Indiana Housing Conference

Indiana's must-attend conference for affordable housing professionals.

TDA

Demystifying Rental Underwriting

August 15, 2017

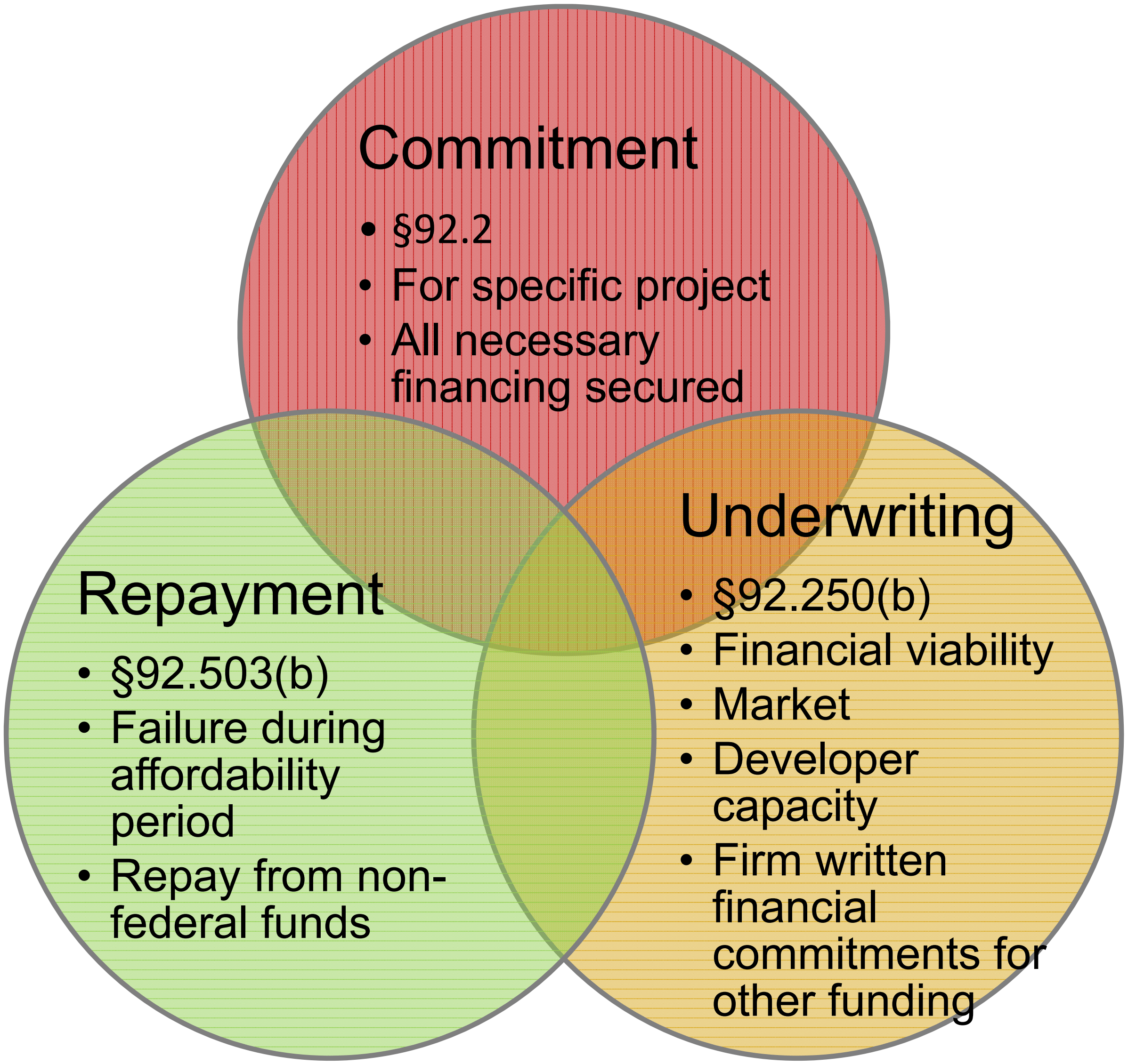
ihcda

Indiana Housing & Community Development Authority

Welcome & Introductions

- Delivered by Steve Lathom, TDA Consulting
  - www.tdainc.org
  - slathom@tdainc.org
  - 517-203-4130
- Session Objectives
  - Regulatory issues driving PJ review of rental
  - Challenges for PJs
  - Packaging a rental project – a play in five acts
  - HOME's influence

