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ANALYSIS OF LOW-INCOME HOUSING TAX CREDIT FINANCING SCENARIOS SUBMITTED BY THE TUCSON HISTORIC PRESERVATION FOUNDATION

May 4, 2015

The Tucson Housing Preservation Foundation (THPF) has submitted to the City of Tucson's Housing & Community Development Department several scenarios for the historic rehabilitation of the Downtown Motor Hotel with 19 units using the Low Income Housing Tax Credit (LIHTC) program. In one scenario, units are designated as "small" and "large", so I assume that even of are studios for purposes of a tax credit application, with 12 larger units considered as 1-bedroom apartments. One of these scenarios uses competitive tax credits (commonly referred to as "9% credits"), and the second uses a combination of tax-exempt bonds and "4% credits". Both scenarios couple these with preservations for Historic Preservation Tax Credits.

At the request of the Department, Sabino Community Development Resources has reviewed and analyzed these scenarios. For the reasons stated in this analysis, it is highly unlikely that either LIHTC scenario would be successful. The tables in this analysis are taken from the attached spreadsheet titled Worksheets for THPF Analysis.

9% credit scenario: One scenario provided by THPF includes what are commonly referred to as 9% credits and conventional debt financing. In this scenario, seven units have gross rent of \$507 for the studios and \$633 for the 1-bedroom units, with an allowance for utilities (assuming that all are paid by the tenant) of \$103 and \$126, respectively, resulting in net tenant-paid rents of \$404 and \$507. This scenario raises the following concerns:

1. Credit rates and basis adjustments

While the credit for construction and rehabilitation of affordable housing is commonly called the 9% credit, the rate actually floats using a formula tied to the Applicable Federal Rate and announced monthly by the Internal Revenue Service. Though this rate was temporarily set at a flat 9% by Congress in mid-2008 as part of an overall economic stimulus in response to the recession, this floor rate has expired and the credit rates now float as they previously had. (Though some members of Congress have proposed making this floor rate permanent, there is no certainty that this will occur; past proposals thought likely to pass have not been adopted, so any analysis must assume that credit rates will continue to float.) The current rate (May 2015) established for construction/rehabilitation credits by the IRS is 7.44%; the acquisition credit is 3.19%. Historical data on tax credit rates is available from Novogradac & Company at <http://tinyurl.com/credit-rate-history>.

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TPHF’s scenario also does not take into consideration other elements of the LIHTC program that, on the one hand, help offset the lower rate but, on the other, reduce the amount of LIHTC that will be available to this project:

- THPF’s model does not include the 130% basis boost available for construction credits that, until 2008, had been limited to certain qualifying census tracts but is now available to virtually all 9% tax credit projects;
- The model does not recognize that the rehab basis must be reduced by the amount of the Historic Preservation Tax Credit. (In fact, it appears that without using the historic credit, the project would support nearly the same amount of equity because the rehabilitation basis would not be reduced, and further avoiding the considerable expense associated with SHPO review and oversight. The enclosed Worksheets for THPF Analysis compare potential equity with and without the historic credits.)
- The general partner or managing member must retain a small share of the ownership, with the investor typically holding a 99.99% interest, resulting in a very slight reduction in the amount of credit delivered and equity invested. investor.

Assuming the accuracy of the estimates of \$1,310,425 in eligible construction basis (which is impossible to verify because of the THPF scenario does not break out the costs that would enable review of whether all are eligible basis items) and \$252,055 in historic tax credits, the rehab credits would be lower than projected by THPF:

	THPF scenario	Actual credit rates with boost
Rehab credit rate	9.00%	7.44%
Acquisition credit rate	4.00%	3.19%
Rehab basis	1,310,425	1,310,425
Less historic tax credit	0	(252,085)
Eligible rehab basis	1,310,425	1,058,340
Basis boost	0	130%
Rehab basis after boost	1,310,425	1,375,842
Annual rehab credit	117,938	102,363

THPF’s scenario overstates the amount of rehab credits delivered over ten years by more than \$150,000.

