AHIC Recommended Deal Point
Underwriting Guidelines

The attached language is intended for informational and educational purposes only and is not intended to supplant individual analysis by an investor and is not intended to mandate any particular deal point underwriting guidelines.

Before entering into an investment for low-income housing tax credits (LIHTC), the following Deal Point Guidelines can be used as an outline for investment documents and underwriting for both fund and direct investments. The Guidelines can be used to identify and mitigate variance associated with individual deals.

These points are in addition to those items that should typically be addressed by an investor prior to undertaking any investment with a fund sponsor (See additional AHIC recommendations for underwriting Syndicators/Sponsors) or directly with a developer. Following these guidelines will not necessarily lead to successful projects. The multiple dimensions of real estate success or failure are inter-twined, complex, and risky.

REAL ESTATE OPERATING PROJECTIONS

- Operating Projections
    - Operating projections should be based on and compared to information obtained from various sources including similar properties in the developer's, Syndicator's (if applicable) property manager's and investor's portfolios as well as data provided in third party reports (listed below) and other real estate sources, such as IREM.

- Rental Revenue Analysis
    - Unit rents should be compared to maximum LIHTC rental rates as well as similar existing market and LIHTC rental rates to determine competitive advantage and positioning. Rents should also be compared with similar properties in relevant portfolios.
    - Properties with rents below similar, existing market and LIHTC properties most likely will have a competitive advantage.
    - Properties with rents at the maximum LIHTC rents may experience tightening of cash flow in the event area medium incomes (a factor used to calculate maximum LIHTC rents) do not increase at or greater than expense escalations or utility allowances are increased. Area medium income trends for the property's region should be analyzed for deals at or close to maximum LIHTC rents
    - Base year rents can be established using current rents or rents trended upward to the start of leasing, typically 12 to 18 months following commencement of construction. Market conditions and forecast can assist in determining base year assumption.
    - Rent escalations should be at minimum 100bp below expense escalation for the 15 year compliance period. Standard rent escalations range from 2%-3% Caution: Watch how incomes inflate according to HUD, and then decide upon whether to allow rents to inflate. Rent trending may not be appropriate in areas where AMI's remain flat.
    - "Other income" should be reasonable and comparable to other properties within the region and developer's portfolio, and must be voluntary items only.

- Vacancy rates should be justified based on market conditions as verified by third party reports. Vacancy rates are typically 7%; however, may vary based on proposed tenant profile (seniors, family).

- Expense Analysis
  - Expenses should be based on comparable property information obtained from the developer, property manager, investor portfolio, Syndicator portfolio information, if applicable, third party reports (listed below) and other real estate resources such as IREM.
  - Investors should be cautious as to assumptions used in expense projections. Expenses projections may reflect expected economies of scale based on developer or property management overall portfolio.
  - Expense escalations should be at minimum 100bp above income escalations for the 15 year compliance period. Standard expense escalations range from 3%-4%.
  - Property Management Fees should be included in the expenses even if affiliated with the developer (a third party may have to be engaged in the future).
  - Annual replacement reserves range from $200 - $350 per unit per year depending on tenant profile (senior, family), construction type (new or rehab), and location. (AHIC and NCSHA recommend $250 per unit for new seniors, $300 per unit for new family, and more on rehabs.) Replacement Reserves can be verified by an architect or engineer for rehabilitation projects.
  - Reserves should be maintained by owner to fund future cash flow problems. Once used, it should be replaced through available cash flow from the property prior to developer distribution. The Investor or Syndicator, if applicable, should have approval rights for reserve withdrawals over a specific dollar amount to insure proper use.

- Third Party Reports
  - Professional analysis should be obtained relating to revenues, expenses, and construction.
  - A market study less than 6 to 12 months old or with current updates should be used in the analysis of rental rates, absorption rates and demand assumptions.
  - An appraisal completed on the behalf of a party other than the developer can provide information to assist in the analysis of operating projections and loan to value. The appraisal information should be used in conjunction with property management data and comparable property information.
  - Environmental site assessments provide information regarding environmental risk and remediation. Significant environmental issues may require assistance by Investor's legal counsel and/or Licensed Environmental Professional ("LEP"). Environmental site assessments should be less than 6 months old.
  - Engineering studies reviewing plans and specifications assess risk associated with the construction cost and potential construction risks.
  - Physical Needs Assessments should be used to identify and provide cost estimates for immediate physical needs and physical needs over the 15 year compliance period for moderate rehabs. The assessment should include a 15 year analysis of replacement reserves.
  - Construction inspectors are regularly hired by lenders and often by Syndicators and Investors to monitor construction, identify timing and/or financial deficiencies, and determine achievement of construction benchmarks for purposes of equity capital contributions.

