

Creating Multifamily Rental Housing Through Renovation

PROGRAM
OPERATIONS



A Complete Overview of the Skills and Finances Needed To Run a Successful Program

Launched in 1982 by Jim and Patty Rouse, The Enterprise Foundation is a national, nonprofit housing and community development organization dedicated to bringing lasting improvements to distressed communities.

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This book is part of the Enterprise Community Development Library, an invaluable reference collection for nonprofit organizations dedicated to revitalizing and reconnecting neighborhoods to mainstream America. One of many resources available through Enterprise, it offers industry-proven information in simple, easy-to-read formats. From planning to governance, fund raising to money management, and program operations to communications, the Community Development Library will help your organization succeed.

ADDITIONAL ENTERPRISE RESOURCES

The Enterprise Foundation provides nonprofit organizations with expert consultation and training as well as an extensive collection of print and online tools. For more information, please visit our Web site at www.enterprisefoundation.org.



About This Manual

How is multifamily rental housing developed through renovation?

Multifamily housing consists of rental apartments concentrated at one site. In a renovation project, dilapidated or poorly configured buildings are renovated to provide quality, affordable living accommodations for individuals, families and people living with special needs.

Creating Multifamily Rental Housing Through Renovation is designed for board members and staff of nonprofit community development organizations who are not experienced in managing successful programs for developing multifamily housing through renovation. This manual can make that process easier and clearer. It should be used with the more detailed information and helpful documents available in The Enterprise Foundation's Developer Support System found on the Web at www.enterprisefoundation.org. This manual contains information on:

- Phases of development
- Role of the nonprofit as sponsor, developer or co-developer
- Staffing and consultants
- Funding sources including the Low-Income Housing Tax Credit
- Development budget and fees
- Potential risks

The manual is part of the *Program Operations* series within The Enterprise Foundation's Community Development Library™. The series provides detailed information on the housing-related programs used most by nonprofit organizations. Other manuals in the series include information on:

- Single-family subdivision new construction
- Single-family acquisition and rehabilitation
- Single-family housing for infill
- Multifamily new construction
- Scattered-site rental housing
- Home improvement programs
- Supportive housing
- The HOME Investment Partnership Program

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Introduction

The renovation of multifamily rental housing substantially enhances the lives of low-income residents in your community by increasing the quality and availability of affordable housing options. Beyond improving people's homes, multifamily renovation can serve as a wonderful platform for stabilizing and revitalizing neighborhoods.

Quality rental housing is often the most desired option for many consumers with incomes between \$10,000 and \$25,000 per year. But renovation of multifamily rental housing places new demands on a housing organization whose previous experiences have been limited to homeownership counseling or rehabilitation of single-family housing. The financing is complex, the production process geared toward volume, and the long-term responsibilities large. Errors in administering a multifamily program can have costly and enduring consequences.

On a more positive note, it is not unusual for an organization to earn \$5,000 to \$7,000 per dwelling unit in development fees. If your projects involve 40 to 150 units, even a single project can have a significant effect on your organization's budget.

These days, much of this business is defined by the requirements of the major financing vehicle for rental housing, the Low-Income Housing Tax Credit (LIHTC), which is explained further in a later section. This is currently the only federal program supporting large-volume production of affordable rental housing for low-income working people. The strengths and limitations of this program, as well as its legal requirements, drive many of the choices faced by developers of multifamily rental housing.

As with all new and expanded business ventures, you need to assess your own organization's capacities. Are the resources available for you to carry out this effort? Is the time right for your organization to get involved? Are there suitable and available buildings in your neighborhood? Does the necessary political and neighborhood support exist? These are very important questions because of the large risks and long-term commitment that a multifamily rental housing business involves. This manual will provide you the basic information (and direction on how to gain more detailed knowledge) to guide you through this highly specialized business.

Development Process

Once the commitment has been made to renovate multifamily housing, essentially two challenges remain: hiring or contracting for the specialized building and management of the development, and financing it, from concept to lease-up. You will experience seven specific phases of development: strategic and market analysis, program setup, feasibility, securing financing, construction, lease-up, and operations and asset management. An overview of each is given below; several aspects of each phase are detailed in later sections of the manual.

For more detailed information about the development process, see The Enterprise Foundation’s Developer Support System at www.enterprisefoundation.org.

PHASE 1

STRATEGIC AND MARKET ANALYSIS

Your organization’s vision for the proposed development includes a description of whom you want to serve, as well as how and where you want to serve them.

For example:

We envision a mid-rise apartment building for 50 to 70 low-income families located on a bus line within a particular neighborhood. The development should be linked to both on-site and nearby social services.

Start with the idea of the market you want to serve — where do your prospective tenants want or need to live, what kind of housing do they want or need, and what can they afford to pay? This analysis is based on your understanding of the proposed neighborhood and community.

Many times, the concept begins with a specific building. Most low-cost, available buildings are also in poor condition and affected by neighborhood problems. Many harbor drug activity or are defaced by graffiti. Sometimes, deteriorated

buildings are clustered together in neighborhoods with high crime rates and other indications of poverty and blight. Will low rent levels alone ensure a market demand for your units?

PHASE 2

PROGRAM SETUP

If your organization only wants to do one or two projects in the foreseeable future, we recommend that you consider co-developing with a more experienced organization. This will save you the time and money required to learn a process that you will not use again.

If, however, you are considering multifamily renovation as a regular business, then you should be planning your second project (and how you will staff for it) even as you are still in the preconstruction phases of your first. Because a project can easily require three years, an adequate pipeline requires that you have two or more projects under way for every project you hope to complete each year.

Be aware of the two main external limitations to your production: availability of good sites and limits on subsidy (largely public dollars). You must understand your state’s allocation system; developers almost everywhere compete aggressively for scarce LIHTCs. You should also become familiar with the market for rehab stock in your target area. You may find that your current target area impedes your ability to become a consistent producer of renovated multifamily buildings.

If you intend to partner with a major developer who will share in the risks and rewards of the project, both your board and the potential partner should sign a letter of understanding during this phase. The letter of understanding should set out the general goals, roles and responsibilities of parties. The specifics can be elaborated on in a more formal agreement.