2. Acquisition basis calculation

The projection shows eligible LIHTC acquisition basis of \$685,000, the total acquisition cost. However, acquisition credit is not available on land, so only the building value is eligible for credits. For purposes of this analysis, I have assumed that the land value represents 50% of the total acquisition cost, resulting in annual acquisition credits of

approximately \$11,000 and total annual credits of \$137,670. The actual split between land and buildings would be determined by the as-is appraisal.

Because THPF has overstated the amount of both rehab and acquisition credits available, it has overestimated the amount of equity, even increasing the price for LIHTC equity to \$.90 per \$1.00 of LIHTC credits to match the assumptions in Bethel’s scenario:

Calculation of LIHTC and Equity Investment	THPF scenario	Actual credit rates	Difference
Annual rehab credit	117,938	102,363	(15,576)
Annual acquisition credit	27,400	10,926	(16,474)
Total annual credit	145,338	113,288	(32,050)
Total credits over ten years	1,453,383	1,132,884	(320,499)
Investor ownership	100.00%	99.99%	
Price per \$1.00 of LIHTC	\$0.85	\$0.90	
LIHTC equity	1,235,375	1,019,494	(215,882)
Historic equity at \$.90/\$1.00 of credit	226,877	226,854	
Total equity	1,462,252	1,246,347	(215,904)

3. Rent limits

“9% credits” are obtained through a competitive process administered each year by the Arizona Department of Housing (ADOH). In the most 2015 round, applications for approximately \$26 million were submitted, far more than the amount available. Under the scoring in the Qualified Allocation Plan (QAP), to be successful an applicant must maximize the scoring available under the Income Targeting on page 37, which provides 35 points for urban projects in which 35% of units are limited to households with incomes no higher than 40% of Area Median Income (AMI) and 45% are limited to households with incomes no higher than 50% of AMI. With Pima County’s AMI of \$59,000, the income targeting requirement for a 19 unit project, and the maximum rents net of the utility allowance, would be:

	Target AMI	Units	Max gross rent	Utility allowance	Max net rent
Studio	40%	3	413	103	310
	50%	3	516	103	413
	60%	1	620	103	517
One Bedroom	40%	4	443	126	317
	50%	6	553	126	427
	60%	2	664	126	538

In order to maximize scoring, the weighted average rent could be no more than \$384 for the studios and \$409 for the 1-bedroom units, resulting in substantially less rental income

than THPF's projections show. The maximum rents for the seven units with a 40% limit and the nine units with a 50% limits are lower than those shown in the THPF scenario.

4. Development budget

THPF's scenario shows only two components of cost: acquisition and rehabilitation. This omits the many transaction costs of a tax credit development, including substantial legal fees for the developer and (often) the equity investor, required project reserves, and application fees to ADOH. Some, but not all, of these are includable in basis. It is virtually certain that the total development cost would be substantially higher than shown in the THPF scenarios.

5. Operating cost

The various scenarios show operating expenses ranging from \$107,509 to \$154,080; however, these sums include debt service payments, which are not an "operating cost" for purposes of determining Net Operating Income, a key determinant in calculating a project's debt service capacity. Without debt service, the two LIHTC scenarios show annual operating expense of \$59,381. However, this includes \$1,068 in bad debt, which is typically included not as an operating cost but as part of the vacancy allowance, which includes both physical vacancy (units not occupied) and economic loss (the rent not paid by a tenant of an occupied unit). It is significant that the operating expense table in the Arizona LIHTC application, does not include an allowance for bad debt. Without this bad debt expense (which is transferred to the vacancy allowance in the NOI analysis later in this analysis), the annual operating expense is \$58,313, or \$3,069 per unit:

Operating Expense Projection	Total	Per unit
Property management salary	30,255	1,592
Bad debt - INCLUDED IN VACANCY	0	0
Repairs & maintenance	1,068	56
Taxes	20,000	1,053
Insurance	3,000	158
Administration	3,990	210
Total operating expense	58,313	3,069