- An evaluation should be made that the structure(s) are designed appropriately for the relevant seismic zone. Properties in seismically active areas should have a PML analysis, with no more than a 20% PML factor at 90% confidence level. Variance may be acceptable based on structural design.
- Civil Engineer or Survey should verify that the property is not within a 100-year flood plain (FEMA flood zone "A" or "B"). If it is within a 100-year flood plain proper insurance or mitigants should be in place to minimize risk of damage.
- The properties exposure to other environmental conditions, such as hurricanes, should be assessed and properly mitigated with insurance and/or structure.

- Financing Analysis
  - Leverage represents one of the biggest threats to equity ownership of any Partnership.
  - Property financing should be identified and committed prior to investment, or suitable mitigants should be in place.
  - Minimum 15 years fixed rate financing is preferred to avoid interest rate uncertainty, which could lead to debt service problems.
  - Cash flow from operations or identified capitalized reserves should provide sufficient cash to cover "must pay" debt service at minimum 1.15:1 with a minimum of 1.20:1 for Tax-Exempt bond and mixed-income properties.
  - If floating-rate debt is used, a program of 15-year caps, swap, or other rate protection mechanism should be in place.

<u>DEVELOPMENT BUDGET</u>

- Sources of Funds
  - All sources should be identified and committed along with terms and conditions.
  - Sources may include "must pay" financing secured by the real estate, "soft" loans, grants and developer equity.
  - A portion of developer fee that is deferred can be included as a source if the entire developer fee is included as a use. Caution: to the extent that developer fee is deferred, it is not available as a margin of error.
  - Net Operating income from a property during lease-up prior to perm loan closing/ conversion may be included if defended and acceptable based on the type of project and leasing assumptions. Caution: construction loan interest and start-up expenses must be accounted for in detail.

- Uses of Funds
  - All major categories should be identified, including acquisition, construction, contingencies, financing, reserves, developer fee and other soft costs.
  - Engineer study can be used to review the adequacy of the construction hard cost.
  - For acquisition-rehab projects, a Property Condition Report should be used to identify needs, and set budget priorities. Caution: rehab budgets of less than $15,000 per unit, or an amount insufficient to provide a 20-year life of structures and major systems may be inadequate to protect a LIHTC investment.
  - Reserves
    - Interest reserve should reasonably cover construction period financing costs.
    - Capitalized Operating Reserves. The property should maintain a reserve for operating deficits (AHIC and NCSHA recommend at least 6 months of all operating expenses and must-pay debt service).

- Capital Replacement Reserves should be established and if used replenished through available cash flow from the property prior to cash distribution to partners.
- Lease-up Reserves should be established to support operating costs during leasing prior to stabilization.
- Other reserves can be established to mitigate a specified risk associated with the property, such as turnover if an operating subsidy disappears.
- Reserves should be stress tested to determine the financial impact of construction or lease-up delays.

➢ Contingencies should be based on the developer and contractor experience, type of project, underwriting of other budget items. Hard cost contingency typically range from 5% for new construction to 10%-15% for rehab projects. Soft cost contingency ranges from 2% to 3% but will vary depending on whether fees have been negotiated and fixed prior to closing. Unused contingency may have a negative impact on qualified basis and ultimately reduce tax credits. This is not often the case with projects having excess basis.

➢ Total developer fee (as capped by the Allocation Agency) should be included in the budget with a notation regarding deferred developer fee.

- Sources and Uses of Fund must balance to avoid financing gaps.

<u>**TAX ISSUES**</u>

- **Tax counsel experienced with Section 42 should be engaged to review and identify tax issues. An independent CPA familiar with Section 42 should be engaged to verify 10% test, 704 (b) analysis, capital account analysis and the like.**
- Below are some tax issues that may arise in LIHTC developments.
  - ➢ Placed in Service Issues – Review and determine the acceptability of the construction and leasing schedule
    - Properties receiving 9% credits must be placed in service no later than 12/31 the year following tax credit allocation. Check certificate of occupancy and placed in service requirements for the specific municipality and allocation tax credit agency.
    - Units leased prior to 12/31 of the 1st tax credit year will deliver credits over a 10 year period. Units leased after 12/31 of the 1st tax credit year will deliver credits over a 15 year period <u>at 2/3 the allocation rate</u>. In most municipalities "placed in service" is determined on a building by building basis.
  - ➢ Verify acceptability of costs included in qualified basis.
  - ➢ Identify whether the credit rate was locked or if not locked whether the developer financial strength or budget modifications can cover the potential reduction in equity in the event the credit rate is lower than originally projected.
  - ➢ Acquisition Rehab projects need to meet the "10 year rule" and "Max 10% continuing interest" of related party tests.
  - ➢ Ensure that tax exempt bonds meet the "50% Test"
  - ➢ No more than 20% of developer fee should be a part of the "10% Test"
  - ➢ Payout of deferred developer fees should be within 10-13 years, per the IRS.
  - ➢ Site costs should have back-up documentation if excessive.
  - ➢ Obtain an acceptable "should" tax opinion.

