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ANALYSIS OF LOW-INCOME HOUSING TAX CREDIT FINANCING SCENARIO SUBMITTED BY THE BETHEL DEVELOPMENT

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Bethel Development, Inc. (Bethel) has submitted an economic model to the City of Tucson's Housing & Community Development Department that attempts to show that it is not feasible to develop a 19-unit LIHTC project as proposed by the Tucson Historic Preservation Foundation (THPF), instead of the 44-unit project for which an allocation of 2014 Low Income Housing Tax Credits (LIHTC) was reserved by the Arizona Department of Housing (ADOH).

At the request of the Department, Sabino Community Development Resources has analyzed that model. Although it appears that Bethel has constructed a worst-case scenario that appears to overstate certain costs of both development and operation, SCDR concludes that even with more generous assumptions:

1. the project would not generate sufficient cash flow under ADOH's underwriting standards to support conventional debt service, and

2. the development budget deficit resulting from the inability to support debt cannot be made up from reasonably-obtainable sources of gap financing.

The tables in this analysis are taken from the attached spreadsheet titled Worksheets for Bethel Analysis.

A. Development costs

The Bethel model uses a substantially higher acquisition cost ($980,000) than does THPF ($685,000). If the Bethel cost assumptions are supported by an appraisal, then it is appropriate to include them in the LIHTC development budget. Unlike THPF, whose scenarios assume that the entire acquisition cost can be included in basis, Bethel shows only the building value (shown to be $300,000) as eligible for acquisition credits.

Bethel's direct construction cost of $1,871,000 is well within the ADOH cost caps. The construction contingency reserve of 10% of direct costs is consistent with investor requirements in rehabilitation projects because of the uncertainty involved with existing structures that may have concealed defects. If the buildings have or are likely to need environmental abatement (such as asbestos or lead paint), the $96,000 hazardous waste contingency is appropriate, but without having reviewed environmental reports it is not possible to say for sure.

The professional fees appear to be in line with those charged for LIHTC projects. While some of those (for example, legal fees) are high on a per-unit basis, this is because they are fixed and must be spread out over a smaller number of units in a 19-unit than a 44-unit project; the same legal work is necessary for a small as for a large project, which is one of the many reasons that developers and investors typically avoid projects as small as that proposed by THPF.

The construction financing costs appear to be higher than warranted. Given that the model shows a $28,000 fee as 2% of the loan amount, the total construction loan would be $1,400,000. If the loan is outstanding for 15 months, the average outstanding balance is 70% of the total loan amount (which is probably high), and the average rate on the loan is 5.0%, the total interest would be less than the $150,000 shown in the model:

Construction loan amount	1,400,000
Average balance at 70%	980,000
Average interest rate	5.00%
Average monthly interest	4,083
Months outstanding	15
Total construction interest	61,250

2% also appears to be a higher-than-normal fee for a construction loan, though this has a relatively small impact on the overall budget. Other construction financing costs appear to be in line with industry standards.

ADOH requires both lease-up and operating reserves equal to six months of operating expense plus primary debt service. Using Bethel's operating cost projection (which, as discussed in the next section, appears high), the required reserves are lower than those shown in the model ($85,000 for each category). Bethel projects total operating cost of $11,835 per month and no primary debt, so the total reserve in each category need be no higher than $71,000 (and under the model used in this analysis, with lower operating costs, would be less than $50,000).

Other costs and development fees are consistent with other projects and with the underwriting standards in the ADOH Qualified Allocation Plan (QAP).

B. Rental revenue

The Bethel model assumes that all 19 units will have one bedroom, and it recognizes that to be competitive for what are commonly called 9% credits, the project must maximize the points for income targeting (see page 37 of the 2015 QAP), under which 35% of units are restricted to households with incomes no higher than 40% of Area Median Income (AMI) and 45% are restricted at 50% of AMI. It is virtually impossible for a project to qualify for credits without the 35 points available in this category, which represent the largest component of the competitive scoring in the QAP. Bethel has therefore projected seven units at 40% of AMI, nine units at 50%, and three at 60%.

Under the recently released 2015 AMI tables, AMI for a family of four in Pima County is $59,000. Using the household size adjustments mandated by the LIHTC program, the maximum permissible rents (with no adjustment for utility allowances because Bethel assumes all such costs will be paid by the owner) are $443 at 40%, $553 at 50%, and $664 at 60% of AMI. These are slightly higher than shown in Bethel's model, which I assume is based on 2014 AMI.

