Housing Development Finance 101

Doug Olcott, Regional Director, Hudson Valley Office

Community Preservation Corporation

MISSION-DRIVEN SINCE 1974

CPC believes housing is central to transforming underserved neighborhoods into thriving and vibrant communities.

CPC is a nonprofit affordable housing and community revitalization finance company providing flexible capital solutions, fresh thinking and a collaborative approach to the complex issues facing communities.

Our goal is to be more than just a lender. At CPC, we work as a partner to provide technical expertise and hands-on support to help meet the capital needs and broader community revitalization goals of our customers, local stakeholders and the communities we serve.

Adaptive Reuse
500 Seneca Street
Buffalo, NY

UNCOMMON EXPERTISE. UNMATCHED IMPACT.

Since 1974, CPC's creative financing solutions have supported critical projects in neighborhoods across New York State and beyond, resulting in wide-reaching physical, economic, and social impacts that improve communities and people's lives.

$14 BILLION

of private & public capital invested in
New York and contiguous states

PHYSICAL

225,000+
residential
units financed

SOCIAL

1.1 Million+
people provided with
high quality, stable
housing

ECONOMIC

120,000+
Jobs created via
construction
lending

MISSION-DRIVEN SINCE 1974

Today, CPC uses its unique expertise in housing finance and public policy to:

Expand housing access and seek new ways to lower the cost of producing affordable housing

Invest in closing the racial wealth gap, and increase diversity and equity in the development industry

Commit to and expand investment in the green economy and lessen the impact of climate change

THE CPC TOOLBOX: FLEXIBLE CAPITAL AND UNIQUE EXPERTISE

We use our unique expertise in housing finance and policy to help meet the capital needs and broader community revitalization goals of our customers and the communities we serve.

THE FIVE "C'S" OF CREDIT

1. Character – Credit history and experience of borrower, business references, credit references.

2. Capacity – Ability to pay the loan and previous projects completed (similar size and scope), personal and business financial statements of the developer and general contractor.

3. Capital – Sources of funds to finance housing projects (equity/cash contribution, public subsidy sources and CPC Loan).

4. Collateral – The property and projected completed product of what is planned to be constructed. Also Letters of Credit and bonds to secure completion and fund possible cost overruns.

5. Conditions – Neighborhood, construction costs, local economy, national economy, interest rates, market rents etc.

PROJECT FEASIBILITY/PRE-DEVELOPMENT

1. Site and Project -
   Neighborhood, zoning, comparable rents, access to transportation & other amenities, comparable projects, municipal considerations (permits, building codes, community plans and preferences).
2. Development Team – Due Diligence
   a. Owner/developer and partners, not-for-profit sponsors
   b. Architect/Engineer
   c. General Contractor/Job Superintendent
   d. Property Manager
   e. Other consultants (e.g. energy efficiency)
3. Financials of Rental Properties – Determine Loan Amount
   a. Income – Apartment rents, retail/office rents (if mixed use), laundry, parking fees, cell towers, etc.
   b. Expenses – Property Operating & Maintenance (O & M) Costs
      1. Real Estate Taxes
      2. Insurance
      3. Utilities – Water & sewer, gas & electric, heat
      4. Repairs & Maintenance
      5. Management Expenses – Property Manager
      6. Administrative, Legal & Accounting
      7. Salaries – Super, Porter etc.
      8. Landscaping & Snow Plowing
      9. Cleaning & Exterminating
      10. Building Reserve/Capital Reserve

PROJECT FEASIBILITY/PRE-DEVELOPMENT CONT.

c. Net Operating Income –

Gross Potential Income

Less: Vacancy loss (5%-10%)

Less: Operating expenses (O & M)

= Net Operating Income

NOI – A portion is used to pay debt service (mortgage payments). The remainder will become developer profit or cash flow.

d. Example: 123 Main Street, Newburgh

5 Apartments + 1 Store

Residential Rents ($1,190 * 5) = $5,950 per month

Retail Rent ($1,000 * 1) = $1,000 per month

Annual Residential Rent	$71,400	
Annual Retail Rents	$12,000	
Total Gross Rental Income	$83,400	
Less: Residential Vacancy (7%)		($4,998)
Less: Retail Vacancy (10%)	($1,200)	
Net Effective Income	$77,202	

PROJECT FEASIBILITY/PRE-DEVELOPMENT CONT.

