Virginia Community Capital

Affordable Housing Underwriting

July 20, 2010

Our Agenda This Morning

- **Underwriting Multi Family Affordable Housing Projects**
  - **Predevelopment Lending**
  - **Acquisition Lending**
  - **Construction Lending**
  - **Permanent Lending**
  - **Workouts**

- **Panel Discussion, Q&A**

  - ask the experts……what works, what does not work, where are the alligators?

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Your Presenters

Instructor:

Bill Skeen, Chief Credit Officer, VCC

The Panel Discussion:

Thomas E. Wilkinson, III, Franklin Development Group

Bob Adams, HD Advisors

Jim Chandler, Virginia Housing Development Authority

Who is Bill Skeen and What is VCC?

Instructor:

- Bill Skeen, Chief Credit Officer, VCC - a new community development financial institution for the state of Virginia with $60 in assets, $35 million in loans, providing affordable housing, small business and community facility loans through a Community Development Financial Institution and Community Capital Bank of Virginia, headquartered in Christiansburg, Virginia, with a Richmond LPO office.

- 27 years in banking as a credit analyst; consumer, commercial, mortgage and community development lender and executive community relations market manager with primarily Wachovia

- 20 years experience as an adjunct professor with Virginia Western Community College

- What I really do all day long: "*I badger people to borrow money and pay it back*."

- I won the "senior" men's tennis doubles championship in Richmond last year!

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Who Are You and Why Are You Here?

Tell everyone:

- Your name, institution, position
- What you really do all day long at work
- Something no one would know just by looking at you
- Why you are here (what you expect to get out of today’s session)

Many ask,
what’s it like being in the
community development,
affordable housing lending business?

Well truth is, it’s a little like
“herding cats.”

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Today's Protocol

Learning is different for everyone!

- Take notes if you want, but I will send you a CD with all materials *(just sign up with your contact information)*
- Ask questions anytime!
- Offer your thoughts, experiences!
- Make this a discussion!
- I can't talk the whole time!

(this is a lie, I can, but you won't get the benefit of others' thoughts and experience)

What Is Affordable Housing?

It means different things to different developers:

- Generally based on area median income ("AMI") from census bureau statistics as adjusted by HUD

In general:

- 50% or less of AMI, defines low income housing
- 50% to 80% of AMI, defines moderate income housing *(workforce housing)*
- 80% to 120% of AMI, defines "market rate" housing

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Variations In Affordable Housing Projects

Affordable housing can take on variations providing significant benefits; however, complicating underwriting analysis and possibly threatening project success:

- **Mixed income projects**

  (welcome to Mayberry - the best of social policy, municipal planning and long-term stability)

- **Mixed use projects**

  (combining housing and commercial space that can tax cash flow, but can add attractive amenities)

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Why Make Affordable Housing Loans?

- The supply of affordable housing is dwindling!
- The demand is great!
- The market demand is evident as the vast majority of LMI individuals and families need decent, safe affordable housing!
- If rents are priced competitively and amenities comparable, the next renter is already on the waiting list!
- Banks earn CRA credit!
- If done properly, risks are easily mitigated!
- You get real estate collateral and problem projects have a broad resell market!
- You get good community public relations benefits, photo opportunities, and media coverage!

Why Not To Make Affordable Housing Loans?

- There are a lot of moving parts!
- On the surface, it looks far too complicated!
- Everything must go right!
- There are different risks at every stage of development and with each type of loan and project!
- Traditionally, the LMI renter is more likely to experience financial problems (lack of wealth) and is subject a higher level of unemployment due to economic downturns
- The project is dependent on equity infusion to make it affordable which is usually financed, blowing out the LTV ratio as the appraisal is usually based on the below market rent structure!

What Is Underwriting?

It means generally the same thing to most lenders:

- In banking, commercial underwriting is the process of analyzing and structuring a proposed loan to quantify risks, utilizing a detailed credit analysis, based on information furnished by the borrower, such as borrower background/history, project experience, and financial statements; publicly available information, such as the borrower's credit history, which is detailed in a credit report; the lender's evaluation of the borrower's credit needs and its ability to repay the loan from multiple sources (cash flow, collateral liquidation, guarantor resources).

- The process culminates in setting suitable terms and conditions for approval of a loan request or the denial of a loan request.

- The process of periodically re-underwriting a booked transaction.

Affordable Housing Lending at 20,000 Feet

We want:

- A project that meets mission and a loan that meets lending policy
- All the documentation to underwrite and document the transaction and the file
- A solid analysis demonstrating a profitable transaction with the capacity to repay, mitigating traditional risks
- Easy committee approval
- A smooth closing
- No problems with:
    - completion of development activities,
    - zoning and site acquisition,
    - timely project initiation,
    - adherence to budget,
    - timely completion,
    - timely lease-up,
    - timely equity and/or grant receipt,
    - the permanent loan takeout,
    - ongoing long-term occupancy and solid project management,
    - timely receipt of financial reporting for the project, the sponsor and guarantors,
    - on-time repayment according to initial agreement.