-	Target AMI	Units	Rent in Bethel Model	2015 max rent	Utility allowance	2015 max net rent	Annual max net rent
One Bedroom	40%	7	427	443	-	443	37,170
	50%	9	534	553	-	553	59,738
	60%	3	641	664	-	664	23,895
Total		**19**					**120,803**

Bethel's model uses a vacancy allowance of 7%. While THPF disputes the applicability of this rate, it is in fact commonly used in the LIHTC industry. Because in a small project a single vacancy will have a disproportionate impact on the occupancy rate, it is even more likely that an investor would require a higher vacancy allowance in a 19-unit project. (Notwithstanding this, my analysis of the THPF financing scenarios uses a lower vacancy rate to show that even with more optimistic assumptions those scenarios are not feasible.) It also adds miscellaneous income of $20/unit, as permitted by ADOH. With these adjustments, the total revenue in the first year of operation would be $112,346, compared to $110,294 projected by Bethel.

C. Operating expense analysis

Bethel projects very high operating costs of $142,020, or $7,475 per unit. Broken down by direct cost of operations, replacement reserve, and costs for supportive services, the operating expense are:

Operating Expenses:	Total	Per unit
Payroll:	68,000	3,579
Management Fees:	7,980	420
Administrative:	3,450	182
Repairs and Maintenance:	12,350	650
Utilities:	19,665	1,035
Property Taxes:	6,650	350
Insurance:	3,040	160
ADOH Compliance Fee:	2,235	118
Expenses before reserves and supportive services	**123,370**	**6,493**
Replacement reserve	6,650	350
Supportive services	12,000	632
Total operating expenses	**142,020**	**7,475**

In order to perform an "apples-to-apples" comparison with the THPF scenario, SCDR has assumed that this will not be a supportive housing project and I have excluded the $12,000 for services. (However, it would certainly increase the competitive advantage in the LIHTC application process to qualify either for points for services or under the supportive housing set-aside.)

Costs that are particularly high under this budget are payroll, presumably for management personnel. Bethel's justification for this high cost is the high cost that would be charged by a property management company for working on such a small project; as with professional fees in the development budget, many fixed costs would need to be spread over a small number of units so that the overall expense appears high on a per-unit basis. The utility costs are high because all are paid by the owner (which is offset in part by the higher rents available with no reduction for utility allowances).

Regardless of the justification (or lack thereof) for individual line items, to be consistent with the analysis of the THPF LIHTC scenarios, this analysis is based on the ADOH underwriting standards in the 2015 QAP at 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."

Because Bethel proposes to pay water, sewer, and trash, the minimum operating cost must be adjusted upward (as the THPF costs were correspondingly lowered because these costs would be tenant-paid). The required replacement reserve of $350 per unit per year is also added:

Adjustment for tenant-paid utilities	**Total**	**Per Unit**
ADOH minimum op expense (unadjusted)	85,500	4,500
Adjust for water/sewer/trash	5,415	285
Adjusted ADOH minimum op expense	90,915	4,785

Replacement reserve	6,650	350
Total operating expense	**97,565**	**5,135**

With the operating costs shown by Bethel (including the supportive services costs), the project has an operating loss of nearly $30,000. With the ADOH minimum operating costs and no supportive services cost, it has pro forma net operating income of more than $14,750. This would appear to be available to support a small permanent loan on commercial terms. Assuming an interest rate of 5.5%, a 30-year amortization (though the lender might require a shorter amortization term), and a 1.20 debt service coverage ratio, the pro forma first-year net operating income could support a loan of approximately $240,000:

Stabilized NOI	19,581
Debt service coverage ratio	1.20
Interest Rate:	5.50%
Amortization:	30
Maximum potential first loan	239,943
Annual Debt Service:	16,318

However, because of the underwriting requirements of both ADOH and equity investors, the project could not sustain debt service past the first third of the LIHTC compliance period.

D. Long-term operating projection

A key factor in long-term projections of the operation of LIHTC projects is that operating expenses often increase at a faster rate than do rents. This is because rents are limited by the area median income and (at least if set at the maximum levels permitted under the program) cannot increase at a faster rate than does AMI. A common assumption made by investors is that operating expenses increase at an annual rate one percentage point higher than does rent, and this is incorporated in the Arizona QAP (page 101): “Revenues and expenses shown on the pro forma must increase annually at two percent (2%) and three percent (3%) respectively. Annual replacement reserve obligations must increase at three percent (3%) per year.” The history of AMI in Pima County supports conservative analysis of rent increase: the 2015 AMI, $59,000 for a 4-person household, is the same as it was in 2010, and AMI fell in two of the last five years; because of a large drop in 2014, the average annual change is actually negative, -1.1%. Adjusted for inflation, real AMI is lower than in 2010. Operating expenses, in the meantime, continue to increase.