This projected expense is too low to satisfy the underwriting standards in the 2015 Arizona QAP (page 101):

ADOH underwrites annual Operating Expenses for new construction Projects at \$4,200 per Unit per year **and for acquisition/rehabilitation Projects at \$4,500 per Unit per year**, not including replacement reserves and resident Supportive Services. The \$4,200 and \$4,500 Operating Expense assumptions also assume that the utilities for the Units will be broken down as follows: 1) tenants will pay for power and gas in their Units, and 2) water, sewer and trash expenses will be borne

by the Owner. Waivers will only be considered where the Developer can demonstrate by providing past operating statements from similar properties over which the Developer has a Controlling Interest, which demonstrate capacity to operate the Project within the proposed operating budget without deferred maintenance.... ADOH underwrites replacement reserves for new construction of Housing for Older Persons Projects at the rate of \$250 per Unit per year, and other new construction projects and all acquisition/rehabilitation projects at \$350 per Unit per year.”

To satisfy the terms of the QAP, the annual operating expense for a rehab project, absent the documentation required by ADOH, must be at least \$3,680 (\$4,500 less the \$820 shown by THPF for tenant-paid water, sewer, and trash):

Adjustment for tenant-paid utilities	Total	Per Unit
ADOH minimum op expense (unadjusted)	85,500	4,500
Adjust for water/sewer/trash	(5,576)	(820)
Adjusted ADOH minimum op expense	69,924	3,680

To this must be added \$350 per unit per year for the required replacement reserve, resulting in total operating cost of \$76,574, or \$4,030 per unit.

6. Vacancy and economic loss

The various scenarios provided by THPF include a 3% vacancy rate. As discussed in the section of this analysis on Operating Expenses, bad debt is typically included in the vacancy allowance as economic loss. Each of the THPF scenarios sets bad debt at 1% of gross potential rent (which is a reasonable assumption consistent with the LIHTC market), so the adjusted vacancy allowance is 4%.

It is exceptionally unlikely that a tax credit equity investor would underwrite at such a low rate because of the risk associated with the required 15-year holding period under the LIHTC program. Such investors typically use a sensitivity analysis to evaluate how a project would operate under best-, medium-, and worst-case scenarios, and a 4% vacancy loss is the best of all possible cases because it assumes (1) sustained strong market conditions and (2) very low turnover and nearly immediate re-occupancy, so that there is minimal rent loss while a unit is made ready for and then occupied by a new tenant. Except in the strongest rental markets or where apartments have project-based rental assistance (and even then they often perform an alternative analysis assuming elimination of rental subsidies), LIHTC investors frequently underwrite to a 7% total vacancy rate including bad debt. Until 2015, the Arizona QAP underwrote to a minimum 7% vacancy loss; the current QAP allows the applicant to use the vacancy allowance derived by the market study, subject to ADOH review. It is especially unlikely that a low vacancy rate would be used in a small project, where the impact of one vacant unit is magnified—if one unit is vacant in a 19-unit project such as proposed by THPF, the vacancy rate is 5%. In a 50-unit project, that same vacant unit would create a 2% vacancy rate. It is

extremely unlikely that either the Arizona Department of Housing or an equity investor would assume a constant 4% vacancy/economic loss allowance for a 15-year holding period during which economic conditions and occupancy will likely fluctuate.

7. Investor interest in small transactions

Few, if any LIHTC investors are likely to be interested in an investment of approximately \$1.2 million. LIHTC investments have substantial transaction costs, both at the time of closing and over the 15-year holding period during which the investor has to incur asset management expenses. The average amount of annual credit for which an application was submitted in 2015 was more than \$827,000, or a total of more than \$8.25 million over ten years; the lowest was \$223,000, or \$2.23 million in total credits over ten years, and this was a rural project, where credit allocations are typically smaller. The smallest LIHTC request from the state's two urban counties was \$412,000. It would be difficult to find an investor willing to close a project with substantially less than that in annual credits, because it could find much more cost-effective ways to allocate its capital.