The period from the decision of initial feasibility to commitment of all project financing can take from six months to two years. Few professionals, such as architects or consultants, will work at their own risk, so you must secure adequate predevelopment funding during this phase to complete project pro formas — architectural drawings and other items required to secure construction and permanent financing commitments.

PHASE 3

INITIAL FEASIBILITY

A feasibility analysis will tell you if purchasing, renovating and operating the proposed project with available resources is possible. If not, the analysis should identify what is needed. The analysis will include several components. Below are a few aspects to consider when determining the feasibility of your development.

Selecting Buildings LIHTCs, the program that offers credits against federal taxes for profit-motivated entities that invest in affordable housing developments, are based on the depreciable costs of the building and improvements. The more construction or renovation required — as with substantial or “gut” rehab, where all major systems and components of the building (roof, electrical, plumbing, HVAC, kitchens and bathrooms) are replaced — the more tax credits available.

To maximize this financing source, groups usually should not target buildings in excellent condition; instead, older structures that can be purchased for little or no money and require a significant amount of repair are better prospects. Of course, this desire to maximize tax credits must be balanced with a reasonable cost per housing unit. Structural soundness and adequate interior space are musts for potential buildings. Also, they need to be well located for the proposed population and contain at least 30 units. Because of the fierce competition for the tax-credit allocation, it is often best to avoid very large projects (over 250 units); it is unlikely that you will receive adequate tax credits to finance such projects.

If your community contains historical districts or a large number of historic buildings, you may consider developing a structure eligible for historic tax credits that can be used in addition to the LIHTC. Be forewarned that historic renovation can add considerably to renovation costs.

If you have two buildings to select from, the nonphysical variables are usually most crucial. If seller one requires \$10,000 in earnest money and seller two is willing to finance the purchase, with interest payable upon the construction closing, the financial advantages of the second deal far outweigh any physical differences between two similar properties.

This feasibility study should tell you if it's possible to build and operate your project at the identified location with the currently available resources. If not, it should identify what further resources will be needed.

Existing Tenants. Existing tenants in a building provide both an opportunity and a cost to be considered. The opportunity is that the tenants may want to continue to live in the building after rehabilitation is done, solving some of the marketing problem. The cost is that tenants who move require relocation benefits. Also, beginning development for tenants who stay often increases costs, as the construction needs must be phased in to account for them, or the tenants need temporary accommodations.

Once rehabilitated, rent prices rarely can be maintained at original levels. Despite the use of government funds and the good intent of the owner, rents usually increase after construction. Tenants receive a better housing product — everything works like new — but they may not choose, or have the income, to pay higher rent.

For any property with existing residents, the developer must find out whether existing tenants will move or stay after rehabilitation, and factor these costs within the feasibility calculations.

Development Team Personnel. By bringing the following development team members on board you can better determine project feasibility.

- Engage an architect to execute a preliminary design, especially if the renovation requires substantial reconfiguration in the unit layout (such as when a property with many one-bedroom units will be changed to accommodate three- and four-bedroom units). Do not, however, always trust architects' estimates on construction costs. Their strength is in design, not cost estimating.
- Hire an engineer or a builder to provide you with reasonably accurate projections of costs. Review the construction schedule in detail with the builder or engineer; this significantly affects the financial viability of your project.
- Retain a lawyer who has experience in multi-family renovation developments. This is especially important if you have questions regarding zoning.
- If you are inexperienced or attempting to substantially increase your production level, you should consider hiring a development consultant to complete initial financial projections and to map out an appropriate strategy.
- Sign on a property manager to help you estimate an operating budget and calculate an appropriate lease-up schedule.

Feasibility determinations are not completed until you have solid estimates of the costs and sources of funds for development, as well as solid estimates of the revenues and expenses that you expect from the operations of the rental property. (Many of these aspects are covered in later sections of this manual.) This can take three months if the team is in place. If it is a new team and everyone needs to be interviewed and screened, this process can take longer.

PHASE 4

SECURING FINANCING

Once a site is secured and a budget is in place, you can apply for financing. It helps to think of financing needs in phases: predevelopment, acquisition, construction and permanent. Some funding sources may meet more than one need, but others will limit their support to one phase only. Most organizations look to foundations or nonprofit lenders during the early, riskier stages; as the project progresses they are able to secure commitments from conventional lenders and equity investors. Financing phases, uses and sources are described briefly below (further detail is given in the Sources of Funds section).

As financing starts to gel:

- Architect should complete working drawings, if necessary.
- Builder should guarantee prices and completion date and obtain building permits.
- Property manager should formally agree to the operating budget.
- Attorneys (and you) should finalize terms with equity investors and other development partners.

Phase	Uses	Sources
Predevelopment	Architectural, engineering and consultant costs	Foundation grants; nonprofit housing fund loans; city program funds
Acquisition	Land costs; title and legal fees	Nonprofit housing fund loans; banks; city program funds; grants
Construction	Construction and architectural costs	Nonprofit housing fund loans; banks; city program funds; grants; LIHTC bridge loan funds
Permanent	Repayment or conversion of acquisition, construction and predevelopment loans	Banks; city program funds; grants; LIHTC bridge loan funds

PHASE 5

CONSTRUCTION

Time is everything, because you are now paying interest on money borrowed for building acquisition and construction soft costs such as the appraisal, lender's legal fee, marketing and utilities during construction. Your investors and the LIHTC issuer are looking at their watches. While the contractor coordinates the labor, the development consultant provides an extra set of eyes and ears for you and the lender. You oversee the maintenance of smaller problems, addressing them before they become larger ones. Count on construction taking from nine to 12 months for a 100-unit project.

All projects budget contingency funds for unexpected costs or cost overruns. Spend your contingency with care. When your budgeted contingency is gone, additional costs come out of your developer fees.

PHASE 6

LEASE-UP

Your property manager needs to begin acting on a marketing plan at least three months before the first unit is available. You may keep a waiting list even earlier, but know that such lists for rental housing grow stale quickly; potential tenants usually do not look for long before deciding on a new home. If you are doing multiple building developments with staggered completion dates, lease-up will begin several months before construction is complete. You may be able to reach stabilization within a month or two after construction completion, but if your project is large or the market is soft, it could easily take six months or longer.