<u>**DEVELOPMENT TEAM ANALYSIS**</u>

The expertise and capacity of the development team is essential to the success of a project.

- Developer:
  - Background checks, including lien and litigation searches, should be made no sooner than 45 days prior to closing. Updates should be done periodically (annually) for compliance violations, arrests, or other pertinent information.
  - New developer reviews should include site visits to previously constructed units.
  - Developer should have experience with similar development or create a development team with experience in similar developments.
  - Developer financial capacity should be assessed through a review of financial statements, tax returns, schedule of real estate, contingent liabilities, etc.
  - The developer and/or guarantor should have sufficient liquidity and net worth to provide financial support based on the size and scope of the project.
  - Evaluate current work load to determine sufficient capacity and management of growth.
  - Provision should be made that developer financial statements and background check be received and reviewed annually, including an analysis of liquidity and net worth.
  - Obtain and review schedules of real estate, which includes project status, to identify potential financial and/or capacity issues.

- Property Management:
  - Perform background checks with state agencies where properties are located.
  - Review annual financials.
  - There should be on-site visits to properties currently under management and tenant file reviews.
  - Analyze LIHTC property experience, including property compliance procedures and tenant policies. AHIC recommends a minimum of 3 years of directly relevant experience, or a new manager should be teamed with a manager deeply experienced in Sec 42 compliance.
  - Property managers should have compliance training and experience.

- Contractor:
  - Contractor should have experience with similar projects.
  - Contractor should (i) provide a payment and performance bond issued by a nationally, financially recognized bonding company and in forms acceptable to the Investor or, (ii) a letter of credit in an amount equal to at least fifteen percent (15%) of the total amount of the Construction Contract. Bonding companies will not bond contractors affiliated with the developer, but major subs can be bonded.
  - An engineer should be retained to review of the plans, specs, and the construction contract for completeness and deliverability.
  - Construction contracts are typically guaranteed maximum or fixed price. Penalties for slippage are common in deals where timing is tight.
  - Obtain and review a backlog, a list of current project which includes percentage of completion, to identify potential financial and capacity issues.
  - Terms and conditions of the construction contract must be arms length even with contractors affiliated with the developer.
  - Pay on a draw request basis with retainage.

- Development Team Professionals
  - A development team should include experienced professionals:
    - The architect should be licensed and have experience with similar projects.
    - An experienced CPA or financial advisor.
    - Counsel should be experienced with IRS Section 42.

- A State-Licensed Environmental Professional consultant should be engaged to perform a Phase I and, if necessary, Phase II Environmental Site Assessment. The consultant should identify potential environmental risk, recommend action, and review remediation if needed.

PARTNERSHIP AGREEMENT

- Capital Contributions:
  - Timing, benchmarks and amount of individual capital contributions can be used to manage various risks of construction, leasing and financing.
  - Benchmarks often fall into several or all of the following broad categories:
    - closing/admission to the partnership
    - 50% construction completion
    - 75% construction completion
    - Construction completion and Certificate of Occupancy
    - Stabilization for a minimum of 3 months, with a "Breakeven" or 1.15x DSCR test.
    - Receipt of 8609
- Repurchase Obligation
  - The General Partner is required to acquire the entire interest of the Investor by making payment equal to capital contributions paid if a project fails to qualify for tax credits or has:
    - Significant changes in the tax credit delivery (i.e. 15 year versus 10 year tax credit delivery period)
    - Failure to meet the final closing requirements of the Partnership often including breakeven operating performance, permanent loan conversion, receipt of 8609
    - Significant (10% or greater) change in qualified basis

- Credit Adjuster:
  - Timing:
    - The amount of tax credits delivered, typically in Year 1 and Year 2, can vary from the original projections as a result of a change in the month the project is Placed in Service, or pace in leasing. Any change in credits delivered during these years will be offset by a change in Years 10 and 11 credits. Timing changes do not affect total credits delivered but has an affect on the present value return and internal rate of return.
    - Investors must identify and analyze the effect of timing changes on financial performance measures to determine appropriate adjuster language.
    - Downward timing adjusters are used to mitigate the negative impact of delayed credit delivery. Upward timing adjusters can be used to compensate a developer for early credit delivery. A cap can be used to limit upward adjusters.
    - Typical timing adjuster structures:
      - Capital contributions are reduced or increased based on a specified price multiplied by the amount of credits delayed or delivered early.
      - Capital contributions are reduced or increased based on maintenance of a predetermined yield. This calculation can include all tax benefits or only tax credits. The latter eliminates any influence from additional losses generated by the construction delay.
  - Credit Basis Amount:

        - The amount of total tax credits may vary based on actual qualified development costs set forth in the 8609. This causes a direct impact on total benefits to the investor.
        - Downward credit adjusters minimize the negative impact of a reduction in total credits. Upward credit adjusters compensate a developer for additional credits delivered to the investor. A cap can be used to limit upward adjusters.

