Housing Preservation Guide

A Guide to Preserving and Restructuring Affordable Housing

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City of Seattle
Office of Housing

Acknowledgments

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Organizations that undertook work on preservation plans using the City of Seattle's MacArthur Grant funds were Capitol Hill Housing, Housing Resources Group, and Catholic Housing Services of Western Washington. These three organizations worked together to develop financial analyses, databases, capital needs assessments, and operational tracking systems for their respective portfolios. In the course of that work, the team developed tools, strategies, and plans, along with presentation materials included in the Guide. The Guide also includes tools from the Best Practices Toolkit developed by the Asset Management Affinity Group, a best-practices work group of practitioners of the Housing Development Consortium of King County, facilitated by Impact Capital.

Special thanks go to our consultant, Housing Development Center in Portland, Oregon, for their invaluable work in providing research, content, and project management for the production of this Guide. Over the last few years, the Office of Housing has worked with the Housing Development Center to study and communicate information directed at preservation and strengthening asset management practices. Much of their experience working on restructures and asset management best practices is blended into the content of this Guide.

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Sue Cary	Capitol Hill Housing
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Kathleen Krushas	To the Point Publications
Kathy Fors	To the Point Publications
Camela Raymond	Editor

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Foreword

Seattle's affordable-housing portfolio meets a critical need for residents priced out of the private housing market or facing other barriers to accessing housing. More than half the residents living in Seattle's affordable-housing properties earn less than 30% of area median income. Many of these residents are disabled, formerly homeless, or struggling with mental illness. The City of Seattle is deeply committed to ensuring these units will remain affordable for decades to come, especially as properties age and begin to face financial and physical challenges. This booklet, *A Guide to Preserving and Restructuring Affordable Housing*, has been developed to help owners and sponsors of affordable housing extend the longevity of their existing rental-housing portfolios. When we talk about "preservation," we mean making sure that a particular property or portfolio is secure enough, both physically and financially, to continue providing housing over the long term. In this Guide we will talk about a full range of preservation strategies, from creating forward-thinking asset management plans to completing financial restructures and property improvements.

Seattle's Preservation Story

Over the past 25 years, the City of Seattle has shepherded a tremendous increase in Seattle's supply of affordable, high-quality housing. Seattle was one of the first large U.S. cities to create a voter-approved bond levy dedicated to this purpose. These housing levy proceeds, along with federal and state funds, enabled Seattle to build an impressive portfolio of affordable housing, containing more than 11,000 units. This new generation of housing was created using private debt and investment to leverage public dollars, a significant departure from the old model that relied primarily on federal funds.

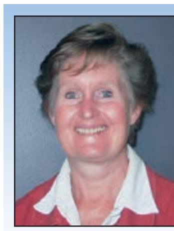
To protect this shared investment and to ensure that these properties meet their public and private investment goals, the City of Seattle's Office of Housing (Office of Housing) has established a strong asset management program, which requires regular financial and performance reporting from project sponsors. In 2008, the Office of Housing set out to survey the capital needs of projects within their portfolio. The Office of Housing initiated a process to better understand and preserve its portfolio.

First, it collaborated with the Housing Development Consortium of King County (a professional association and advocate for the King County affordable-housing community) to establish a best-practices working group for project owners, which was facilitated by Impact Capital, a local intermediary. The working group, called the Asset Management Affinity Group, represents a collaboration between public funders and housing professionals, who have collectively developed many of the tools and planning strategies incorporated into this Guide.

In addition to working with project sponsors, the Office of Housing commissioned two studies to assess the condition of its portfolio. Through a partnership with King County, the Washington State Housing Finance Commission, and the Department of Commerce (the agency that administers Washington's Housing Trust Fund), the Office of Housing commissioned an assessment of housing outcomes and of the financial condition of 214 affordable-housing properties located in King County, Washington. The City of Seattle's portfolio constituted the majority of the 13,643 units in the study. Findings in the study identified a resounding success in achieving the City's key mission objectives: more than one-half of the residents served by Seattle's affordable housing had incomes less than 30% of the area median income (AMI), and rents charged ranged from 29% to 65% below market rents. However, the study also found that approximately 42% of the properties were not generating enough income to cover both operating costs and required debt payments.

2009 MacArthur Grantees


John Hickman Patrick Park


Cindy Erickson


Jill Fleming Sue Cary Josephine Wong

CatholicHousingServices OF WESTERN WASHINGTON

capitol hill housing


Sue Yuzer Arminda Alexander Lynda Carey

Housing Resources Group
Creating communities that work

Seattle's second study focused on the overall physical condition of the affordable-housing portfolio. The study reviewed a sample of 33 recent capital needs assessments for a range of project types within Seattle's portfolio; it drew upon information from the Office of Housing's reporting system to evaluate the level of replacement reserves available to address upcoming capital needs. Based on this summary-level analysis, about three-quarters of the properties appeared to have adequate reserves to address projected capital needs during the subsequent seven years. The remaining one-quarter did not have enough reserves—a shortfall that, when totaled up, represented a significant looming demand on public funding. The recommendations that came out of the study included bolstering strong asset management practices to meet the future needs of the housing portfolio.

Working in collaboration with many state and local partners, the City of Seattle, in partnership with Washington State Commerce, submitted an application to the MacArthur Foundation to fund a proactive initiative to strengthen and preserve the state's affordable housing. The MacArthur Foundation made a generous three-year award in 2009 that allowed the City of Seattle's Office of Housing to take its preservation planning work to a new level. The City passed grant funds on to Seattle's top-performing nonprofit housing providers to develop well-conceived portfolio plans and creative preservation strategies. To date, eight Seattle-based agencies, which collectively own approximately 90 properties containing over 4,300 units, have received awards. Washington State Commerce promoted similar efforts statewide. The collective analysis, tools, and lessons learned by all these agencies contributed to this MacArthur-funded Guide. Our goal is to provide a resource for asset managers in Seattle as well as for housing providers in other regions and cities across the country.

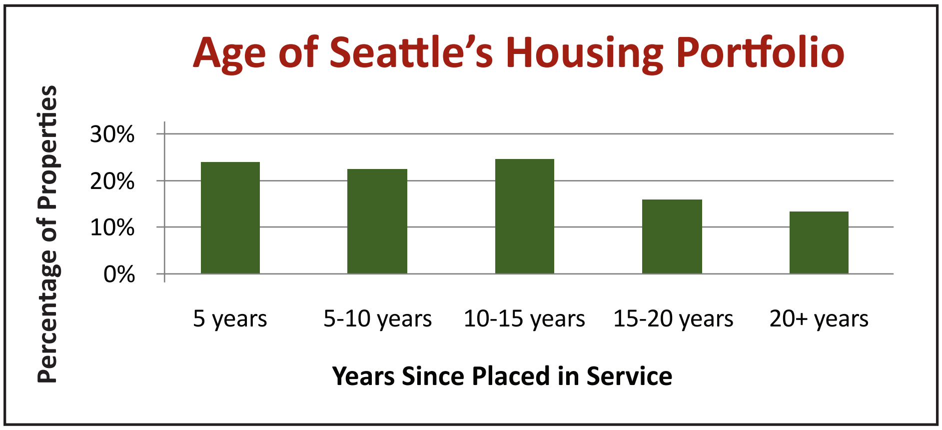
Characteristics of Seattle's Affordable Housing

The City of Seattle's investment in affordable rental housing began with a 1981 voter-approved city housing bond and four subsequent successful housing levies. With the formation of the federal Low Income Housing Tax Credit Program (1988) and the HOME program (1992), Seattle's rental production again increased. Section 8, Section 202, and Section 811 programs also helped grow production. Today, Seattle's portfolio provides a range of affordable rental units for all types of people, including seniors, special needs populations, low- and moderate-wage workers, and formerly homeless individuals and families.

Some of the notable characteristics of the Seattle portfolio include:

- Overall, the Seattle portfolio is fairly young. Currently only 9% Seattle's housing projects have been in operation for more than 20 years. By 2016, however, one-third of the portfolio (3,300 units) will have reached the 20-year benchmark, an age when many properties begin to need reinvestment in their physical assets.

- The Seattle portfolio represents a mix of new-construction projects and previously existing buildings that were converted for use as affordable housing. In the late 1980s and early 1990s, a majority of new projects involved conversions, whereas the percentage of new-construction projects has increased in recent years.



- Seattle's portfolio contains projects of varying sizes. About 45% of properties in Seattle have 25 or fewer units, and these smaller properties have a significantly higher rate of financial distress.

- As with portfolios across the country, Low Income Housing Tax Credits were used to finance the development of most of the larger properties in Seattle's portfolio.

- Two characteristics may be somewhat unique to Seattle's portfolio: (1) most of the properties are owned or sponsored by nonprofit organizations, and (2) the Seattle Levy program requires a minimum affordability period of 50 years. These two characteristics connect the City's Office of Housing and Seattle's nonprofit housing providers in a common mission to preserve existing affordable housing in Seattle.

Why Seattle Is Committed to Preservation

With more than 11,000 units in operation, the full replacement cost of City-funded affordable housing in Seattle now exceeds $2 billion. Though the question of whether to reinvest must be decided on a property-by-property basis, on a portfolio level investing in recapitalization is a strategically wise policy choice: generally, the cost to preserve existing properties is a fraction of the cost of developing new units. Property location is also a factor weighing in favor of reinvestment. Much of Seattle's affordable housing is located on very desirable sites close to transit and other amenities. Comparable replacement sites are not available, are cost prohibitive, or do not provide similar amenities. A shift to disposition and replacement could have the undesirable effect of creating concentrations of affordable housing in specific neighborhoods, which would not serve residents or communities well.

Goals of the Guide

The Guide is intended as a general road map that will help project sponsors to assess the needs of individual properties and entire portfolios, as well as to develop workable preservation plans. Included are ready-to-use tools and strategies for each step of the process, and an introduction to creative approaches to common problems. The goal of the Guide is to build the capacity of affordable-housing owners to oversee and plan for the long-term viability of their portfolios, to address potential problems early, and to prevent major unplanned crisis-based restructures.

Project Financing of Properties Addressed by the Guide

The Guide focuses on preserving multifamily affordable-housing properties that have been financed with a combination of private and public funding. These funding sources typically include a commercial amortizing loan or tax exempt bond in combination with one or more subordinate loans and grants from federal, state, and/or local governmental entities. Many of the properties in the City of Seattle's portfolio have also accessed private equity through federal Low Income Housing Tax Credits (LIHTCs); thus, in this Guide we will address issues specific to those properties, as well. While projects funded exclusively with federal sources, such as HUD 811 projects, are not our focus, we will occasionally comment on issues unique to 100%-rent-subsidized properties.

Disclaimers

Each property presents a unique situation, shaped by the property's original financial structure, its physical condition, and current market conditions. Each project sponsor also comes with a different set of systems, level of financial strength, and overall organizational capacity. The information in this Guide is not a substitute for the expertise that a team of professional legal, accounting, and architectural advisors can provide. The Housing Development Center and the Office of Housing strongly encourage property owners to utilize the services of skilled development, design, legal, and accounting professionals to assist them in their long-term preservation efforts.

Katharine's Place, a project of Catholic Housing Services of Western Washington

Notes

Introduction to Preservation and Restructures

What Is Preservation?

In this Guide, we define "preservation" as the process of improving the performance of an affordable-housing property to extend its useful life and realize its public and private goals.

Preservation involves three basic steps:

1. **Assessing** the property, which includes reviewing the property's operations, financial performance, applicable regulatory requirements, and current physical condition.
2. **Setting priorities** and developing a Preservation Plan, which synthesizes information gained from the property assessment, together with other variables such as organizational capacity and funder requirements.
3. **Implementing** the Preservation Plan, which can involve the same level of energy as a new development.

The outcome of a Preservation Plan, may be as straightforward as strengthening an individual property's financial viability through improved property management; or it may be as complex as a portfolio-wide refinance and rehabilitation. Whatever the ultimate result, Preservation is iterative in nature: you'll develop solutions for your troubled projects through a continuous process of needs assessment, incremental operational improvements, and evaluation of options. This process can be quite lengthy. Given the numerous stakeholders involved, operating a portfolio of affordable housing properties is a bit like captaining a large barge: changing directions takes time.

We refer to the specific process of making changes to a project's financing as a Restructure. A Restructure may serve one or two purposes: to address a project's financial nonperformance and/or to fund rehabilitation work whose costs exceed available reserves.

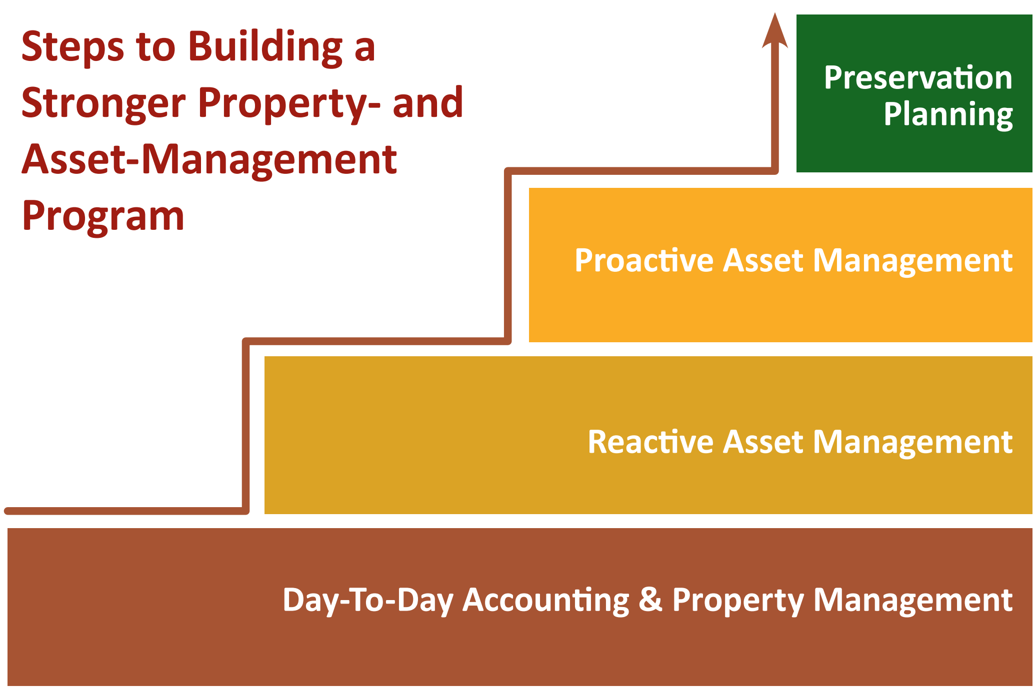
Restructures? Workouts? Repositioning?

This Guide uses the word **restructure** to refer to the process of altering the financial structure of one or more properties – ranging from refinancing loans to resyndication of LIHTCs to securing additional public funding. From a lender's perspective, this process is sometimes referred to as a **workout**. Note that this Guide also uses **repositioning** interchangeably with **restructure**.

While a Restructure may involve only one property, a Preservation Plan addresses the needs of your organization's entire portfolio. Taking the time to assess your portfolio is important for several reasons: to understand how the needs of a specific property relate to the needs of the entire portfolio; to identify overall operational trends that, if addressed, could improve the performance of the full portfolio; and to determine which properties are your highest priority. Looking at the entire portfolio offers another advantage, as well: should you ultimately decide to restructure an individual property, prospective funding partners will want to know the condition of the rest of your portfolio. The deeper your knowledge base and the stronger your planning effort, the stronger the case you can make to these funders.

Preservation Plans and Asset Management

Over the past decade, the affordable-housing industry has significantly deepened its understanding of the need for active property oversight. This oversight begins with adequate fiscal systems and effective property management. However, complex financing structures and regulatory requirements inherent in affordable housing obligate owners to do more than just "manage the property manager." They must also understand and respond to the needs of multiple funders, while making sure that properties live up to affordability commitments of 50 or more years.



Successful owners of affordable-housing projects engage in ongoing, proactive tracking of operating performance indicators (such as occupancy rates, unit turn-around efficiency, and speed of work order completion) and financial indicators (such as net cash flow, reserve balances, and healthy debt cover). Information collected through this tracking process should be used to identify weaknesses and initiate immediate corrective actions. You will find that, depending on the goal, this information will fall into different monitoring cycles. Some indicators require a monthly review while others decisions have an annual planning-based schedule.

MONTHLY

- Operations: Monitor occupancy, turnover rates, and collection
- Financials: Monitor monthly financial statements compared to budget
- Maintenance: Monitor work orders and turnovers

ANNUALLY

- Operations: Determine rent increase schedule
- Financials: Set annual operating & capital budgets
- Maintenance: Do annual inspections, set annual capital improvement scope, update reserve model

PRESERVATION PLAN

- Operations: Make major changes to address portfolio-wide trends
- Financials: Undertake refinancing, LIHTC Year 15 exits, and resyndication
- Capital Improvements: Do major rehab work

Good asset management means planning for the long-term economic and physical viability of each property in your portfolio. Preservation planning is the map your asset manager can use to set a course toward long-term performance. In this Guide, we will discuss how to grow and expand on operational and financial tracking systems you already use, plus how to incorporate these and other tools and strategies to inform your Preservation Plan. In the course of this assessment you may find ways to realign properties for better long-term performance. You will also determine whether a financial restructure is your best option.

Active involvement in implementing a thoughtful Preservation Plan is its own reward. It can help you move from a reactive mode of handling problems to transforming asset management into a more predictable set of events, actions, and outcomes that both maximize your own resources and create new opportunities.

Preservation Plans May Include Restructures

In the course of developing your Preservation Plan, it is likely that certain properties will be identified as candidates for Restructure. Situations common to candidates for Restructure include the following:

- A property is not performing. Either it needs capital improvements beyond what available reserves can provide, or it is struggling to generate sufficient cash flow to cover expense, debt, and build reserves.
- A property is approaching a major milestone such as an LIHTC Year 15 transition, the end of a loan term, or a balloon payment coming due.
- An organization is assuming ownership of an existing affordable-housing property that requires due diligence and some level of property repositioning — at minimum, the reassignment of existing financing.

We recommend that you begin work on a Restructure at least two years before you need to refinance and/or start construction. Refinancing an existing loan, even if no rehabilitation work is planned, can take up to a year. Preparing for an LIHTC Year 15 transition should start by monitoring capital accounts and tracking reserves no later than Year 10. (Appendix A contains a more detailed description for analyzing a Year 15 transition.)

Why Do Projects Fail?

Restructures are often triggered because one or more properties in an owner's portfolio have run into trouble. These are some of the key contributors to project failure:

- **Market.** The property is unable to attract renters or to command adequate rents, either because it lacks amenities or services available elsewhere in the market, or because of a slump in demand.
- **Management.** The property is not being properly managed, owing to faulty operational systems or lack of oversight by the owner's asset management team.
- **Physical condition.** The property's declining physical condition has resulted in units being taken out of service, high vacancies, out-of-control utility and maintenance costs, expensive claims for personal injuries, high insurance rates due to prior claims, and/or significant upcoming capital improvement needs.
- **Initial restructuring.** The initial financial structure overleveraged debt payments, overestimated achievable rents, or underestimated operating expenses or rehabilitation needs, resulting in chronic operating shortfalls.

What Causes Properties to Fail?

Expense controls are rarely the driver of long-term problems:

- **Good management trumps bad markets**
- **Excessive debt trumps good management**
- **Inadequate rehabilitation trumps debt**

Adapted with permission from NeighborWorks America™

Sometimes, improved property management practices can quickly and economically improve a property's financial and physical condition, even mitigating the impacts of a weak rental market. The best management in the world, however, can't overcome issues such as bad project design, defective construction, inadequate rehabilitation, and excessive debt. And sometimes major capital repairs are needed not because of any systemic failing, but because the property's building systems have simply reached their full life expectancy.

Special Vulnerabilities of Rent-Regulated Affordable Housing

Affordable-housing properties face financial and physical-upkeep challenges similar to those of any rental property. But they also face unique challenges that make them more financially vulnerable than their market-rate cousins:

- ***Rent-burden restrictions.*** Nonprofit owners are mission-bound to keep rents affordable to low-income residents; unlike for-profit owners, they can't cover operating deficits simply by instituting rent increases.
- ***High operating expenses.*** Populations frequently served by affordable-housing projects include the homeless, extremely low-income households, large families, and persons with special needs. Relative to the population at large, it costs more to house these populations, especially if the housing includes supportive services.
- ***Higher debt risk.*** Underwriters typically size mortgage payments based on a property's debt coverage ratio (DCR), calculated by dividing the annual income less expenses (Net Operating Income) by the annual debt payment. For a project with higher rents, a DCR of 1.15 to 1.20 leaves enough cash flow to provide significant cushion against rent or expense fluctuations. In properties with reduced rents, this percentage-based cushion results in a much smaller real dollar amount, making low-income-targeted projects more vulnerable to financial failure over time.

Underwriting Differences by Income

SAMPLE: TWO-BEDROOM APARTMENT, ONE UNIT				
Median Income Served	**30% MFI**	**40% MFI**	**50% MFI**	**60% MFI**
Annual Net Revenue (7% vacancy)	$4,280	$6,038	$7,795	$9,553
(Less Annual Operating Expenses)	-$4,532	-$4,532	-$4,532	-$4,532
Net Operating Income	-$252	$1,506	$3,263	$5,021
Available Annual Debt Payment **at 1.15 Debt Cover Ratio**	$0	$1,310	$2,837	$4,366
Net Cash Flow Per Unit Per Year at 1.15 DCR	-$252	$196	$426	$655
Net Cash Flow as % of Operating Expenses	-5.6%	4.3%	9.4%	14.5%
Net Cash Flow as % of Net Rents	-5.9%	3.3%	5.5%	6.9%

HUD Properties

Fully rent-subsidized properties, such as HUD 202 and 811 projects, don't face the same concerns as other affordable-housing properties. Rents at HUD properties are often based on expense levels and required deposits to reserves. The challenge with HUD properties is that it may be difficult to align your costs with HUD's rules. Costs disallowed by HUD might not be covered by rents. If you want to recapitalize beyond a HUD property's reserves, there are often restrictions placed on your ability to take on debt or access some kinds of financing. Work closely with your local HUD office if you want to make any changes to your financing structure.

- ***Lack of resources to address capital needs.*** With rent restrictions and commitments to own properties long-term, owners of affordable housing cannot expect to address capital needs with periodic recapitalizations. Recent reports by Dupre and Scott, a Seattle-based real estate market analyst, show that typical owners of private market-rate rental properties hold properties for 10 to 12 years. When buildings change ownership, the new owners typically invest an average of $12,000 per unit. These capital investments are often paid for by additional private debt supported by substantial rent increases. In a sample of buildings purchased between 1995 and 2005, average rent increased 15.5% within one year after a building's change in ownership.

Accepting the Need for Restructures

Accepting that a project is at risk can be difficult for sponsors and funders alike. Though even the best managed, highest quality projects reach a point where they require reinvestment, the industry's expectation has long been that affordable housing will sustain itself after an initial public investment. Facts show that this is not always a realistic expectation, and coming to a common understanding of problems and solutions on a specific property can create conflicts for all parties. Sponsors may hesitate to bring troubled projects to the attention of their funding partners. Representatives of public funding agencies will scrutinize any funding request that competes with their goals for new production of more affordable units. Finally, private partners may have concerns that property Restructures will put their investment goals and obligations at risk.

Until Restructures become a planned and well understood part of the affordable-housing delivery process, sponsors (and all involved parties) will need to learn to deal productively with the feelings of loss, frustration, fear, etc. that Restructures can generate. Review the box at left. It is important to recognize that boards, staff, and funders will move through the stages described at different times and at different rates. Addressing problems quickly, providing clear communication, obtaining third-party documentation of relevant facts, and allowing people time to come to terms with issues are all important ways that sponsors can help partners move toward acceptance.

Stages of Acceptance

Elisabeth Kübler-Ross described five "stages of grief" in her 1969 book, *On Death and Dying*. Though the emotional gravity of a property failure is not comparable that of a human death, Kubler-Ross's explanation of the grieving process may be helpful for those coming to terms with the need to restructure. Modified somewhat for our purpose, the five stages are as follows:

Denial. "This can't be happening; it'll work out."

Anger. "Who is to blame?"

Bargaining. "If I can scrape together a little extra cash, maybe the problem will go away."