Expenses	
RE Taxes	$18,000
Insurance	$3,300
Water & Sewer	$2,200
Gas & Electric	$960
Heat	$0 (Tenants Pay)
Payroll	$2,000
Cleaning & Exterminating	$1,620
Management (5%)	$3,860
Repairs & Maintenance	$4,000
Legal & Accounting	$1,000
Building Reserve	$1,250
Total O & M Expenses	$38,190
Net Effective Income	$77,202
Less: Total O & M Expense	($38,190)
Net Operating Income (NOI)	$39,012

PROJECT FEASIBILITY/PRE-DEVELOPMENT CONT.

Net Operating Income (NOI)	$39,012
Less: Annual Debt Service ($440,000, 30 year loan @ 5.25%)	($29,156)
Cash Flow/Profit	$9,850

Debt Service Coverage = $\frac{\text{Net Operating Income}}{\text{Annual Debt Service}} = \frac{\$39,012}{\$29,156} = 1.34$

Debt Service Coverage (DSC) is the ratio of NOI to debt service of mortgage payments.

Minimum DSC lenders require : 1.20-1.30

This means that for every dollar of debt service, the owner has $1.20-$1.30 in their pocket available (balance is profit).

PROJECT FEASIBILITY/PRE-DEVELOPMENT CONT.

e. Loan to Value (LTV)

Ratio of the amount of the loan to the 'As-completed" value of the property. Lenders typically require a maximum LTV of between 70%-80%.

Value Example: 123 Main Street, Newburgh

$$\text{Value} = \frac{\text{Net Operating Income}}{\text{Cap Rate}} = \frac{\$39{,}012}{7.00\%} = \$557{,}000$$

$$\text{LTV} = \frac{\text{Loan Amount}}{\text{Value}} = \frac{\$440{,}000}{\$557{,}000} = 79\%$$

Capitalization (Cap) Rates – Based on expected returns that real estate investors expect to earn in a particular market. In the Hudson Valley, cap rates range between 6.00%-8.00%.

PROJECT FEASIBILITY/PRE-DEVELOPMENT CONT.

f. How do debt service coverage (DSC) and Loan-to-Value (LTV) affect project feasibility?

They limit the amount that a developer can borrow for a particular project. If a developer cannot borrow enough funds, the project may not be feasible financially.

g. Capital Types

1. Equity – Capital provided by the developer from his/her own funds or from their partners (cash).
2. Debt – Capital that is loaned to the developer by the lender that must be repaid from a mortgage (principal + monthly interest) typically over a 15-30 year period.
3. Subsidy – Capital generally from a public source in return for which the recipient is providing a public benefit (i.e. lower rents in an affordable housing project). Typically a grant or deferred loan.

h. Development Costs

1. Acquisition
2. Construction costs (hard costs)
3. Soft Costs
    a. Professional fees (architect, engineer, appraisal, title, survey etc.)
    b. Carrying costs (construction interest, RE Taxes, insurance, utilities etc.)

Total Development Costs = (Hard Costs + Soft Costs + Acquisition)

PROJECT FEASIBILITY/PRE-DEVELOPMENT CONT.

Example: 123 Main Street, Newburgh

Acquisition	$105,000
Construction Costs	$344,000
Professional Fees	$46,000
Carrying Costs	$60,000
Total Development Costs (TDC)	$555,000

Sources of Capital

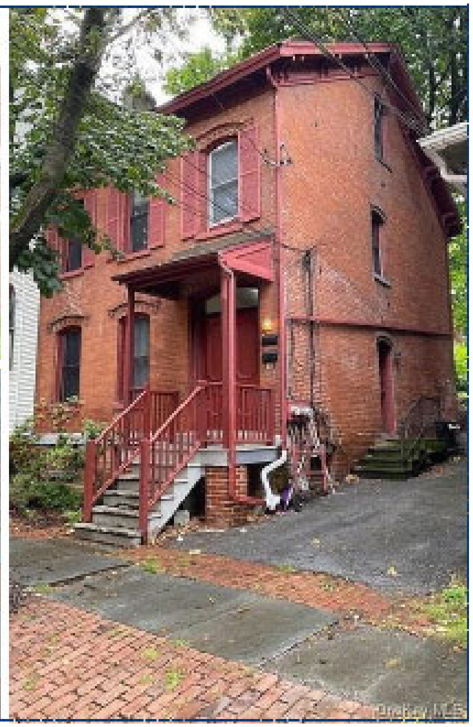
Equity	$115,000 (21%)
Debt (CPC Mortgage)	$440,000 (79%)
Total	$555,000

Project Feasibility/Pre-Development Cont.

i. <u>Ratio of Debt to Equity</u>

Generally equity will fund 20-30% of TDC and debt will finance 70-80% of TDC.