Although it may be advisable to leave execution of the marketing plan primarily to your management agent, make sure that the plan takes advantages of the strengths of your organization's knowledge of and ability to reach your target market. Use the market information you gathered when deciding what to build. For example, you may know:

- Where your prospective tenants are living now
- Where they work
- What other associations, both personal and professional, they may have

If the building has tenants, they are your first market. Make sure all existing tenants are given information and counseling prior to construction. Current residents who stay in the building will provide good word-of-mouth advertising for the development.

If you expect to attract tenants from the development's surrounding community, make sure your marketing materials are in local stores, libraries and other public places. Target neighborhood media with news about your project.

Lower-wage employers are often happy to help their workers find nearby places to live. Doing so reduces absenteeism and increases workforce retention. Research the neighboring employers of people in your target income range.

If your development targets people at the entry wage level, you may be able to reach them through employment training, counseling organizations and other human service agencies. Trade schools may also be a likely source. Other associations, such as churches, can be an important addition to your marketing efforts.

The lease-up process itself should be carefully monitored. Analyze the hand-off system between your contractor and management agent and make sure it is as efficient as possible. Ensure that the contractor's responsibilities for punch-out and clean-up are clear, but do not let the management agent hold things up over small details — encourage problem solving.

Also, confirm that you and the management agent agree when leasing agents are to be on-site. With a project of 100 units or more, it is common for a leasing agent to be on-site 35 to 40 hours each week, including evening and weekend hours, from the time the first units are available to show. To facilitate this, your contractor should schedule the completion of the management office to *precede* coincide with the completion of the first units.

PHASE 7

OPERATIONS AND ASSET MANAGEMENT

The nonprofit owner generally has long-term responsibility for operation of the project. The nature of this responsibility is detailed in the limited partnership agreement, described further in the section on LIHTCs. The nonprofit is usually required to provide operating deficit and construction completion guarantees as well as replacement reserves.

The nonprofit must ensure that the property remains leased, in good repair and financially solvent for at least 15 years but maybe as long as 30 years. The greatest risk outside your control is changing market conditions.

Organizational Roles

In multifamily development, nonprofit organizations can play one of four roles:

1. Sponsor
2. Developer with strong technical consultants
3. Developer with in-house expertise
4. Co-developer

ROLE 1

NONPROFIT AS A SPONSOR

This structure requires the least participation by the nonprofit. It leaves the real estate development work to another organization, either a for-profit or another nonprofit, which will do most of the work.

The role of the nonprofit in this model includes:

- Defining community interests
- Working with governments to obtain subsidies
- Handling a specific job, such as marketing
- Protecting your own organizational interests

ROLE 2

NONPROFIT AS A DEVELOPER WITH STRONG TECHNICAL CONSULTANTS

In this development model, the nonprofit organization handles the following tasks:

- Serving as the sponsor
- Finding land
- Submitting or assisting in submitting funding and subsidy applications
- Selecting professionals for the project
- Handling financing and cash flow needs
- Meeting programmatic rules and deadlines

ROLE 3

NONPROFIT AS A DEVELOPER WITH IN-HOUSE EXPERTISE

In this model, the nonprofit organization must have the strong technical knowledge and experience in tax, finance, legal and construction activities — everything that is done by consultants in the previous model. This model also requires an organizational commitment to ongoing multifamily development to justify the high overhead costs associated with learning the business.

ROLE 4

NONPROFIT AS A CO-DEVELOPER

Here, the nonprofit organization seeks partners to co-develop a project. Reasons may include inadequate capitalization, inexperienced staff, a desire to share the project's risk or simply the anticipation that this will be the only such project undertaken by your group.

A development partner can bring the following resources to the development effort:

- Up-front development money
- Equity for land purchases
- A strong financial balance sheet
- Extensive multifamily development experience and experienced staff
- Reserve guarantees
- Strong ongoing relationships with architects, builders and engineers that ensure a final quality product
- Back office support to achieve compliance with all rules and deadlines

Keep in mind that your fee income will drop according to the amount of work you pass on to a partner. You also will have to give up substantial control of the development process. While you may learn from watching the process, you should consider what authority you need in order to guarantee that the project meets your goals. At a minimum, you probably need to maintain some control over the management agent and operating budget.

NONPROFIT BOARD ROLES

The role of your nonprofit's board of directors is one of policy-making. As such, the board should make the decision to get involved in multifamily housing. Ultimately the board will have to pass resolutions authorizing the organization to accept the financing necessary for the multifamily development.

The board ensures that your mission is being met and that the necessary resources are available. The board — especially for smaller and newer nonprofits — may also need to raise the capital needed to begin or expand multifamily housing development and the necessary funds for specific projects. Some boards may establish a committee to oversee this process, but board members undoubtedly will be involved.

The board should not be involved in the details of negotiations (although members with expertise may serve on a committee of similarly experienced development professionals). Multifamily housing development by nonprofits is even more complex than private market development because of the multiple funding sources and public funding regulations. Trust your staff with the details.

A word of caution. Board members should not personally or professionally profit from the development activity. Every board member knows this, but sometimes the rule is difficult to follow. Do not use a law firm, engineer, builder or other professional from the board, even if the services are pro bono. This changes the dynamics of the deal and does not allow staff to negotiate in the best interest of the project and organization. The exception to this is a banking relationship. There are a limited number of banks involved in multifamily housing, and the banking process has several layers of decision making, which will reduce the direct involvement of your board member.

Staffing and Consultants

As developer, in-house developer or even co-developer, the nonprofit will need experienced staff people filling a variety of roles. What follows is a list of the roles, time allocations and required skills for an organization acting as a developer that produces 60 units annually through multifamily renovation. This list will be more extensive (adding legal, engineering and architectural expertise) if the nonprofit acts as in-house developer, and less extensive (subtracting accounting expertise and time allocations from the other positions) if the nonprofit acts as co-developer with an experienced partner. Note that the fractions of FTEs refer to the amount of time each project will consume. For example, the executive director's annual salary may range between \$50,000 and \$60,000, but this particular project is estimated to take only one-fifth of his or her time.