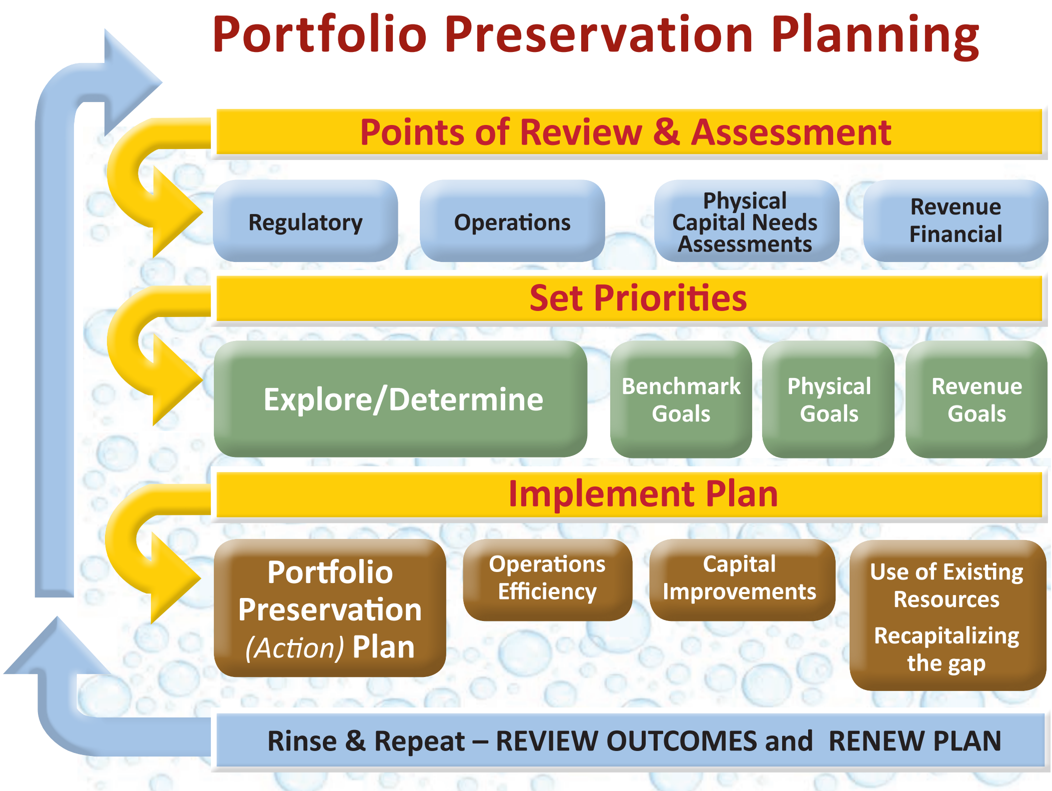
Depression. "I feel hopeless and overwhelmed."

Acceptance. "I can't fight it, I may as well prepare for it."

Steps to Developing a Preservation Plan

All of these challenges notwithstanding, we have developed a nine-step strategy that will help you develop a creative, efficient, successful Preservation Plan. While using this Guide, just keep in mind that Preservation planning is iterative; though the nine steps are presented in linear fashion, you will be continuously reevaluating your assumptions and reorienting your course as you proceed.

The diagram on page 17 is probably familiar to anyone who works with the Office of Housing. Preservation planning follows the same principles. To set the best course for your project, you must continually review and assess all aspects of a project: physical, operational, and financial.



Overview of Chapter 1: Review & Assessment

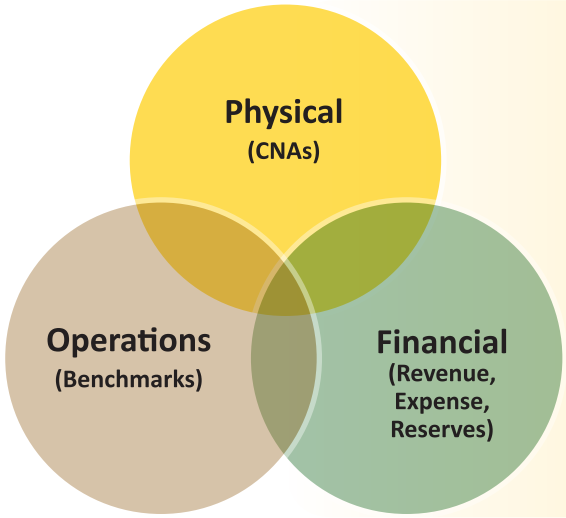
Step 1: Building an Effective Team. Restructures require the participation of a team including professionals from property management, affordable-housing finance, and construction management. In this section we'll talk about the types of skills and authority you need to complete a successful Restructure.

Step 2: Understanding Your Legal Obligations. We'll help you outline the legal and contractual obligations that apply to your property—including regulatory and funding restrictions, loan terms and conditions, and, for some users, Low Income Housing Tax Credit partnership terms and conditions. This information will help you understand your options with respect to whether, when, how, and with whose involvement you should undertake a Restructure.

Step 3: Optimizing Operations. In this step you'll review the operational and financial fitness of your entire portfolio, paying special attention to your Priority Properties. Performing this analysis will help you identify financial-performance weak spots, formulate strategies for improving operations, set investment priorities, and identify financing opportunities in your organization's full portfolio.

Step 4: Performing Capital Needs Assessments. A thorough Preservation Plan will include a capital needs assessment (CNA) and a construction cost estimate for each of your at-risk properties, as well as an overview of the capital condition of all the properties in your portfolio and an analysis of the availability of reserves. In this step we will discuss how to obtain/create high-quality CNAs, cost estimates, and reserve models.

Preservation Planning



Even though we're laying out preservation planning out as a series of steps, in reality the process is iterative, and all the components overlap. A property's physical condition affects operations (you can't lease a building that isn't well maintained); operations affect the financial condition (poor rent collection means you can't pay debt); and financial condition affects physical condition (you can't do repairs without income). Keep this in mind when you are working to understand a struggling property's underlying problems.

Overview of Chapter 2: Setting Priorities

Step 5: Right-Sizing Your Debt. You'll use the income and expense analysis completed in Step 3 to develop and analyze cash-flow projections. You'll then evaluate the ability of your Priority Projects to carry debt. In addition, you will review property balance sheets to evaluate the loan-to-value ratio on your Priority Properties, along with the net worth and liquidity of your organization as a whole.

Step 6: Synthesizing Your Knowledge. You'll step back and summarize your key findings from Steps 1 through 5, then sort all the properties in your portfolio into three categories: those "good to go" for five or more years, those you plan to restructure within the next five years, and those needing evaluation for potential disposition or demolition and redevelopment.

Overview of Chapter 3: Implementation

Step 7: Determining Uses of Funds. In this step, you will incorporate your cash-flow projections into your standard acquisition/rehabilitation pro forma, focusing on areas where income/expense projections and uses of funds may differ from a new project's. Note: completing the tasks in this section will require a relatively high level of development expertise.

Step 8: Identifying Sources of Funds. We'll outline several types of potential funding sources and provide case studies showing how actual project sponsors used different strategies to preserve their properties.

Step 9: Managing dispositions. In prior steps, you may have identified a property or properties potentially suitable for sale, transfer, or demolition/reconstruction. This Step highlights some issues to consider before making a final determination.

Chapter 1: Review and Assessment

A complete Preservation Plan will address all the properties in your portfolio and also focus on a subset we refer to as Priority Properties. Priority Properties are those that are

1. financially nonperforming or at risk of financial failure;
2. facing a financial milestones; and/or
3. being considered by your organization for acquisition.

When appropriate, the steps in the Guide call out which tasks apply to Priority Properties and which apply to your entire portfolio.

STEP 1 Building an Effective Team

Goals for Step 1 You will learn what skills, support, and other resources are needed to build a successful preservation team; identify the individuals and agencies, within and outside your organization, that need to be involved in the planning process; and determine how and when to involve each of them.

Why is this important? Creating a Preservation Plan is complex, technically demanding, and cost intensive. Taking time to assemble your most important resource—people with the ability and will to get the job done—will strengthen the process from start to end.

JosephinumTower, a project of Catholic Housing Services of Western Washington

Hint

If you're uncertain whether your organization owns any financially at-risk properties, then you may need to start with a review of your entire portfolio (see Task 3.3). Completing portfolio-level reviews regularly will ensure you are focusing appropriate attention on at-risk properties; will help you identify efficient, creative strategies to strengthen your portfolio; and will bring additional returns by boosting the confidence and support of funding partners.

Building a Team

Task 1.1

Secure Organizational Support

Objectives for Task 1.1 Build executive support for creating a Preservation Plan.

Completing Task 1.1

- To gain the backing of executive decision-makers, you'll need to develop a clear and persuasive argument as to why a Preservation Plan is needed. Start by creating a briefing paper containing basic information about each of your Priority Properties; include number of units, property location, population served, and key funders. Add a concise summary of why you consider these properties financially at risk. Summarize known data in support of this conclusion, and add it to your briefing paper.

- Set up a meeting to discuss the need for a Preservation Plan with your organization's executive leadership. Review the information on your briefing paper and communicate the potential impact of identified risks on the organization, property, and residents. Outline the types of support you will need, including personnel and budget, to move forward with creating a Preservation Plan. If your needs include consultant contracts, you might need a board resolution authorizing expenditures.

- Set a timeline for working through the steps of your Plan; decide when you will update your executive team on your progress.

Building a Team

Task 1.2

Identify the Members of Your Preservation Planning team

Objectives for Task 1.2 Understand the key skills, decision-making powers, and negotiating authorities you will need on your preservation planning team. Identify who, within and outside of your organization, will assist you in creating a Preservation Plan, and secure executive support for your proposed assignment of roles and duties.

Completing Task 1.2

- **Obtain staff participation.** Request the participation of staff members within your organization who have requisite skills, knowledge, and authority in the following areas:

- ***Compliance requirements.*** You'll need someone on your team with knowledge of relevant loan documents, grants, and—if your Priority Properties include an LIHTC project—partnership agreements. For different organizations, this knowledge might reside with the asset manager, the developer, and/or a financial executive (see Step 2).

Preservation Plan Team

Skills	Staff (internal)	Consultant (external)
Compliance	Jenny, Asset Manager	
Property Management		David, ABC Property Management
Construction Management		Jo, LMN Development Consultant
Finance/Development	Clara, Housing Developer	
Legal		Amy, XYZ Law Firm
Accounting	Leticia, Fiscal Manager	

- ***Property management.*** You'll need the help of someone who can asses the operations and financial performance of properties within your portfolio, as well as outline and implement immediate and long-term operational-improvement objectives (see Step 3).
- ***Construction management.*** The Plan requires a review of capital needs assessments (CNAs), which is best managed by someone with building experience who can identify immediate and long-term capital improvement priorities (see steps 4 and 6-8). This team member can also act as the project manager on any rehabilitation work your organization elects to undertake.
- ***Finance and development.*** You'll need a team member able to develop operating projections, explore options, and run different financial scenarios to determine the appropriate financing structure for each Priority Property (see Steps 5 and 6). For LIHTC Year 15 transitions or acquisitions, fiscal staff may need to calculate investor capital accounts.
- ***Legal and accounting.*** To complete a Restructure, you will eventually require legal counsel to help review and negotiate financing and contract documents. For LIHTC deals, you may need an accountant to review loss projections or determine eligible basis.

Designate a leader. Clear leadership is essential to keeping your planning and implementation work on track. Choose someone who has strong experience managing teams of people with multiple skills, understands your organization's goals and priorities, and is results-oriented. Every Preservation Plan needs a good leader motivated to effect positive changes to your portfolio.

Make it official. Forming your team proactively and assigning responsibilities will help you move efficiently through the steps outlined in this Guide.

Building a Team
Task 1.3

Identify Funders and Other Stakeholders

Objectives for Task 1.3 Identify project stakeholders. For Priority Properties, decide when to contact each one.

Completing Task 1.3

Identify funders. For Priority Projects, determine which funding partners need to be involved in the preservation planning effort, and identify the individuals within each funding agency who will serve as your ongoing contacts (see also Step 2). If a property is a candidate for Restructure, contact any person or entity with a recorded interest in the property. For non-Priority Properties, simply list the funders' names. Knowing which properties share funders will be helpful later on.

Identify other stakeholders for Priority Properties, including residents, service providers, and affected community members.

Determine timing to involve each stakeholder. Working through a Restructure can influence the way funders view your entire organization. As you plan your communication strategy, be prepared to discuss the timing of this Restructure as it relates to other deals you have going with your funding partners. Notify residents and other community members of intended changes, particularly those that directly affect them, before they hear about them from a second-hand source.

Make a contact list and take the time to distribute it to your team. Revise it periodically to include new contacts.

Hint

Put yourself in your stakeholders' shoes

Remember that different stakeholders want different things from the properties to which they provide financial and other support. Consider the individual needs and interests of your partners as you approach each one.

- Sponsors care that the project meets mission objectives and operates well enough to at least cover project costs.
- Private lenders care that their loan is repaid on schedule and that the asset is protected and maintained.
- Public funders care that the project meets housing objectives and regulatory requirements, that the property is physically maintained, and that their investment is secure. Some may have repayment interests, as well.
- Tax-credit investors care about compliance, return compared to projections, and protection of the asset.
- Community members care that the property has both street appeal and is a quiet, peaceful neighbor.

STEP 2 Knowing the Deal: Understanding Your Legal Obligations

Goals for Step 2 In this step, you will review the regulatory and funding requirements that apply to each Priority Property, with the goal of answering the following questions:

- What are the interests and legal rights of your funders?
- What financial and compliance obligations does your organization have to each funder?
- What changes to loan and compliance requirements are anticipated to occur, and when?

You will also prepare two documents that will be critical in developing your Preservation Plan:

- **A chart containing key project milestones for all of your properties.** Include loan terms and regulatory timelines described below.
- **A Schedule of Real Estate Assets.** (Your organization may already have one of these, since many funders now require them for new developments.)

Why is this important? Anyone with a real property interest (lien position) on a Priority Property typically has the legal right to approve changes to the property's ownership, debt structure, and physical structure. Public funding partners and foundations may have imposed additional binding restrictions on rents, resident incomes, and populations served. Tax credit partnerships (or limited liability corporations) often place extensive limitations on the rights of the general partner or managing member to make changes to the property or its financing. Failure to comply with these various restrictions and obligations may trigger defaults or other penalties. Financial restructure is an opportunity for owners to meet today's goals and for funders to strengthen the performance of their portfolios.

Hint

Know where to look for property agreements

- **Title reports.** A full title report with copies of all recorded documents will help you identify funders with security interests in the property.
- **Sources and uses documents.** Look for the final sources and uses document created for the most recent financing of the project. If the project was financed recently, this document may be found attached to public-funding loan agreements or to LIHTC partnership agreements. The sources and uses document may reveal nonrecorded funders with interest in the property.

Knowing the Deal
Task 2.1

Assemble Documents for Priority Properties

Outcomes for Task 2.1 Assemble loan, partnership, and grant documents for each Priority Property.

Completing Task 2.1

☑ **Put together a binder for each Priority Property.** Include documents from the original development deal, plus all subsequent amendments or revisions. The sidebar at left lists the primary documents you will need. For HUD Section 8 projects, also include the documents listed below. Create a file of electronic or PDF copies of documents so you can easily send them to team members.

Additional Documents for Project-Based Section 8 Assistance Properties

- Original Housing Assistance Payment Contract (this is referenced as Exhibit in new contracts)
- Current Rent Subsidy Contract
- Three years' worth of audits

Documents to assemble for each Priority Property

Preliminary title report containing all recorded encumbrances on the property

Loan agreements

> Promissory notes
> Loan agreements
> Deeds of Trust
> Subordination agreements

Regulatory agreements/ use covenants

Reserve agreements

Grants

> Use agreements
> Security agreements

Property audits – most recent/last three

Operating statements – current year-to-date

Rent schedules and current rent rolls

Capital-needs assessments, if available

Knowing the Deal
Task 2.2

Review Documents and Synthesize Information

Objective for Task 2.2 Using the documents assembled in Task 2.1, create a Project Abstract that organizes key information for each Priority Property.

Completing Task 2.2

☑ **Use our sample Project Abstract** (contained in the CD included in this Guide) or develop your own chart, matrix, database, or Excel summary that incorporates the following information about each Priority Property:

- ***Rent and income restrictions and population set-asides.*** Note the term period of each funder-required restriction. If there are Section 8 or other rent subsidies, include a summary of the contract terms.

- ***Debt payment obligations.*** This should include must-pay, deferred or residual-receipts payments, and contingent interest obligations. Identify any changing terms over the balance of the loan period(s). Note the term period, interest rate, and amount owed, along with any prepayment restrictions or bond redemption fees. Note the timing of any of loan forgiveness terms.

- ***Reserve requirements.*** Include minimum required balances, required annual contributions, account requirements, and use restrictions. Attach a summary of the required approvals for use of reserves.

- ***Prepayment prohibitions.*** Include conditions that affect a sale. Public funding agreements may be subject to regulatory requirements that survive sale or repayment. These agreements may also have contingent interest conditions that affect how sale proceeds are allocated.

- ***Other.*** Other important items might include reporting requirements, terms and conditions of property tax exemptions, a sale agreement of Transfer of Development Rights (TDR) that limits future redevelopment, historic designation, and/or easements.

Knowing the Deal
Task 2.3

Summarize Data for Non-Priority Properties

Objectives for Task 2.3 Outline key financial milestones for all of your projects; this will frame a long-term schedule for Restructures and major transitions. Create a Schedule of Real Estate Assets.

Completing Task 2.3

Assemble a contract and regulatory information about the non-Priority Properties in your portfolio. In particular, look for key dates such as the end of prepayment periods, the end of loan terms or grant obligation periods, and Year 15 for LIHTC projects. These dates may mark the beginning of less restrictive opportunities that can help your Plan.

☑ **Determine upcoming milestones.** Create a chart (see sample on page 26) that notes key events affecting the properties in your portfolio. Events might include dates when loan terms expire or change, upcoming balloon payments, and expiration dates for funding restrictions. Review your findings carefully. Have you missed any upcoming milestone that might lead you to change your priorities? Begin planning two years in advance of milestones.

Charting Milestones Across Your Portfolio

PROJECT	2011	2012	2013	2014	2015	Notes
Fir Tree Commons	*Prepayment period ends*				*Year 15*	*Explore refinance after Year 15 transfer*
Stoneway Park	*New loan payment starts*					*Make sure we include new loan payments on projections*
Clark View			*Loan term ends/ balloon payment due*			*Refinance now (w/o penalty) for better interest rate*
Broadway Terrace				*End of HOME restrictions*		*Explore option to sell when restrictions expire*

☑ **Develop (or update) a Schedule of Real Estate Values.** Many lenders and tax credit investors now require a summary description of each property in which they invest, often referred to as a Schedule of Real Estate Assets. These schedules generally contain a combination of static property data and current operating and financing data, including the following:

- ***Static Data.*** Property name; address; number of units; type(s) of resident population; LIHTC (yes or no); year built and/or placed in service; names of funders, investors, and lenders.

- ***Performance Status.*** Occupancy, net operating income for the most recently completed year, must-pay annual debt service, current DCR, current net cash flow, estimated market value, must-pay loan balance(s), estimated loan-to-value ratio, must-pay maturity dates, loan terms, and guarantee obligation amounts.

A sample Schedule appears in Appendix B, and a blank electronic copy may be found on the CD included in this Guide. If your organization has recently completed a Schedule, your task will be to update it based on the information you collected earlier in this step.

☑ **Identify common funding partners across your portfolio.** Be aware that when you bring a funder's attention to a property undergoing a Restructure, it can trigger a broader review of the other properties in your portfolio, particularly the properties in which that funder has a financial interest.

STEP 3

Optimizing Operations

Goals for Step 3

- Evaluate the current operational and financial performance of all properties in your portfolio.
- Identify and, if possible, implement immediate steps to (a) improve operations, (b) limit financial losses, and (c) strengthen organizational asset management capacity (expected by funding partners).
- Determine which properties will be best served by a financial restructure.
- Focus special attention on the operational and financial performance of the priority properties in your Preservation Plan.

Why is this important? Your highest priorities for any Preservation Plan are to serve the residents, protect the physical integrity of the building, and minimize financial losses. Property management improvements are typically the most cost-effective means of achieving these ends, capable of producing significant, immediate results and preventing the need to restructure. Operational improvements are also within your authority as an owner, whether you perform property management in-house or contract for third-party management. Finally, if you do move forward with a Restructure, your partners will expect to see a proactive and responsible approach to optimizing operations as a component to your asset management plan.

Optimizing Operations
Task 3.1

Analyze Operations and Financial Performance

Objectives for Task 3.1 For each Priority Property, you will analyze operations and financial data to answer the following questions.

Cash-flow analysis. Is the property generating positive net cash flow according to its potential? If so, has the property been consistently contributing to its replacement and operating reserves? If the property is not cash-flowing, is this a long-term trend or a short-term condition? If the property is operating at a deficit, how many months of losses will the operating reserves cover? What, if any, cash support is your organization providing the property on a monthly and to-date basis?

Critical balance sheet information. What reserves does the property have, including both operating and replacement reserves? Does the property have significant outstanding current liabilities, long-term liabilities, and/or receivables? What balance sheet trends are evident over the last several years?

> *"It is what we do. It is about respect for tenants and the community; being good stewards of public money and earning the trust of lenders and investors. It is about steady execution."*
>
> – Chuck Weinstock on asset management

Completing Task 3.1 for your Priority Properties

- **Gather your data.** Assemble three years of audits plus the current year-to-date financial statements for each property. Note: calculating financial performance indicators over at least three years helps identify underlying problems that can be obscured by short-term trends (e.g. unusual turnovers due to a change in management or a cash influx from an insurance settlement.)

- **Set up a cash-flow projection model.** Set up a cash-flow projection spreadsheet, similar to the one below, for each project. In the "Current Full Year" column, annualize the year-to-date information by dividing year-to-date totals by the number of months reported, then multiplying by 12, making appropriate adjustments for one-time costs. (The enclosed CD has a sample cash flow projection spreadsheet.)

CASH FLOW PROJECTION	Audit Year 1	Audit Year 2	Audit Year 3	Current Year to Date	Current Full Year*
RENTAL INCOME					
Tenant Income (Gross Potential)					
Other Income					
Residential Vacancy					
Net Rental Income					
OPERATING EXPENSES					
List Expenses Here					
Total Operating Expenses					
NET OPERATING INCOME					
DEBT SERVICE					
NET CASH FLOW					

* Current full year = YTD/ number of months reported x 12

- **Select your financial and operational indicators.** Tailor your own report by selecting the set of performance indicators you wish to track in order to measure the desired financial outcomes (e.g. net cash flow and debt coverage ratio). Also select the operational factors that contribute to those outcomes, such as occupancy, collections, turnover rate, rent increases, etc. At minimum, include the measures listed in

Recommended Performance Measures

- Net Cash Flow as percent of effective gross income (EGI)
- Operating Expenses (Average PUPY)
- Net Operating Income (NOI)
- Vacancy loss / Occupancy Rates
- Debt Coverage Ratio (DCR)
- Expense Ratio: operating expenses as percent of effective gross income (EGI)
- Collection Rate
- Unit Turnover Rate
- Average Unit Turnaround (days vacant)

Hint

Know the difference between audits and financial statements

Both of these documents provide important information, but they provide it in very different formats. Audits are generally presented in conformance with Generally Accepted Accounting Principles (GAAP), while property management statements are not. If you are not familiar with the adjustments you need to make to modify GAAP into affordable-housing income and expense statements or cash-flow projections, see Appendix D for help.

the bottom chart on page 28. Appendix C provides a sample “dashboard” of indicators created by King County Housing Development Consortium’s Asset & Property Management Affinity Group. The dashboard is intended to be used by property owners on an ongoing basis to evaluate both financial and operations performance.

Calculate your financial indicators. Insert your selected performance indicators into your cash-flow projections (see example below). These indicators should be calculated for each of the three years of audits and for the annualized year-to-date fields, using information from the property’s most recent financial statement. In Step 5, we will discuss carrying these data forward to look at trending. For now, we are focused on understanding the property’s past, current, and potential performance and identifying strategies to improve operations.