<u>Reason</u>: If a developer has to provide more than 30% equity, then their return on investment becomes less and the project may not make sense financially (e.g. could invest same funds in CD's, stocks, bonds or mutual funds that are less risky for a similar return).



RISKS OF REAL ESTATE DEVELOPMENT

- Acquisition and pre-development expenses for projects that do not move forward (uncompensated costs)
- Delays for project approvals (increase in soft costs)
- Rising construction costs (inflation and supply chain issues results in increase in hard costs)
- Rising interest rates during construction (increase in soft costs)
- Increases in operating expenses (real estate taxes and insurance)
- Unexpected cost overruns (e.g. rock removal, environmental issues, building structural issues)
- Market risk (rents and housing prices less than projected)
- Post lease-up of property – non-paying tenants or unexpected vacancies

SUBSIDY AND AFFORDABLE HOUSING

Public subsidies are generally used to fund gaps in equity and conventional debt which are created by lower rents (less conventional debt can be borrowed when rents are lower due to less cash flow).

Example: 123 Main Street, Newburgh

Rents – Reduced from $1,100/month to $800/month to make project “affordable” for the 5 apartments.

Gross Residential Rents	$48,000 (Reduced from $71,400)
Gross Commercial Rents	$12,000 (Same)
Effective Gross Income	$60,000
Less: Residential Vacancy (7%)	($3,360)
Less: Retail Vacancy (10%)	($1,200)
Net Effective Income	$55,440
Less: O & M Expenses	($38,190) (Same)
Net Operating Income (NOI)	$17,250

Maximum Conventional 30 Year Loan = $200,000 @ 5.25% interest

Annual Debt Service = $13,253

Debt Service Coverage = $\dfrac{\text{Net Operating Income}}{\text{Annual Debt Service}} = \dfrac{\$17{,}250}{\$13{,}253} = 1.30$

Subsidy and Affordable Housing

Subsidy Included in Capital Sources

Equity	**$115,000**	
CPC Loan	**$200,000**	
Subsidy Funds	**$240,000**	**(Gap created by lower loan amount)**
TDC	**$555,000**	

Note: With the "affordable" rents the developer was only able to borrow $200,000 as opposed to $440,000 at market rents ($240,000 less) from the CPC. This was compensated for by the provision of a $240,000 gap subsidy by the municipality, county or state.

Public Subsidies: Affordable housing subsidies are generally structured as grants or deferred loans. In exchange, the developer is required to keep rents affordable for a period of 15-30 years subject to a regulatory agreement. Affordability is typically defined as rents at the 30% or less of household income.

Payment in Lieu of Taxes (PILOT'S) And Affordable Housing

PILOTS, or tax abatements, are a form of public assistance which can be used to promote affordable housing. PILOTS generally provide lower real estate taxes to the project to offset the lower rents. By lowering the operating costs, developers can borrow more conventionally to cover development costs than they would with full RE taxes.

Example: 123 Main Street, Newburgh

Effective Net income ($800 rents)	$55,440
O & M Expenses (incl. RE Taxes)	$38,190
RE Taxes (full)	$18,000
PILOT Taxes (Reduced)	$5,000
Reduction in O & M Expenses	$13,000
O & M Expenses (with PILOT)	$25,190
NOI (with PILOT)	$30,250

Maximum 30 year loan @ 5.25% interest = $360,000

Annual Debt Service = $23,855

$$\text{Debt Service Coverage} = \frac{\text{Net Operating Income}}{\text{Annual Debt Service}} = \frac{\$30{,}250}{\$23{,}855} = 1.27$$

PILOT and Subsidy Included – Capital Sources

Equity	$115,000
CPC Loan	$360,000 (higher loan amount with PILOT due to lower RE taxes- $200,000 loan increase)
Subsidy Funds	$80,000
TDC	$555,000

Conclusion – Both local PILOT agreements and public capital subsidies can be used together to promote affordable housing projects.