8. Timing of investor capital contributions

The scenario appears to show a fundamental misunderstanding of how the LIHTC program functions. Even with its optimistic assumptions, THPF's 9% LIHTC scenario shows total annual costs (operating expenses plus debt service) that exceed rental revenue by approximately \$27,000, but then shows "LIHTC – Annual proceeds from sale of credit." However, the proceeds from the sale of the credits are not revenue paid annually to make up for operating deficits but capital contributions used to pay the costs of development. Even assuming that the project generated more than \$1 million in investor equity, that would be a source of funds in the development budget, not annual cash payments to pay operating costs that exceed rental revenue.

Net operating income: The deviations from ADOH and industry-standard underwriting described have significant impact on the ability of the project to achieve sufficient cashflow to be viable. The following table shows the net operating income (rental revenue less vacancy/bad debt allowance, operating costs, and replacement reserves) both as it would be underwritten by ADOH with a 5% vacancy allowance and under the underwriting standards in the QAP and as proposed in the THPF scenario. The difference in NOI is more than \$45,000:

-	Target AMI	Units	Max gross rent	Utility allowance	Max net rent	Annual max net rent	THPF Scenario
<u>Studio</u>	40%	3	413	103	310	11,160	14,544
	50%	3	516	103	413	14,868	14,544
	60%	1	620	103	517	6,204	4,848
<u>One Bedroom</u>	40%	4	443	126	317	15,216	24,336
	50%	6	553	126	427	30,744	36,504
	60%	2	664	126	538	12,912	12,168
Total units/gross rent		19				78,192	106,944
Vacancy and economic loss allowance (5% for analysis, 4% for THPF scenario)						-3,910	-4,278
Net rental income						74,282	102,666
Operating cost (at ADOH minimum of \$3680 (adjusted for water/sewer/trash) for analysis, \$3069 for THPF)						-69,924	-58,311
Replacement reserve at ADOH minimum of \$350 per unit						-6,650	0
Net operating income						-2,292	44,355

With negative net operating income, the project cannot support any conventional debt service, let alone the \$66,502 assumed in THPF's scenario.

Finally, it is important to not that even with assumptions that are unrealistic for LIHTC projects, the THPF 9% credit scenario shows an unsustainable debt load, with \$103,756 in net annual rent but \$130,207 in total operating costs plus debt service.

Use of 4% LIHTC with tax-exempt bonds One of the four scenarios proposed is the use of what is commonly referred to as 4% low-income housing tax credits that are generally available as a matter of right when combined with private-activity tax exempt bonds for qualifying affordable housing. Because these credits are not awarded competitively, they would theoretically avoid the issue of having to set rents for 80% of the units at levels affordable to households at or below 50% of AMI. There are two main difficulties with this scenario.

First, despite the nickname, the actual credit amount is, and has for many years, been substantially lower than 4%. The credit rate for May 2015 is 3.19%. (Unlike the so-called 9% credit, which actually was fixed at 9% from 2008 through 2013, the credit associated with tax-exempt bonds has never been set at a fixed rate, and the various proposals to set a floor rate apply only to competitive allocations under a state's LIHTC volume cap, not of-right credits allocated in conjunction with tax-exempt bonds.) Therefore, even assuming that the eligible LIHTC basis is the \$1.3 million shown in the scenario (which is impossible to determine without a detailed breakout of all the costs assumed to ensure that all are includable in basis), the total amount of credit (using the May 2015 credit rate) would be approximately \$418,000, more than \$100,000 less than the \$524,000 assumed in the scenario.