Multifamily Development Staff — For 60 Units Per Year

Position/Role	Fraction of FTE allotted to program	Critical Skills Required
Executive Director Cost: \$50,000–\$60,000	.20	Strategic sense of local politics; negotiating and relationship-building skills; knowledge of housing development and finance
Senior Program Director Cost: \$45,000–\$60,000	.25	Strong public and private financing abilities, team management experience; negotiating skills; strong writing and editing skills
Project Manager Cost: \$30,000–\$40,000	1.00	Financial analysis abilities; knowledge of financing programs and procedures; knowledge of construction; writing skills
Administrative Assistant	.50	Record-keeping abilities; aptitude for details
Controller	.25*	Experience with LIHTC; knowledge of cost capitalization and reserves
Bookkeeper	.25*	Aptitude for details; knowledge of reporting formats

* Development phase only. As the inventory of operating projects grows, additional staff must be added.

Note: Nonprofit organizations will generally have these other line items in their general operating budget: Rent, utilities — \$10,000; phone — \$8,000; equipment rental (computers, copier, fax) — \$5,000; supplies (office, program, postage and delivery, printing) — \$10,000; consultants (auditors, public relations, fund raising) — \$25,000; travel and training — \$6,000; program expenses and staffing, if involved in social services or other programs — as budgeted.

FTE = Full-Time Equivalent

OUTSIDE DEVELOPMENT TEAM MEMBERS

In multifamily renovation, it is typical to work with many outside consultants, including lawyers, accountants, architects and specialists in financing and negotiating. Sometimes the financing and negotiation services are provided by organizations such as The Enterprise Foundation and The Enterprise Social Investment Corporation. More experienced nonprofit developers can work directly with private financiers or partners, but even the most experienced nonprofits seek professional advice. It is usually not reasonable to assume that staff can devote sufficient time to the intricacies of changing federal tax codes and other technical nuances of the development process.

Good consultants are those who are respected in your local community or who have state or national reputations. The following consultants are typical:

Attorney — Your attorney must be skilled in partnership negotiations and knowledgeable of LIHTC. The critical question is, “Can he or she provide opinions acceptable to investors?” It helps if your attorney is experienced in real estate and construction law. A reputation for cost-efficient service usually means more for your money. Consider establishing a fixed-price contract.

Architect or engineer — Your architect should be knowledgeable of multifamily renovation and the local code issues. He or she should also be cost-conscious, experienced in affordable housing development and willing to work as part of a team.

Builder — Your builder must be licensed and have demonstrated experience in multifamily renovation, preferably in fair-wage projects. Does the company have the capacity to continue work through delays in payment from city or state funding sources? Check references for the builder carefully, particularly those from other nonprofits. Who are the company’s subcontractors and suppliers? You may want to talk with them, as well as the firm’s bankers. Visit a current construction site. Is it clean? How many workers are on site? Does the builder have sufficient bonding capacity for the project?

Accountant — Your project accountant must have strong knowledge of LIHTC. The critical question is, “Can the accountant provide opinions acceptable to investors on issues of cost certification, taxes and asset management?”

You should make sure the firm can serve as an overall advisor to your organization on financial management issues. The accounting firm can also help you maximize your tax credit award and ensure the eligibility of costs for credits.

Property manager — Property management is paramount to your success. You will be working with these managers every day for the next 15 years. A background in affordable housing is required, as well as experience working with outside owners. Knowledge of LIHTC compliance issues is essential. Do your philosophies of how to work with the property’s residents match? Can the company accommodate your on-site services and staff? Check references with other property owners. Visit sites unannounced, considering both how you are treated and the condition of the site.

Syndicators — If you use the LIHTC, you will need a syndicator, such as The Enterprise Social Investment Company, to help you identify and work with potential project investors. When tax credits are plentiful and investors scarce, syndicators tend to be most responsive to investor needs. With tax credits more scarce, developers get more attention. A good syndicator or consultant knows both parties have to be satisfied for the deal to move forward.

Development Costs

Development costs for multifamily housing through renovation vary widely, by area, type and condition of building. A budget for a typical 50-unit, vacant apartment building follows. Use this as a guide to the specific line items used for development cost budgeting and as a model when creating your own.

Multifamily Rehab Costs — Typical 50-Unit Building

	Average Per Unit
BUILDING ACQUISITION	
Purchase price	\$ 7,200
Title report and settlement fee	150
Title insurance	175
Transfer tax, document stamps & recording fee	100
Environmental audit	400
Survey	225
Prepaid property taxes	50
Prepaid hazard insurance	100
Subtotal building acquisition costs	\$ 8,400
REHAB FEES	
Initial design analysis	\$ 500
Design	1,600
Construction administration	840
Architectural reimbursables	630
Engineering	
Survey	270
Construction	111
Geotechnical	98
Misc/reimbursables	113
Permit fees (County DOT)	7
Termite treatment	132
Historic review	73
Subtotal rehab fees	\$ 4,374
RENOVATION COSTS	
Direct costs @ \$48 per sq. ft.	\$ 52,800
Hard cost contingency @ 12%	6,330
Builder's profit and overhead @ 16%	9,461
Builder's cost certification	130
Performance bond	240
Subtotal rehab costs	\$ 68,961

(chart continued on next page)

Multifamily Rehab Costs — Typical 50-Unit Building, continued

	Average Per Unit
PROFESSIONAL FEES	
Sponsor's legal and audit costs	\$ 100
Financial packager	300
Sponsor's cost certification	<u>130</u>
Subtotal professional fees	\$ 530
FINANCING COSTS	
Origination fees on mortgage financing @ 1.00%	\$ 50
Interest on predevelopment loan \$10,000 @ 3% for 22 months	550
Interest on private construction loan \$82,265 @ 12% for 11 months	<u>5,429</u>
Subtotal financing costs	\$ 6,029
OTHER SOFT COSTS	
Appraisal	\$ 275
Application fee to subsidy sources	125
Lender legal fee	140
Marketing	200
Utilities during construction	150
Working capital/reserve	200
Soft cost contingency	<u>65</u>
Subtotal other soft costs	\$ 1,155
DEVELOPER'S FEE	
6% of \$89,449	<u>\$ 5,367</u>
TOTAL DEVELOPMENT COST PER 3 BED, 2 BATH UNIT	<u>\$ 94,816</u>

Actual line-item costs will vary considerably in different locales. Generally, though:

- “Hard” construction costs will be about two-thirds of the total budget.
- Construction costs are estimated in this budget as an amount per square foot of space within the buildings (in this case, \$48 for each of the 1,100 square feet within each apartment). This is a good first step in budgeting, but more precise estimates will be needed.
- A developer’s fee will usually be charged only if the actual costs of rehabbing the units are at or less than the budgeted amount. If costs are higher, the developer’s fee may be needed to help make up the difference.
- The actual cost for interest and utilities during construction depends on the length of the development period. This budget assumes a 22-month predevelopment period and an 11-month construction period.