SOURCES AND USES SUMMARY-COMPARISON OF 3 SCENARIOS

1) Market Rate Rents

Equity	$115,000 (21%)
CPC Loan	$440,000 (79%)
Total	$555,000

2) Affordable rents with Subsidy

Equity	$115,000 (21%)
CPC Loan	$200,000 (36%)
Subsidy Funds	$240,000 (43%)
TDC	$555,000

3) Affordable Rents with Subsidy & PILOT

Equity	$115,000 (21%)
CPC Loan	$360,000 (higher amount with PILOT) (64%)
Subsidy Funds	$80,000 (15%)
TDC	$555,000

cpc

E. CPC – How We Calculate, Finance and Maintain Affordable Housing Projects

1. Feasibility and Pre-Development
   a. Evaluate budgets and operating proformas for maximum loan.
   b. Recommend public subsidy or tax abatement programs if funding gap.
   c. Evaluate developer capacity – recommend appropriate partners if needed
   d. Inspect properties – buildings and land/building sites.
   e. Conduct market and neighborhood research (including local plans & initiatives)
   f. Review credit and financials of developer
   g. Review architectural plans and construction costs

2. Post-Closing – Construction & Rehabilitation
   a. Monthly inspections by third party engineer.
   b. No funds advanced except for completed work in place or required deposits for materials.
   c. Contingency funds – 5-10% for potential cost overruns
   d. All permits and approvals for construction kept on file
   e. 10% retainage and advances until final Certificate of Occupancy (C of O).
   f. Letters of credit held and bonds until project completion. Typically 10% of construction (hard costs).

SUBSIDY AND AFFORDABLE HOUSING

3. Conversion From Construction to Permanent Loan
    a. Review leases and rent rolls of apartments
    b. Review Certificates of Occupancy (C of O) and final local approvals.
    c. Title search (RE Taxes must be current)
    d. Updated operating pro formas – reviewed prior to permanent loan closing.
    e. Review of property manager – CPC approval of qualified manager required

4. Post-Conversion – Ongoing Management
    a. Annual property inspections. Notification of owner of any deferred maintenance/repairs required.
    b. Quarterly or annual operating statements must be submitted. Evaluate on going financial health of building.
    c. Building Reserves – Capitalized for repairs needed in the future. Monitor and fund from the reserve.
    d. Annual borrower financial statements must be submitted. Financial health of the owner evaluated.
    e. Escrows – Insurance & RE taxes are paid from these monthly escrows.
    f. Insurance claims – for property damaged processed

AFFORDABLE HOMEOWNERSHIP

- **PITI** – **P**rincipal & **I**nterest (on mortgage), (RE) **T**axes and **I**nsurance
- **Affordability –** Typically lenders will provide a mortgage amount up to 33% of household income to cover PITI.

- **EXAMPLE 1**
- $400,000 Market Home Price
- Dutchess County Area Median Income (AMI) = $115,700
- 80% OF AMI (Affordable Target) = $92,560
- Down payment (10%) = $40,000
- Mortgage (90%) = $360,000
- 30 yrs @ 7.00% = $2,395/month * 12 = $28,741/yr

PITI

- Principal & Interest = $28,741
- RE Taxes = $10,000
- Insurance = $2,500
- Total PITI = $41,241

  33%

- Minimum Income Required = $124,972 (108% of AMI)

AFFORDABLE HOMEOWNERSHIP (CONT.)

- **EXAMPLE 2 – Subsidized Sales Price (Affordable at 80% of AMI)**
- Home Price = $400,000
- State Subsidy = ($150,000)
- **Subsidized Sales Price = $250,000**

- Down Payment (10%) = $25,000
- Mortgage (90%) = $225,000
- 30 yrs @ 7.00% = $1,497/mo * 12 = $17,963/yr

- **PITI**
- Principal & Interest = $17,963
- RE Taxes = $10,000
- Insurance = $2,500
- Total PITI = $30,463
  33%
- Minimum Income required = $92,312 (80% of AMI)

ADDITIONAL RESOURCES

- **Start Small Guide to Financing Small Multifamily Building Projects:** https://communityp.com/thought-leadership/resource/start-small/
- **Construction Loans 101 online summary:** https://communityp.com/financing-multi-family-property/