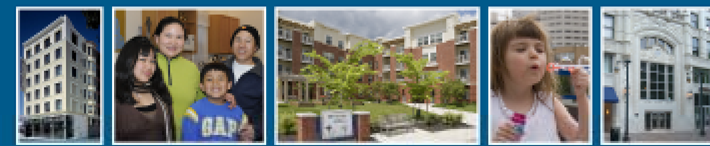
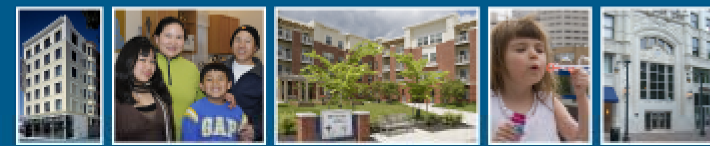
Calculating Debt



- Net Operating Income=$92,300
- Assuming 1.20 Debt Coverage Ratio (“DCR”), allowable debt service shall be $76,917, or $6,410 per month.
- Assuming a 30-year mortgage with a fixed rate of 6.0%, the project can support a first mortgage of $1,069,000
- This is equivalent to $21,400 per unit

The Tax Credit Program



- A housing subsidy program for low-income rental housing
- Created within Section 42 of the Internal Revenue Code
- A federal income tax credit that is allocated by each state's housing finance agency
- Each state receives an amount of credits annually in tax credits to allocate to projects, $2.15 per capita in 2011

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The Tax Credit Program

- Rental units with tenants earning no more than 60% of area median income
- Investors earn dollar-for-dollar credits against their federal tax liability
- Investors also get tax benefits from losses
- Generally, tax credits are received over the first 10 years of operation
- Some tax credits are recaptured by the IRS if the project does not comply for 15 years

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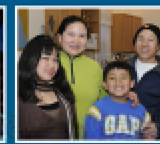
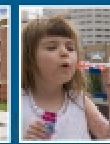
The Tax Credit Program




- **Threshold Elections – Who can live there?**
  40/60 election
  20/50 election
  All tax credit units must be within election parameters

- **Rent Restricted – How much can tenants pay?**
  Rents and utilities – limited to 30% of threshold income
  Allowable rent based on size of unit

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The Tax Credit Program

- **“9%” New Construction/ Rehab Credit** - the standard kind of tax credit
- **“4%” New Construction/ Rehab Credit** - used when project is financed by tax-exempt bonds
- **“4%” Acquisition Credit** – may be applied to <u>building</u> acquisition costs with rehab project under certain circumstances (Substantial rehab, 10-year rule)

Calculating Tax Credit and TC Equity

Overview:

- Credits generated on the basis of "Hard Costs" (construction, rehab, building acquisition, and construction-related indirect costs) attributable to qualified low-income rental use
- Such "Hard Costs" are also known as "Eligible Basis"
- Eligible Basis is adjusted downward by the amount of certain "bad" sources of funding (grants and some federal loans)
- Eligible basis is then adjusted to account for low-income housing use and "Basis Boost," if applicable

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Calculating Tax Credit and TC Equity

Overview, continued:

- Result is known as the “Qualified Basis”
- Qualified Basis is multiplied by the Tax Credit Percentage (commonly known as the 9% or 4% rates, but actually fluctuate)
- Result is annual Tax Credit amount
- Tax Credit amount is generated each year over a 10-Year Period

The Tax Credit Program

Tax Credit Equity = 10 years' of tax credits multiplied by "Price"

"Price" is determined by informal marketing of an individual project to investors and syndicators. It is customarily expressed in cents per dollar of credit generated over the 10-year period.

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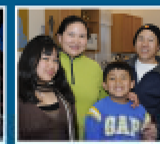
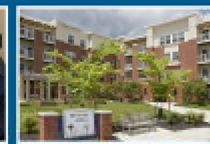
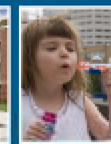
The Tax Credit Program


Tax Credit and Equity Calculation, Recap:

Eligible Basis

X

Applicable Fraction

X

Basis Boost (if applicable)

=

Qualified Basis

The Tax Credit Program

Tax Credit and Equity Calculation, Recap:

Qualified Basis

X

Tax Credit Rate

=

Annual Tax Credits

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The Tax Credit Program

Tax Credit and Equity Calculation, Recap:

Annual Tax Credits

X

10 (Years)

=

Total Tax Credits

Calculating Tax Credit and TC Equity

Total Tax Credits

X

Price (Cents per dollar)

=

Equity

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Calculating Tax Credit and TC Equity

Example: 9% Acquisition/Rehab with 4% Acquisition:

▪ Total Development Budget	$10,632,000
▪ Less Acquisition costs	$ 1,000,000
▪ Less ineligible costs	$ 1,062,500
▪ Eligible Rehab Basis	$ 8,569,500
▪ Applicable Fraction	x100%
▪ QCT/DDA Basis Boost	x130%
▪ Qualified Rehab Basis	$11,140,350