A much more fundamental problem with using tax-exempt bonds and “4% credits” is that this financing method is used for very large projects because of the very high transaction cost of bond issuance. An excellent introduction to the complexity of tax-exempt financing and of all the parties that must be involved, and therefore paid, is Introduction to Tax-Exempt Multifamily Housing Bonds, <http://tinyurl.com/intro-bonds>. These parties include the issuing agency (e.g., the Industrial Development Authority of either the City of Tucson or Pima County), the Arizona Commerce Authority (which must issue the allocation of bond volume cap), bond counsel, issuer’s counsel, the bond underwriter, and underwriter’s counsel. A bond issuance easily can cost in the hundreds of thousands of dollars, and many of these are fixed costs that do not vary with the size of the issuance. It is simply infeasible to use “4% credits” and tax-exempt bonds for project of this size.

Other matters raised in Demion Clinco’s email of April 8, 2015 In his cover email message, Mr. Clinco made several points:

1. *The yearly 22.4% of net Repair and Maintenance is extremely high considering the building would have been fully rehabilitated - this amount should be closer to 5%. As previously discussed, ADOH sets minimum requirements for underwriting expenses, including repair and maintenance. This analysis uses ADOH underwriting standards.*
2. *The Property Management Fees are calculated at 29% of net, industry standards are 5-10%. Because of the compliance requirements that LIHTC property managers are required to meet, including but not limited to IRS- and ADOH-compliant verifications of income at the time of application and annual income recertifications and regular monitoring inspections by ADOH, management fees are typically higher than for unregulated market-rate apartments. Because of the lack of economies of scale, the per-unit management fee for a small project are likely to be higher than for a large property at which overhead and administration costs of the manager can be spread over more units. In any event, the property management fees are included in the ADOH minimum operating expense allowance used in this analysis.*
3. *The Rehabilitation costs are extremely high at 117.00 per sq. ft. Numerous recent residential conversion and rehabilitation projects in the downtown have been 75.00 per sq. ft. or 10K-20K per door. Mr. Clinco does not specify specific projects on which he relies, so it is difficult to evaluate this point. Based upon its large database of LIHTC projects, including a wide variety of construction types, ADOH allows construction costs for urban projects of up to \$117.50/square foot; in the case of rehabilitation projects, additional review is required of the reasonableness of construction costs: “ADOH will further limit the Eligible Basis for rehabilitation costs (including adaptive re-use) to those determined to be reasonable by the independent cost estimator as outlined in Section 2.9(Y)(1)(b). Applicant must provide the documents requested by ADOH or its independent cost estimator in order to determine the reasonableness of rehabilitation costs.” See page 110 of the 2015 QAP.*

4. *The model is created with a 100% financing of land and construction, current traditional financing requires 35% down.* This is not necessarily true; without seeing a detailed schedule of payments, it is possible that the cost of the land and buildings is paid in cash at closing using either LIHTC equity or gap financing. In any event, the LIHTC program was instituted because traditional financing is ineffective in providing affordable housing.
5. *The pro forma as posted online excludes the use of Low Income Housing Tax Credits and Historic Tax Credits that would be available if the scope of the project changed to include rehabilitation.* The current financing model proposed by the development team uses LIHTC. As discussed in this analysis, the various scenarios for historic preservation of 19 units using both LIHTC and Historic Preservation Tax Credits do not appear to provide sufficient funds to pay the costs of development.

Conclusion: A competitive “9%” LIHTC financing scenario is infeasible because

- the Qualified Allocation Plan’s income targeting requirements set maximum rents for most units below the amounts shown in the THPF scenarios
- the minimum underwriting standards in the QAP set the operating expenses far higher than the amounts shown in those scenarios
- investors would very likely underwrite a higher vacancy allowance
- the scenario as presented fails to allocate between eligible basis in buildings and ineligible basis in land and the acquisition credit rate is substantially lower than the 4% assumed by THPF, and
- it is difficult to find investors for very small projects.

The “4%” scenario is infeasible because of all these issues except the income targeting and, more important, the very high costs of bond issuance that limit these transactions to large projects.