Critical Asset Management Financial Indicators	Audit Year 1	Audit Year 2	Audit Year 3	Annualized Yr. to Date
Economic Vacancy Rate	10%	6%	4%	5%
Debt Service Coverage	0.22	1.30	1.23	1.15
Net Cash Flow PUPY	(1,978)	298	179	0
Total Operating Expenses PUPY	7,238	4,406	5,092	5,052
Expense Ratio	93%	57%	62%	63%
Net Cash Flow as % of Revenues	-25.40%	3.87%	2.18%	-1.07%
Net Cash Flow as % of Expenses	-27.33%	6.76%	3.51%	-1.68%

Review balance sheet information. You will also want to include key balance sheet information in your analysis, again using data from the last three years of audits and from the most recent financials. Include the following information:

- ***Current replacement reserve balances.***
- ***Current operating reserve balances.***
- ***Tenant and other receivable balances.*** There are two ways receivable balances decline. Either the receivables are written off as bad debt, or they are paid. It is important to understand which situation applies to your property.
- ***Current payables.*** Note if these have changed over past years. Is the balance increasing? If the property shows cash flow but bills are unpaid, your cash-flow figures are probably overstated.
- ***Debt.*** List outstanding principal balances on long-term loans. Check audit notes for useful information on current and long-term loans and payment obligations.

Collecting and analyzing all this information is hard work.

Take a moment to appreciate how much you’ve already accomplished!

Optimizing Operations
Task 3.2

Identify Contributing Factors & Immediate Strategies to Address Operational Problems

A variety of factors may contribute to your property's poor to negative net cash flow, or low DCR. These factors may include revenue problems, expense problems, faulty debt structure or, most commonly, a combination of the above. Expense-side issues, though they may result in poor value for dollar spent, are rarely the sole driver of operating deficits.

Objectives of Task 3.2 Outline steps to make immediate improvements to operations and determine whether operational improvements alone will fix deficits.

Completing Task 3.2

Work with your property manager to make a plan and correct operational issues quickly, beginning with revenue-side Issues.

☑ **Set strategies to address revenue-side issues.**

- ***Setting rents.*** Determine the maximum achievable rent (lesser of maximum allowable rent and market). Test the marketplace by setting rents for new occupancies at the maximum achievable levels.
- ***Occupancy.*** Maximize rent potential by maintaining optimal occupancy rates. Poor occupancy can be a symptom of other problems: inadequate marketing and leasing, slow referrals, poor property condition or less desirable unit conditions or new rental housing competition in your neighborhood. Drill down to the problems hurting your occupancy rates. Fixing the problems will increase your rental income potential. If the market is tight, or your rents are near market rate, try incorporating marketing strategies such as providing occupancy bonuses to property management staff. "Solving Vacancy Problems" in Appendix E offers a strategy for working through occupancy issues.

A Note on Wait Lists

A good wait list takes some effort. If it's not updated regularly, a wait list can actually slow down lease-up. Call prospective tenants regularly to make sure you have up-to-date information. A good rule of thumb is to have five tenants ready-to-go per vacancy.

Hint

Most financial problems attributable to property management are the result of revenue-side issues, not expense-side issues

Inconsistent rent increases often result in rents well below maximum allowable and market rents. Based on the King County Financial Sustainability Report, the 2006 nonsubsidized rents in King County's affordable-housing portfolio were set at about 22% below maximum allowable levels.

- ***Screening criteria.*** If many applicants are turned away, consider altering your screening criteria or working with property management staff to evaluate your process for approving accommodations and exceptions.

- ***Collections.*** Review collection rates regularly and address issues causing a negative trend. In some cases of resident non-payment, using the eviction process is your best tool to get rent-generating units back on line.

- ***Rental subsidies.*** Are there potential sources of rent subsidy that you have not yet explored? Could elements of the rent-subsidy leasing process be improved to reduce unit turnaround time? Have you maximized your restricted contract rents?

- ***Over-income households.*** Are you subsidizing over-income households in your affordable units by not raising their rents? Check your contract for provisions on over-income households that allow you to raise rents higher than the restricted level. The HOME program requires rent increase for tenants defined as over-income households.

- ***Goal-oriented management.*** Good management staff is key to accomplishing positive outcomes. Set revenue-side goals for your staff and any property management firms that work for you. Consider outcome-based contracts and fee structures.

☑ **Clarify expense-side problems.** There is no one-size-fits-all formula for determining whether a property's operating costs are too high or too low. Expenditures that are appropriate for one project may be woefully inadequate for another. We recommend using the following three approaches to evaluate where expense-side problems may exist.

- ***Historic trending.*** Using the cash flow projections set up in Task 3.1, determine the percent by which each expense line item has increased over the last three years. Examine changes in expense totals, as well. Do you see any unusual expense increases or one-time costs?

- ***Comparisons across properties.*** How do operating expenses compare to those of similar properties? To compare costs accurately, calculate operating-expense line items on a per-unit, per-year (PUPY) basis. Catholic Housing Services of Western Washington identifies anomalies by charting each category of operating expense as a percent of total expenses (see example on p. 33). Whether on a dollar-per-unit or percent basis, compare your costs to those of other properties with similar profiles (same number of units, building type, property age, unit size, population served, elevator system, extent of landscaping, etc.).

Hint

To understand trends, we find it's helpful to roll up expense line items into a few categories:

- On- & off-site property management
- Utilities
- All maintenance (including personnel, contract, turnover, landscaping, elevators, etc.)
- Administration (fees, bad debt, office, supplies, etc.)
- Insurance
- Reserve contributions
- Resident services
- Asset management

When you isolate a problem, then you may want to drill down in specific categories.

Set strategies to Improve Operating Expenses. Look for immediate steps you can take to reduce operating expenses without jeopardizing occupancy rates or tenant retention. Meet with your property management team to explore strategies such as the following.

- ***Property taxes.*** If you are not receiving a property tax exemption, but believe the project is eligible, work with an attorney or consultant to explore possibilities.

- ***Property insurance.*** Shop for insurance every three years and consider joining an insurance pool.

- ***Security.*** Work with local police and neighborhood watch programs to implement crime prevention strategies. Unplanned security personnel costs can quickly increase a project's expenses. Consider organizing tenant meetings to exchange ideas about cost-effective ways to improve security.

- ***Maintenance.*** Expenditures for completing scheduled property improvements will either be paid through operating revenues or reserves. Identify the revenue source for each type of maintenance expenditure, remembering your lender may restrict reserves for major components only. Prioritize maintenance that will keep the property safe and occupied. Consider the timing of repairs, particularly if it is more cost effective to include the repairs under a larger rehabilitation.

Overview of Maintenance and Replacement Tasks in Order of Priority

1. Emergencies
2. Vacancy repair and reoccupancy
3. Routine and preventive maintenance
4. Programmed maintenance and repairs
5. Tenant-requested maintenance and repairs

- ***Resident services.*** What resident service costs are charged to the project, and are these services effective? Without these costs, would the project be viable and successful? Do other revenue streams exist that can help support resident services costs? If not, how might you modify the services you deliver and/or the populations you serve in order to reduce service costs on a temporary or permanent basis?

- ***Replacement reserves.*** Updating your replacement reserve model (see Step 4) will help you plan your use of reserves until your next major capital improvement project, as well as inform your next planned recapitalization. For LIHTC properties, you may choose to strategically spend down reserves before Year 15 unless you are certain reserves will remain with the property.

- ***Utilities.*** Teach residents to conserve energy and water. If you don't already, consider giving them a financial incentive to turn off the lights or lower the A/C by billing them directly for utility costs (metering units individually as appropriate). Inquire and take advantage of available weatherization and water conservation programs that can assist with improvements that will save money for you and your residents.

- ***Property management.*** Make sure the property management firm you use is providing good service for your property. Some management firms work well with some populations but less well with others. If you are doing property management in-house, consider whether this is really the most cost-effective strategy for your organization. Add up all the costs you pay to support your property management staff and compare that to the cost of hiring a good-quality third-party manager.

A Note on Value

The chart below, created by Catholic Housing Services, shows what percent of each property's operating budget was spent in various categories. While calling out anomalies is important, make sure you study them in context. A high management fee that results in strong occupancy rates, excellent rent collection, and tenant satisfaction might be worth the price. Alternatively, a low maintenance line item might mean the work isn't getting done and building conditions are declining. Consider why a project's expenses are where they are before deciding to change them.

Programs Categorized by Type

	Administrative	Utilities	Maintenance	Taxes & Ins	All Exp/Unit
Josephinum_222	35%	19%	42%	4%	$9,420
Wintonia_92	44%	19%	34%	3%	$8,902
Ozanam_56	62%	13%	24%	1%	$6,073
Traugott_50	60%	11%	24%	6%	$10,165
Dorothy-Day_41	61%	13%	21%	5%	$10,510
Westlake_I_53	40%	15%	40%	5%	$9,788
Katherines_25	54%	17%	24%	5%	$13,437
Teresita_26	41%	22%	23%	15%	$11,154
Spruce_45	40%	27%	23%	10%	$9,488
Leroy Helms_11	34%	45%	8%	13%	$12,762

Catholic Housing Services

High Density · SRO · Family · Unsubsidized

Optimizing Operations
Task 3.3

Review the Current Performance of Your Portfolio

Objectives for Task 3.3 Assemble financial information about all properties in your portfolio, utilizing the data to continue work on your Schedule of Real Estate Assets and to confirm or revise your selection of Priority Property(ies).

Completing Task 3.3

☑ **Identify required performance indicators for your Schedule of Real Estate Assets.** As you work through this Task, record the results of your financial review in your Schedule.

☑ **Complete operations and financial review of your entire portfolio.** For all properties, we recommend that you calculate, at minimum, the following five risk indicators:

- ***Annual net cash flow.*** Include total-project and per-unit cash flow.
- ***Net operating income (NOI).***
- ***Debt coverage ratio.***
- ***Expense Ratio.*** This ratio helps assess the long-term impact on a property should rents accelerate more slowly than expenses. It is calculated by dividing total operating expenses by effective gross income. Typically, a ratio above 70% indicates declining net cash flow, given normal income and expense accelerators.
- ***Net cash flow as a percent of total operating expenses.*** This ratio shows the percent variance in operating expenses that a project could absorb without producing a deficit. We recommend that projects have cash flow equal to at least 8% of operating expenses, except on fully rent subsidized projects.

Note: these factors apply differently to projects that have budget-based rent subsidies.

Hint

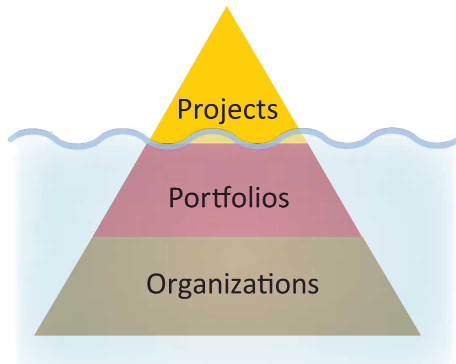
Communicate the dollar impact of operational problems

Expressing issues such as vacancy loss or collection loss in real dollar amounts can help focus organizational efforts. For a board member, it may be more meaningful to hear that your organization is losing $150,000 per year than to hear it is experiencing an 8% vacancy loss.

- ☑ **Identify any additional Priority Properties.** After completing the reviews detailed in Tasks 3.1 and 3.2, you may have identified other properties that show signs of financial weakness. Go back to these properties and complete the in-depth review and analysis outlined in Tasks 1 and 2 to determine the causes of nonperformance. Can you take steps to address operational issues right away? Will you add these to your list of Priority Properties?

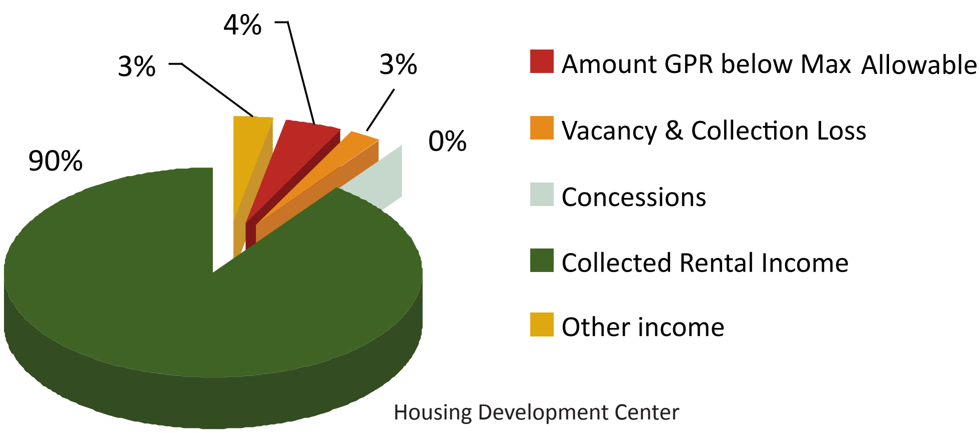
- ☑ **Evaluate and address troublesome policies or practices that impact the entire portfolio.** Often, a single property's low performance stems from overall organizational practices. Identifying portfolio-wide trends can reveal the need for changes in asset management practices. One failing project may be the iceberg that shows above the water line, signaling deeper issues.

Properties Reflect Organizations



As an example, look at the chart below. It shows that the properties in this portfolio are losing 10% of their gross potential rental income. Vacancy and uncollected rents account for about one-third of that loss, but nonmaximized gross rents (the amounts shown in the red slice) account for nearly double that percentage: over $350,000 in annual lost revenues. Revenue losses may stem from a variety of factors; when they affect the majority of a portfolio, however, the likely culprit is a training, supervision, or systems problem.

Maximizing Revenues



Housing Development Center

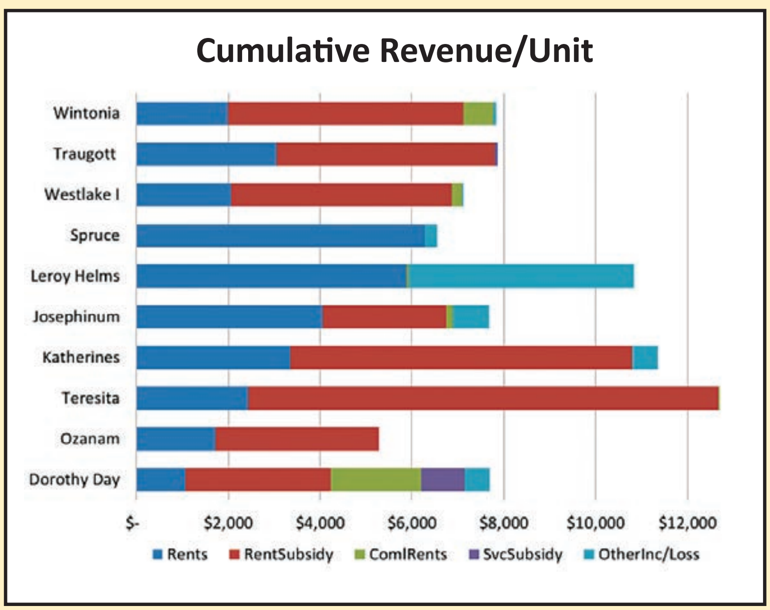
CASE STUDY

Serving Extremely Low Income Households

Catholic Housing Services of Western Washington's Preservation Plan

Catholic Housing Services of Western Washington is a nonprofit organization that provides a range of housing programs, with a focus on serving communities of concern including very low-income seniors, African Americans, Native Americans, Farm workers and urban Latinos. The organization owns 1,758 units of permanent rental housing, along with 119 units of transitional housing. Their 49 properties are located across western Washington, with 10 properties located in Seattle. Most of Catholic Housing Services' properties serve households with incomes below 30% of the area median income (AMI), with rent regulatory agreements restricting rents at between 30% and 50% of AMI.

As one of the first three groups to complete a Preservation Plan through the City's MacArthur Grant, Catholic Housing focused on the planning for the future viability of their 10 extremely-low-income-targeted Seattle properties. These properties vary in the degree to which they face challenges, and they have varied revenues and operating expenses related to upcoming capital needs. However, Catholic Housing's analysis revealed a number of common trends.

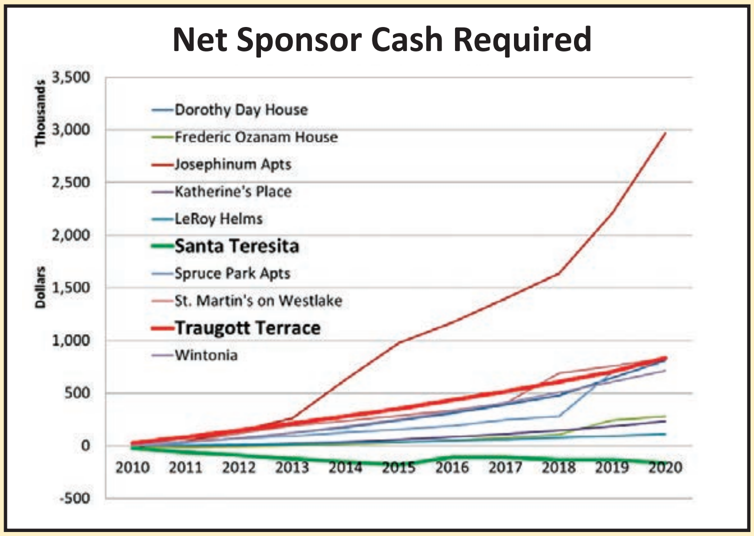


Revenue Trends

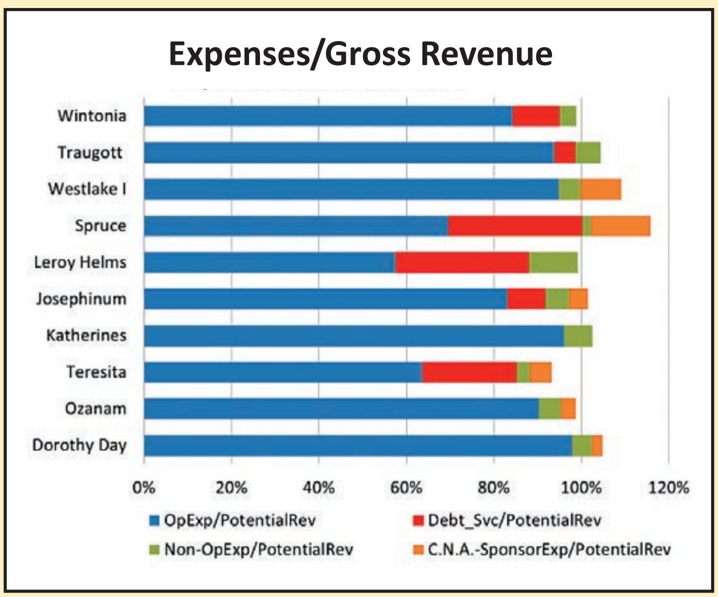
As part of their preservation planning, Catholic Housing Services evaluated the revenue sources for their 10 Seattle properties. As you can see from the dark blue portion of the bars in the graph at left, tenant-paid rents are a small portion of the total revenues for most of the properties. This chart clarified two key risk areas for Catholic Housing: 1) dependency on rent subsidy, much of which is short term, and 2) amount of revenues labeled "other/ loss," which represent the organization's support through fund development.

Expense Trends

Using the analysis at right, Catholic Housing Services calculated each type of property cost as a percent of the property's gross potential income — e.g., operating expenses divided by gross potential income; debt service as a percent of gross potential income; etc. The chart shows that, for some properties, operating expenses used up almost 100% of the gross potential income. Remember that gross potential income does not deduct vacancy or collection losses, which are included in the green "nonoperating expense" category.



Catholic Housing focused on the planning for the future viability of their 10 extremely-low-income-targeted Seattle properties.



With this analysis completed, Catholic Housing Services was better able to have informed discussions about differences between properties, as well as about projected fund development needs, and to begin to develop a Preservation Plan.

Conclusions

Catholic Housing Services now more clearly understands to what extent it will need to support operations of its high mission-value programs over time. It used this information to better predict its annual funding gap over the next decade. Using industry-standard income and expense accelerator assumptions, assumptions about future rent subsidies, and data from replacement reserve models, staff completed cash-flow projections for each of the 10 properties. The graph at left quantifies the results.

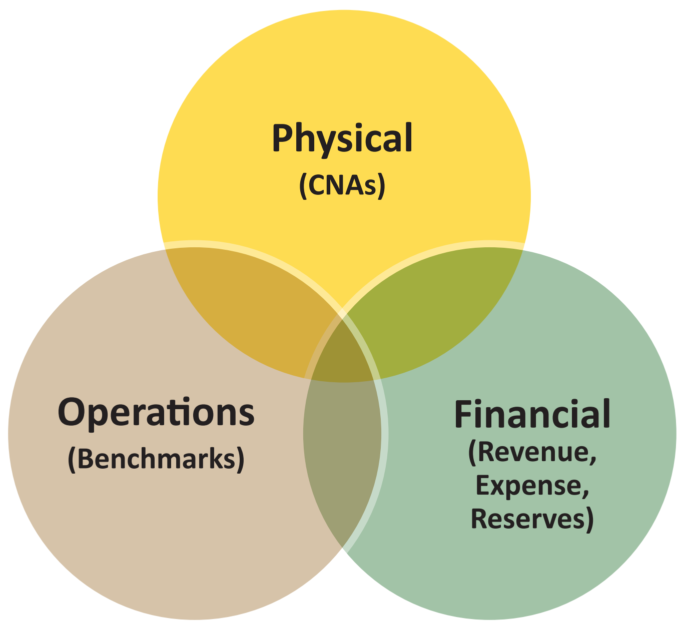
STEP 4

Performing Capital Needs Assessments

Goals for Step 4

- Ensure that you have correctly identified your Priority Properties.
- Assess the current physical condition of your Priority Properties and estimate the cost and timing of needed capital improvements.
- Perform financial modeling to determine the required reserve contributions and likely recapitalization timing for the balance of your organization's portfolio.

Preservation Planning



Why is this important? We've already looked at project operations and financial projections. In Step 4, we'll work with the third component of your Preservation Plan: maintaining the physical condition of your portfolio to meet the objectives of your organization.

Getting the right CNA. Capital needs assessments are the foundation of all capital planning. The scope and depth of a CNA will vary depending upon its intended use. For simplicity, we have divided CNAs into two categories: Phase-One CNAs, which inform long-term planning and replacement reserve models, and Phase Two CNAs, which prepare for imminent rehabilitation work.

The following chart summarizes the two types of reports and their associated uses and costs:

	Phase One CNA	Phase Two CNA
Uses	The Office of Housing requires project sponsors to complete a 20-year (Phase One) CNA for every new project and for existing projects under review. Asset management best-practices guidelines recommend that project sponsors review CNAs annually and update them at least every five years.	The Phase Two CNA builds more detail into the model to provide enough information to develop a full rehab scope. This information informs your team and partners of the project scope, and is essential for cost estimating and financial modeling.
Deliverables	• On-site observations • Assessment of building conditions and systems • Replacement reserve model, including a replacement schedule and corresponding expenditure estimates • Analysis of the adequacy of reserve balances and contributions • Review of replacement schedule and preventive maintenance plan for opportunities to reduce replacement needs	• Preliminary rehabilitation scope for financing applications • Report on hidden or underlying conditions such as mold, pest damage, or dry rot. • Recommendations for upgrades to improve accessibility, energy efficiency, and modernizations • Recommendations for security and programmatic improvements • Preliminary estimate to complete repairs/ replacements
Investigations	• Full site inspection • Take-off quantities • Full inspection of the building exterior, site, and common areas • Inspection of 25% to 100% of units • Review of plans, service contracts, maintenance records, and replacement schedules. (Original specification and schedule of values is a good source of information on building components) • Interviews with maintenance and management staff. • Review of work orders.	• Full site inspection • Measurements and take-offs for contractor estimates • Investigation (destructive testing) of all problem conditions — exteriors, site, and common areas • Inspection of 100% of unit interiors • Assessment of code-related deficiencies or work that will trigger code requirements • Meetings with local planning and building officials Note: Some funders may require an updated environmental report
Team	• Phase One CNAs can be completed in-house or by enlisting help from an architect, inspector, contractor, or other construction management service	The scope of work will determine what sort of expertise is needed to complete the project. Team members could include: • Architect/team coordination • Envelope consultant; civil, structural, and/or geotechnical engineers • General contractor and estimator • Mechanical, electrical, and plumbing consultants or subcontractors Note: Some public funders require that CNAs be completed by a third party.
Approximate Cost in 2011	\$5,000 to \$10,000	\$20,000 to \$40,000

A more detailed comparison of different CNA types is included in Appendix F.
A sample of the Office of Housing's 20-Year (Phase One) CNA is in Appendix G and on the CD.