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Calculating Tax Credit and TC Equity

- Qualified Rehab Basis $11,140,350
- Applicable Rate (8/12) x 7.36%
- Annual Rehab Tax Credits $819,930

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Calculating Tax Credit and TC Equity

Plus the Acquisition Credit:

- Acquisition costs $1,000,000
- Attributable to Building (per appraisal) $ 800,000
- Eligible Acquisition Basis $ 800,000
- Applicable Fraction x100%
- Qualified Acquisition Basis $ 800,000

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Calculating Tax Credit and TC Equity

Acquisition Credit:

- Qualified Acquisition Basis $800,000
- Applicable Rate (8/12) x 3.15%
- Annual Rehab Tax Credits $ 25,200

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Calculating Tax Credit and TC Equity

- Annual Rehab Tax Credits $ 819,930
- Annual Acquisition Tax Credits $ 25,200
- Total Annual Tax credits $ 845,130
- 10 Years x 10 years
- Total Tax Credits $ 8,451,300
- Price Paid x $0.85
- Equity $ 7,183,605

Equity represents 68% of development costs

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Calculating Tax Credit and TC Equity

Same deal, but with 4% Rehab Credit:

▪ Qualified Rehab Basis	$11,140,350
▪ Applicable Rate (8/12)	x 3.15%
▪ Annual Rehab Tax Credits	$ 350,921

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Calculating Tax Credit and TC Equity

- Annual Rehab Tax Credits $ 350,921
- Annual Acquisition Tax Credits $ 25,200
- Total Annual Tax credits $ 376,121
- 10 Years x 10 years
- Total Tax Credits $ 3,761,210
- Price Paid x $0.85
- Equity $ 3,197,029

Equity represents 31% of development costs

Organizational Structure

Key Characteristics of Organizational Structure:

- Project owned by new, single-purpose, for-profit entity
- New owner is 0.01% owned by a general partner (GP), 99.99% owned by an investor limited partner (LP)
- Sponsor controls or owns GP 0.01% interest, but controls and operates the entity
- Passive limited partner invests equity

  in return for 99.99% ownership
- Tax benefits run 0.01% to GP, 99.99% to LP

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Organizational Structure

Limitations on GP Rights

- LP consent needed for borrowing
- LP constraints on reserves
- LP limits on spending
- LP approval of annual budgets
- LP approval of change orders
- LP approval of development team members (property management firm, contractor, architect)
- LP consent to acquire or dispose of property
- LP has right to remove GP under certain circumstances

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Organizational Structure

GP Obligations

- To ensure operation of the real estate in accordance with contemporary, professional standards
- To maintain financial feasibility of the project, make sure project avoids cost overruns, high vacancy, operating deficits
- To keep the project out of default with lenders
- To keep the project in compliance with all TC requirements and to avoid credit recapture
- To prepare quarterly reports, annual audits and tax returns
- To maintain compliance with all applicable laws, regulations, and agreements with financial parties (lenders, credit allocating agency, PILOT provider)

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Risk and Reward

From LP's perspective:

- Primary benefit is return from tax benefits to investor, fees to syndicator
- Primary risk is loss or recapture of credits due to:
  - Project not being constructed after equity funded
  - Project not meeting requirements in time to qualify for credits scheduled (i.e., missing placed-in-service dates, minimum set-aside, failed 50% Test)
  - Failure to complying with TC requirements (income certifications, rents in excess of allowable)
  - Units out of service before end of compliance period
  - Foreclosure

Risk and Reward

LP mitigates risk by:

- Underwriting development team: developer, general contractor and property manager
- Market analysis: are rents for the proposed product supportable in the market
- Loss run analysis: for subsidized projects, examining the financial results of lost operating subsidy
- Confirming that development budget and operating budget are sufficient to build and operate the project
- Operating reserves, construction contingency, and guarantees
- Asset Management ovsight

Risk and Reward

Benefits from GP's perspective:

- Developer fee payable from sources and uses
- Possible sales proceeds if purchased from related party
- Future cash flow
- Ability to purchase property at end of TC compliance period
- Benefits to PHAs, in particular
  - Ability to preserve existing project
  - Potential to maintain management portfolio and earn property management fees
  - Ongoing control of property through GP, with limitations

Risk and Reward

Risk and Reward

Risk from GP's perspective:

- LP has ability to remove GP
- Limits on control of property
- Guarantees to financial partners
  - Construction completion
  - Credit adjusters
  - Compliance
  - Operating deficit

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Risk and Reward

GP mitigates risk by:

- Assembling a strong team
- Proper setting of rents
- Use of project-based operating subsidy
- Design, construction, and management quality that is well-suited for intended population
- Solid budgeting
- Operating reserves, construction contingency, fixed price contract and payment and performance bond from contractor
- Support from co-developer, if needed
- Third party property management or third party compliance assistance

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Risk and Reward

Partnership is Key Factor:

- Long-term relationship
- Reasonableness
- Shared goals
- Trusted advisors