Sources of Funds

Organizations generally encounter six different capital needs when using tax credits to develop successful multifamily housing. They are: predevelopment, acquisition and construction, working capital, LIHTC equity, mortgage financing and a permanent debt subsidy. LIHTC equity is described in the next section; the other five types of funds are described here in detail.

PREDEVELOPMENT FUNDS

The predevelopment period lasts until you actually close on an acquisition and construction loan. The major costs in this period involve analyzing buildings, applying for tax credits, paying consulting and professional fees and covering staff expenses. In addition, building option costs are included as a predevelopment expense.

Except in a few hot markets across the country, the developer should achieve site control through a contingent contract using a note for the earnest money. This involves very little outlay of cash or interest payments prior to the initial settlement. Where this is not possible, the nonprofit may have to option the property. The nonprofit must provide anywhere from \$2,000 to \$10,000 for an option, funds that can be lost if the settlement does not occur within the contracted time period (often 12 to 18 months).

As noted above, national foundations such as The Enterprise Foundation, and some local foundations, often extend predevelopment loans or recoverable grants to finance up-front costs on an unsecured basis with or without recourse to the local nonprofit. You may decide to develop in partnership with an organization that has in-house expertise and the capacity to pay some or all predevelopment costs.

ACQUISITION AND CONSTRUCTION LOANS

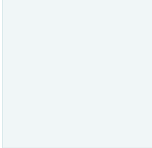
Acquisition and construction loans (typically this is one loan for both purposes) are usually borrowed from the private banking system once there is a guarantee of a permanent mortgage. These relatively safe, short-term loans are drawn down after the work is completed, minus a 10 percent retainer based on the bank inspector's approval of the finished product. If low- or no-interest funds are available for acquisition and construction (often from city or state housing agencies), use these monies first to save interest expenses.

WORKING CAPITAL

Inadequate cash flow is a major problem during the development of multifamily housing, so prepare your cash flow budget very carefully. Remember, many cash outlays are required prior to obtaining construction financing — options on the buildings, environmental surveys, preliminary drawings, market studies and some attorney's fees. These costs easily run from \$45,000 to \$100,000.

Prudently estimate cash flow during construction — will your financing sources keep pace with the demands of your contractor? Lagging payments can be a particular problem with public dollars. Is there a history of delays in public funding in your area? Calculate your cash flow needs month by month. What is the largest cash drain you may experience during the project? Work to eliminate it. Your staff CFO or controller should be involved in this planning process. See the Community Development Library's *Developing Realistic Cash Flow Projection* for more information.

The best sources for meeting cash flow shortages are a foundation or corporate grant, a program related investment from a foundation, or a line of credit from a lender.



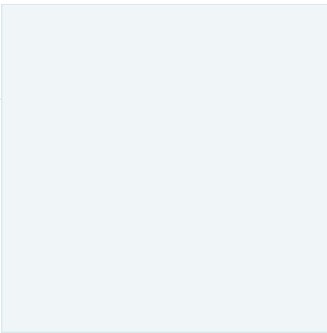
Include discussions of cash flow in your negotiations with equity partners. On occasion, you can negotiate receipt of some fees at construction start or during construction. You may also be able to get an advance against your fees. That is unlikely, however, if you do not already have a history of consistent on-budget development.

MORTGAGE FINANCING

There will normally be an interest-bearing first trust that is fully amortized and payable monthly to a private lender, usually a bank, but sometimes an insurance company or a consortium of banks form a trust fund. Often this mortgage covers less than half of the total development cost.

PERMANENT DEBT SUBSIDY

Because grants would reduce the amount of your costs that is eligible for tax-credit funds, structure as many subsidy funds as possible in the form of interest-bearing loans that accrue large negative balances over time. Sources for permanent debt may include Community Development Block Grant (CDBG) funds, State Housing Finance Agency Rental Production funds, HOME Investment Partnership Program subsidy funds and lead-based paint grants.



Low-Income Housing Tax Credit

The vast majority of affordable multifamily rental housing produced today uses the federal LIHTC. Established as part of the 1986 federal tax reforms, the LIHTC program offers credits against federal taxes for profit-motivated entities that invest in affordable rental housing. Investors achieve most of their expected return in the form of reduced federal tax liability, reducing the need for rents to repay loans.

To qualify for tax credits, a project must house tenants with incomes no greater than 60 percent of the area median income, adjusted for family size. The tax credits are distributed to the project's owners during the first 10 years of operation.

These tax credits are allocated and regulated by units of the state government, typically housing finance agencies (HFAs). The state agency establishes its own priorities or *selection criteria* for the credits, which are in high demand. Developers must compete for the tax credits on an annual basis.

Common selection criteria established by states include preferences for rents below the maximum allowed under the program, geographic dispersion of projects, lower-cost projects and projects linked with social services or integrated into an overall community development plan. In some states, nonprofits have scoring advantages under the selection criteria; in others, nonprofits complain that they are virtually shut out of the program.

LIHTC investors are generally corporations that agree to invest a certain amount of money in a project in exchange for receipt of the credits, usually by means of a *limited partnership*. Limited partnerships are vehicles by which investors own most of a project (typically 99.99 percent), thus gaining the tax benefits of ownership, but limit their liability for its operation by granting most decision-making authority to a *general partner*, who owns the remaining .01 percent of the project.

Usually, a nonprofit will form a single-purpose for-profit subsidiary to act as general partner in a specific project. This leaves the effective day-to-day control of the project with the nonprofit.