When carried over the life of this project, the compounded increase in operating costs reduces every year the ability of the project to service debt. As shown in the attached pro forma operating budget and partially reproduced below, while debt service coverage in the first year of operation is 1.20, it declines to 1.16 the second year and falls below 1.0 in the sixth year, showing that the project fails to generate sufficient cashflow to pay the first mortgage debt service, let alone any payments on subordinated debt or for investor services fees that are often required by LIHTC investors:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Net rental revenue	117,146	119,489	121,879	124,317	126,803	129,339	131,926	134,564	137,256	140,001
Total operating cost	97,565	100,492	103,507	106,612	109,810	113,105	116,498	119,993	123,592	127,300
Net Operating Income:	**19,581**	**18,997**	**18,372**	**17,705**	**16,993**	**16,234**	**15,428**	**14,572**	**13,663**	**12,701**
Loan #1	16,318	16,318	16,318	16,318	16,318	16,318	16,318	16,318	16,318	16,318
Loan #2	-	-	-	-	-	-	-	-	-	-
Investor services fee	-	-	-	-	-	-	-	-	-	-
Cash flow after all debt service & investor services fee	3,264	2,680	2,055	1,387	675	(83)	(890)	(1,746)	(2,655)	(3,617)
DCR - 1st mortgage	1.20	1.16	1.13	1.08	1.04	0.99	0.95	0.89	0.84	0.78
DCR - All loans and investor services fee	1.20	1.16	1.13	1.08	1.04	0.99	0.95	0.89	0.84	0.78

With rents more 80% of the units affordable at less than 50% of AMI, it is impossible that the project could support a conventional loan; no lender would make a loan that is certain to default, and no tax credit investor would supply capital for a project that is certain to go into foreclosure, wiping out its investment.

E. Sources and Uses of Funds

Although Bethel did not do so, in order to make the various development scenarios more comparable, I have assumed the use of Historic Preservation Tax Credits as proposed by THPF (though, as discussed later, the project generates nearly the same equity without the historic credit). Based on this analysis, it appears that the project would support the following sources of funds:

1. Using Bethel's estimated price of $.90 per $1.00 of credit, LIHTC equity of $1,983,560, based on qualified basis of $2.8 million for rehab and $384,111 for acquisition.

2. Using THPF's estimated price of $.90 per $1.00 of credit, Historic Preservation Tax Credit equity of $570,622, based on qualified basis of $3.17 million.

3. $600,000 in City of Tucson HOME funds.

Total sources are $3,154,182. Bethel's estimated total development cost is $4.3 million, leaving a gap of $1.15 million. While I have identified some cost savings (such as construction loan interest and required reserves), they would reduce the gap, in the aggregate, by approximately $100,000, still leaving a $1 million gap. LIHTC developers typically look to several sources for filling such deficits, but I conclude that none are likely to be effective in this project:

1. Arizona Department of Housing HOME ADOH allows up to $750,000 in gap financing for LIHTC projects. However, this is a very limited resource that must be divided among many projects, and ADOH would be unlikely to provide nearly $40,000 per unit. I would expect no more (and possibly less) than $200,000 in ADOH gap financing.

2. Federal Home Loan Bank Affordable Housing Program Because of its generous terms, the AHP program is among the most sought-after and therefore difficult to obtain sources of funds available. The FHLB of San Francisco typically limits AHP funds to those serving special-needs populations such as the homeless, disabled, or other targeted populations. To qualify for AHP funds, the supportive services funds I have taken out of the operating cost calculations would need to be added back, making the economic viability of the project even more difficult to sustain.

3. Deferred development fee ADOH allows up to 40% of the development fee to be deferred and used as a source of funds. In this case, the development fee is approximately $370,000, so less than $150,000 would be available as a source of funds.

If the developer were to proceed without using the Historic Preservation Tax Credit, the result would be similar. Because LIHTC basis would not be reduced by the amount of the historic credit, the combined acquisition and rehab tax credits would be higher ($2.8 million over ten years), resulting in $2.53 million in investor equity, nearly the same as with the Historic Credits and without the intensive review and oversight required for historic renovation projects.

F. Conclusion

While it appears that Bethel is overstating some costs of both development and operation, even using a more measured approach I arrive at the same ultimate conclusion: a 19-unit project would neither support sufficient funds from reasonably obtainable sources to pay the costs of development nor could it generate enough cashflow over the 15-year compliance period to support a conventional loan that would eliminate the deficit in the development budget.