Sources of Affordable Housing Financing in Massachusetts

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March 9, 2016

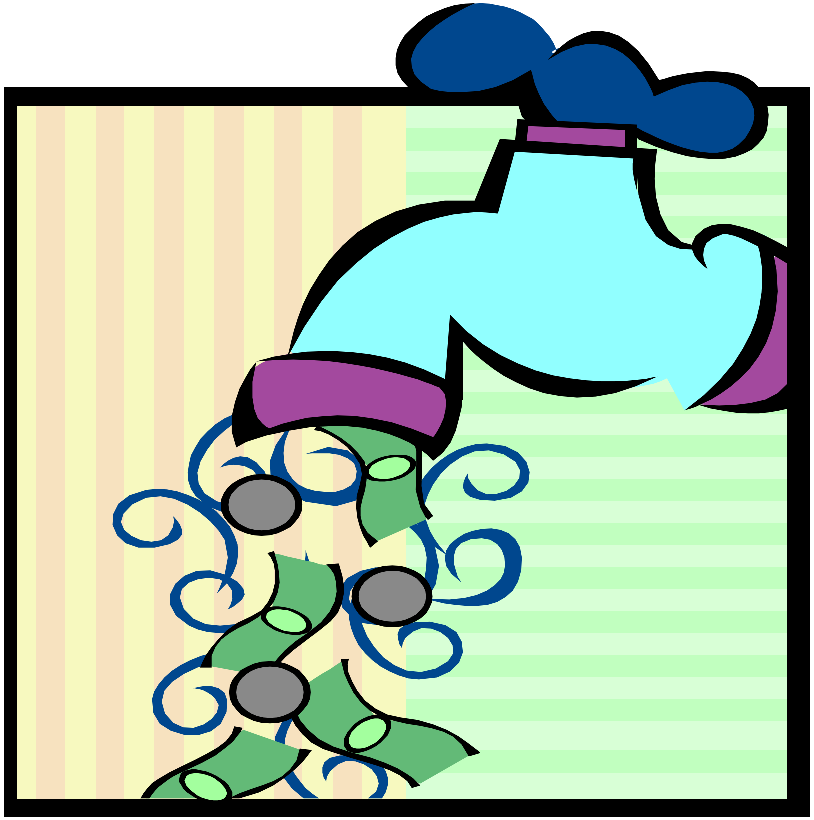
Who is MHP?

Quasi-public corporation devoted to promoting high-quality affordable housing solutions in Massachusetts.

- Multi-family lending: using $1.19B in low-cost debt capital (10-year credit lines) from banks, we have financed 350 housing developments in Massachusetts, totalling nearly 16,000 units of rental housing, and $650MM in loans, since 1991. We are now also a FNMA and FHA lender.
- First-time homebuyer support: MHP's ONE Mortgage helps first-time low- and moderate-income homebuyers. In its 25-year history, it has
  - helped more than 19,000 low- and moderate-income families buy their first home
  - leveraged $3.3 billion in private, below-market mortgage financing
  - served low-income homebuyers – median household served earns only 55% of AMI
  - and served them well, as the delinquency rate remains low -- comparable to the delinquency rate of prime mortgages in Massachusetts, with foreclosure rate at less than half of the pace of conventional mortgages.
- Technical assistance to towns, housing partnerships, and non-profit developers.

The Grim Reality
of Affordable Housing Finance

Does funding for affordable housing flow like this?



NOPE, you have to…

….very carefully…

….because resources for affordable housing are more precious than ever…

- **Federal:**
  - While **federal funding for housing assistance** has grown over the last five years, it is still about 6% below what it was in FY10, and most of the growth sustains rental assistance for the 4.6MM low-income households currently served, rather than increasing rental assistance resource.

  - **LIHTC program** getting new scrutiny in Washington -- new Tax Reform Act of 2014 would do away with tax-exempt bonds for housing and introduce changes that would reduce the attractiveness of the 9% tax credit program for investors

- **State:**
  - Volume cap (private activity bonds) for housing in Massachusetts is very constrained,
  - Tax-credit and capital grant resources are chronically over-subscribed, and some have been cut severely, notably HOME.
  - Some special needs programs have gained support.
  - State Sect 8 has eliminated certain utility allowances for electric.
  - MRVP to be reduced under Gov. Baker’s budget.