Regulatory Drivers for PJs

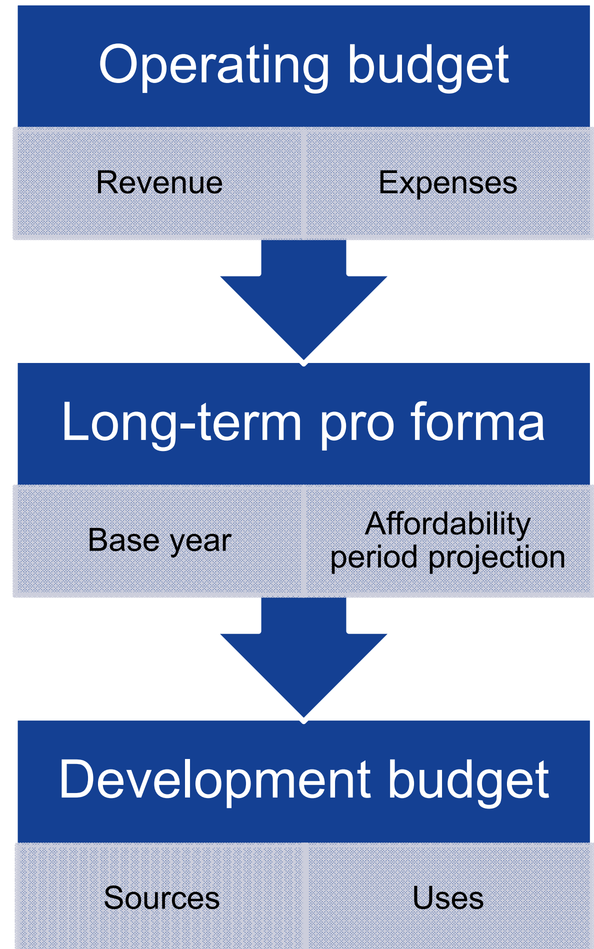


Challenges

- Development process is disjointed and risky
- Layered finance = No one will pay for it all
  - Lots of players
  - Lots of formats
  - Complex interplay between requirements
- Asymmetric negotiations
  - Public funders must be transparent
  - Hard to know developer’s real “bottom line”
  - Developers may know more than we do

Packaging a Project in 5 Steps

1. **Revenue** - Who do you seek to serve and how much will they pay?
2. **Operating Expenses** - What will it cost to operate?
3. **Long-term Proforma** - Will it remain viable over time?
4. **Development Uses** - What will it cost to develop?
5. **Sources** – Where will the money originate?



Rents & Revenue

- HOME sets maximum rent
  - Doesn't mean they can pay it
  - Doesn't mean they will pay it
- Market analysis
  - Understanding income band
  - Competition/supply and unmet demand
- Rent schedule ≠ revenue
  - Total economic vacancy
    - Physical + bad debt + concessions

What Can Market Analysis Tell Us?

- Market area: Geography of primary customers
- Demand pool
  - Number of households in target income range and target household demographics
- Supply and competition
  - Rents in comparable projects (assisted/unassisted)
  - Vacancy rates
  - Competitive advantages or disadvantages
- How quickly new units are absorbed

Affordability Example

- Low HOME Rent limit based on income limit of $30,000/yr = $2,500/month x 30% = $750 rent
- $750/40% = $1,875/month = $22,500/yr
- Effective range of target market: $22.5K - $30K

- Washington County, Indiana
- Single-parent with 2 kids – needs <u>3 bedroom</u> unit
- Working full-time at $12.50/hour
- $12.50 x 2080 hrs = $26,000/year = $2,167/month
- <u>40%</u> x $2,167 = $867
- High-HOME rent for <u>3 bedroom</u> unit = $923

TDA

Projecting Revenue

- Gross Rent Potential: Potential revenue if all units full at scheduled rents
- Total Vacancy: Adjust for rent not collected
  - Physical vacancy—no tenant, no rent
  - Bad debt—tenant in place, not paying any
  - Concessions—tenant in place, discounted rent
- Effective Gross Income: Expected revenue

Key Operating Costs

- Formats vary, but key elements include:
  - Administration and Management
  - Operating, Maintenance, and Utilities
  - Taxes and Insurance
  - Reserves
  - Debt Service
- Summary v. itemization
  - Closer you get to the property, the more detail you should see

Advice on Operating Costs

- Budget completely
- Budget realistic costs
  - Not “how much do I have to work with?”
  - Use comparable properties informed by industry averages or underwriting standards
- Budget a margin for error
  - Variance from budget is normal and expected
  - Don’t budget for “optimal” scenarios