CNA
Task 4.1

Complete Phase One Capital Needs Assessments

Objectives for Task 4.1 If you are not already completing regularly scheduled CNAs for all of your properties, it may not be feasible to assess every property immediately. For the purposes of your Preservation Plan, try to at least complete or update Phase One CNAs for the following types of properties:

- LIHTC properties placed in service 10 or more years ago
- Properties financed by a loan whose term will end within three years
- Properties whose high maintenance and/or utility costs jeopardize financial viability
- Properties whose poor physical condition or unattractive appearance negatively impact occupancy or rent levels
- Properties with exterior problems or moisture issues
- Any property that could be a future Priority Property

Completing Task 4.1

Follow these strategies to get the most out of your Phase One CNA:

- ☑ Make sure your Phase One CNA includes a review of the effectiveness of your preventive maintenance plan, particularly the part pertaining to building systems.
- ☑ If you choose to perform your CNAs in-house, refrain from assigning this responsibility to maintenance supervisors. While their input is essential, another lead person can bring additional perspective and expertise.
- ☑ Ask your property manager to identify any units clearly in need of work, particularly if the repair needs are affecting your bottom line by causing high turnover costs or vacancy (e.g. water damage, outdated components, security problems, or other issues). Ask if there are any life-safety issues. Make sure to include these troubled units in the building inspection.
- ☑ Because exterior-envelope deterioration is a common and high-cost risk, pay special attention to assessing preventive maintenance needs related to failures associated with site drainage, soil/wood contact, flashings and sealants, gutters or downspouts, windows and doors, ventilation, rotting decks, and mold, insects, or pests.

A sample inspection checklist is attached as Appendix H. Because every property is unique, you'll want to customize the checklist and include details for each of your properties.

Hint

More on CNAs

- Your CNA has a lifetime use and needs to be in an Excel or other software format that can be easily updated year to year.
- When working with a third-party CNA consultant, be sure to ask for an electronic budget worksheet with 20-year cost projections as a deliverable.

CNA
Task 4.2

Complete Phase Two Capital Needs Assessments

Objectives for Task 4.2 Obtain a Phase Two CNA for each Priority Property you plan to rehabilitate or refinance. We also recommend that you complete a Phase Two CNA for any property you are considering acquiring from a third party.

Completing Task 1

Following the steps below will help ensure that you obtain a complete and high-quality Phase Two CNA.

☑ **Outline a scope of work that includes the following:**

- An inventory of all building systems (not only those that have exhausted their service life or are in obvious need of repair)
- Take-off quantity information on all building components for estimating costs
- Clearly stated assumptions about replacement items and materials
- Preliminary cost estimate to complete the work outlined in the CNA (add in an annual inflation factor for work scheduled beyond the current year).
- A narrative description of the property's history and current condition, along with photographs of representative conditions (these items will help readers lacking a background in building construction, such as board members and lenders, make sense of the scope of work).
- A spreadsheet containing estimated 20-year replacement costs of major components (make sure you get this information in a format that's easy to update — e.g., Excel — so that you can use it, year to year, as a planning tool).

☑ **Solicit proposals (RFPs) for Phase Two CNAs.** It's likely that you will need the services of more than one building professional to complete your CNA, including a general contractor that can provide estimates for all recommended repairs/replacements. The job of coordinating these various sub-consultants may be performed in-house or by an architect.

The following known or suspected property conditions are good indicators that you will want your CNA team to include the expertise of specific consultants or sub-consultants:

- Settlement or cracks in the building exterior (civil engineer)
- Water infiltration and/or mold (envelope specialist)
- Complex building systems, e.g., elevators, HVAC, fire protection, and security systems

Hint

Know when to spend your LIHTC reserves

On an LIHTC project, it's important to carefully consider when and whether to use reserves, especially as you near the end of the 15-year partnership. In some cases, the most strategic choice is to spend down reserves rather than allow them to revert to the limited partner when you exit. But if you intend to recapitalize the project with a new round of LIHTCs, you should plan that spending carefully. Only work completed within a 24-month period can be counted toward basis. Read your partnership agreements closely and consult legal counsel when necessary.

Major renovations can trigger additional code requirements and upgrades to energy, seismic, electrical, and other systems. Generally, if you replace a component, open existing walls, or change the structure, expect to replace it according to the current code. Example: replacing a gas wall heater may trigger an upgrade to ventilation. Additional specialists may be needed to scope and estimate these costs.

☑ **Select your team.** When selecting team members to assist with a thorough capital needs assessment, consider these questions:

- Does the person/firm have thorough knowledge of the particular housing type to be assessed, as well as experience providing the specific types of data demanded by those who will rely on the report—including funders and other stakeholders?
- Does the person/firm scoping the work have a broad understanding of local code requirements?
- Does the inspector understand local market conditions and the demographic profile of residents?
- Do your team members have building-envelope, mechanical, electrical, and plumbing expertise? If not, will they contract with qualified sub-consultants as necessary?
- Have you reviewed your consultants' sample reports to make sure the format is something you can easily understand and work with? If you need a spreadsheet of replacement needs, costs, and schedule, be sure to ask for that as a deliverable.

☑ **Complete the inspection.** The quality of the CNA report will depend greatly upon how well you prepare your third-party inspector. Provide the inspector with all available historic information about the property, including the following:

- Records for prior replacement of major systems, such as roof, weatherization upgrades, HVAC, hot water tanks, etc.
- Historical replacement schedules and costs for short-lived items such as carpet, window treatments, and plumbing fixtures (this will help verify that the proposed timing of replacements and their costs make sense)
- As-built architectural plans and specifications for the project
- Service contracts and maintenance records for elevators and fire-alarm systems
- Other reports: Haz Mat survey, historical designation, operation and maintenance manuals

Management and maintenance personnel familiar with the property's building systems and history should accompany your consultants on the inspection, to answer any questions that arise.

CNA
Task 4.3

Synthesize and Summarize CNA Results

Objectives for Task 4.3

- Create a summary of identified capital needs for each Priority Property. Rank needs by their level of immediacy, estimate the total costs of all recommended rehab work, and compare these costs to available reserves.
- Implement needed changes to maintenance practices, annual capital-improvement schedules, and budgets.
- Evaluate long-term trends and compare needs across your portfolio.

Completing Task 4.3

☑ **Determine the best rehabilitation strategy for each Priority Property.** Once you have digested the results of the CNA, decide which of the following three options best serves the property:

- ***Phased rehab.*** If the total dollar amount of improvements needed within the next five years is not significantly more than available reserves, you may elect to phase repairs and defer a full-scale rehabilitation until you have reached a project financing milestone—such as the end of a 20-year HUD HOME compliance period or a LIHTC Year 15. You may also choose this course if another property has more pressing needs.
- ***Full-scope rehab.*** If your rehabilitation will require a significant amount of new resources, you may be headed toward refinancing your primary debt, using LIHTCs to secure new equity, or requesting a significant amount of funding from a public agency. Since each of these funding sources will subject the property to long-term restrictions that can make it hard to bring in new capital, make sure your rehab scope addresses everything you will need to physically maintain the property through the restriction period.
- ***End of useful life.*** In some cases the results of a CNA indicate that there is very little remaining useful life in the property. Funding a complete rehabilitation might not result in a property that meets the goals of the organization, or the cost of rehabilitation might exceed the cost of building an equivalent new project. In either case, such findings may lead you to consider (a) disposition or (b) demolition and redevelopment on the site.

> ***Hint***
>
> ***Create a lasting CNA team***
>
> If possible, select a CNA team that will work with you for the duration of the project, including the rehabilitation stage. With each step in the process, you and your team members will gain valuable knowledge that will inform your ultimate course of action.

- [x] **Note opportunities and limitations that could impact phasing of the rehabilitation work.** If you are working on more than one Priority Property, evaluate properties both individually and collectively:

  - Is there an obvious ranking among the projects, based on urgency, scope of capital needs, or available funding? For example, since water penetration issues get worse with time, a project with a serious roof leak would be a good candidate for immediate rehab, as would a project that qualifies for a temporarily available grant.
  - Are there potential efficiencies or cost savings that could be achieved by completing rehabilitation work on two or more projects together?
  - Will any of the potential rehabilitation projects require tenants to be relocated? If so, how might relocation issues affect the cost and timing of the project?

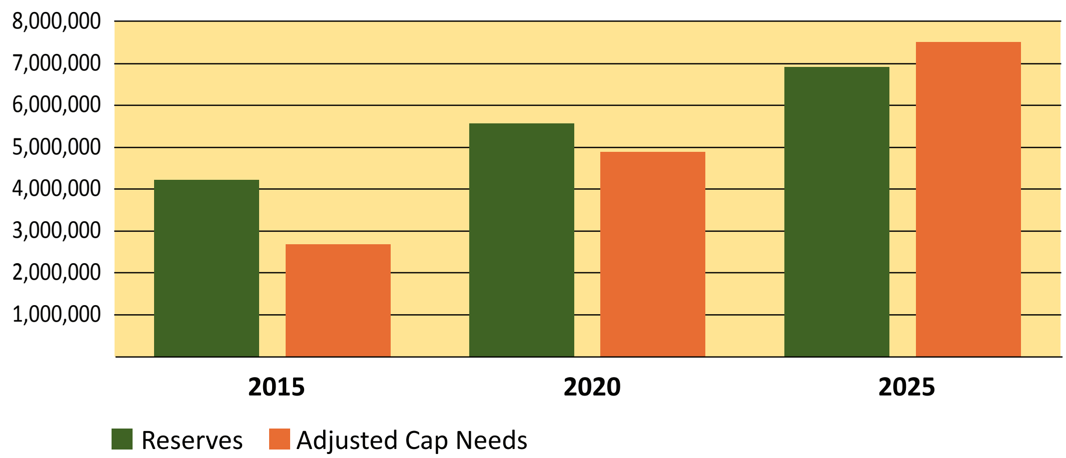
- [x] **Summarize findings for Priority Properties.** We recommend that you prepare a written summary of your CNA findings, including the cost for the recommended rehab work and potential alternative rehabilitation approaches. This information will help you communicate with funding partners as you build support for your chosen rehabilitation strategy.

- [x] **Add financial information to replacement reserve models for your non-Priority Properties.** Depending on the reserve model used for your CNAs, you may need to augment it to incorporate current reserve balances, annual reserve contributions, and assumptions about future refinancing. The Housing Development Center has an Excel-based replacement reserve model that allows you to input sources of funding information. You can find it at www.housingdevelopmentcenter.org or on the Guide's CD.

- [x] **Revisit Priority Property decisions.** Review the CNA and updated reserve model for each non-Priority property to identify properties that are expected to burn through reserves within a five-year period. Evaluate the potential dollar impact on the organization and reconsider whether the property needs to be designated a Priority Property.

Complete feedback loop to maintenance and development staff. It is likely that your CNAs have identified (a) immediate repairs needed to improve life safety, increase marketability, and prevent further deterioration of the properties; (b) trends across your portfolio and ways to apply preventive maintenance to extend the useful life of various building systems in your properties; and (c) materials and specifications that should (or should not!) be incorporated into future developments. Make sure the appropriate people in your organization are aware of these findings. Direct property management personnel to address immediate repairs, tell asset managers to strengthen their tracking systems, and advise developers about materials that are failing, along with those that perform well and have low maintenance costs.

Reserves vs. Adjusted CNA Needs



Evaluate long-term trends across your portfolio. This step is critical for both long-term planning and understanding the context of upcoming restructures. By adding together the projected annual capital costs for all your properties, as well as the annual available reserves, you can better understand the potential impact of aging properties on your organization.

Capitol Hill Housing incorporated multiple-property capital needs trending into their Preservation Plan. The chart above shows their findings.

CASE STUDY

Assessing and Managing Capital Needs Over Time

Housing Resources Group and the Security House Rehabilitation

Housing Resources Group (HRG) is a large affordable housing provider that serves neighborhoods in central Seattle. Founded in 1980, HRG has developed more than 3,000 units of housing, nearly 2,000 of which it owns and manages. Many of these are efficiency units in buildings that HRG has rehabilitated. These buildings include several historic structures, as well as some HUD-funded developments that use Project-Based Section 8 subsidies.

Acknowledging the risks inherent in owning a large and aging portfolio, HRG decided to complete comprehensive needs assessments for all its properties. In the past, HRG had ordered CNAs on a case-by-case basis, but the quality of these contracted reports had been unreliable. So in 2001, HRG hired a qualified full-time staff person to complete the CNAs. To ensure thorough and accurate results, the staff person used a standardized process that included tenant interviews and inspections of 100% of the units. Specialty consultants were hired when necessary, and free consultations by service contractors were solicited when available. In the first year, HRG completed investigations and assessments of 18 properties.

One of the investigations tackled the first year was Security House, a 14-story Section 8 property that provided housing to more than 100 very-low-income seniors and disabled persons. HRG acquired Security Housing in 1999, using 4% LIHTCs and funding from Seattle's Housing Preservation Fund.

HRG recognized that Security House suffered from water intrusion, but resources for rehabilitation were limited. At the time of acquisition, HRG spent around $8,000 per unit on rehabilitation, replacing the building's roof, painting the exterior, and installing new windows on the west-facing façade. However, the structural deficiencies that led to the water intrusion could not be immediately addressed. Security House has a reinforced concrete frame with an exterior envelope built of very porous concrete block. The only permanent solution was to over-clad the existing envelope using a rain-screen-technology system. To control costs and contain further deterioration, HRG installed the rain-screen system in two phases, starting with the west and south facades—the sides most exposed to the weather.

The first phase of the rehabilitation cost $1.4 million. HRG met most of this expense using $700,000 from replacement reserves and $600,000 in new debt (an increase to HRG's permanent mortgage). To pay for the second phase, HRG renegotiated a cash-flow note held by the City of Seattle. The City agreed to defer receipt of cash-flow payments for four years so that HRG could save up that money to complete the new envelope.

HRG was able to use its extensive knowledge of the building structure and the required scope of repairs to demonstrate to financial partners that it had a sound approach to correcting the problem. HRG's financial modeling provided funders with reliable and realistic expectations of the project's post-rehabilitation financial performance. HRG also demonstrated its willingness to participate in the solution by delaying repayment of outstanding debts. The strategy saved costs and still secured the physical integrity of the building, so HRG can continue to provide quality housing to low-income residents for many years to come.

Chapter 2: Setting Priorities

STEP 5 Right-Sizing Your Debt

Goals for Step 5 Use the financial assumptions developed in preceding steps to estimate how much debt each of your Priority Properties can realistically carry over the next 20 years.

Why is this important? Like property management fees and capital improvement costs, debt payments represent a major portion of affordable-housing spending. Establishing what is the "right" debt burden for each of your Priority Properties is a critical step in completing your Preservation Plan. Assessing your debt burden can reveal both problems and opportunities, including the opportunity to leverage new private capital—often the best choice for preserving affordable housing, given scarce public resources.

Note that for some properties, carrying any debt is unsustainable. Small projects (fewer than 10 units) and those serving special-needs populations often use all their operating revenue just to meet operating expenses. For such projects, you might end up doing a Restructure that replaces must-pay debt with grants or soft loans.

Frederic Ozanam House, a project of Catholic Housing Services of Western Washington

Looking at the balance of your portfolio

In Step 5, the focus is on your Priority Properties, but eventually you'll want to do financial analyses for ALL your properties. This will help you to actively monitor long-term project health, identify problems before they become critical, and identify trends across your portfolio. Once you set up a long-term cash-flow projection for a given project, you'll just need to update it once a year to make sure the project is still on track.

Long Term Viability

Task 5.1 Develop Cash-Flow Projections

Objectives of Task 5.1 In Step 3, you created a new operating budget for each Priority Project, based on recent operating history and proposed operational changes. Now, take that information and project it out 20 years, modeling alternate revenue and expense scenarios. Finally, evaluate the possibility of reducing, or perhaps even increasing, your debt payments.

Completing Task 5.1

- ☑ Open the operating budget created in Step 3 and make a copy of the file.
- ☑ As shown in the sample below, insert 20 new columns, each representing a year, and project your annual revenues and expenses forward in time. Since none of us know exactly to what extent inflation will affect costs, or what regulatory and other changes will impact rent income, we recommend that you base your projections on industry-standard accelerators: 2% per year for revenues, 3% per year for expenses.
- ☑ Include the financial indices from Step 3 (net cash flow, debt cover ratio, expense ratio), projecting them through the full 20-year period.

Sample Project: 20-Year Operation Projection

Sample 25-unit project	Inflator on income:	2.0%	Inflator on expenses:		3.0%										
CASH FLOW PROJECTION	**Current Year**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**	**Year 10**	**Year 11**	**Year 12**	**Year 13**	**Year 1**
RENTAL INCOME															
Tenant Income (Gross Potential)	$153,900	$156,978	$160,118	$163,320	$166,586	$169,918	$173,316	$176,783	$180,318	$183,925	$187,603	$191,355	$195,182	$199,086	$203,0
Other Income	$5,624	$5,736	$5,851	$5,968	$6,088	$6,209	$6,334	$6,460	$6,589	$6,721	$6,856	$6,993	$7,133	$7,275	$7,4
Residential Vacancy (7%)	-$9,080	-$10,988	-$11,208	-$11,432	-$11,661	-$11,894	-$12,132	-$12,375	-$12,622	-$12,875	-$13,132	-$13,395	-$13,663	-$13,936	-$14,2
Effective Gross Income (EGI)	$150,444	$151,726	$154,761	$157,856	$161,013	$164,233	$167,518	$170,868	$174,286	$177,771	$181,327	$184,953	$188,652	$192,425	$196,2
OPERATING EXPENSES															
List Expenses Here															
Total Operating Expenses	$128,200	$132,046	$136,007	$140,088	$144,290	$148,619	$153,078	$157,670	$162,400	$167,272	$172,290	$177,459	$182,783	$188,266	$193,9
NET OPERATING INCOME (NOI)	$22,244	$19,680	$18,753	$17,768	$16,723	$15,614	$14,440	$13,198	$11,886	$10,499	$9,037	$7,494	$5,870	$4,159	$2,3
DEBT SERVICE	$20,985	$18,566	$17,692	$16,762	$15,776	$14,730	$13,623	$12,451	$11,213	$9,905	$8,525	$7,070	$5,537	$3,924	$2,2
CASH FLOW	$1,259	$1,114	$1,061	$1,006	$947	$884	$817	$747	$673	$594	$512	$424	$332	$235	$1
Debt Coverage Ratio (DCR)	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.06	1.0
Cash Flow Per Unit (25 units)	$50	$45	$42	$40	$38	$35	$33	$30	$27	$24	$20	$17	$13	$9	
Efficiency Ratio	85%	87%	88%	89%	90%	90%	91%	92%	93%	94%	95%	96%	97%	98%	9
Cash Flow as Percent of EGI	0.84%	0.73%	0.69%	0.64%	0.59%	0.54%	0.49%	0.44%	0.39%	0.33%	0.28%	0.23%	0.18%	0.12%	0.0
Cash Flow as Percent of Expenses	0.98%	0.84%	0.78%	0.72%	0.66%	0.59%	0.53%	0.47%	0.41%	0.36%	0.30%	0.24%	0.18%	0.13%	0.0

- ☑ Make adjustments to the cash-flow projection to account for revenue and expense items that you believe will increase faster or slower than the standard accelerator rate. For instance, factor in anticipated utility rate hikes, regulatory changes that will affect rent maximums, property-tax changes, and increases or reductions in program costs.
- ☑ Create separate tabbed worksheets to model additional “what-if” scenarios. Constant values may be pulled directly from the base-scenario worksheet, using Excel’s “linking” function. That way, any updates made to those values will automatically be incorporated into your “what-if” worksheets.

Long Term Viability

Task 5.2 Stress-Test Your Projections

Objectives of Task 5.2 A stress test evaluates a project's long-term financial viability and helps identify factors that will contribute to the project's ultimate financial success or failure. It is particularly important to stress-test projects that are already showing signs of financial instability.

Completing Task 5.2

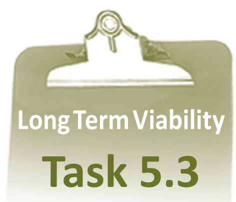
☑ Spend some time playing with the numbers in the cash-flow projection developed in Task 5.1. As you manipulate your assumptions, observe which factors most affect project viability. Where might small changes significantly improve or reduce project cash flow and/or debt cover? Here are some things to try:

- Input achievable changes to revenues and expenses, based on the operational improvements made in previous steps. How do these changes impact project viability?
- How would changing annual revenue and expense accelerators affect project viability? Adjusting inflation factors can reveal how vulnerable your project is to unpredictable economic changes.
- How would changes in occupancy rate affect viability?
- How would smaller or larger collection losses affect your bottom line?
- If the project's cash flow and debt coverage look healthy, and you need major improvements, could the project support a higher debt payment?

☑ Model what it would look like if you refinanced your primary debt, either now or in the future. Try using different interest rates and amortization periods. When doing these calculations, it can be helpful to replace your primary-mortgage debt payment with a mortgage calculation formula, breaking the payment out into three lines: one for principal, one for interest, and one for total debt service. Tracking principal separately allows you to monitor the loan balance as you look at refinancing options. (You can find the amount of your current outstanding principal on your most recent balance sheet.)

- [x] Use the information gleaned from this exercise to answer the questions below.

    - Based on prior performance (over the last three-plus years), will the property be able to meet its expense and debt obligations for the next five years? What about through the end of the loan term?
    - If future operating deficits are indicated, could operational (management) improvements improve the bottom line—or at least extend the period of positive performance, creating opportunities for refinancing, tapping reserves, or requesting loan payment deferrals?
    - Are deposits to reserves sufficient to meet future improvement needs? At any point does that trend reverse?
    - With realistic operational improvements and budget controls, could the project support higher must-pay debt payments and thereby access additional capital?



Address Special Factors Affecting the Restructure of Mixed-Use Properties

Objectives of Task 5.3 Evaluate the financial performance of the commercial component of each of your mixed-use properties; determine the impact of its performance on the project's overall viability.

Completing Task 5.3

Mixed-use properties present unique challenges. If you've created a cash-flow projection for a project that includes a commercial component, consider taking these additional steps:

- [x] Create cash-flow scenarios modeling different discount and vacancy rates, remembering that lenders tend to underwrite commercial revenues conservatively.
- [x] Evaluate the lease terms and make sure they are accurately reflected in your 20-year cash-flow statement. Factor in anticipated owner-paid tenant improvements.
- [x] Keep in mind that lenders negotiating a restructure will want to see long-term leases in place for your commercial units. Get these leases signed now.

- If the project has a large commercial space, be aware that lenders generally make underwriting decisions based on the financial fitness of major lessees as well as of the project sponsor. Discuss this fact with your lessees and, if possible, obtain copies of their financial statements to share with your lender. If any of your lessees are not financially stable, anticipate a higher level of scrutiny by your lenders.

On the plus side, a successful commercial lease can sometimes leverage additional debt that will support the residential portion of a project. Some funding sources even specifically target rehabilitations of commercial units within mixed-use properties (see Step 7's discussion of New Markets Tax Credits).

Long Term Viability
Task 5.4

Evaluate Loan-to-Value Ratios, Liquidity, and Net Worth for Your Organization

Objectives for Task 5.4 To attract new capital to a property, you'll need to demonstrate three things: (1) the property has the ability to support the proposed debt payments, (2) the property has an adequate loan-to-value ratio, and (3) your organization has adequate net worth and liquidity. We have already addressed the first issue, debt capacity. In this task, we will address the other two, starting with a review of your property and organizational balance sheets.