Good websites for information on housing programs:

- CHAPA (www.chapa.org)
- Center on Budget Policy and Priorities (www.cbpp.org)
- Massachusetts (DHCD) –
  - (rental assistance): http://www.mass.gov/hed/housing/rental-assistance/
  - (capital subsidies): http://www.mass.gov/hed/housing/affordable-rent/
- HUD -- www.hud.gov
- MHP – www.mhp.net

So, don’t plan on building something like this…

But, you can end up with something like this…

Putnam Green, Cambridge (40 units)

Brian Honan Apartments, Allston (50 units)

Key Sources of Affordable Housing Finance

- Hard Debt
- Soft Debt
- Grants
- Tax Credit Equity
- Sponsor Equity

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- Hard Debt
- Soft Debt
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Characteristics of Hard Real Estate Debt

- **Affirmative, regular payment obligations**
    - *Principal + interest, interest-only, balloon payment at maturity*
- **Secured by first mortgage and assignment of rents and contracts**
- **May be either recourse or non-recourse**
- **Limitations on rights of prepayment, assignment, or transfer of borrower interests**
- **Reserve and escrow requirements**
- **Reporting requirements**
- **Affordability requirements**

How does a lender determine the quality of a loan?

Lenders look to be satisfied about their

sources of repayment.

Lender’s Three Sources of Repayment

- *First:* CASH FLOW

Operations of the property

- *Second:* COLLATERAL

Value of the property in foreclosure

- *Third:* SPONSOR

Quality, if any, of the guarantee, if any

First Source of Repayment – CASH FLOW
Key: Sizing the loan

REVENUE

Rental Income

10 1-BR @ 1000	120,000
20 2-BR @ 1300	312,000
10 3-BR @ 1500	180,000
	612,000
Less: Vacancy 5.0%	(30,600)
EFFECTIVE RENTAL INCOME	581,200

EXPENSES

Management (4.5% of collected rents)	22,059
Administrative	60,000
Maintenance	120,000
Utilities	100,000
Taxes and Insurance	60,000
	362,059
Less: Contribns to Repl.Rsv. 325/u/yr	13,000
TOTAL EXPENSES	375,059 ($9,051 /u/yr)
NET OPERATING INCOME	206,341

AFFORDABLE DEBT

Debt Coverage Ratio 1.15 (or higher, depending on nature of deal)

Available for Debt Service 179,427

Divide by: Annual Constant 6.73 *

** 5.30%, 30yr amortization*

Maximum Mortgage Amount is….
2,666,000
($66,000/unit)

Analyzing the Pro-Forma

- Revenue:
  - **Residential rents must observe constraints of ….**
    - Market
    - Maximum allowable program rents
    - Utility allowance
    - Use restrictions imposed by permitting
    - Discontinuation of rent or operating subsidies prior to loan maturity
  - **Commercial rents must observe constraints of…**
    - Market
    - Need for brokers' and tenant fit-up costs at turnover

- Expenses
  - **Expense budget must not understate the cost of operations**
    - Property management (at least 4.5% of collected rents)
    - Administrative (legal, accounting, office)
    - Operations and Maintenance – ***importance of budgeting based on actual comparables***
    - Utilities (who pays which utilities?, water/sewer, heat, electricity)
    - Real estate taxes and insurance
    - Contributions to Replacement Reserve
    - Special case – condominium structures and shared common expenses

Rental Income

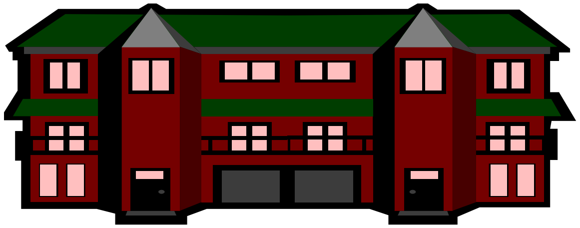
Soft Debt Providers and Tax Credits Impose Rent Limitations

(see Boston MSA example of income and rent limitations below, updated for 2014).

Rents assume landlord pays all utilities.

Max. Allowable Rent (by BR size)	**0-BR**	**1-BR**	**2-BR**	**3-BR**	**4-BR**
50% of AMI	$823	$882	$1,058	$1,223	$1,365
80% of AMI	$1,186	$1,270	$1,525	$1,761	$1,965
Section 8 FMR	$1,042	$1,164	$1,454	$1,811	$1,242
Income (by HH Size)	1 person	2 people	3 people	4 people	5 people
50% of AMI	$34,250	$39,150	$44,050	$48,900	$52,850
80% of AMI	$45,500	$52,000	$58,500	$65,000	$70,200

Second Source of Repayment – COLLATERAL



REVENUE

Rental Income

10 1-BR @ 1000	120,000
20 2-BR @ 1300	312,000
10 3-BR @ 1500	180,000
	612,000
Less: Vacancy 5.0%	(30,600)
EFFECTIVE RENTAL INCOME	581,200

EXPENSES

Management (4.5% of collected rents)	22,059
Administrative	60,000
Maintenance	120,000
Utilities	100,000
Taxes and Insurance	60,000
	362,059
Less: Contribns to Repl.Rsv. 325/u/yr	13,000
TOTAL EXPENSES	375,059 ($9,051 /u/yr)

NET OPERATING INCOME 206,341

MAXIMUM DEBT

Apply Capitalization Rate
.06

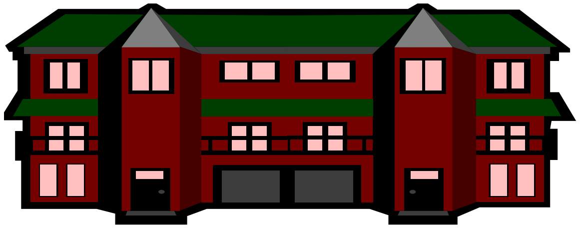
Estimated Value
3,439,000

Maximum Loan-to-Value Ratio
85%. In this case, 77%.