Base Year

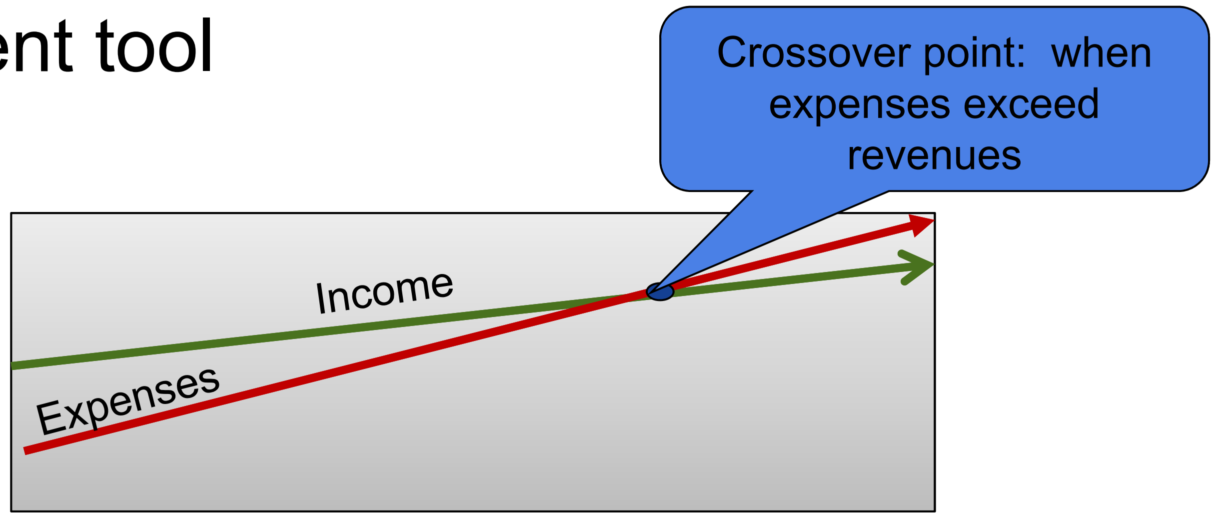
- Base year for underwriting is "stabilized occupancy" & full operating expenses
  - Not including the "rent-up" period
  - Expected normal occupancy & turnover
  - Normal marketing expenses, not 1st year
  - Not 1st year maintenance costs (when everything is new & under warranty)

Trending Assumptions

- Expenses increase faster than rents
  – But debt service shouldn’t change
- Straight-line projections
  – Reflect “average”’ expected increases
- Industry rules of thumb:
  – 1–2% rents
  – 3–4% expenses
  – Do these rules of thumb make sense?

How Projections Help Us?

- Project revenues v. expenses + debt service to analyze viability over the affordability period
  - Cross-over point: when expenses > revenues
  - Project expected changes (e.g., debt service)
  - Examine reserves
- Useful for underwriting & as ongoing management tool



When Cash Flow Turns Negative

- Does the deal go negative?
  - When? By how much?
- Can you:
  - Adjust rents or cost assumptions
  - Increase initial improvements to control maintenance costs
  - Capitalize a reserve ("sinking fund")

TDA

Development Costs

- Costs to develop and occupy the project
- Formats vary, but key categories include:
  - Acquisition
  - Site improvements and infrastructure
  - Construction/rehabilitation hard costs
  - Soft costs and fees
  - Pre-funded escrows and reserves
  - Developer fee
- Must be comprehensive and complete
  - Not listing a cost does not make it disappear

Keep in Mind

- Budget contains <u>all</u> development costs
  - HOME will be allocated to HOME-eligible costs
  - HOME-ineligible: Off-site infrastructure, accessory structures, organization/syndication, most reserves
  - Limits on pre-commitment costs
- Basic cost principles apply; <u>all costs</u>:
  - Contribute to gap, so subject to PJ review
  - Must be reasonable, necessary, allocable, documentable

Reserves

- Capitalized reserves
  - Rent-up (initial operating deficit, up to 18 months) – for deficits during lease-up/stabilization
  - Operating reserve – unexpected rainy day
  - Operating deficit reserve – predicted deficit
  - Replacement reserve – capital repairs
  - Others – services, security, tenant subsidy, etc.
- Only rent-up is HOME-eligible

TDA

Major Types of Sources

- Equity
  - Typically only in Tax Credit projects
  - Nonprofit contributed property or other grants
- Hard debt
  - First mortgage or other amortizing financing
- Soft debt fills the "gap" between total uses and equity and hard debt
  - HOME & other public sources

Getting to the Gap

Development Budget

Sources

Equity
Debt
Subsidies

Uses

Acquisition/SI
Construction
Soft Costs
Working Capital ______
TDC

Operating Budget

Revenue

Gross Pot Rents
Vacancy/CL ______
Eff. Gr. Income

Op. Expenses

Admin/Mgt
Maintenance/Util
Taxes/Insur
Reserves ______

NOI
Debt Service
Cash Flow

The "Gap"

TDA

Commitment Timing

- HOME commitment requires all other financing be firmly committed in writing
  - May be contingent upon HOME award

- PJ must determine that:
  - Terms/amounts consistent w/ underwriting
  - Sources compatible with HOME requirements
  - Reasonably expected to close before disbursement of HOME funds
- Low Income Housing Tax Credits
  - Reservation from allocation agency
  - Good faith offer of equity investment

TDA

Lest We Forget the Developer

- Developer capacity
  - Expertise
  - Financial capacity (management, net worth, liquidity)
- Track record
  - Visit comparable projects
  - Troubled projects
- Can/will they
  - Explain their own deal
  - Answer your questions
  - Keep their story straight


Q
&
A