Completing Task 5.4

Refinancing Priority Properties can be challenging since affordable housing often doesn't fit typical lending parameters. Private lenders generally limit real-estate loans to 75% to 80% of a property's appraised value, and that percentage can drop even lower if the property is considered high-risk. Additionally, in recent years lenders and investors have been increasing their scrutiny of sponsor balance sheets when deciding whether to underwrite real estate loans. Sponsors seeking to refinance an existing project may expect to face the following challenges:

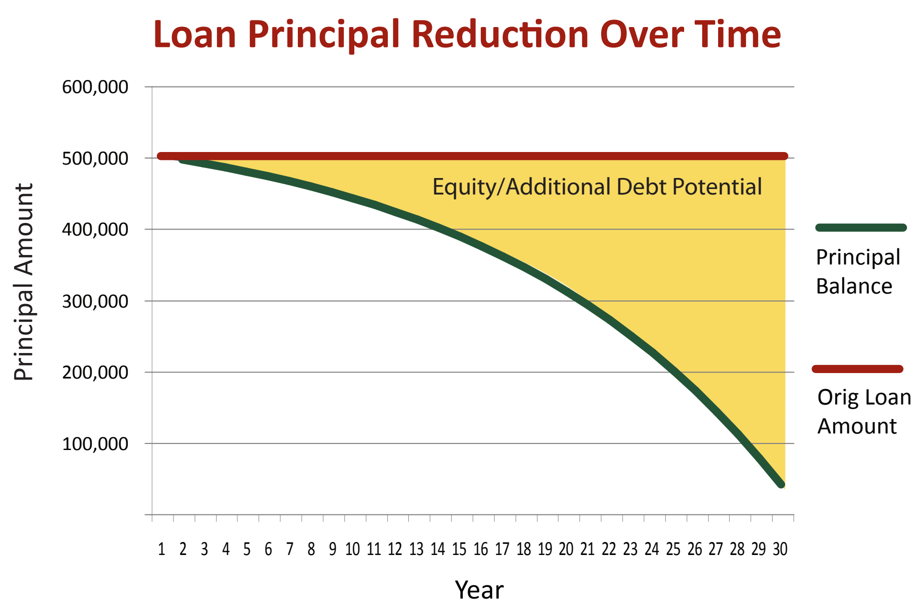
- **Low appraised property value.** Lenders often appraise a rental property's value based on how much income it generates. Below-market rents will negatively impact the appraised value.

- **Heavy liabilities burden.** Affordable-housing properties are typically financed with a lot of soft debt. While soft debt benefits operations, it reduces available equity. In a refinance, expect your primary lenders to require subordinate lenders to subordinate to the new amortized debt.

Weak sponsor's balance sheet. Lenders look for sponsors with balance sheets that show high liquidity levels and strong net assets. Meeting these criteria can be a significant challenge for affordable housing sponsors, not only because of their significant soft debt burdens, but also because many project sponsors own properties through single-asset entities (such as LIHTC partnerships and HUD single-asset entities), which do not appear on sponsor balance sheets. Lenders familiar with the non-profit industry may have more experience in understanding the anomalies on your balance sheet.

To prepare for meeting with lenders, work though the following analyses with your fiscal manager:

Estimate property values. Ultimately, you will need to obtain a formal appraisal for any properties included in a refinance. For now, make the market value estimate based on recent sales data for comparable properties. To get this data, talk to a real estate broker or review any recent appraisals obtained by your organization or other project sponsors. Once you have a number, include it on the Schedule of Real Estate Assets you started developing in Chapter 1.



Evaluate liabilities and net assets. Using the information you gathered in Step 2, add up the outstanding liabilities of each of your Priority Properties. Next, subtract these liabilities from the property's estimated market value to determine its net value (or equity). As illustrated in the diagram above, refinancing later in the amortization period usually results in significantly more equity.

Evaluate organizational liquidity. Make a list of your organization's liquid assets. Liquid assets are defined as assets that exist as cash or are easily converted to cash: e.g., cash accounts and readily collected accounts-receivable. Liquidity requirements vary among funders; check with your lender(s) to see how well your organization meets theirs.

☑ **Identify strategies to improve loan-to-value ratios, organizational liquidity, and net worth.** To help your balance sheet appear as strong as possible to a lender, consider strategies such as these:

- ***Property sales.*** Some nonprofit sponsors have followed the lead of housing authorities and increased liquidity by disposing of smaller properties and nonperforming assets.

- ***Debt forgiveness or loan extensions by public funders.*** Some public-funder loans are structured to include incremental forgiveness over time. Public funders may also be willing to provide loan extensions in exchange for extended affordability periods.

- ***Adding units.*** In some cases, properties may contain unused land or development capacity (floor area ratio). Adding units may increase a property's value; if paid for in part by new LIHTCs or other equity, such additions could improve the property's loan-to-value ratio.

- ***Partnering.*** Consider forming partnerships or collaborations with organizations that have strong balance sheets. For a fee, a project partner or another nonprofit may consider providing short-term guarantees, such as construction completion guarantees.

Santa Teresita, a project of Catholic Housing Services of Western Washington

STEP 6

Synthesizing Your Knowledge

Goals for Step 6 You will review all the information and analysis you have completed thus far, synthesize the information, and come up with cost-effective preservation strategies.

Why is this important? You have amassed a significant amount of information, started implementing operational improvements, and may well be talking to external stakeholders about portfolio-strengthening strategies. At this point, it's critical to prioritize the work ahead. Having a clear plan will also help you effectively communicate your goals, both internally and externally.

Synthesis & Goals

Task 6.1

Develop a Portfolio-Wide Strategy

Objectives of Task 6.1 This task has three objectives:

1. Set your top priorities for improving operations across your portfolio.
2. Scope out the work required in the next five years to financially reposition your projects.
3. In the process, sort your properties into three categories: 1) Good to Go, 2) Restructure, and 3) Disposition, Transfer, or Redevelopment.

Completing Task 6.1

☑ **Assemble information.** Review the key portfolio-wide analyses created in previous steps:

- Financial milestones chart (Step 2)
- Financial reviews for each property (Steps 3 and 5)
- Replacement reserve model for each property (Step 4)

☑ **Set priorities for improving overall operations.** After reviewing the analyses collated above, identify three to five top-priority actions you wish to take within the next five years to strengthen your portfolio. Consider ways to maximize revenues as well as to minimize expenses:

Revenues

- ***Rents.*** Implement scheduled rent increases.
- ***Concessions.*** Do you need them to draw tenants?
- ***Occupancy / tenant satisfaction.*** Can you take any actions that will increase tenants' length of stay and decrease turnovers?
- ***Routine maintenance practices.*** What can you do to enhance the curb appeal and marketability of your property?
- ***Unit turnaround times.*** How can you reduce the average number of days your units sit vacant between tenants?
- ***Leasing.*** Review your screening criteria and referral process to ensure you are maximizing efficiency and not screening out too many potential tenants.
- ***Collection losses.*** Are there steps you can take to improve collection rates?
- ***Other sources of income.*** Can you make increases to tenant-paid parking, laundry, and other fees?

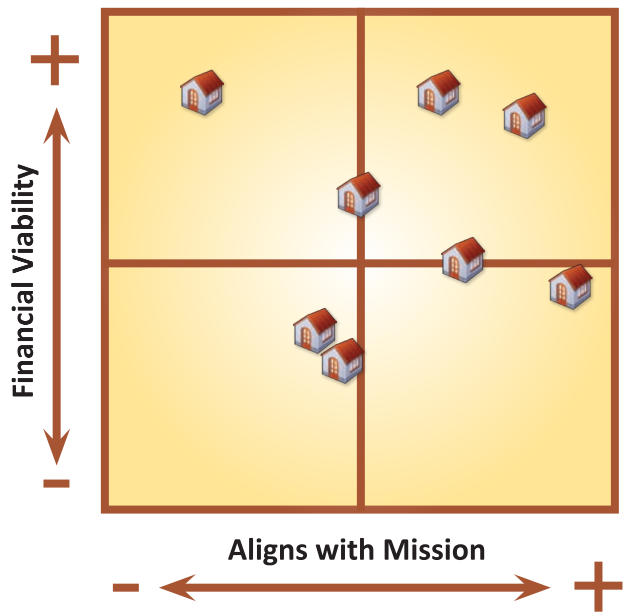
Expenses

- ***Preventative maintenance.*** What can you do to extend the life of building components and reduce repair costs?
- ***Scheduled repairs.*** Are there timely improvements you can make to avoid building/equipment deterioration and reduce chronic repair needs?
- ***Sustainability measures.*** Can you implement changes to increase materials durability and conserve energy and water use through equipment retrofitting and staff/resident education?
- ***Unit turnaround costs.*** Are turnarounds being completed as efficiently as possible?
- ***Work order process and purchasing.*** Are repairs being addressed in a timely fashion?
- ***Effective and efficient management.*** If management staff are consistently not meeting lease-up or expense management targets, tighten the supervision, or consider changing on-site property managers.

Determine what indicators to track in order to measure the effects of these improvements. Outline the key organizational-system changes, staffing changes, and procedural changes that will be needed to implement these improvements.

☑ **Assess each property's financial performance in relation to its success serving its social mission.** Affordable-housing nonprofits and housing authorities are mission-based organizations, so no decision about a property can be based solely on the property's financial situation. Moreover, an organization may rightly have different financial expectations for different properties: e.g., one that serves formerly homeless families versus one that provides workforce housing. A "Scattergram" like the one at right is a great way to graphically illustrate how well your portfolio is performing both financially and in terms of meeting mission goals. Projects that are not meeting either performance measure (those in the lower-left corner) are candidates for further review.

Portfolio Scattergram



Developed by Consortium of Housing Asset Managers (CHAM)

Create a Portfolio Scattergram by using data from your financial and capital needs assessments (CNAs), along with your knowledge of how successfully your projects have served the needs of their target populations. Place each property where you think it belongs on the two continuums. As you analyze the resulting diagram, be open to the possibility that projects that are neither financially viable nor central to your mission may no longer belong in your portfolio. Disposition of such properties may be a better solution than making further investments in them. This exercise can be particularly useful when completed with a broad group of staff and/or your organization's board of directors.

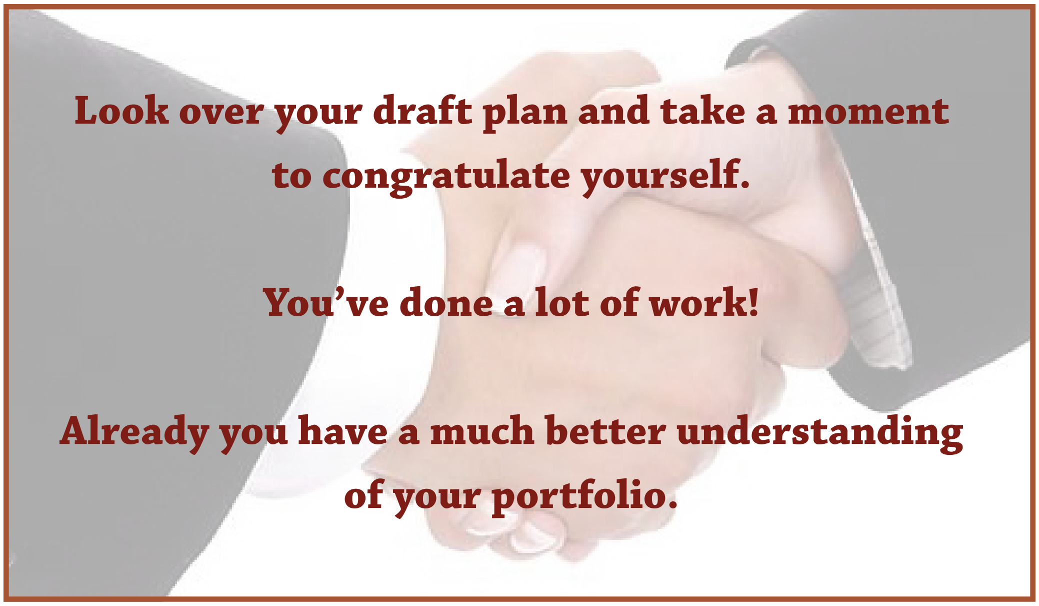
Preservation Planning: Sort Your Portfolio

☑ **Sort your properties.** Based on the evaluations performed above, sort your properties into three groups:

- ***Good to Go.*** Through continued focus on operational improvements, these properties have sufficient cash flow and reserves to meet projected expenses and required capital improvements for at least the next five years.

- ***Restructure.*** These properties need or could benefit from major financial repositioning within the next five years because a) rehabilitation needs are beyond what reserves can support; b) they face upcoming financial milestones, such as the end of a loan term; c) there's a clear opportunity to gain significant financial/operational benefits from refinancing; or d) operational improvements alone will not result in positive cash flow.

- ***Disposition, Transfer, or Redevelopment.*** These are properties that a) do not meet your mission goals or service priorities; b) put your organization at unacceptable financial or liability risk; c) have declining physical structures that are not worth reinvestment; and/or d) have financial obligations so out of balance with their assessed value and financial capacity that you believe it would be infeasible to restructure them successfully.



☑ **Formulate a draft Preservation Plan.** Summarize your conclusions and recommendations from Task 6.1 to create a draft Preservation Plan. Your Plan should list all your concerns about each Priority Property, the steps you propose to resolve those issues, and notations about milestones or projected capital needs for all the properties in your portfolio. Now is a good time to get the input of your development staff about how a Restructure will impact your development pipeline. Then take your Plan to executive staff and board for review and endorsement.

Synthesis & Goals
Task 6.2

Determine Goals and Schedule for Each Priority Property Selected for Restructure

Objective of Task 6.2 Now that you've determined which properties should be restructured, it's time to establish the scope of work required to complete each one.

Completing Task 6.2

☑ **Assemble team members.** As you prepare to go forth and negotiate a restructuring deal, it may be appropriate to reorganize your Preservation planning team. If an asset manager has thus far led the team, you may want to assign the leadership role to a member of your development staff. But for several reasons, it will be important to maintain the high-level involvement of your asset management team:

- Funding partners are likely to have existing working relationships with your asset management staff.

- Funding partners will want to know what went "wrong" with the project being restructured. They'll rely on your asset management staff to provide extensive information about operations, income and expense history, management capacity, property conditions, reserve balances, and capital needs assessments. (When seeking to restructure an existing project, you'll generally be expected to provide more detailed information about operations than if you were seeking to finance a new project.)
- Funding partners will want your asset management team to demonstrate that the balance of your portfolio is performing successfully — or that there are real, active efforts to strengthen weak areas.

☑ **Summarize key goals and set a restructuring timeline for each Priority Property.**

Think through the following issues regarding each Priority Property:

- ***Timeline.*** What is the best timeline for your Restructure? For example, do you want the property to perform for the next five years, until a specific milestone is reached, or for another 20 years?
- ***Cost estimate.*** Given your intended timeline, the findings of your capital-needs assessment, and your reserve model, what is your likely total rehabilitation cost? Select the staff and outside professionals needed to accomplish the Restructure.
- ***Residents***. What impact will different funding and rehabilitation scopes have on residents, on the property, and on your organization?
- ***Contract and negotiations.*** Decide the most cost-effective strategy for contracting the work:
  - If two or more projects share funders/investors, and both need to be restructured, working on them simultaneously may save time and offer efficiencies in legal costs, contract negotiations, etc.
  - If you are rehabbing multiple sites, using a single contractor may produce savings, especially if the sites are close to each other. Pick a qualified team member to review potential cost savings (including purchase, delivery, staging, storage, job office, administration, project management, and other cost savings).
  - Contractors and architects originally involved in the project may have knowledge and experience that offer savings.

While putting together your Preservation Plan, remember the process is iterative. If your plan fails to satisfy a key funder, you will be forced to rethink it and design a new set of goals.

The Capital Hill Case Study on the following page is an interim work product Capitol Hill Housing used to help frame their Preservation Plan.

CASE STUDY

Creating a Portfolio Wide Plan

Capitol Hill Housing's Portfolio Review

Overview of Portfolio

- Our portfolio strengthening work is focused on 27 of 42 buildings.
- The portfolio is rapidly aging.
- The buildings are small.
- The properties' cash flow will not grow significantly—or at all—over time.
- In general, reserves are insufficient to meet all eligible capital costs.

Broad Conclusions

- Building occupancy must be maximized.
- Effective preventative maintenance practices will be critical to managing costs of future capital needs and ensuring sustainability.
- Building reserves will never be sufficient to cover all the capital needs of the buildings over time.
- Many CHH buildings are over-leveraged with bank debt.
- Some CHH buildings are not sustainable over the long term in their present form.
- Current poor operating performance has a direct impact on our ability to finance new projects.

Ten Important Strategies

1. Increase rental income.
2. Reduce expenses.
3. Refinance to reduce debt service payments and to potentially raise capital.
4. Eliminate, reduce, and/or restructure existing debt.
5. Identify opportunities to sell future development rights as a preservation strategy.
6. Utilize out-of-the-box strategies to maximize internal resources.
7. At the front end of new developments, consider the long-term impact of proposed financing structures.
8. Position tax-credit buildings for maximum advantage at Year 15.
9. Be proactive with preventative maintenance and plan for long-term capital needs.
10. Strive to enact the most effective management models.

capitol hill housing

Chapter 3: Implementation

STEP 7

Determining Uses of Funds

Goals for Step 7 Create a development budget for each Restructure project. The budget will incorporate the income-and-expense statement and the cash-flow projection developed in prior steps. It will also incorporate a uses-of-funds estimate (cost breakdown) based on the scope of work, the schedule, and the cost estimates you have in hand.

Why is this important? Understanding overall project costs, including both rehabilitation costs and related soft costs, will help determine your financing strategies.

Uses of Funds
Task 7.1

Set Up a Pro Forma for Each Restructure Project

Objective of Task 7.1 Create a basic financial pro forma to determine next steps.

Completing Task 7.1

- ☑ **Create a basic model.** If you have one, use your agency's standard acquisition/rehabilitation pro forma, including tabs for sources, uses, a pro forma and a cash flow projection. Include essential project data such as unit sizes, square footage, current rents, and rent restrictions. If you expect to use LIHTCs, New Markets Tax Credits, and/or Historic Tax Credits, working from a prior tax-credit pro forma will be most efficient.

Hints

Plan your Restructure pro forma

Expect to create several pro forma models as you review and refine the rehabilitation scope, costs, and financing options for each Priority Property. Use spreadsheets that can easily factor in adjustments. Many public funders have standard forms available on their websites.

On financial-spreadsheet pro formas for scattered-site projects, we have found it helpful to do the following:

- Set up separate tabs for each site's cost breakdown and link them to a summary sources and uses budget, or put costs in separate columns for each property;
- Create cost allocation formulas for shared costs that link to a reference cell so that you can easily modify allocations between properties;
- Allocate shared costs on a per-unit or per-square-foot basis.

Happy Acres Apartments

Financial Description

Sample Detailed Cost Breakdown for 9% LIHTC Project

		Total Costs	Depreciable for 9% Credits	Depreciable for Acquisition Credits
	Insert Your Total Square Footage and Contingency Percentage	22,764		
Acquisition Cost				
Acquisition Price: Land				525,000
Acquisition Price: Improvements			1,725,000	-
Acquisition Price: Purchase Option				-
Construction Costs				
Construction: Commercial				
Construction: Residential	88,442	4,743,706	4,743,706	
Construction Contingency	10.00%	474,371	426,934	
Furniture, Fixtures, Equipment		50,000	-	
Soft Costs				
Development Costs				
Energy Audit		5,000	5,000	
Environmental Study (Level I, II)		4,000	4,000	
Fees: Building Permits		30,000	30,000	
Fees: SDC’s		-	-	
Insurance: Builders Risk		15,000	15,000	
Insurance: Owner’s Liabilty & Property		25,000	25,000	

☑ **Incorporate cash-flow projections into the pro forma.** Insert the cash-flow projections you created in Step 5 into your Restructure pro forma. If you are changing a loan or adding a new one, make sure you incorporate the new loan information into the cash-flow projections.

Uses of Funds
Task 7.2

Complete Your Preliminary Uses of Funds Budget

Objectives of Task 7.2 Draft a preliminary uses of funds budget based on your CNA cost estimate and on the average soft costs for recent comparable acquisition/rehabilitation projects. As with any affordable-housing development, you will refine this budget as you work through recapitalization strategies (in Step 8) and as you make more detailed decisions regarding the recapitalization strategies outlined in Step 8 and make detailed decisions regarding your rehab plan, including the scope, costs, schedule, and contractor team.

Completing Task 7.2 Most affordable-housing developers will be familiar with the process of creating a sources and uses budget; therefore, the following questions and tips are focused on issues specific to budgeting for a Restructure:

- ☑ **Acquisition costs related to a change in legal ownership.** Does the Restructure call for a property transfer to another legal entity (e.g., a resyndication or the creation of a HUD Single Asset Entity)? If so, include estimated acquisition costs, with the price to be substantiated later through an appraisal. Any equity from the land's or building's value will become a source of funds, in the form of either a general-partner/sponsor loan or a capital contribution. However, if the property is to remain under its prior ownership, the budget need not typically account for any acquisition costs (such costs will show up as neither a source nor a use of funds). Generally, existing subordinate debt will be assigned to the new owner and will not be reflected as a source or a use for the "new" project.
- ☑ **Refinancing.** If the remaining principal of any loan is refinanced or paid off, the repayment of the outstanding principal becomes a use of funds, while any new financing becomes a source. Check with your funders for any rules pertaining to refinancing and subordination of existing loans (Seattle Office of Housing has guidelines available upon request).
- ☑ **Occupied rehabs with contingencies.** If the project was occupied at the time the CNA was performed, it may not have been possible to complete the level of investigation needed to fully inform cost estimates (e.g., to determine whether mold exists behind kitchen cabinets). Try to include both a design/estimate contingency and a 15% construction contingency in your budget.

Hint

Use unit prices when negotiating contracts for occupied properties

At the time you sign a construction contract for the rehab of occupied units, you may not have all the information you need to accurately estimate quantities. How much of the framing will need to be repaired by the time construction actually commences? How much carpeting will need to be replaced? Specify a per-unit cost for key items in the contract; include a fixed amount allowed for profit and overhead should change orders be required. Then do your best to estimate the actual quantity or percentage of each item needing repair/replacement (e.g., 50% of kitchen cabinets). By establishing cost limits up front, you'll reduce the time spent negotiating change orders later.

- **Mixed-use property rehabilitation.** Completing rehabilitation of a property containing an occupied ground-floor commercial space presents myriad challenges, from accessing the commercial area to temporarily interrupting access to the business. Seismic upgrade of an older property generally requires significant work on the ground floor. Evaluate how work can be phased to minimize disruption. Careful analysis, along with early and frequent discussions with your commercial tenants, is critical. Remember that some funding sources (LIHTC, HOME, Trust Fund) will not cover work within the commercial area, but all funders will scrutinize how the commercial portion contributes to the project financially.

- **Relocation costs.** Relocating tenants can be complicated and expensive. Do the research needed to develop a thorough and accurate relocation budget, including administration costs, temporary-relocation costs, and, if necessary, permanent-relocation costs. In addition to any relocation policies prescribed within your organization, keep in mind that federal regulations attached to some funding sources will require specific actions:

  - If a project will utilize federal funds (including but not limited to HOME, Community Development Block Grant, HUD 202, and 811 funding), the Restructure project must comply with the Uniform Relocation Assistance and Real Property Acquisitions Policies Act of 1970 (URA).

  - If the project will utilize federal funds and involves the demolition of affordable housing (rent-regulated or not), the project must also comply with Section 104(d) of the Housing and Community Development Act of 1974 (104(d)), which imposes additional regulations and will increase the cost of relocating tenants.

  - Even commercial tenants may be eligible for relocation assistance.

  - Rolling a project into a new tax-credit partnership can also raise relocation issues, since current households with incomes above 60%-AMI limits may no longer qualify to live in the newly re-restricted housing.

  - Make sure you review federal relocation requirements before taking any actions, such as making rent increases (which can trigger economic displacement) or applying for federal funds (which can set the clock for various relocation noticing requirements).

Operating reserves during redevelopment. Rehabilitation can cause a short-term dip in your property's operating revenues and/or a spike in its operating expenses. If the Restructure includes significant rehabilitation, for instance, the project will likely experience higher than normal vacancy levels. For some phased rehabilitations, the development team may even elect to stop leasing units prior to the start of construction in order to facilitate onsite relocation of residents. A transfer of property management duties can also affect operating income. We recommend preparing for the above possibilities by building an operating-shortfall reserve into your development budget.

LIHTC Projects and Year 15 Exits. If the Restructure involves the exit of an equity investor from an existing LIHTC ownership, start negotiating with the exiting partner as early as possible. These negotiations will determine exit costs (legal costs, unpaid investor-services fees, and payments required to meet the investor's tax obligations) and help anticipate the amount of reserves available for the Restructure project. Local funders will expect to see the balance of operating and replacement reserves listed as a source and the new reserve amount listed as a use.