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Affordable Housing Lending At Ground Zero

The Process:

- Initial interview, sniff test
- Understand what type(s) of loans you are being asked to finance
  (pre-development, acquisition, construction, bridge tax credits, permanent)
- Kill DOA's quickly *(no equity, no market, no experience - <u>no loan</u>)*
- Gather underwriting documentation
- Analyze and produce a solid analysis that includes benchmarks, strengths and weaknesses and mitigations for weaknesses
- Gain committee approval
- Close the transaction
- Manage the transaction

The Principals of Affordable Housing Underwriting

- Above all, know the fundamental risks of the basic types of loans!
  - Know your lending policy and product lines
  - Know your sponsor
  - Know the general market economics and political landscape
  - Know and test the market rent comparables
  - Know and test the market rental expenses
  - Know the equity, grant and soft money providers/ particulars
  - Know the underwriting ratios and benchmarks
  - Know the primary, secondary and tertiary sources of repayment
  - Know your appraiser selection process and your appraisal review process
    (test and document every appraisal for accuracy, completeness, equivalent comparables and lease-up timeframe)
  - Know your environmental firm selection process and report review process
    (*ensure all issues are dealt with prior to acquisition and/or in the abatement process)*
  - Know the current condition of the property if it's a rehab project
  - Keep a management, legal, and workout process and in place

Finally, underwrite as if you are the permanent lender!

The Basic Types of Affordable Housing Loans

- Pre-Development
- Acquisition
- Construction
- Bridging Tax Credits
- Permanent Mortgage Loan

Of course you can do one or more or all of these types of loans for one transaction.

The Fundamental Risks of

- **Pre-development Lending** – depending on complexity and size, costs can reach up to $500,000. How do you get repaid if:

  - the project does not qualify for tax credits or grants

  - the project cannot find obtain a commitment for the purchase of tax credits or the bottom falls out of market pricing

  - the project meets government or neighborhood opposition

  - the project does not receive desired zoning approval

  - the project costs and projections don't pencil out

Repayment is based on sponsor's financial condition and earnings potential or alternate collateral!

The Fundamental Risks of

- **Acquisition Lending - how do you get repaid if:**

  - the project does not appraise *(get the appraisal first)*
  - **the project uncovers environmental problems** *(get the Phase 1 first)*
  - the project cannot find obtain a commitment for the purchase of tax credits *(get commitments first)*
  - the project meets government or neighborhood opposition *(ensure the developer has properly vetted the project)*
  - the project does not receive desired zoning approval
  - the project rehab cost projection runs over budget *(get the property needs assessment first)*

Repayment is based on the project obtaining construction financing!

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The Fundamental Risks of

- **Construction Lending – how do you get repaid if:**

  - the project runs over budget and beyond commitment schedules?
  - the permanent lender does not provide the permanent takeout loan due to market meltdown or regulatory conditions?
  - the tax credit buyer does not follow through on its commitment to purchase and provide the needed equity?
  - the grant source does not follow through on its commitment to provide soft money?
  - the developer (for profit, sole owner) catches a cold or worse?
  - the contractor does not deliver, does not pay sub-contractors, does not build according to specs, municipal code or historical tax credit guidelines?

  (Underwrite the Contractor? Bonding – can you get one, is it worth it?)

Repayment is based on "on budget, on schedule" project completion, equity infusion, partial lease – up, and a permanent take out loan.

The Fundamental Risks of

- **Bridging Tax Credits– how do you get repaid if:**

  - the project does not get completed?
  - the project does not meet the tax credit program requirements and certification?
  - the tax credit buyer fails to perform on the purchase?
  - the market melts down and tax credit prices fall?

Repayment is based on "completion as initially approved and project certification".

The Fundamental Risks of

- **Permanent Lending – how do you get repaid if:**

  - project management does not perform
  - lease-up is off schedule and slow to produce revenues
  - unit turnover becomes problematic and costly
  - expenses run over projections
  - profits don't provide for funding the maintenance reserve, the replacement reserve or the operating reserve
  - competition enters the market

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- **Lets dig deep into the principles of affordable housing underwriting…… because you don't know what will jump up and bite you…..and you don't want to bite yourself…..**

Know Your Affordable Housing Lending Policy and Product Lines

- **Without a policy and defined product lines, you are lost.**
- **Know your:**

  - lending limit

  - concentration limits

  (geographical, category, borrower)

  - product lines

  (what you can do and can't do)

  - market territory

  - acceptable and unacceptable risks

  - minimum equity requirements

  - maximum LTV parameters

  - minimum acceptable debt coverage ratio

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Know Your Sponsor

- **Underwrite the sponsor first !**

- Understand their history of experience and success
(or lack there of)
- Understand their history of working with similar projects
- Understand their history of building neighborhood support
- Understand their history of working with LIHTC, State and
- Federal Historic Tax Credits
- Understand their history of receiving and managing local/ state/federal government grants
- Understand their history of placing permanent debt with VHDA, HUD, USDA, other permanent debt providers
- Understand the management team, their experience and the management team depth

"The past is a mirror of the future!"