A caveat: In exchange for their money, investors may negotiate restrictions on the freedom of the general partner to operate the project as it sees fit. They often, for example, demand approval of the property management agent prior to agreeing to become limited partners and may make it difficult to change the property manager. They will certainly establish performance criteria for the operation of the project and require financial guarantees. These will be included in the *limited partnership agreement*.

NEGOTIABLE ITEMS IN PARTNERSHIP AGREEMENTS

- How much the investors are willing to pay for tax benefits
- The scheduling of payments (how much up front, during or at completion of construction) from investors, including what will happen if development does not proceed according to plan
- What cash and other forms of guarantees the nonprofit must provide
- The size and timing requirements of cash reserve accounts
- Under what terms the general partner may be forced out of the project
- Under what terms the nonprofit may acquire the project at the end of the 15-year tax credit compliance period

GENERAL PARTNER'S RESPONSIBILITIES

The nonprofit general partner is responsible for ongoing delivery of the tax credits to investors. This requires:

- Ensuring that basis (costs eligible for tax credits) forecasts and expenditures are correct
- Completing construction on time
- Meeting the qualified occupancy timeline and documenting that income-eligible tenants are leasing the apartments
- Developing adequate operating budgets
- Maintaining full occupancy
- Keeping accurate and accessible records

USING TAX-EXEMPT BONDS

In response to the increasing competition for 9 percent LIHTC allocations (given for new construction or rehab costs), many developers are turning to tax-exempt bond financing with and without the 4 percent LIHTC (given for acquisition costs). The spread between taxable and tax-exempt bond financing varies depending on the bond market, but tax-exempt rates are always lower, making this type of financing attractive to developers of low-income housing.

A brief introduction to tax-exempt bond financing follows. It is important to note that bond financing, like the LIHTC program, is a complicated process subject to Internal Revenue Service regulations. It is also important to note that bonds have additional soft costs that can make financing prohibitively expensive. These transactions include a bond issuer, bond underwriter, bond counsel and usually some form of credit enhancement provided by a third-party source. Each of these additional entities carries a cost. As a result, most bond-financed housing consists of larger projects.

Tax-exempt bonds are divided between private-activity bonds and public-purpose bonds. Public-purpose bonds are used to develop housing that will remain publicly owned. Private, nonprofit and for-profit developers of multifamily housing commonly use two types of private-activity bonds: exempt facility bonds and 501(c)(3) bonds.

Multifamily rental projects can qualify for exempt facility bonds if one of the following conditions exists:

- Twenty percent or more of the residential units are set aside for households with incomes at or below 50 percent of area median income.
- Forty percent or more of the residential units are set aside for households with incomes at or below 60 percent of area median income.
- The minimum compliance period is either 15 years or the term of the tax-exempt bond financing, whichever is longer.

Multifamily rental projects can qualify for 501(c)(3) bonds if:

- The primary beneficiary of the bond issue is a 501(c)(3) organization (for example, if a 501(c)(3) organization will own and operate the financed housing project for the benefit of low-income households).

One critical difference between exempt facility and 501(c)(3) bonds is a volume cap: exempt facility bonds fall under a state's private-activity bond volume cap and 501(c)(3) bonds do not. In many states, competition for private-activity bond allocations is substantial, with interests other than housing fighting for this resource.

Another critical difference between exempt facility and 501(c)(3) bonds is eligibility for the 4 percent LIHTC. Projects financed through exempt facility bonds receive an as-of-right tax-credit allocation; projects financed through 501(c)(3) bonds are ineligible for tax credits.

In order to qualify for the 4 percent LIHTC on all eligible units, the tax-exempt bond must exceed 50 percent of development costs, including land acquisition. In order to meet this test, many projects use tax-exempt bond financing in excess of 50 percent during construction and then take out a portion of the financing with lower interest rate debt for the permanent phase.

Bonds can be sold through private placements or public offerings. In a private placement, an investor buys the bonds directly from the issuer; in a public offering, the issuer sells the bonds to a bond underwriter, who then resells them to many investors. Public offerings require investment grade ratings from agencies such as Moody's or Standard & Poor's, both to increase the marketability of the bonds and to keep interest rates low. Investment grade ratings usually require credit enhancement in the form of bond insurance, a bank letter of credit or some other third-party guarantee.

A tax-exempt financing project using the 4 percent tax credit might have the following chronology:

1. Initial feasibility determination
2. Development team selection — bond issuer, bond underwriter, credit enhancer, accountant, tax-credit investor, in addition to usual development team members
3. Inducement resolution — bond issuer passes an inducement resolution to notify the public of its intention to issue tax-exempt bonds
4. Private-activity bond cap allocation — bond issuer receives a private-activity bond cap allocation
5. Credit enhancement commitment — the project secures a commitment from a credit enhancer such as a bank or mortgage insurance company
6. Tax Equality and Fiscal Responsibility Act hearing — the bond issuer holds a public meeting to hear public comments on the proposed issuance
7. Tax-credit application — the project, although entitled to the 4 percent LIHTC, needs to secure a reservation or binding commitment from the LIHTC allocating agency
8. Legal documents and final underwriting — all documents completed and bonds priced
9. Bond closing

Operating Budget

You must also have an operating budget that demonstrates your ability to carry the project beyond development and into occupancy. The budget will include expected rent levels, vacancy rates, maintenance fees and other ongoing expenses. The operating budget intersects at many points with the development budget. Rent levels will reflect the apartment sizes and amenities shown in the development budget. Maintenance expenses will be higher if some older building systems (roof, heating and air conditioning, plumbing, electrical) are repaired and not replaced. The operating budget will show the debt service payments that can be made in the future, and these payments also will be described in the development budget.

EXPLANATION OF OPERATING BUDGET

The development's operating budget (also known as a pro forma operating budget, or simply pro forma) projects, in numbers, the operating performance of the project. It consists of three main parts: operating income, operating expenses (which, when subtracted from operating income, result in net operating income, or NOI), and debt service and reserve payments (which, when subtracted from NOI, result in net cash flow). Four years of the operating budget are shown in the sample spreadsheet.

Operating Income

Gross Rental Income: This is the income potential of the project, before deducting vacancy and nonpayment. It increases annually by the income inflation assumption listed in the spreadsheet.