Plymouth on Stewart, a project of Plymouth Housing Group

Explore ways to reduce project costs

- Bidding: Get the best price for your dollar.
- Time the rehab to coincide with optimal seasonal conditions.
- If you have multiple projects that need rehabilitation, consider hiring one contractor to complete all the work.
- Evaluate different approaches to relocation (keeping the units occupied, phasing relocation, fully vacating the building) and associated costs (staffing, lost rental income, tenant payments, construction costs, loan interest, etc.).
- Hold units vacant at turnover in the months leading up to the rehabilitation to create cost-effective in-house relocation options.
- Some parts of your development budget should not be looked to for savings. Do not skimp on reserves and contingencies. Once rehabilitation is underway, finding additional dollars to cover unexpected costs is difficult.

STEP 8

Identifying Sources of Funds

Goals for Step 8 Identify adequate resources to cover the cost of capital needs and to improve the financial sustainability of the Priority Properties you intend to restructure.

Approach to Step 8 Affordable housing relies on one or more basic restructuring strategies. There is no magic to it, but there can be significant creativity involved in refining and combining these strategies. As your portfolio grows and ages, the need for restructuring will increase, and you will need to expand your toolkit. Having a clear understanding of the three basic strategies may focus your efforts:

1. Improve net operating income (debt capacity) by increasing revenues and/or reducing expenses.
2. Make more effective use of NOI by improving the terms of amortized debt or refinancing to better utilize available income.
3. Fill the remaining gap between sources and uses with one or more equity source or subordinate nonamortizing loan.

In Step 3 we focused on the first strategy: improving net operating income by increasing revenues and/or reducing expenses. In Step 8 we will focus on the second and third strategies. We'll also use case studies to demonstrate how several project sponsors, most located in the Seattle area, combined financing strategies to restructure actual projects.

Sources of Funds
Task 8.1

Make More Effective Use of Available Debt Service

Objectives of Task 8.1 There are two possible goals for a refinance:

- To add additional amortized debt in order to access capital for rehabilitation and replenish reserves, and/or
- To partially pay down existing amortized debt in order to resize debt payments, improve cash flow, and build reserves.

Completing Task 8.1

☑ **Approaches to refinancing.** In Step 5 you completed an analysis of the long-term debt service capacity of each of your Priority Projects. For projects with debt service obligations in excess of payment capacity, you will have to either reduce the debt load or find more favorable loan terms. For properties whose debt payments are easily affordable, you may have the opportunity to take out a new loan and finance improvements.

Here are some things to consider while working with funders during a Restructure:

- ***Begin with the existing lender.*** If the property is not currently performing, expect your existing lender to be both concerned and interested. Your lender is often your most motivated financial partner.
- ***Evaluate prepayment penalties.*** Prepayment penalties can be substantive. If feasible, think about delaying the refinance until the prepayment penalty declines or ends. Alternatively, it may be possible to obtain a penalty waiver or reduction, particularly on a partial pay-down. Talk with your lender about options.
- ***Present an adequate level of rehabilitation for the proposed loan term.*** If the refinance will extend the term of the existing loan or bond, the lender (or bond underwriter) will want to see that your rehabilitation plan ensures that the asset—their collateral and repayment source—will remain marketable for the term of their loan. If the proposed amortization period exceeds the loan term, the lender will want assurances that the property's residual value at the end of the loan term will be sufficient to secure repayment sources. This may preclude or limit your ability to refinance projects involving limited-scope rehabilitations.
- ***Be aware that many permanent lenders don't want to be involved during construction.*** If your property requires substantial rehabilitation, the existing permanent lender may not want to keep its loan in place during the rehabilitation process. (Generally this is not an issue, since larger rehabilitation projects typically incorporate refinancing of the primary debt.)

☑ **Loan options.** The following types of loans and bonds typically offer more favorable terms than those of standard commercial mortgages:

- ***Tax-exempt bonds may provide both lower interest rates and longer amortization periods than commercial loans.*** Generally, the bond principal amount will need to be at least $3 million in order to support bond issuance costs. However, nonprofit bonds, like those offered through the Nonprofit Housing Bond Program in Washington, may be cost-effective for smaller principal amounts.

  The case study below illustrates how a group in Oregon used tax-exempt bonds to restructure a portion of its portfolio, while simultaneously strengthening its organizational balance sheet.

CASE STUDY

Refinancing Multiple Properties with Tax-Exempt Bonds

Central City Concern, Portland, Oregon

Central City Concern (CCC) is a nonprofit agency serving single adults and families who have been impacted by homelessness, poverty, and/or addiction. Founded in 1979, CCC provides affordable housing integrated with services including healthcare, recovery counseling, and employment.

CCC owns or manages over 1,600 residential units in 24 buildings; much of CCC's portfolio consists of alcohol-and-drug-free housing located in refurbished former downtown hotels. Most residents earn less than 30% of area median income and experience multiple barriers to achieving stable housing, including homelessness, chronic unemployment, addiction, and past incarceration.

Providing the intensive social services necessary to transform people's lives means that operating expenses at CCC housing projects are high relative to rents. As a result, CCC's properties can afford little privately financed debt. Most projects are funded with soft subordinated loans provided by the City of Portland. Payment of these loans is contingent on available cash flow.

Over a period of years, the accrued unpaid interest on CCC's public debt was building up large contingent liabilities, impacting the organization's net worth. With operating expenses increasing more quickly than the very-low-income-targeted rents, the portfolio's net operating income was declining over time, making it impossible to repay soft debt or to support additional debt payments. On top of this, the 2008 recession led to a decline in the market value of CCC's property portfolio. Together, these factors were seriously undercutting CCC's ability to leverage private financing for new development activities.

Top right:
The Mark O. Hatfield Building
Bottom left:
The Medford Building

Central City Concern's solution was to bundle and refinance five of its properties, utilizing a tax-exempt bond issued by the Oregon Facilities Authority (OFA) through OFA's Small Nonprofit Accelerated Program (SNAP). SNAP uses standardized documents and a streamlined approval process to underwrite loans of $5M or less, making it a feasible source of financing for smaller borrowers and projects. (Information on a similar financing tool in Washington State, known as the Streamlined Tax-Exempt Placement (STEP) program, may be found at www.wshfc.org/facilities/step.htm.)

Photos courtesy of Central City Concern

Tax-exempt-bond financing presents several advantages for nonprofit borrowers, chief among them better rates of interest. Because the interest that investors receive from tax-exempt bond holdings is not subject to federal tax, investors can charge lower interest while achieving the same after-tax return as they would for a market rate loan. Rates may be 2% to 4% lower than those of comparable private mortgages.

CCC began its feasibility assessment by identifying all properties in its portfolio with existing bank loans at higher than prevailing interest rates. It also completed a global CNA, produced in-house, to assess the capital needs of its entire portfolio.

Through this process, CCC identified several properties as potential candidates for refinance. The candidate pool was limited to projects solely owned by CCC or an entity controlled exclusively by CCC. CCC then eliminated from the pool properties whose refinancing would result in onerous prepayment penalties. The final cut eliminated properties that would be unlikely to generate, through refinancing, enough equity to meet outstanding capital needs. Buildings in good physical condition, with underutilized equity, were thus matched with buildings in need of substantial rehabilitation.

The favorable terms of the SNAP loan enabled CCC to improve the financial performance of the five selected properties and still undertake important rehabilitation. Working closely with their lender, CCC succeeded in securing the loan against two properties rather than all five, enabling the three remaining projects, whose cash flow was relatively constrained, to operate debt-free. To improve organizational net worth, CCC renegotiated a subordinate debt it owed to the City of Portland. The City reduced the interest rate charged to CCC to 0% and forgave a portion of the outstanding accrued interest.

CCC's experience highlights the importance of structuring public financing in a way that strengthens nonprofit sponsors over the long term and positions them to leverage essential private dollars. Through a creative collaboration among CCC, the City of Portland, and CCC's private lender, CCC was able to address the critical needs of these properties without having to tap into scarce additional public dollars.

Above:
The Sally McCracken Building

Bottom:
The Butte Hotel

- ***Sponsor loans are the simplest refinancing solution available.*** Putting your own organization's assets into a project requires limited approvals and is generally under your own control. Other funders look favorably on sponsors who put their own assets into a project, making those funders more likely to partner with you. The case study on the following page describes how Capital Hill Housing (CHH) used the City of Seattle's Transfer of Development Rights Program to capitalize a replacement reserve, then lent proceeds from that reserve to another property to pay off a high-interest mortgage.

- ***Federal loan-guarantee programs are another excellent loan option.*** HUD's 221(d)(3) program offers loan guarantees for nonprofit housing developers. This guaranteed loan usually comes with a low interest rate, since the lender's risk is lower than a standard commercial mortgage lender's. Loans can be amortized up to 40 years, impose no tenant maximum-income restrictions, and can cover up to 100% of the replacement cost of the property. Applicants work with an approved lender who is responsible for submitting required preapplication exhibits to HUD. To find an approved lender, contact your local HUD office. You can also find out more about the program on HUD's website, found online at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/progdesc/rentcoophsg221d3n4.

Residents at Plymouth on Stewart, a project of Plymouth Housing Group

CASE STUDY

Out-of-the-Box Solutions: Capitol Hill Housing

Capitol Hill Housing

Capitol Hill Housing is one of the largest affordable-housing providers in the Seattle area. Founded in 1976, the nonprofit organization owns a substantial portfolio of 42 buildings, concentrated mostly in the diverse and vibrant Capitol Hill neighborhood. In the 1980s and 1990s, Capitol Hill Housing facilitated a mutual-housing program, which provided opportunities for local residents to manage and maintain their own units through cooperative arrangements. Several years ago, CHH converted those properties to rental units; the new financing structure did not adequately address long-term capital needs. Capitol Hill Housing's rental portfolio now includes 27 of these aging properties. Nineteen of the 27 buildings have fewer than 30 units; 11 of these have fewer than 20 units.

One of the properties, Byron Wetmore, faced a balloon payment of approximately $100,000. Not having enough cash to pay it off, Capitol Hill Housing had to come up with another strategy. LIHTCs weren't an option: with only 12 units, the property was too small to warrant the up-front costs of resyndication. The net operating income on the property was trending downward (as is typical for smaller, aging properties serving low-income residents), which prevented commercial refinancing.

Capitol Hill Housing owned several other properties burdened with immediate capital needs, including Gale Place (24 units) and Elizabeth Dean Wells (5 units). Altogether, the three properties—Byron Wetmore, Elizabeth Dean Wells and Gale Place—had immediate repair needs of roughly $300,000 and were required, according to restrictions imposed by the City of Seattle, to remain affordable for another 30 years.

Capitol Hill Housing's diverse portfolio also included a historic property, the Devonshire, which had excess development rights under the City of Seattle's Transfer of Development Rights (TDR) program. Given the Devonshire's historic significance, Capitol Hill Housing had no intent to redevelop the property or to use the excess development rights to add more units. CHH decided instead to sell the Devonshire's development rights through the Seattle TDR program and to put the funds into a new reserve account.

Because the Devonshire was subject to regulations imposed by the City of Seattle's Office of Housing, using the new reserve account required City approval. Capitol Hill Housing provided an analysis of Devonshire's replacement needs that confirmed that the Devonshire had no immediate capital repair needs. With the City's permission, Capitol Hill Housing instead used the new reserve fund to pay off the Devonshire's private mortgage and fund immediate capital improvements at all four properties. The Devonshire will rebuild its reserves with its own cash flow and with loan payments from the three rehabbed properties.

This low-cost, internal, out-of-the-box solution allowed Capitol Hill Housing to preserve dozens of affordable-housing units. The recipient properties are now in better shape, both physically and financially, than they were before. Additionally, while the properties shared funding, all the previously existing legal ownership structures remained separate and intact.

Sources of Funds

Task 8.2 Bringing in New Dollars

Objective of Task 8.2 Identify sources of funding to cover the full cost of your Restructure.

Completing Task 8.2 Amortizing debt rarely covers the full cost of any affordable-housing project, and Restructures are no exception. Small and special-needs properties often can't support any debt at all. Funding gaps have to be covered through a combination of equity, grants, and cash-flow-contingent or subordinate loans. Following are some sources worth considering:

- ☑ **Project reserves.** Existing project reserves, both operating and replacement, can sometimes be used to pay for either predevelopment or rehabilitation costs. Keep in mind that for larger rehabilitations especially, funders typically require that reserves be recapitalized as part of the Restructure; therefore, using reserves may provide interim financing only.

- ☑ **Sponsor equity.** Given the number of affordable-housing properties that need restructuring, public funders are generally favorably disposed toward sponsors who participate financially in the restructuring effort. Options for sponsors include dedicating cash resources, fundraising, taking lower development fees (or contributing them back to the project at a later date), and disposing of other properties.

- ☑ **Governmental subordinate loans or grants.** Washington State and the City of Seattle offer a number of different funding programs for housing, including the Housing Trust Fund, the Seattle Housing Levy, HOME, and CDBG. Most developers are probably familiar with these programs. Following are a few considerations to keep in mind, should you wish to request a second round of government funding for a project that's already received public dollars in the past.

    - The HOME program disallows HOME-funded projects to access additional HOME funds within the federal compliance period. Your local HUD office can sometimes approve exceptions to this rule, however.

    - Unless your local jurisdiction has adopted more restrictive policies, Community Development Block Grant funds may be used more than once on eligible properties.

- State and local housing finance agencies may have specific requirements and procedures for applying for additional funding. Check with each funder for details. For instance, the Seattle Office of Housing has an Administrative and Financial Plan with specific criteria related to supplemental funding of projects previously funded by the City.
- Weatherization and other grant programs offered by local utilities often direct their resources to low-income households.
- HUD recently issued "emergency" grants for existing HUD 202 projects. If you have a HUD-funded project, contact your local HUD office to see if your project qualifies for special programs such as this one.

☑ **Syndication or resyndication using Low Income Housing Tax Credits (LIHTCs).** Restructure projects that require significant rehabilitation ($50,000 - $80,000 per unit) may need to consider applying (or reapplying) for LIHTCs. LIHTC equity provided through a 9% competitive allocation can fund as much as 65% of a property's restructure costs. Noncompetitive 4% LIHTCs tied to a new tax-exempt bond (under the state volume cap) provide less equity—they cover approximately 35% of costs— but are still an option to consider, particularly if the project qualifies for acquisition credits. Policies on using LIHTCs to fund existing affordable housing differ among state housing finance agencies. The Washington State Housing Finance Commission's current project ranking and credit set-asides can be found at www.wshfc.org/tax-credits/index.htm.

- ***Federally subsidized preservation projects.*** Many state housing finance agencies (HFAs) have created specific programs and LIHTC set-asides to encourage the preservation of projects reaching the end of HUD rent-subsidy contract periods. Contact Washington State Housing Finance Commission for set-aside details.
- ***Year 15 and beyond.*** Existing LIHTC projects that have completed their initial compliance period (Year 15) may be eligible for both acquisition and rehabilitation credits. If the project was originally financed with tax-exempt bonds and 4% LIHTCs, and if you are hoping to resyndicate using 9% LIHTCs, it is critical to avoid making a material modification to the original bond terms during restructuring, as this could jeopardize a new 9% allocation. Consult tax counsel for how this might affect your project.

Hint

Avoid snags with allocations of LIHTCs

- Projects receiving an additional LIHTC award will begin a new Initial Compliance Period, but will still be required to meet the remaining Extended Use Period requirements of the initial allocation. Consult tax counsel when negotiating a new partnership to make sure you don't violate existing agreements.
- Also consult with tax counsel on LIHTC tenant income requirements for existing residents during resyndication.

- ***Prior to Year 15.*** Projects that are still within their initial compliance period may apply for a new LIHTC allocation solely for new rehabilitation and related expenditures, but are not eligible for acquisition credits. Generally, HFAs will only consider awarding a new allocation of tax credits prior to Year 15 if the project is severely at risk. Options for securing an investor during this period are also limited; generally, the original investor must agree either to exit the partnership early or to stay in and acquire the additional credits.

☑ **New Markets Tax Credits (NMTC) for Mixed-Use Properties.** New Markets Tax Credits, administered through the U.S. Department of Treasury's Community Development Financial Institutions Fund, may be a potential source of equity for commercial properties, including nonprofit community facilities, and for mixed-use properties. The purpose of the NMTC program is to provide capital for investments in low-income communities, and the program provides a credit against federal tax obligations. Credits are awarded to community development entities (CDEs), which in turn allocate NMTCs to parties that invest in projects serving low-income communities. The investors receive the credits over a seven-year period.

NMTCs may be unfamiliar to many affordable-housing organizations; if you wish to make use of the program, we recommend seeking advice from legal counsel with prior NMTC experience. The following general information may help you determine whether NMTCs are an option for your project:

- The New Markets Tax Credit program is an economic development program. As a consequence, there are restrictions on the percentage of project revenues that can come from residential uses (consult legal counsel familiar with the NMTC program for details). As well, most NMTC investors want to invest in properties in designated "hard to develop" areas; check the Novogradac & Company website for these locations: http://www.novoco.com/new_markets/index.php.
- NMTCs cannot be used on a project that is also making use of Low Income Housing Tax Credits—unless the project's commercial component and its LIHTC-funded units are owned by different entities.
- Many NMTC investors consider $10 million in sources (excluding the NMTC equity) to be a good transaction size, and few NMTC investors are interested in projects using less than $5 million in allocation.

Historic Tax Credits. The Federal Historic Preservation Tax Incentives program provides equity for the rehabilitation of historic properties. This program is administered through the National Park Service, in partnership with the Internal Revenue Service and with state historic preservation offices (SHPOs). Historic Tax Credits provide a federal tax credit equal to 20% of the certified rehabilitation costs of the project seeking funding, and because the credits may be taken in a single year they are generally very attractive to investors. Using this program offers two significant advantages to affordable-housing projects:

- Historic Tax Credits may be taken for both commercial and residential rehabilitation costs.
- Historic Tax Credits may be combined with NMTCs or LIHTCs (however, your LIHTC-eligible basis will be reduced to account for the value of Historic Tax Credits attributable to residential rehab costs).

Details about the program can be found here: www.nps.gov/tps/tax/incentives/application.

If you plan to pursue Historic Tax Credits, we recommended that you work with a historic preservation consultant and/or an architecture team experienced with the program. The case study below describes how one nonprofit sponsor used both New Markets and Historic tax credits to restructure and rehabilitate a historic mixed-use affordable-housing property in downtown Seattle.

St. Charles Apartments, a project of Plymouth Housing Group

CASE STUDY

Using New Markets and Historic Tax Credits to Upgrade New Central Hotel

New Central Hotel

In 2006, the Seattle Chinatown International District Preservation and Development Authority (SCID PDA) faced an intractable challenge: how to raise enough capital to buy out the New Central Hotel's high-yield investors and complete $3 million in renovations—without saddling the historic property with too much debt.

SCID PDA had been trying for years to solve this problem. When New Central Hotel was originally converted to affordable housing in 1983, it was overleveraged. The property had a Section 8 contract whose subsidies covered operating costs. But every year the project's investors took a distribution of roughly $40,000 from project cash flow, so the property had no money available to make capital improvements or pay down debt.

The project's senior tenants didn't cause much wear and tear on the 29 residential units, but the apartments were dated. The building needed life-safety repairs, elevator upgrades, and energy improvements including a new central hot-water boiler, new windows, and new insulation. Meantime, a bridge loan from the Seattle Office of Housing was coming due. Given all these challenges, the property was negatively impacting SCID PDA's balance sheet.

SCID PDA considered seeking an allocation of Low Income Housing Tax Credits, but rejected the idea for several reasons: the cost of the buyout was too high, the number of affordable rental units was too small, and almost 50% of the building area was devoted to commercial space. Only the cost of the residential portion of a rehab counts toward LIHTC basis; therefore, an LIHTC transaction wouldn't generate enough funds to solve the project's financial problems.

SCID PDA instead chose to generate equity using New Markets Tax Credits (NMTCs) in conjunction with Historic Tax Credits (HTCs). NMTCs are intended to spur economic development and job growth in distressed neighborhoods. They are not targeted for housing development, but they can be used in mixed-use projects where at least 20% of gross income comes from commercial uses. New Central's large commercial component, the fact that the property was a listed historic structure, and the infeasibility of using LIHTC all were factors making NMTC financing a good choice.

The final funding sources for New Central's rehabilitation included a $3.2-million loan from Key Bank, a $3.4-million equity contribution from Key CDC, and a $1.1-million loan from the Seattle Office of Housing. Foreclosure by any lender during the seven-year NMTC tax investment period would jeopardize the tax credits. It took some time for the Seattle OH to get comfortable with a security position that did not include a deed of trust on the property.

In the end, the New Central restructure met SCID PDA's goals. With the previous investors bought out, more cash is staying with the project, and the apartments have many added years of useful life.

STEP 9

Disposition, Transfer, and Redevelopment

Goal for Step 9 Evaluate the merits and feasibility of disposing of the properties you identified in Step 6 as candidates for disposition, transfer, or redevelopment.

Why is this important? For those who've invested great effort to develop a housing portfolio, the decision to dispose of even a single property may be difficult. Getting rid of a property can be emotionally hard for those within your organization who've owned and managed the property over a long period of time. Finally, and most importantly, residents may be forced to move, suffering financial impact and loss of community.

Nonetheless, sometimes letting go of a property is the best way to ensure the sustainability of both your portfolio and your organization. Nationally, project sponsors are increasingly including disposition as a necessary Preservation strategy.

Dispositions

Task 9.1 Dispositions

Objective of Task 9.1 For each property you are considering for disposition or redevelopment, compile and evaluate the data that will inform your decision.

Completing Task 9.1 Work through the following steps to determine the best outcome for any property you are considering for disposition/ redevelopment.

- ☑ Define the outcomes you hope to achieve through disposition. Is the primary goal to secure cash to invest in another property? Or is it to rid yourself of a property that no longer meets your organizational objectives?
- ☑ Confirm that you are prepared to demonstrate to investors and other stakeholders that (a) your organization has made significant efforts to improve operations; and (b) holding on to the property is not financially practical; and (c) there are advantages to pursuing other options.
- ☑ If there are rent subsidies attached to the property, consider the impact to the community if the building were to be torn down or sold. Would the subsidy be lost?

Hint

Handle dispositions with care

- Though sometimes useful and necessary, property dispositions may requires approvals and may raise concerns within the affordable housing community. Work to maintain confidentiality until you have made a final decision.
- If any board member has a conflict of interest regarding a property being considered for disposition, make sure he or she declares the conflict and abstains from discussions and decisions that affect the property.

A Note on Dispositions

Dispositions are difficult. They can be time-consuming and emotionally draining for staff. But the payoffs are often worthwhile. Clearing away properties that don't serve your portfolio will strengthen your organization. Think of disposition as a pruning process: cutting away ailing or misaligned branches to create a flourishing and healthy plant.

- ☑ Review the rights and interests of each of your funding partners, as well as the rights of your organization, with respect to the following:
  - What are the terms and funder approval requirements related to disposition?
  - How does the property's estimated value compare to the value of your lenders' outstanding principal balances?
  - Are there any guarantees that your organization will be obligated to fund if you dispose of a property?
  - What regulatory requirements will still apply to the property, even if it is sold or demolished?
  - What are your funders' key interests respecting the property? What risks do they face? Can you make the case that disposition/ redevelopment will realize the best possible benefit for your funders?
- ☑ Review all of the information you have gathered on the property. Consider why the property is not working for your organization and what the impact of disposition will be. Make a decision to sell it, transfer it, or demolish the structure and rebuild. Here are a few things to consider:
  - If it is too expensive or complicated to get out from under funder restrictions, consider delaying the disposition.
  - If the location of the property is a valuable asset, but the building is not, demolition and reconstruction may be the best option.
  - If you want to sell it, will the proceeds from the sale be sufficient to pay off all the property's liabilities?
  - If a sale is not an option, but the property is in relatively good condition, consider a transfer to another nonprofit that might welcome an opportunity to assume ownership with no disruption to current residents.

Dispositions

Task 9.2 Redevelopment

Objective of Task 9.2 Create an action plan for each site you've targeted for redevelopment.

Completing Task 9.2 If the balance of evidence reviewed in Task 9.2 points toward redeveloping one or more of the buildings you own, commence the following actions for each:

- ☑ Work with an architect and contractor to evaluate the site's development potential.

- ☑ Define program objectives for the redevelopment that align with your organization's mission and financial goals.
- ☑ Develop a summary-level sources and uses budget to determine if your plan is feasible.