Maximum Mortgage Amount (restricted rents) is .....

2,923,000
(= $73,000/unit)

Second Source of Repayment – COLLATERAL



REVENUE

Rental Income (Market Rents)

10 1-BR @ 1200	144,000
20 2-BR @ 1600	384,000
10 3-BR @ 2000	240,000
	768,000
Less: Vacancy 7.5%	(57,600)
EFFECTIVE RENTAL INCOME	581,400

EXPENSES

Management (4.5% of collected rents)	22,059
Administrative	60,000
Maintenance	120,000
Utilities	100,000
Taxes and Insurance	60,000
	362,059
Less: Contribns to Repl.Rsv. 325/u/yr	13,000
TOTAL EXPENSES	375,059 (= 9,051 /u/yr)

NET OPERATING INCOME 335,341

MAXIMUM DEBT (MHP)

Apply Capitalization Rate	.06
Estimated Value	5,589,000
Maximum Loan-to-Value Ratio	85%

Maximum Mortgage Amount is…

4,751,000

(= $119,000/unit)

Really….?

Don't forget…

- Debt coverage

  The real benefit of the MHP option to dispense with affordability requirements is not a bigger loan, but….

  lower Loan-To-Value (56% LTV, in this case)

- Senior use restrictions

  Imposed by zoning (including 40B Comprehensive Permits), prior public funders, or other covenants running with the land, which can't be eliminated in foreclosure.

A word about underwriting Section 8….

- **the good news**
  - *government-guaranteed revenue source*

- **the bad news**
  - *it can be taken away or reduced*

- **What if the Section 8 payment standard is above market?**

Third Source of Repayment – SPONSOR

Whether a loan is GUARANTEED or not, much of the lender's sponsor analysis is the same…

- Who is standing behind the project?
- Who are the key members of the development team?
- Who is managing the property over the long term?
- Who is watching the asset over the long term?

FORMS of RECOURSE

- Notes are usually "recourse to the borrower", but borrowers are usually single-purpose entities.
- **Full recourse** means a guarantor is legally obligated to repay all principal and interest in the event of default.
- **Limited recourse** places a limit on the repayment obligation, e.g. a fixed dollar amount, % of loan, interest but not principal. It may be limited by a loan-to-value threshold.

QUALITY of the GUARANTEE

- Sponsor financial condition
- Net worth
- Liquidity and leverage
- Performance of other real estate
- Contingent liabilities
- Minimum net worth and liquidity covenants

Are there even more Sources of Repayment?

- Reserves
- Side collateral
- Additional equity from partners
- Re-syndication proceeds

Elements of Affordable Housing Finance

- Hard Debt
- Soft Debt
- Grants
- Tax Credit Equity
- Sponsor Equity

Characteristics of Soft Debt

- Payment obligations either non-existent or required only from available cash flow. Performance obligations (maintaining affordability) required.
- Secured by subordinate mortgage and assignment of rents and contracts
- May be either recourse or non-recourse
- Limitations on rights of prepayment, assignment, or transfer of borrower interests
- Reserve and escrow requirements – generally default to first mortgage lender and/or investors
- Reporting requirements
- Affordability requirements – Mass Docs!

Sources of Soft Debt/Grants and Operating Subsidies

- Federal
  - FHLB Boston AHP Grants (also subsidized advances which assist sponsor in supporting higher hard debt amount)
  - CDBG (distributed through state and local agencies)
  - HOME Funds (distributed through state and local agencies)
  - HUD Section 811 and 202– for disabled and elderly, respectively
  - McKinney Grants for the homeless and disabled -- upfront and/or ongoing grants
  - Project Based Section 8 (operating subsidy which supports higher hard debt amount)
- State
  - (rental assistance): http://www.mass.gov/hed/housing/rental-assistance/
  - (capital subsidies): http://www.mass.gov/hed/housing/affordable-rent/
  - Affordable Housing Trust Fund (new production only)
  - Housing Stabilization Fund (production and preservation)
  - Capital Improvement and Preservation Fund (preservation only)
  - Housing Innovations Fund (innovative, SRO or co-op housing)
  - Community Based Housing Fund (housing for HHs at risk of institutionalization)
  - Facilities Consolidation Fund (DMR/DMH clients only)
- Local
  - Community Preservation Act (in selected communities)
  - Local housing trust funds

Elements of Affordable Housing Finance

- Hard Debt
- Soft Debt
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- Tax Credit Equity (Federal and State)
- Sponsor Equity

Low Income Housing Tax Credits (Federal)

- Private investors earn credits (dollar for dollar reduction in tax liability) for 10 years, and take losses for 15 years, in return for investing in affordable rental housing.