Laundry Income: In developments with a coin laundry, the anticipated income is entered here. However, the cost of constructing a fee laundry (or other fee amenities, such as paid parking) may not be included in the basis for calculating the amount of LIHTCs the project will earn.

Vacancy: This is the percentage of rents that the development will not receive, because of either vacancy or nonpayment by tenants. Typically, the percentage is higher in the first year of

operation, because of a lag between units coming available and tenants taking occupancy.

Additional Subsidy: Rental assistance payments not included in the base rent charged to tenants are shown here.

Net Rental Income: The total of rents and other income less the allowance for vacancy and nonpayment.

Operating Expenses

The first column shows the estimate of what each operating expense would be at the beginning of operations, if the development were in operation for 12 months in the first calendar year. The second column shows the actual anticipated expenses for the portion of the first calendar year that the development will be in operation. Expenses are increased each year thereafter, according to the expense inflation assumptions listed in the spreadsheet.

Real Estate Taxes: Taxes vary widely between localities. They can, however, be estimated with a high degree of accuracy if you understand your locality's method of valuation and know the mathematical formula for calculating taxes based on valuation. This information can usually be obtained from your local county assessor's and treasurer's offices.

Insurance: The cost of property and liability insurance can also be accurately estimated based on the value of insurance. Your lender and investors will usually require minimum coverages. Find out what these are, and get a quote from your insurer as you put together your operating budget.

Utilities — Common Area: This includes the cost of lighting and heating unleased areas, such as hallways and parking lots. You should also include estimated costs of utilities in vacant apartments. In cases where the owner of the development is paying utilities other than water and sewer, these should be included in a separate line item.



Development Operating Budget

OPERATING CASH FLOW

INCOME: 3% inflation factor

	1999	2000	2001	2002
	Year 1	Year 2	Year 3	Year 4
Gross Rental Income	\$202,020	\$353,246	\$363,843	\$374,759
Laundry Income	0	0	0	0
Less: Vacancy (@ 5% after stabilization)	30,303	17,662	18,192	18,738
Net Income	171,717	335,584	345,651	356,021
Additional Subsidy	0	0	0	0
Net Rental Income	\$171,717	\$335,584	\$345,651	\$356,021

EXPENSES: 5% inflation factor

Real Estate Taxes	\$22,750	\$22,750	\$23,888	\$25,082
Insurance	7,000	14,000	14,700	15,435
Utilities — Common Area	5,250	10,500	11,025	11,576
Water/Sewer	15,167	30,334	31,851	33,444
Maintenance/Repairs/Decorating	7,500	20,000	21,000	22,050
Administration	12,833	25,666	26,949	28,296
Management Fee (@ 6% of gross rents)	12,121	21,195	21,831	22,486
Audit and Tax Return	0	5,000	5,250	5,513
Asset Management	2,625	5,250	5,513	5,789
Other	0	5,000	5,250	5,513
Total Expenses	\$85,246	\$159,695	\$167,257	\$175,184
Net Operating Income	\$86,471	\$175,889	\$178,394	\$180,837

DEBT SERVICE

Principal	\$6,223	\$11,166	\$12,060	\$13,025
Interest	61,833	105,502	104,609	103,644
Total Payable	\$68,056	\$116,668	\$116,669	\$116,669

DEBT SERVICE COVERAGE RATIO:

Replacement/Equip. Reserve	1.16	1.39	1.41	1.43
	\$7,700	\$13,596	\$13,860	\$14,553

OPERATING CASH FLOW

Lease-Up Reserve	10,715	45,625	47,865	49,616
	7,000			

NET CASH FLOW

Incentive Management Fee	\$17,715	\$45,625	\$47,865	\$49,616
	0	0	0	0

RESERVES

Reserves Funded Through Equity Pay-Ins	\$80,000	\$20,000	\$20,000	\$20,000
Cumulative Operating Reserve	97,715	163,340	231,205	300,821
Interest Income	0	0	0	0

Water/Sewer: In most communities, the owner pays for water and sewer service. These costs can be substantial, especially if the project includes water-using amenities, such as in-unit washers or hookups and dishwashers. Remember to estimate the cost of water for maintaining landscaping as well. An experienced property manager can be of help in figuring this line item.

Maintenance/Repairs/Decorating: This line item includes the costs of all repairs except for replacement of major capital items (such as roofs and furnaces), which is funded from the replacement reserve. Include in your estimate the cost of routine unit make-ready between tenants. Again, an experienced property manager can help with this estimate.

Administration: This item generally includes the cost of management staff and the direct expenses of your property manager on the project. Costs that can be passed through to the owner should be spelled out in detail in the property management agreement. This line item may also include contracted services, such as legal expenses.

Management Fee: Usually property managers are paid a percentage of collected rents, in addition to allowable pass-through expenses. Because LIHTC rents are often lower than market rents, this percentage may be higher for these types of developments. In some cases, owners and managers have negotiated per-unit fees rather than a percentage of rents. In either case, the payment should be based on actual payments (collected rents on occupied and paying units).

Audit & Tax Return: Tax credit partnerships must file an annual tax return. Investors generally require an annual audit, as well.

Asset Management: This fee may be paid either to the general partner or to a party designated by the limited-partner investors to pay for the extra costs of record-keeping and reporting to investors on the performance of an LIHTC project.

Debt Service

This section shows the amount of principal and interest payment and, where appropriate, the amount of interest accrued for each loan obtained.

Debt Coverage Ratio: This shows, year by year, the projected ratio of NOI to the required debt service on the first mortgage loan. Lenders set minimum debt coverage ratios they expect to see in projections once the project has reached full occupancy, generally in the second calendar year of operations. The Debt Coverage Ratio shown in this example deducts required replacement reserve payments (see below) from the NOI before dividing by debt service.

Replacement and Equipment Reserve: Lenders and investors will require that the project make minimum contributions to a reserve for replacement of major capital items. This amount is based on the number of dwelling units; in this case the contribution is \$200 annually per unit.

Incentive Management Fee: The general partner and limited partners may negotiate payments to the general partner based on the amount of cash the project earns, as an incentive to the general partner.