Dispositions

Task 9.3 Transfers

Objectives of Task 9.3 Create an action plan for each site you've targeted for transfer to another nonprofit owner.

Completing Task 9.3 Transferring an existing property to another sponsor both preserves the housing and strengthens your portfolio. Here are some things to consider while exploring the transfer option.

- ☑ It may make sense to transfer a property if the following conditions apply:
  - Your organization does not have the expertise to serve the population that lives there.
  - Your organization does not have the current financial or staffing capacity to address issues, while another organization may.
  - The project is located ouside of your defined geographic area.
  - The building type is distinctly different from organization's typical housing model (i.e., it's a single-family home, whereas your other properties are large downtown buildings).
- ☑ No organization wants to take on a property that will be a financial drain. You can only transfer properties that will benefit someone else.
  - It's a good idea to talk with your public funders about why you want to transfer the property. They may be able to suggest organizations that are well positioned to take ownership. Note that the Seattle Office of Housing has published guidelines on transfers of ownership.
  - Expect that prospective owners will complete due diligence and look for positive aspects such as transfer of reserves and high occupancy. Be open to a cooperative negotiation that provides a "win-win" going forward.
- ☑ You should be completely honest with prospective buyers. Share your financials and your reasons for wanting to get rid of the property.

CASE STUDY

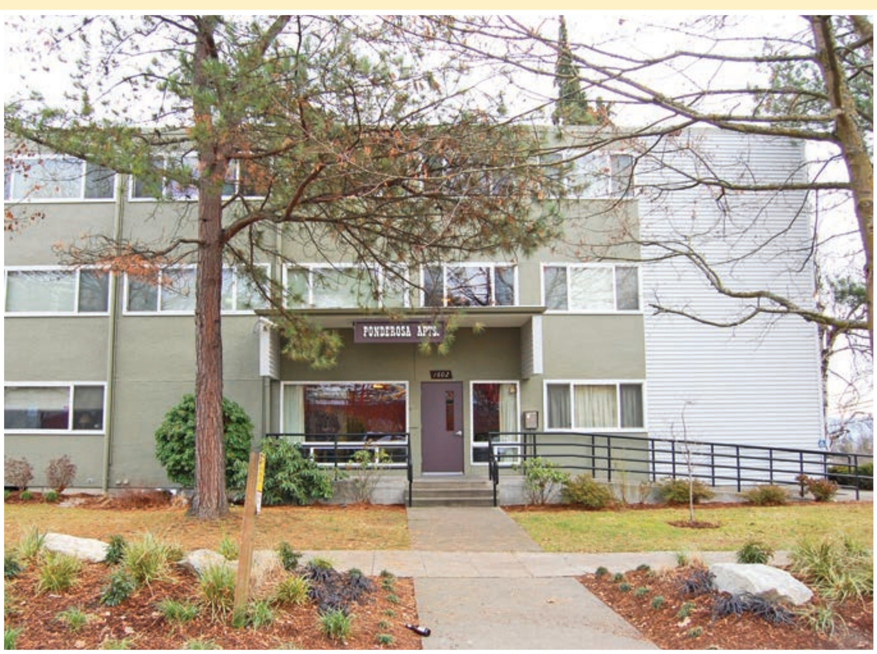
Transferring a Property to Another Nonprofit Owner

Capitol Hill Housing and the Ponderosa Apartments Acquisition

Capitol Hill Housing (CHH) is an affordable-housing agency whose mission is to provide housing and preserve neighborhood character in Seattle. Founded in 1976, CHH owns 42 buildings that are concentrated in the diverse and vibrant Capitol Hill neighborhood. The organization is dedicated to providing clean and affordable apartments where individuals and families can live comfortably despite Seattle's rising cost of living.

Among the properties CHH owns are nine projects that have HUD rental assistance contracts. In 2007, CHH was approached by another Seattle nonprofit, Plymouth Housing Group (PHG); PGH wanted to know whether CHH would be interested in taking ownership of Ponderosa Apartments, a HUD-financed, rent-subsidized project.

PHG wanted to transfer the property for two main reasons: 1) Ponderosa was the only property in PHG's portfolio overseen by HUD's Contract Management Services, and the administrative costs of complying with HUD requirements were unjustifiably high for a single project to bear; 2) Ponderosa was located in the Capitol Hill area, whereas most of PHG's properties were located downtown. CHH appeared to be a better match for Ponderosa, because the property was located in CHH's primary service area, and CHH had the necessary expertise to handle both the project's financing and the needs of the low-income residents.



After completing a preliminary assessment, CHH staff secured board approval for the transfer. Staff then undertook a full review of Ponderosa's financial and physical condition; satisfied with the results, CHH took over Ponderosa in the fall of 2008. The transaction primarily entailed CHH assuming the property's existing debt. CHH paid the costs associated with the transfer, and the existing replacement reserve accounts, worth $250,000, remained with the property.

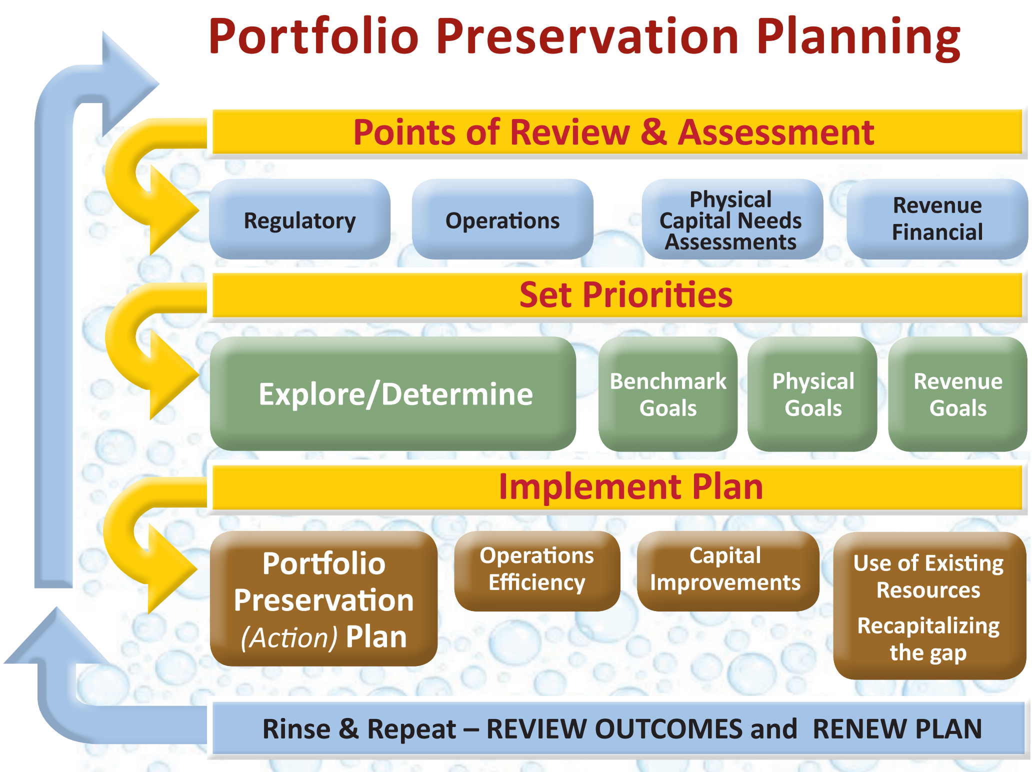
Helping to smooth the transition, CHH retained Ponderosa's existing property manager. To create economies of scale, CHH also combined Ponderosa's operations with those of a small CHH-owned property across the street. In 2009-10, CHH accessed some of the property's reserves to undertake exterior improvements. These improvements included painting, building an accessible patio, and installing raised garden beds and improved landscaping.

Both CHH and PHG are pleased with the transfer. Ponderosa fits well within CHH's portfolio, and PHG is assured that this important, federally subsidized property will remain affordable for many years to come.

Conclusion

Creating a Preservation Plan is only the first step to owning a healthy affordable housing portfolio. However carefully you plan, tomorrow will present new challenges and fresh opportunities. The key to ensuring ongoing success lies in diligent asset management.

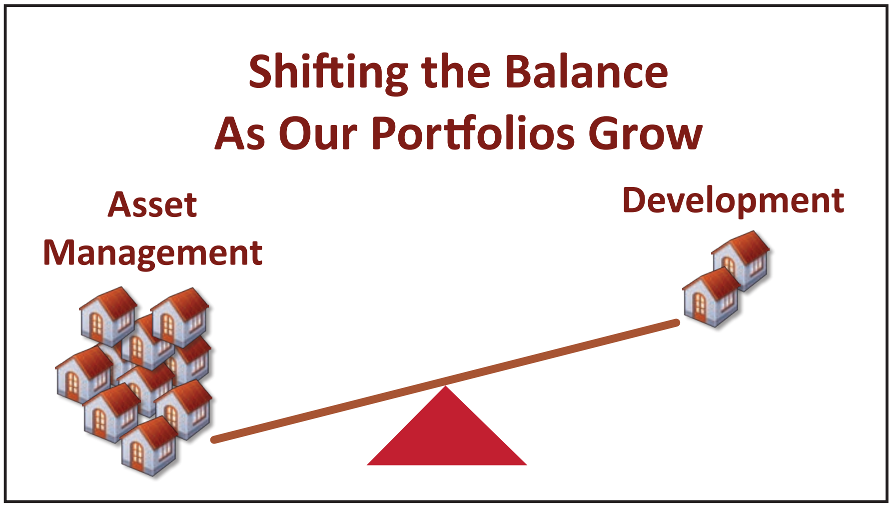
Remember this graphic from Chapter 1?



This graphic illustrates the essence of asset management work. "Rinse and repeat" represents the iterative and dynamic nature of asset management: assess your portfolio, set priorities, implement a plan, and then start assessing all over again. Every organization has to develop systems that allow it to continually evaluate its properties, make adjustments early, and plan for upcoming milestones. The steps in this Guide can help you create those systems, but it is up to you to incorporate them into your agency's daily life.

Moving Forward

As an industry, affordable housing is in the midst of a major shift. Organizations are reprioritizing their goals, with a more balanced emphasis on both development and long-term ownership; they're becoming asset managers, committed to preserving existing projects and growing their portfolios. Creating a Portfolio Preservation Plan is important work, which this Guide aims to support. Preservation work might be less glamorous than attending a grand opening for a new project, but it is no less vital for your organization's overall success.



The industry's mission remains the same as before: providing high-quality, affordable homes to low-income households; but our aging and growing portfolios require attention in order to meet the challenge of preserving our existing housing resources. Success will be measured by how well we sustain our current housing without dramatically undermining our ability to produce new units for more low-income individuals and families. Being successful will mean giving attention to a thousand things, month after month after month, so that everyone in our community has a place to call home. It's important work. The future is determined by the actions we take now.

Appendix A

Low Income Housing Tax Credit Year 15 Analysis

Overview

Planning for the exit of the LIHTC investor really begins during the negotiation of the limited partnership agreement when critical terms like the general partner's rights to acquire the property or the investor's interest in the partnership at the end of the initial 15-year tax credit compliance period, are agreed upon. It's important to understand, through a careful reading of the partnership documents, the tax benefits the investor anticipates from its ownership of the property and the critical milestones by which it expects to have received those benefits, and to monitor the project's financial performance accordingly. By ensuring the property performs according to initial expectations, the nonprofit sponsor may prevent a reduction in benefits or a tax liability to the investor. Since the sponsor has guaranteed to either deliver credits, or in some cases, ensure the investor a certain rate of return, planning and financial management are critical to the financial health of the sponsor and the property.

Word of Caution

The following illustration is made to familiarize you with some of the most critical aspects of financial monitoring on an LIHTC-financed project. It is in no way intended as a substitute for the services of a qualified tax accountant well-versed in the provisions of the LIHTC program. Track the project's financial data, monitor the limited partner's return, but by all means verify your conclusions with your tax accountant before relying upon them for purposes of discussing the project or potential exit strategies with your limited partner.

Also note that while people generally talk about Year 15 as the end of a partnership, in reality a limited partner is allowed to exit the partnership any time after the 10th year of initial compliance.

The Year 15 transition plan for the property needs to consider both the:

- ***Exit of the Investor from the Limited Partnership***, either through a third-party purchase of the property, acquisition by the project sponsor, or purchase of the investor's interest in the partnership.

- ***Positioning the Project for Continued Performance*** as affordable housing through the LIHTC Extended Use Period and beyond. This includes completing capital improvements, replenishing reserves, and refinancing loans that are maturing or have unfavorable terms.

Monitoring the Investor's Capital Account, Exit Taxes, Credits, and Benefits

If the partnership agreement includes a right of first refusal to the nonprofit sponsor, this will grant the sponsor the right to acquire the property at the end of Year 15 for a purchase price equal to the lesser of fair market value or "debt plus taxes." In this equation:

> **The "debt"** in this equation includes all loans secured by the project, including loans from the general partner, and any accrued interest. Upon transfer, the debt will have to be assumed or refinanced by the new owner. Alternatively, the limited partner can step out of the partnership by transferring its interest to a substitute limited partner designated by the general partner. In this situation, ownership of the property remains the same and the existing debt remains in place.
>
> **The "taxes"** portion of the equation includes any federal, state, or local taxes "attributable to such sale."

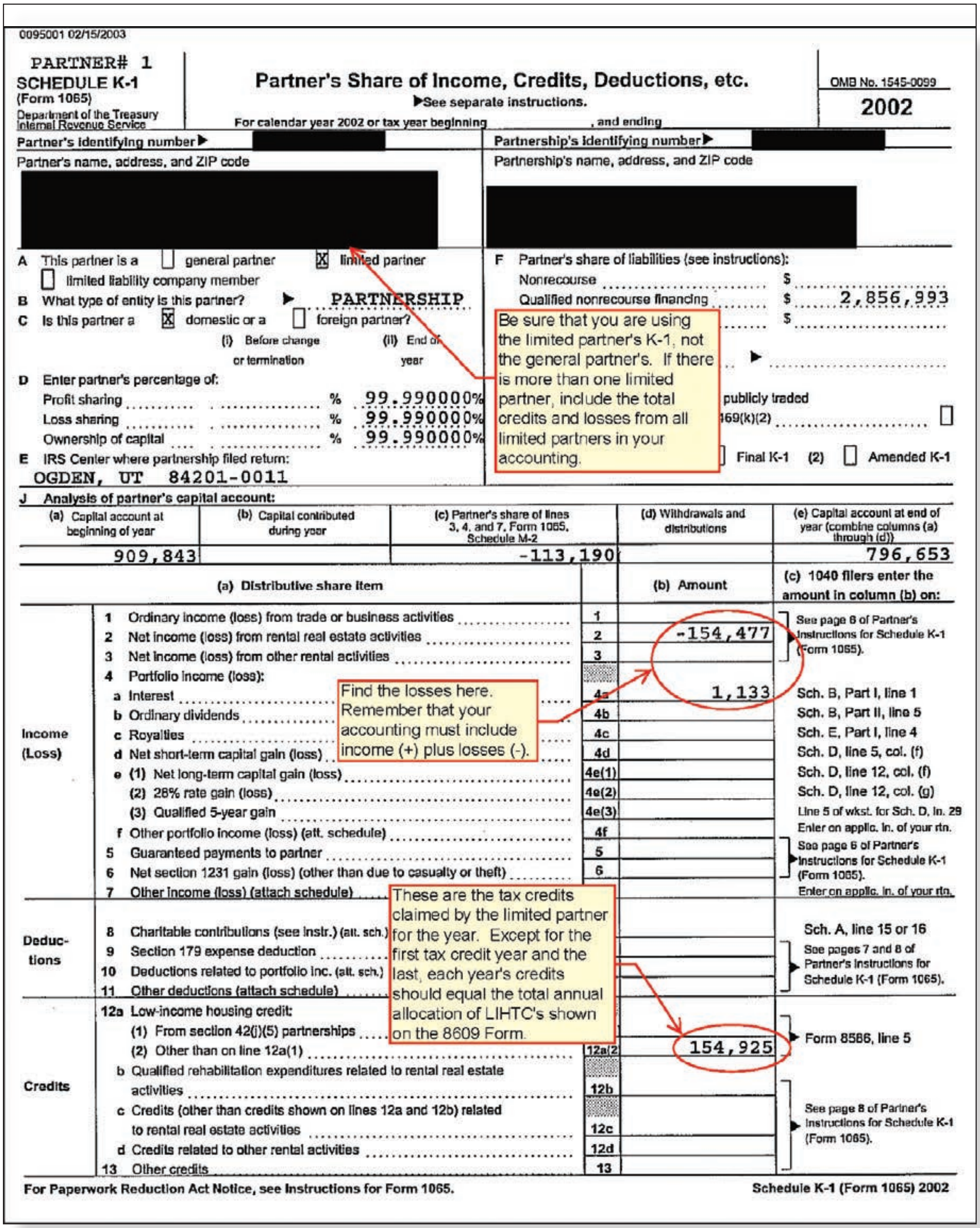
The LIHTC investor provides capital for development costs primarily in return for a stream of tax benefits. In a partnership, the benefits of ownership are distributed based on the ownership percentage (e.g., the investor owns 99.99% and therefore realizes 99.99% of the benefits). Benefits include tax credits against the investor's federal tax obligation, taken over the project's 10-year tax credit delivery period. The investor also receives the tax benefit of losses, in the form of both operating losses and depreciation. The ***capital contribution*** of the limited partner establishes its ***capital account*** in the partnership, from which cumulative losses are deducted to derive the partner's ***capital account balance***:

$$\text{Capital Contributions} - \text{Losses} = \text{Capital Account Balance}$$

If cumulative losses allocated to the limited partner exceed its capital contributions, the limited partner will have received an excess tax benefit and may have to recognize its gain as taxable income. In this case, the limited partner would owe "exit taxes" on its gain upon leaving the partnership or upon sale of the property.

Determining the Investor’s Capital Account Balance

The limited partner’s capital account balance can be monitored, and potential exit tax liability estimated, by tracking this information from the K-1 Form for the limited partner, found in the annual partnership tax return (see line J: Analysis of partner’s capital account).



0095001 02/15/2003

PARTNER# 1
SCHEDULE K-1 (Form 1065)
Department of the Treasury Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.
▶See separate instructions.
For calendar year 2002 or tax year beginning , and ending

OMB No. 1545-0099
2002

Partner's identifying number ▶ [redacted]
Partnership's identifying number ▶ [redacted]

Partner's name, address, and ZIP code
[redacted]

Partnership's name, address, and ZIP code
[redacted]

A This partner is a ☐ general partner ☒ limited partner ☐ limited liability company member
B What type of entity is this partner? ▶ PARTNERSHIP
C Is this partner a ☒ domestic or a ☐ foreign partner?
D Enter partner's percentage of: (i) Before change or termination (ii) End of year
Profit sharing % 99.990000%
Loss sharing % 99.990000%
Ownership of capital % 99.990000%
E IRS Center where partnership filed return: OGDEN, UT 84201-0011

F Partner's share of liabilities (see instructions):
Nonrecourse $
Qualified nonrecourse financing $ 2,856,993
$

Be sure that you are using the limited partner's K-1, not the general partner's. If there is more than one limited partner, include the total credits and losses from all limited partners in your accounting.

publicly traded
469(k)(2) ☐
Final K-1 (2) ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
909,843		-113,190		796,653

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2 Net income (loss) from rental real estate activities	2	-154,477	
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a	1,133	Sch. B, Part I, line 1
	b Ordinary dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f)
	e (1) Net long-term capital gain (loss)	4e(1)		Sch. D, line 12, col. (f)
	(2) 28% rate gain (loss)	4e(2)		Sch. D, line 12, col. (g)
	(3) Qualified 5-year gain	4e(3)		Line 5 of wkst. for Sch. D, ln. 29
	f Other portfolio income (loss) (att. schedule)	4f		Enter on applic. ln. of your rtn.
	5 Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	6 Net section 1231 gain (loss) (other than due to casualty or theft)	6		
	7 Other income (loss) (attach schedule)	7		Enter on applic. ln. of your rtn.
Deductions	8 Charitable contributions (see instr.) (att. sch.)	8		Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	10 Deductions related to portfolio inc. (att. sch.)	10		
	11 Other deductions (attach schedule)	11		
Credits	12a Low-income housing credit:			
	(1) From section 42(j)(5) partnerships	12a(1)		Form 8586, line 5
	(2) Other than on line 12a(1)	12a(2)	154,925	
	b Qualified rehabilitation expenditures related to rental real estate activities	12b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c		
	d Credits related to other rental activities	12d		
	13 Other credits	13		

Find the losses here. Remember that your accounting must include income (+) plus losses (-).

These are the tax credits claimed by the limited partner for the year. Except for the first tax credit year and the last, each year's credits should equal the total annual allocation of LIHTC's shown on the 8609 Form.

For Paperwork Reduction Act Notice, see Instructions for Form 1065. Schedule K-1 (Form 1065) 2002

The following are the loss figures for the limited partner in the project represented by the K-1 Form on page 49, through the 10th year of its Initial Compliance Period.

Tax Credit Year	Capital Contributions (A)	Losses from Tax Returns (B)	Capital Account (A-B)
1	1,329,910	251,331	1,078,579
2		184,673	893,906
3		153,344	740,562
4		144,868	595,694
5		149,455	446,239
6		159,092	287,147
7		97,846	189,301
8		124,806	64,495
9		21,132	43,363
10		14,476	28,887
11			
Totals	**1,329,910**	**1,301,023**	**28,887**

Even though tax credits are claimed in the first 10 years after the project was placed in service, usually the credits will show up on the investor's K-1 Form for the first 11 years. That's because it's highly unlikely that any project would be placed in service on January 1, allowing the investor to claim 10 years of equal credit. More likely, the investor will claim a partial year of credits through December 31 of the first tax credit year, an amount equal to the annual allocation for the next 9 years, and the balance in year 11. An exception to this general rule occurs when the project was placed in service late in the year. In this case, the investor may defer taking credits until the following year, claiming an equal amount of credit for a full 10 years.

We can now add another column to our chart, tracking the limited partner's tax credits claimed in years 1 through 10, with the amount needed to claim the remaining allocation of credits in year 11 shown in red:

Tax Credit Year	Capital Contributions (A)	Losses from Tax Returns (B)	Capital Account (A-B)	Tax Credits Claimed (C)
1	1,329,910	251,331	1,078,579	111,247
2		184,673	893,906	154,942
3		153,344	740,562	154,942
4		144,868	595,694	154,942
5		149,455	446,239	154,942
6		159,092	287,147	154,942
7		97,846	189,301	154,942
8		124,806	64,495	154,942
9		21,132	43,363	154,942
10		14,476	28,887	154,942
11				**43,695**
Totals	**1,329,910**	**1,301,023**	**28,887**	**1,549,420**

Based on previous trending, it's highly likely that losses in the 11th year would cause the limited partner's capital account to become negative, unless special measures are taken. There are a number of strategies that can be used to limit the impact of negative capital accounts, but ***none of these strategies should be considered without the advice of tax counsel and accountants.*** Every project is different and subject to unique criteria. What might be a good solution in one situation could have significant negative consequences in another.

Estimating Tax Obligation

Since the goal is to avoid paying exit taxes to the investor when it exits, your task as an asset manager is to monitor losses, recognize when exit taxes might become an issue, and then take steps to limit them. Ask your tax accountant to help you calculate exit tax liability before you need to discuss it with the investor. You can arrive at a rough estimate of the investor's tax liability by using the following equation:

Exit Tax = (Capital Account Balance) x (Investor's Tax Rate) x (One "Gross Up")

Adding the gross up is necessary because the taxes paid to the investor will represent additional income, upon which taxes will also be due. As an example, a capital account balance of negative $50,000 for an investor at the 35% corporate rate will result in exit taxes of approximately $24,000, as follows:

Exit Tax = -$50,000 x 0.35 x 1.35 = -$23,625

The LP's Return on Investment

The last critical piece of information that you should be monitoring is the total benefits delivered to the LP investor. Partnership agreements may refer to this by various terms, including "Priority Return" or "Total Benefit Amount." In any case, the concept is the same: In executing the partnership agreement, the general partner has guaranteed a return to the limited partner. Once you have accounted for the losses and credits allocated to the limited partner, you can calculate the net present value of their benefits based upon a discount rate established by the partnership agreement. Building upon our example:

Tax Credit Year	Capital Contributions (A)	Losses from Tax Returns (B)	Capital Account (A-B)	Tax Credits Claimed (C)	Actual Loss Benefits* (D = B x 0.35)	Total Benefits (C+D)
1	1,329,910	251,331	1,078,579	111,247	87,966	199,213
2		184,673	893,906	154,942	64,636	219,578
3		153,344	740,562	154,942	53,670	208,612
4		144,868	595,694	154,942	50,704	205,646
5		149,455	446,239	154,942	52,309	207,251
6		159,092	287,147	154,942	55,682	210,624
7		97,846	189,301	154,942	34,246	189,188
8		124,806	64,495	154,942	43,682	198,624
9		21,132	43,363	154,942	7,396	162,338
10		14,476	28,887	154,942	5,067	160,011
11				43,695		
Totals	**1,329,910**	**1,301,023**	**28,887**	**1,549,420**	**455,358**	**1,961,085**

* Represents actual tax benefits of losses allocated to the limited partner at the 35% corporate tax rate.