- Two kinds: 4% and 9% Credits

- 9% Credits are allocated to the states by the IRS on a per-capita formula, and then awarded by DHCD through highly competitive semi-annual funding rounds.

- 4% Credits are awarded automatically with use of private activity tax exempt bonds for eligible rental housing.

Pros/Cons of 9% vs. 4% credits

- 9% credits raise much more equity and so benefit projects where rehab cost is much higher than acquisition cost.

- For 9% credit projects, the Tax Credit % on rehab basis is 7.43% (vs. 3.30%) (check for latest tax credit %'s at http://www.novoco.com/low_income_housing/facts_figures/2012)

- 130% premium for projects in difficult-to-develop areas available only with 9% credits.

- 9% credit awards are made on a highly competitive basis and usually require two or more years from initial application for an award to be made. 4% credits are awarded automatically with tax-exempt financing.

- Cap on annual eligible basis for 9% credits is $200M per low income (LI) unit for production projects, and $250M per LI units for preservation projects; no such caps for 4% credit projects

Sample Tax Credit Raise Calculation for 4% Credits (48-unit rehab, Fenway neighborhood)

Acquisition Basis (excl. land value):	$5,275M
Times % Low Income SF/Units:	x 100%
Qualified Basis:	$5,275M
Times Tax Credit %:	x 3.30%
Annual Credit Amount:	$ 174M
Times 10 years:	x 10
Total Credit, 10 years:	$1,740M
Times Equity Raise:	x.85
Equity Raise:	$1,479M

Sample Tax Credit Raise Calculation for 4% Credits (cont.)

Rehab Basis (include rehab costs but excl. reserves and non-Depreciable Costs):	$4,265M
Rehab Basis Boost in Diff. To Dev. Area:	x 130%
Times % Low Income SF/Units:	x 100%
Qualified Basis:	$6,074M
Times Tax Credit %:	x 3.33%
Annual Credit Amount:	$183M
Times 10 years:	x10
Total Credit, 10 years:	$1,830M
Times Equity Raise:	x.85
Equity Raise:	$1,556M

TOTAL RAISE: $1,479M + $1,556M = $3,035M

Costs of Using Federal Low Income Housing Tax Credits

- Loss of Control– 99+% of the entity will be held by the limited partner that purchases the tax credits…and limited partners can impose onerous financial conditions on the general partner.
- Syndication costs
- Additional Reserve Requirements– min 6 months DS/Operating Exp.
- Loss of Cash Flow/Residuals– As of today, 90% of cash flow and residuals typically go to the sponsor-owned General Partner and 10% go to the Limited Partner (LP).
- The sponsor may need to pay LP’s exit taxes to take back ownership of the property at end of tax credit compliance period.
- Major repercussions of not complying with tax credit requirements during 15-yr term of compliance period.
- Administrative burden of complying with tax credit reporting requirements.

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Sponsor Equity

- Often, a private investor or pension fund partnering with the developer.
- Return on equity requirements – 10 to 20%, or more? By when?
- Often documented in a partnership, or operating, agreement, laying out the respective investment obligations, term of investment, share of cash flow and residual property values, and decision-making roles.

Putting it all together

- Are the project sources sufficient to cover costs, including contingencies?
- What are the funding conditions for each of the sources?
- What are the funding <u>schedules</u> for each of the sources?
- What are the risks and consequences of unexpected delays in either financing or building the project?
- How does the project meet the developer's need to cover its overhead, and to make a reasonable return?
- Does the project rely on operating subsidies that may discontinue during the financing term?
- What will the project's long-term economics look like? What are the market prospects in its location?

Why keep working on affordable housing?

- The need has never been greater.
  - Just to pay the typical 2-BR rent of $1200 in Massachusetts, you have to make $23/hr. The median hourly wage in Massachusetts is $17/hr, and the minimum wage is $8/hr. *(National Low-Income Housing Coalition data.)*
  - There are 94,000 households on DHCD’s Section 8 waiting list, up 10,000 from one year ago, and DHCD issued just 248 vouchers to households on that list in 2010.
- These developments help stabilize our neighborhoods and contribute to diversity.
- They help keep our workforce from leaving Massachusetts, and add value to the economy.
- And, despite scarce resources, they do present excellent design and urban planning opportunities.







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NOW LEASING

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