Net Cash Flow: This is the amount remaining from operating income after all operating costs, debt service payments, replacement reserve contributions and incentive fees have been paid. Depending on the terms of the partnership agreement, this cash may be distributed to the partners in the project, left under the ownership of the limited partnership as a reserve fund, or both.

Reserves: This section projects the contributions to a capital reserve to fund operating deficits. In this case, contributions to the reserve include payment from the equity contributions of the limited partners, net cash flow from the project and interest earned on the balance of the operating reserve account.

Investor Funds

You will need to figure out how to fund costs that will ultimately be taken out by investor equity. Investors generally will not put in their funds until the project is completed and leased. This cash flow problem is difficult to overcome and requires advance planning.

Community Interaction

During the development process, many constituencies will surface. The nonprofit real estate developer must pay very close attention to the needs and demands of these groups. Each is important, and all interact informally and are influenced by the comments of others. Many projects have been delayed or entirely derailed by community opposition, even developments sponsored by established, politically connected organizations.

WORK WITH YOUR NEIGHBORS

Remember that neighbors of your building will be neighbors of your residents. Work with them throughout the development and initial occupancy phase. This will help your residents feel welcome in their new neighborhood. But remember most people do not like change. Even replacing a dilapidated building with low-income apartments may cause complaints. Expect to make some design changes in response to neighbors. Residents in the broader geographic area may be more supportive because they see the development as the removal of an eyesore or an increase in business opportunities.

AVOID OPPOSITION, IF POSSIBLE

A particular market constraint often affecting affordable housing producers is “NIMBY” (Not In My Back Yard). This can take the form of legal restrictions (numerous approvals required, high amenity requirements, flat-rate impact fees) or general opposition. The approval process may be a basis for a legal challenge, which most developers do not have the time and money to fight. If NIMBY is a continual constraint, you may have to organize with civil rights groups, other developers and the business community to seek political or judicial solutions. If this fails, look for projects in other neighborhoods or jurisdictions.

INVOLVE NEIGHBORS EARLY IN THE PROCESS

Regardless of whether you expect the development to cause major conflict, involve neighbors and supporters early in the process. Some NIMBY is a cover for racism, and it is helpful to have these neighbors expose their opinions early and loudly so the public can reject them. Take some friends to meetings with you. You will feel better with support in the audience. If you believe that your project will be controversial, seek help from your public donors and organizations with similar goals. Make a special effort to involve public officials, briefing them early and often. And do not forget informal community leaders, like the woman on the block who knows everybody.

Development Fees

Revenues to the nonprofit organization from multifamily renovation developments will generally be limited to the development fees you receive as developer of the project. Expect no cash flow from an operating project. Unless you are an experienced and sophisticated property manager, do not expect to make a profit in property management.

Fee constraints come from the marketplace and public sector donors. Any increase in your fee results in an increase in rents, because any increase in costs must be recouped by higher rents. Remember, your tenants can only pay so much rent. Also, both your LIHTC issuing agency (state) and your sources of soft second mortgage or grant financing may seek to limit your fees in order to limit their indirect subsidy of your organization.

Your financial partners may also restrict your ability to collect development fees quickly. This both improves their return (by delaying expenses) and gives them leverage to ensure that you continue to do your job (get the project built, leased up and operating in the black).

You can earn \$5,000 to \$7,000 per unit in development fees if you are not sharing fees with a developer. The timing of the payment is negotiable, but generally these fees will be paid by stabilization (or “operating breakeven”). This fee may cover your organizational overhead costs, but it leaves little margin for error. As you expand production, you may see some efficiency savings, but these will likely go to salary increases; you must offer attractive compensation in order to prevent your staff from joining for-profit organizations that are looking for professionals with experience in LIHTC projects.

Long term, if you do a very good job, you will probably see residual value (equity) in the project itself after the investors exit in 15 years. At that time you probably will confront significant maintenance and marketability issues, but you may find that you can continue to operate the development affordably, without major new injections of public subsidy.

Risks and Their Solutions

Risk — Construction costs may be higher than anticipated.

Solutions —

1. Create a construction budget that includes more contingency. The earlier development budget includes 12 percent contingency for construction costs. This may be adequate, but you should budget even more contingency in certain situations; for example, if the development team lacks significant experience in multifamily rehabilitation or you will be using a builder you have never worked with. Also, if you expect to keep some of the building systems (electric, plumbing, HVAC, roofing) in the final product, you may want to factor in additional contingency.
2. Double-check the cost estimates. Estimating rehabilitation costs always is more difficult than estimating the costs of new construction, simply because you never know what you will find in an old building until construction actually starts. Make sure your development team uses cost estimators very experienced in construction of similar types of buildings. Do not accept an overall square footage estimate of costs; a good estimate needs to show costs for each construction line item.

Risk — Vacancy rates may be higher than anticipated.

Solution — Keep rents low. Anticipate minimum rent increases during the life of the financing. Do not project rent increases higher than 3 percent annually. The lower you can set your rents, the broader market you can reach. This also may give you more room to raise rents if expenses run high. Do not plan an operating budget without anticipating an increase in expenses of at least 4 percent per year. You can improve your forecasting by involving your property and asset management firm in your operating budget review.

Risk — The long-term feasibility of the project is not secure.

Solution — Budget sufficient reserves. You should establish higher reserves than you believe necessary. Your financial partners will want this as well. Organizations such as the Institute for Real Estate Management (IREM) or the Consortium for Housing Asset Management (CHAM) can give you an idea of how to figure these numbers. To reach CHAM, call 800.624.4298. For IREM, call 312.329.6000 or see their Web page at www.irem.org. Your property manager can also help. Investors often require operating reserves of six months of debt service and operating costs.

THE ENTERPRISE FOUNDATION

The Foundation's mission is to see that all low-income people in the United States have access to fit and affordable housing and an opportunity to move out of poverty and into the mainstream of American life. To achieve that mission, we strive to:

- Build a national community revitalization movement.
- Demonstrate what is possible in low-income communities.
- Communicate and advocate what works in community development.

As the nation's leader in community development, Enterprise cultivates, collects and disseminates expertise and resources to help communities across America successfully improve the quality of life for low-income people.

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