At a 14% discount rate, the net present value of the total benefits delivered to the limited partner through the first 10 years equals $1,048,188.

Monitoring Accounts

HDC recommends that you work with your tax accountant on the following list annually, but especially when you get to Year 10.

- ***Total Investor Benefits.*** The investor has projected an expectation of return on its initial investment. It's important to know whether the project has achieved or exceeded that return when formulating your exit strategy. It is also critical to know whether you, as the general partner, have guaranteed this return in the partnership agreement. It will be important to communicate with the investor to ensure that the project delivers credits and losses necessary to meet this return, while managing the potential for exit taxes.
- ***Tax Credit Delivery.*** You should monitor capital accounts throughout the tax credit compliance period. If it appears that the investor's capital account will become negative before Year 10, consult your tax accountant to ensure there are no issues related to delivery of tax credits. Generally, credit delivery must follow allocation of certain types of tax losses, and the allocation of losses may be affected by the relative relationship of the general partner and the investor's capital accounts. It is important that you monitor this because you have guaranteed credit delivery to the limited partner, and the condition of the capital accounts at the time the investor exits the partnership will determine whether the exit transaction is a taxable event.
- ***Projected Exit Taxes***. When monitoring capital accounts, evaluate both the current exit tax obligation and the projected exit taxes at the time you intend for the limited partner to exit the partnership.
- ***Plan and Implement a Strategy to Limit Exit Taxes***. If the investor's capital account balance looks like it will be negative by Year 15, work with your tax accountant to identify and propose strategies to your investor to reduce the exit tax obligations starting in Year 11. Strategies could include improving operations to reduce operating losses, forgiving debt, reallocating certain classes of losses to the general partner, capitalizing rather than expensing repairs, exiting the investor prior to Year 15, or other tax strategies outlined by a tax accountant knowledgeable in the LIHTC program. ***DO NOT take any of these steps without first discussing them with your tax accountant.*** Ill-advised changes in property operations or financials can have devastating consequences down the line.

Negotiating With Your Investor

Negotiating with your investor will proceed most favorably if you are prepared: know what you want and know as much as you can about the investor's interests. Understand how your project has performed for the investor, and find out what your investor has agreed to in other dispositions. Negotiations should incorporate your work from the steps above:

- ***Know your documents.*** Exit terms, sponsor guarantees, investor's expected return per above;
- ***Know your deal.*** Know the expected return to the investor, capital account balances, capital needs, reserve balances, outstanding debt, and estimated value of the property;
- ***Know your investor.*** Talk with your investor about its interests, ***and*** talk with other sponsors, your tax counsel, and your accountant about projects that have completed Year 15 transitions or are currently being negotiated with your investor. Keep in mind:
  - Investors are negotiating Year 15 Dispositions on a project-by-project basis, and no two projects are the same in terms of project debt to value, capital account balances, and the investor's actual, in comparison to projected, return.
  - Some investors agree to terms that are more favorable than those in the partnership agreement.
  - Investors are negotiating Year 15 Transition Plans based on the needs of the specific investment fund. Each fund will have different earnings, need for losses, and return requirements, and these may vary from year to year as well.
  - Investors' general approaches to Year 15 seem to vary, with different interpretations of their fiduciary responsibility to maximize return to their investors.

We would also like to acknowledge the excellent technical assistance and training provided by Enterprise in developing these examples. Enterprise has developed a Year 15 spreadsheet that provides an excellent format for monitoring capital accounts, estimating exit tax obligations, and modeling disposition strategies, which is available on the Housing Development Center's website at www.housingdevelopmentcenter.org. Enterprise has asked that all first-time users of this tool obtain technical assistance before relying on any outcomes.

Appendix B

Sample Schedule of Real Estate Values

Statement of Developer/Sponsor Activity

Please provide information on every rental property in your portfolio, including those that are stabilized, under construction, or in the pre-development stage. This informa
outside the employ of National Equity Fund Inc. unless you provide your permission to do so.

No.	Name of Project	City	State	% Ownership	Total Number of Units	Number of LIHTC Units	Development Status^	General Contractor
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
18								
19								
20								

^ Under Construction; In Service; or Planned (i.e., plan

This sample can be found in its entirety on the enclosed Guide CD.

Appendix C

This sample can be found in its entirety on the enclosed Guide CD.

Housing Development Consortium's Asset & Property Management Affinity Group Dashboard

Affordable Housing Best Practices Dashboard

Marketing & Leasing	Benchmark	Frequency
Occupancy Rate (as a percentage of potential days of occupancy)	98% excellent, 95% good, 90% poor	M
Unit Turnaround Time	< 14 days excellent, 21 days good, 30+ days unacceptable	M
Resident Turnover Rate	<5% excellent, < 15% adequate, > 30% unacceptable	2/yr
Collections & Evictions		
Percentage collected	97–100% excellent, 93–96% good, 90–92% poor	A
Percentage of Current Rent Collected	> 95% excellent	M
Notice to Pay or Quit	Serve notice to pay or quit 3–5 days after rent is due	M
Maintenance & Management		
Unit Make-Ready Time	< 10 days	M
Unit Inspections	Per established policies	
Fiscal Management		
Budget Variances	0–5% Excellent, 6–10 % Good, > 11% Unacceptable	M
Replacement Reserves	Minimum standard to meet funder requirements; should be based on current C.N.A.	M
Operating Reserves	3 mos. of expenses including replacement reserves & debt service	M
Capital Needs Assessments	Reviewed annually; updated every 5 years	A
Economic Collection	95% good, 90–94% investigate, < 90% poor	M
Financial Analysis		
Expense to Revenue Ratio (Expense Ratio)	< 25%	M
Expense Cost per Unit (PUPY)	Total costs include reserves; $5,319	A
Compliance		
Funder Reports	Timely & accurate	M
Recertifications	Begun 90–120 days before due & 100% completed on time	M
Project Debt Ratio (uses loaded NOI w/AM fee, PM fee, Reserves, and Def. Developer Fee above the line)	1.05 excellent, 1.00 good, <1.0 concern	Q
Debt Coverage Ratio/Debt Service Coverage Ratio	1.15 excellent, 1.05 good, <1.0 concern	A

Key: M=Monthly, Q= Quarterly, A=Annually Rev. 9-11-08

Appendix D

Differences Between Generally Accepted Accounting Procedures (GAAP) Financials and Pro Forma Income & Expense Reports

GAAP Accounting	Pro Forma Income/Expense Reports
Depreciation included as operating expense on Statement of Activities	Depreciation not included as an "above the line" operating expense in determining Net Operating Income
Interest expense included as an operating expense on Statement of Activities	Interest not included as operating expense on Income and Expense Statement – included in total debt service (P&I)
Replacement reserve contributions are not an expense, reflected in change in reserves shown on balance sheet	Replacement reserve contributions shown as an "above the line" operating expense on most pro formas
No principal payment reflected on Statement of Financial Activities (reduction of liabilities on Balance Sheet)	Debt Service = Principal + Interest, shown on Income and Expense Statement below NOI

Cash	Accrual
Revenues generally show only cash received from tenants	Gross Potential Rent shown on Income and Expense Statement
Unable to calculate revenue indices that are generated from Gross Potential Rents such as vacancy loss or concessions (without additional reports)	Vacancy loss and concessions shown on Statement of Activities
Uncollected rent not on Statement of Activities – need separate report	Rent receivables shown on Balance Sheet, also see aged receivable report
Operating Expenses reflected when paid (invoices in the drawer?)	Operating expenses shown when cost is incurred (services received or invoiced) Payables (including current payables) reflected on balance sheet

Operating Statement Adjustments to GAAP for Asset Management Financial Performance Review

I. Revenue-Side Adjustments

Gross Potential Rent (Rental income to project if all units were rented and all rents were collected)

– Vacancy loss

– Uncollected Rent (Bad debt expense + tenant receivables)*

____

= Net Rental Income

+ Other Income (e.g. laundry, interest, etc.)

____

= Effective Gross Income (EGI)

**Some organizations include bad debt as operating expense and do not reflect bad debt in Net Rental Income – per GAAP*

II. Expense-Side Adjustments

Total Operating Expense

+ Add in replacement reserve contributions

_ Take out depreciation

_ Take out interest expenses

_ Take out capital improvements

____

= **Total (adjusted) Operating Expenses**

III. Indices After Adjustments

Net Operating Income = Effective Gross Income – Total (adjusted) Operating Expenses

Net Cash Flow = Net Operating Income – Debt Service Payments (Principal & Interest of First Mortgage & Subordinate Debt) – Capital Expenditures

Vacancy Rate = Net Rental Income / Gross Potential Rent

Rent Collections = Rent Collected / Rent Billed (GPR – Vacancy Loss)

Operating Expense per Unit = Total (adjusted) Operating Expenses / # of units

Debt Service Coverage Ratio = Net Operating Income / Must Pay Debt Service (Principal & Interest)

Monthly Net Cash Flow as Percent of Gross Revenues = Net Cash Flow / Gross Potential Rent

Monthly Net Cash Flow as Percent of Operating Expenses = Net Cash Flow / Total (adjusted) Operating Expense

Monthly Expenses as a Percent of Net Revenues = Total (adjusted) Operating Expense / Effective Gross Income

Appendix E

Solving Vacancy Problems

Turnover Rate High? — Yes / No

Yes → **Diagnosis:**
- Tenant surveys?
- Reasons for move-outs tracked?
- Reasons for FEDs or 30-day notices tracked?
- Rents compared to market?

If not, you are solving an tenant retention problem

Is there traffic? — No / Yes

No → **Work Items:**
- Marketing Plan – review advertising (where, invitation ad), signs, balloons, contact service providers, radio, in other languages
- Rent level
- Signage clear?
- Curb appeal?

Are applications being received? — No / Yes

No → **What are the issues:**
- Are on-site staff doing a good job of "selling" the unit (friendly, positive, responsive, informed)? *("Shop unit"/ You may need to train on-site staff)*
- Is the unit ready and appealing?
- Are the grounds/ buildings in good repair, clean, well lit?
- Is the rent at or below market for the unit size/ amenities and condition? *(research and marketing)*

Are applications being accepted? — No / Yes

No → **Consider these issues:**
- Identify "reasons" for turndowns (are there trends?)
- Review screening criteria with property management company
- Institute appeal process
- Consider accepting clients if services/ other support is available
- Revisit marketing plan

Move Ins Prompt? — No / Yes

No → **Every day = lost money:**
- Prioritize turnovers
- Outsource cleaning

Appendix F

Uses and Approaches to Assessing Capital Needs

		WHAT & WHY		HOW	
		TYPE	DESCRIPTION OF USE	QUANTITY TAKEOFF ACCURACY	LEVEL/ SOURCE OF INVESTIGATION
Maintenance	Operating, Maintenance, & Capital Needs Budgeting	**Operating & Maintenance Plan**	**Plan for Capital Improvements to be undertaken in the next year** - costs - identified source of funds (operations or reserves or other) Generally required by funders	**Project Setup**: - if quantity measurements/ counts are completed at acquisition/ development, these will be available for annual budgeting **Annual Inspections**	**Historical Data**: - number of turns & type of repairs on prior turns - average carpets, vinyl, blinds **Annual inspections** - estimate quantities - Repair/ replace decisions **Maintenance Logs** **Service Contracts/ Inspections** - elevator - mechanical **Capital Needs Assessment** - scheduled replacements
	Long-Term Reserve Planning, Refinance Planning	**CNA** Strategic Facility Plans (3–5 year look) * (Strategic Facility Plans include larger picture, such as business plans, development pipeline, funding milestones)	**Setting priorities** for capital improvements over 3–5 years **View is at both project and portfolio levels** (also pipeline) **Gives adequate time** to work out financing strategy **Establish good order of magnitude numbers** for major capital improvements within 3–5 year window **Informs which repairs** to do in the interim **Evaluate life cycle/ cost savings** potential of improvements or alterations (energy, maintenance, insurance)	**Quantities based on Capital Needs Assessments** - seek format that gives total quantities (square footage, total windows, sqs. of roofing, lineal feet cabinet per unit) - obtain CNAs generally rank by condition - obtain CNAs with Estimated Useful Life, Remaining Useful Life, and replacement schedule across years - seek CNAs that also summarize interiors (e.g. 50% of heaters = B rating) **Quantities modified by work completed since CNA and annual inspections**	**Full site inspection:** - dumpsters, enclosures, fencing, parking asphalt, signage, curbing, landscaping, lighting, ADA (504), drainage **Full exterior inspection** - Exterior siding, roof, gutters, stairways, windows, decks, landings **Full Common Areas inspection**: similar to units **Interiors** - percent of units 25% to 100% **Mechanical/ Plumbing/ Electrical** - minimum talk with service contract providers - get 3– to 5– year recommendations from vendors, contractors, sub-consultants for larger ticket items
Development	Capital Improvement Projects	**CNA+** Funding Applications for Major Rehabs (existing or Acq/ Rehab projects)	**Outlines preliminary rehab scope** for applications **Basis for uses of funds** budget **Often required by funders –** including a replacement reserve analysis for post rehab	**Specific quantity takeoffs** **Generally 100% of units inspected** **Unit-based pricing estimates**	**Full investigation to be able to outline a scope of work within 10%–15% range** (see sub-consultant/ engineer involvement) **May include destructive testing** Generally also required to provide a **post rehab replacement reserve model** **Generally includes code review,** meetings with jurisdictions to evaluate regulatory requirements for a given scope
	Capital Improvement Projects	**Design Process** Scope of Work for Major Rehab/ Bidding	**After funding:** Preparing bid packages, drawings, specs, applying for permits	**Structure contracts with unit pricing** to allow easier contract revisions during rehab	**Full architectural/ engineering team per above,** plus **Destructive testing** **Consider doing asbestos/ mold mitigation early**
	Acquisitions	**CNA** Property Acquisition of Existing Property	**Determine Acquisition Yes/ No** **Evaluate timing and scope on future rehabilitation** **Negotiating Price** **Satisfying lender requirements**	100% of units	**CNAs per Strategic Facility Plan** Level, then follow up investigation of any major areas identified - CNAs should have costs projected by years for the next 15–20 years to evaluate future needs for rehab/ refinancing windows - talk to on-site staff, if you can get maintenance logs, they may help **Environmental Assessments** **May require geotechnical review**

HOW			HOW OFTEN	HOW MUCH
SUB-CONSULTANT/ ENGINEER INVOLVEMENT	**COST INFORMATION SOURCE**	**ANALYSIS/ PLANNING (Financial Analysis)**	**FREQUENCY/ LENGTH TO COMPLETE/ USEFUL LIFE**	**COST OF STUDY**
Service Contracts/ Vendors - elevators, boilers, heating/ cooling **Potential additional sub-consultants** - bids (roof, Seal Cote on parking lot gutter replacement) - energy & water conservation = audits	**Historical Data** - turnover history **Vendors/ Service Contract Providers** **Contract Proposals/ Bids** - get bids according to organizational policies **Lease Renewal or New Tenant TIs** over Next Year	**Determine draft scope of work**: **Determine costs** **Determine source of funds** - rental revenues/ operating budget - replacement reserves (impact on long term), or - other capital sources **Align Scope with budget** - create "add backs"	**Annual**	**CNA in-house energy audits =** $2,500 if there is a simple heating/ cooling system like PTACs; up to about $7,500 if there is a more complex HVAC system in the building
Additional investigation for larger capital improvements - include contractors or engineers for major capital items - include energy audit/ green building opportunities in planning major capital improvements - architect needed to assess additional regulatory requirements (e.g. Accessibility, Seismic, Sprinklers)	**All of above sources of data** **Cost Estimates by Contractors Preferred** **Include design and soft costs in planning** **Larger capital improvement projects need full sources and uses**	**Follows steps above, plus** **Update replacement reserve analyses** - new data from CNAs - reserve balances and projected contributions, accelerators - any use of reserves (depletion) for smaller capital items (appliances, carpet) **Update financial model** - refinancing opportunities - upcoming Year 15 terms re: reserves **Planning across portfolio** includes priorities for applying to public agencies (development pipeline)	**Three- to Five-Year Plan**	**CNAs $5,000–$15,000**
Full architectural team with engineers: - environmental update may be required - may include civil/ geotech (if drainage or settling issues) - accessibility may require civil engineer - structural (if seismic requirements or objective) - mech/ electrical subs or engineers (elevator, plumbing, electrical, heating/ ventilation) - may require industrial hygienist (organic growth, lead paint) - may require envelope consultant (exterior water penetration issues)	**Contractors or cost consultants** **Verify materials and systems specifications in cost assumptions** - good place to include maintenance staff	**Rehabilitation Project –** Full sources and uses **Complete financial projections** for property – can property support existing debt for 20 years or until end of term? More debt? (and still cash flow) **Obtain needed approvals** to use reserves **Make operational** **Improvements** to position project to be attractive to lenders and investors **Investigate other sources**: - grants, public funding, resyndication	**15–20 year rehab** (varies by building system) **Partial rehab projects** (at acquisition) usually need significant rehab between years 5–8	$25,000–$35,000 per project
Standard Rehabilitation Scope, generally requires architect. If scope is limited, may use envelope, roofing, or specific engineer to prepare specifications and monitor limited scope projects	**Standard project processes – generally Contractors or cost consultants**			Rehab architect/ engineer fees 6– 9%
per Strategic Facility Plan above	**CNA consultant for routine costs**, but **Contractors for any major items identified** **Talk to service contractors, on-site staff** Evaluate per-unit operating costs per appraisal with your costs (deferred maintenance?)	**Update 20-year financial projections:** - with your operating costs - with reserve contributions per replacement reserve schedule - how would you capitalize a replacement reserve, what size does it need to be?	At acquisition	CNAs $5,000–$15,000

Appendix G

Sample 20-Year Capital Needs Assessment Template

Building Name	Sample Building
Year Built/Rehabbed	2010
Age of Building	0
Number of units	50

Component	Description	Typ'l Useful Life	Useful Remaining Life	Quantity	Unit Cost	Cost in 2010 $'s	2010	2011	2012
Building Systems									
Plumbing supply, waste, vent pipes, hot water tank	copper supply, ABS waste	100	100						
Sewer & storm drainage	cast iron	100	100						
Elevator	Kone high efficiency	50	50						
Electrical distribution	circuit breaker panels, copper wiring	50	50						
Fire sprinklers/alarms		50	50						
HVAC	Energy Recovery Ventilator	15	15			$8,000			
Exterior									
Exterior envelope (siding, sealants)	EFIS	30	30						
Exterior Trim (window, door, parapets, entry)	painted wood	10	10	15K sq/ft.	$1	$15,000			
Paint		15	15			$20,000			
Windows/Doors	double pane vinyl	30	30	200	$250	$50,000			
Roof, flashing, vents, gutters, downspouts	hot tar with mineral cap	20	20			$25,000			
Intercom/security system/exterior lighting	works with personal phones	15	15			$5,000			
Parking lot, paving	recoat, restripe	10	10	800 sq/ft.	$10	$8,000			
Outdoor (walkways, deck/fence, landscape, irrigation)	eco-pavers, wrought iron fence	50	50						
Units									
paint	paint	10	10	50	$800	$40,000			
Vinyl floor covering (kitchen bath)		7	7	50	$1,000	$50,000			
carpet		7	7	50	$1,000	$50,000			
appliances (range, hood, frig, dishwasher)	Energy Star refrigerator, range & range hood	15	15	50	$1,200	$60,000			
hot water tank	(whole house system included above)	na							
kitchen cabinets, countertops	laminate	15	15	50	$1,000	$50,000			
kitchen fixtures (sink, faucet, disposal)	faucet, trap, sink, garbage disposal	15	15	50	$300	$15,000			
bath cabinets/countertops)	24' vanity with p-lam tops	15	15	50	$200	$10,000			
bath fixtures (toilet, sink, tub/shower, fan, misc)	sink, faucets, toilet, tub, surrounds	15	15	50	$1,200	$60,000			
window coverings	(replace on turnover thru op budget)								
Lighting fixtures	Energy Star kitchen, bath, hallway	20	20	150	$50	$7,500			
heating	EBB and electric forced air	15	15	50	$200	$10,000			
doors	wood entry-solid; bdrm-hollow core	30	30	150	$250	$37,500			
Common Areas									
Painting	common area halls and stairs	10	10	15K sq/ft.	$0.40	$6,000			
Floor covering	Marmoleum in all common areas	40	40						
Laundry appliances	5 washers, 5 dryers—Energy Star	15	15	10	$800	$8,000			
Exits/signage/mailboxes		10	10	10	$100	$1,000			
Lighting	Energy Star common area halls and stairs	20	20	100	$50	$5,000			
	Sub-totals each year						$0	$0	$0
	Escalation (3%/year)					3.00%	100.00%	100.00%	106.09%
	SubTotal with escalation						$0	$0	$0
	WA State Sales Tax (8.9%)				8.90%		$0	$0	$0
	Total						$0	$0	$0
Replacement Reserve Balance Beg. Of Year							$50,000	$69,000	[illegible]
Interest Earned on Reserve Balance						3.0%	$1,500	$2,070	[illegible]
Additions to Replacement Reserves	($350/unit/yr increased 3.5% annually)						$17,500	$18,113	[illegible]
Expenditures from Replacement Reserve							$0	$0	[illegible]
Replacement Reserve Balance End of Year							$69,000	$89,183	[illegible]

This sample can be found in its entirety on the enclosed Guide CD.

Appendix H

Sample On-Site Inspection Checklist

This sample can be found in its entirety on the enclosed Guide CD.

Property Name:

Inspection Date: **Inspector:**

Area #1 - Site Fencing & Gates, Grounds, Storm Drainage, Play Areas & Equipment, Walkways & Steps, Refuse Disposal, Signage, Mailboxes, Market Appeal, Parking Lots, Retaining Walls	
Area #2- Building Exterior Doors and Windows, Fences, Signage, Accessible-interior outside areas, Fire Escapes, Lighting, Foundations, Roofs, Walls and Sidings, Walkways, Drives and Parking, Site Drainage, Trees/soils/water separation from building	
Area #3 - Building Systems Thermo systems-Roof-Gutters-Downspouts, Plumbing, Electrical, HVAC, Elevators, Emergency Power, Exhaust System, Fire Protection, Signage, Security, Mail, Garbage Sanitation, Drainage **Area #4 – Units (see back)**	
Area #5 - Common Areas Basement/Garage/Carport, Mechanical/Utility Closet, Patio/Porch/Balcony, FHEO, Accessible-interior and outside areas, Hallways-fire exit routes, Stairs/Corridors, Kitchen, Laundry Room, Pools, Restrooms, Offices, Storage Areas	
Area #6 - Health & Safety Hazards with Air Quality, Electrical, Emergency Fire Exits, Flammable Materials, Garbage & Debris, Hazardous Materials, Infestation, other	

Sample On-Site Inspection Checklist

Property Name:

Inspection Date: **Inspector:**

Area #4 - Units	Floors, Walls and Ceilings, Doors and Windows, Cabinets-counters-sinks, Electrical distribution-outlets-switches-lighting fixtures-Call-Aid stations, Smoke Detectors, Appliances, Plumbing-Hot Water-supply-waste-fixtures, HVAC-heat-fans-ventilation, Kitchen, Bathrooms, Laundry Area, Patio/Porch/Halls/Balcony/Stairs

Unit #	Findings

Unit #	Findings

Unit #	Findings

Unit #	Findings

Unit #	Findings