- General Partner Representations, Warrants and Covenants
    - Investors need to be assured that the General Partners are taking care to execute their key responsibilities, over which the Limited Partners have little control. Obtaining G.P. Rep's and Warrantees in the L.P.A. are critical (see separate document). Additionally, restrictions on authority and LP consents are important as well.

- Insurance
    - The Investor's entire investment is at risk if property insurance is inadequate.
    - General Partners—and Sponsors—need to annually have all-risk property & casualty coverage, as well as general liability coverage, reviewed and approved. Other insurance may be required based on assessment of risks associated with environmental conditions including flood, earthquake, hurricane, etc.
- Limited Partner Responsibilities
    - Limited Partner should have the ability to remove the General Partner upon the occurrence of events of default, as detailed in the Partnership Agreement. Events resulting in removal center on actions which jeopardize the tax credits, the project financing, or Investor ownership.
    - Limited Partner should have approval rights over the following
        - Property Management Agent Change
        - Accountant Change
        - Significant Operating Budget Changes
        - Major Reserve releases
        - Employment of Related Parties (not previously disclosed)
        - Amendments to the Partnership Agreement
        - Any New Loans on the Property, or on General Partner Interests
        - Any Changes in General Partner
        - Any Property Disposition
- Distributions and Liquidations
    - Operating cash flow available for distribution is highly negotiated, but Caution: on non-profit projects the bottom-line split must be 99%+ to the Investor LP, or, to the extent it goes to the non-profit, 40-year depreciation must be used.
    - Counsel advise that no less than 10% of economics go to Investor LP, or the profit purpose of partnership allocations 99%+ to the Investor are in jeopardy.
    - For Profit GP – typically given right of first refusal and right to buy LP interest or property at fair market value.
    - Non Profit – given the above option, plus a Right of First Refusal to acquire the Partnership interests for the Sec 42(i)(7) formula of debt plus taxes.
- Reporting and Asset Management requirements should be included in the Limited Partnership Agreement. A detailed description of the requirements can be found on the AHIC Website under Asset Management. Suggestions include:
    - All units should have an independent party verification of compliance upon initial occupancy.

- All properties should have annual random compliance checks.
- All properties should have a per unit compliance check at least once every three years.
- All properties should be visited by the sponsor prior to closing of the fund, during construction, and upon completion.
- All large properties (> 50 units) should have annual sponsor site visits. All smaller properties should have bi-annual sponsor site visits. Of note, smaller properties can experience more dramatic shifts in cash flow with just a few unit vacancies.

DEVELOPMENT AGREEMENT

- Developer Fees: Payment of cash developer fee can serve to mitigate various development risks typically relating to cash shortfall such as cost overruns, adjusters, etc.
  - Developer fee should not exceed the amount allowable by state credit agency.
  - Total developer fees should include all deferred development fees treated as debt to the partnership.
  - All other fees to the developer (up-front, ongoing, and exit) should be clearly outlined to the Limited Partner.
  - Developer fees included in basis must be paid within 13 (IRS) years of closing.
- Developer Fee Payout:
  - Hold back of developer fee provides an important mitigant to risks associated with construction and stabilization. The larger the developer fee holdback until cost certification, stabilization and permanent financing conversion the greater the cushion to mitigate risk. At minimum 10% of the developer fee should be held until all construction, stabilization and permanent financing benchmarks are met with at least 5% held until receipt of 8609.
  - Other benchmarks include:
    - Closing/admission to the partnership typically not greater than 30% of total cash developer fee.
    - Certificate of Occupancy
    - Stabilized occupancy and debt service performance, typically for 3 months.

GUARANTEES

- Guarantees should be obtained from a financially sound entity in the event the General Partner does not have financial strength or is a single purpose entity with limited assets.
- Guarantees: Guarantees should include:
  - Construction Completion Guarantee – unlimited for completion and lease-up
  - Operating Deficit – Negotiated depending upon project and developer variables; however, a minimum amount is often 6 months operating expenses, reserves and debt services.
  - Credit Delivery – Via Capital Adjusters for amount and timing of credit flow and Repurchase Obligations
  - Tax Credit Compliance – Recapture Guaranty should be a 15-year Guaranty, as the initial compliance and credit recapture period is 15 years.