Know The General Market Economics

- What is the current affordable housing stock?
  - *does it meet market demand?*
  - *what is the relative age?*
  - *does the market need more?*
  - *what does the market expect in amenities?*

- What is the pipeline of affordable housing projects?

- What are the employment trends in the project market?

Know The Political Landscape

- What is the attitude of local government toward affordable housing?
  - *favorable?*
  - *viewed as a burden on local services?*
  - *incorporated into the comprehensive plan?*

- What is the level of neighborhood support for the project?
  - *NIMBY?*

Know and Test The Market Comparables

- What is the acceptable rents structure for the market?

  - is the end product too pricy for the market?
  - do existing and proposed rents cover utilities?

- What is the level of market expectations for amenities?

  - washer/dryer, stove, microwave, refrigerator, disposal, dish washer, IPOD/CABLE/CAT wired throughout, free WI-FI, big screen tv, security system
  - swimming pool, park, playground, club house
  - convenient to grocery store, drug store, restaurants, shopping malls, health care, social services, on the bus line
  - free rent, no security deposit, no renters insurance

- What is the current competition and near future competition?
- Market studies are golden, but only as good as the experience of the firm delivering the study. *Beware of sponsor or municipal engaged studies.*

Know And Test The Market Expenses

- What are the real estate taxes for the municipality?

  - they differ significantly from jurisdiction to jurisdiction

- What is the local leasing and ongoing management costs/fee structure?

  - is local management talent available?

  - is the developer planning on providing the day to day management?

  (watch out, best plan for 5% in your budget just in case they falter or you get it back and have to hire a firm)

- What is the local repair/ongoing expense cost?

  - metropolitan areas have higher costs!

  - a good rule of thumb is $4,000 per year, per unit in metropolitan areas and $3,000 per year, per unit in rural areas.

Know and Test The Market Expenses

- What are ongoing maintenance reserve expenses and what should they be escrowing on a periodic basis?

  - maintenance reserves should be about $200 per year, per unit

- What are the ongoing replacement reserve requirements?

  - replacement reserves for rehab projects should be $300 per unit, per year and $250 per unit, per year for new construction.

- What is ongoing operating reserve requirements?

  - most permanent lenders traditionally want six months of average total annual expenses and debt service! Today, equity providers are requiring 12 months!

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Know The Equity, Grant and Soft Money Providers/Particulars

If these go wrong, you are lost as this is what makes an affordable housing project affordable!

- Be familiar with the LIHTC and Historic Tax Credit application and certification process and the tax credit buyers
  - *experience and past performance ensures the equity infusion will be there as committed for both the developer and the purchaser*
  - *you can't predict the market, but knowing the tax credit purchase ranges helps you to know if a buyer is over quoting*
- Be familiar with the local, state and federal grant providers, the grant particulars and the expectations that come with the money
- Be familiar with the soft money providers/particulars/expectations
  - *residual receipts funding*

Does the developer demonstrate an understanding of these sources of funding and have the internal experience or consulting team in place to deliver the project and paperwork as required by the funding source?

Know The Underwriting Ratios and Benchmarks

- What is the acceptable Loan-To Value (LTV) ratio for the project?

  - what does your internal policy dictate?
  - what does your regulator expect or dictate?
  - historically an 85% LTV is acceptable
  - today, 80% or less depending on the project, the location, the experience of the developer

- What is the acceptable Debt Coverage Ratio for the project?

  - what does your internal policy dictate?
  - what does your regulator expect or dictate?
  - historically a 1.10 coverage based on net operating income (NOI)
  - today, a 1.2 to 1.3 depending on the project, the location, the experience of the developer, and the nature of the project (single use vs. mixed use)

Know The Primary, Secondary and Tertiary Sources of Repayment

- Primary

  - pre-development: a construction loan
  - acquisition: a construction loan
  - construction: permanent takeout loan, equity infusion
  - tax credit bridge: project completion, purchase by investor
  - permanent: cash flow

- Secondary

  - pre-development: liquidation of alternate collateral
  - acquisition: liquidation of collateral
  - construction: liquidation of collateral
  - tax credit bridge: liquidation of alternate collateral
  - permanent, liquidation of collateral

- Tertiary

  - pre-development: guarantor resources
  - acquisition: guarantor resources
  - construction: guarantor resources
  - tax credit bridge: guarantor resources
  - permanent: guarantor resources

Know Your Appraiser Selection Process

- What is your appraiser selection process? Do you have one?

- not all appraisers are equally qualified (SRA, MAI, General)

- not all appraisers are familiar with the project and/or market under consideration

- best practice is to adopt an application protocol that includes a formal application, resume, copy of license to practice, copy of errors and omissions binder and three previous appraisals similar to the engagement under consideration

- best practice is to have an evaluation process that reviews all submitted information and the sample appraisals to render a conclusion that the appraiser is or is not qualified for the engagement under consideration

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Know Your Appraisal Evaluation Process

- What is your appraisal evaluation process? Do you have one?

  - not all appraisals arrive complete

  - not all appraisals reflect the three standard methods of valuation: sales approach, income approach, replacement approach

  - not all appraisals reflect current market conditions; applicable and/or current sales comparables; market absorption or lease-up estimated time frames

  - best practice is to have a formal, written evaluation form that reaches a conclusion regarding the appropriateness of the appraisal and the degree of reliance on the reported values

  - best practice is to separate responsibilities for appraiser selection, engaging appraisals and appraisal evaluation; with no involvement by the originating lending officer or any voting member of the lending committee. No borrower contact!

Know Your Environmental Firm Selection Process

- What is your environmental firm process?
  Do you have one?

  - not all environmental firms are equally qualified

  - best practice is to adopt an application protocol that includes a formal application, resume, copy of license to practice, copy of errors and omissions binder and three previous Phase 1 reports similar to the engagement under consideration

  - best practice is to have an evaluation process that reviews all submitted information and the sample Phase 1 reports to render a conclusion that the appraiser is or is not qualified for the engagement under consideration

Know Your Environmental Evaluation Process

- What is your environmental evaluation process?
  Do you have one?

  - *best practice is to have a formal, written evaluation form that reaches a conclusion regarding the appropriateness of the Phase 1 report and the degree of reliance on the reported condition of the property*

  - *best practice is to consult experts when the report cannot be easily evaluated in-house*

  - *no customer contact if possible*

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Know The Condition Of The Property If It's A Rehab Project

- What is the condition of the property and what are the known and unknown issues?

  - unknown issues will cost the developer additional money
  - unknown issues are budget killers

- A property needs assessment mitigates this risk!

  - should be obtained prior to acquisition
  - the only way to ensure that the project budget is reliable
  - usually provided by engineering firms with an expertise in rehabilitation projects

The project architect should have significant experience in rehabilitation, adaptive use projects!

The contingency budget line item should be more for a rehabilitation project to provide a cushion for the unknown and unexpected costs!

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Keep a Management, Legal, and Workout Team In Place

- Develop an internal review process to test underwriting assumptions, a second review, before seeking committee approval.

  - in many institutions, this is the chief lending or commercial real estate officer

- Develop a network of successful developers, a brain trust to periodically test assumptions, ask questions and understand changes in the market place.

- Develop a qualified legal firm, familiar with affordable housing projects, tax credits, the nuisances associated with construction lending and work outs.

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Underwrite As If You Are The Permanent Lender

- You may have a take-out commitment, but in today's world, this is not always a sure thing.

- Pro-forma projections with a solid LTV and Debt Coverage Ratio ensures that the take-out lender will be comfortable and you will be comfortable if you have to provide permanent financing.

So, What's Most Important?

- Underwrite the sponsor first.
- Know your policy, what you can and can't do.
- Kill DOA's early, they are time killers.
- New and inexperienced developers need a consultant and competent project management.
- Test market rent comparables and expenses.
- Ensure that the project's equity and grant sources are solid.
- Underwrite as if you are the permanent lender.

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What Belongs in a Request Package?

- Cover Request Letter
  - *- amount, type of loan, terms, collateral, borrower structure*
    (Today, single asset LLC is the most common)
- Sponsor Overview
  - *- background, experience, portfolio holdings, management resumes*
- Project Overview
  - *- background, target market, details for # units, amenities,*
    strategic advantage, strategic risks
- Project Sources and Uses
  - *- specific funding sources (equity, grants, debt) and*
    detailed hard and soft costs
- Project Historical Financials and Projections
  - *- 3 years and YTD interim (if existing)*
  - *- revenues, expenses, debt coverage ratio*
- Back-up Information
  - *- sponsor financial information (3 years and YTD interim)*
  - *- guarantors personal financial statements, tax returns (3 years),*
    global analysis
  - *- prior appraisal, environmental report, market study, survey, tax credit info*

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So, if we get all the documentation we need, we underwrite utilizing the right tools to produce a solid credit package then we look like this little dog….