



AHIC 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 proprietary and multi-investor funds and direct investments. The Guidelines can be used to identify and mitigate variances 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/Syndicator 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.

Development Team

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.
- Credit References should be obtained from lenders, Housing Finance Agencies (HFAs) and other investors.
- 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.
- AHIC recommends that a developer and/or co-developer have experience with at least five (5) LIHTC developments or several affordable multi-family rentals that are comparable in size and complexity.
- Current developer workload should be evaluated to determine sufficient management and financial capacity and ability to manage growth.

Guarantor

- Guarantor financial capacity and ability to cover guarantee obligations should be assessed through a review of financial statements (preferably three (3) years of audited financial

statements), tax returns, schedule of real estate owned (REO), and contingent liability schedules. Analysis should include confirmation/verification of real estate exposure, whether affordable or market rate/home ownership/vacant land held/commercial, etc. The REO schedule should provide details including property performance (Debt Service Coverage (“DSC”) and occupancy), project construction and/or leasing status, debt service and GP share of cash flow. The REO schedule should reflect portfolio performance of not less than 1.10 DSC and properties under construction/lease-up should be on target. Underperforming assets should require further explanation.

- Developer and/or Guarantor should have sufficient liquidity and net worth to provide financial support and cover guarantee obligations based on the size and scope of the project.
 - Recommended minimum net worth requirement is the greater of \$5MM and 25% of total development costs.
 - Recommended minimum net liquid assets is the greater of \$1MM or 5% of total development costs.
 - If these minimum requirements are not satisfied, additional safeguards should be implemented such as development fee holdbacks, cash reserves and/or Letters of Credit securing the guarantee obligations, or a combination of these two.
- AHIC recommends construction liquidity of 15% (calculated as the sum of cash development fee held back until 100% completion, hard cost contingency and guarantor liquidity divided by hard cost construction costs) and 25% for rehabs.

Property Manager

- Perform background checks with state agencies where properties are located.
- Credit References should be obtained from HFAs, other developers, lenders, and investors.
- Review annual financials.
- Conduct on-site visits to properties currently under management and tenant file reviews.
- Analyze LIHTC property management experience, including Section 42 compliance procedures and tenant review policies.
- Property management firms should have 10 years of property management experience and at least three years of Section 42 or related affordable housing experience. A new manager should be teamed with a manager deeply experienced in Section 42 compliance.
- Property managers should have current compliance training and experience.
- Ask about 8823's and REAC scores on their properties and ensure that the property manager has ability to deal with these issues.
- Require subordination of property management fees, if property manager is affiliate of Developer, especially if project is operating below breakeven or if tax abatement is revoked. Underwriting, however, should not assume a deferral in order to make the deal work since the affiliated property manager could be removed and replaced at some point.
- Contract 1Yr and then month to month.

General Contractor

- General Contractor (GC) should have experience with similar projects.
- GC should (i) provide a payment and performance bond issued by a nationally, financially recognized bonding company (AM Best A-9) 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 from an acceptable rated lender. Bonding companies will not bond contractors affiliated with the developer, but major subs can be bonded.
- Payment & Performance bond should cover the full construction contract.
- A third party (*e.g.*, engineering or architecture firm) should be retained to review the plans, specifications, 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 and list of current projects, including percentages of completion, to identify potential financial and capacity issues.
- Pay on a draw request basis with retainage.
- There are special considers for GCs affiliated with the developer.
 - Terms and conditions of the construction contract must be arms length.
 - Consider higher retainage or deferral of a portion of the GC profit.
 - Require cost certifications/audits of sub contracts.
 - Investors may want to seek the GC entity as a guarantor.

Other Development Team Professionals

- The **architect** should be licensed and have experience with similar projects.
- The **CPA** or **financial advisor** should be experienced with IRC Section 42.
- **Legal counsel** should be experienced with IRC Section 42.

Development Budget

Sources and Uses of funds must balance to avoid financing gaps.

Sources of Funds

- All sources should be identified and committed along with terms and conditions, such as conversion requirements for both hard and soft (*i.e.*, payable by cash flow) debt and have a clear understanding of what constitutes a default under the contracts/loan agreements for any soft funds and what the rights and remedies are.
- 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. (Note: The cash portion of the developer fee can be used to offset guarantor obligations as long as the developer fee payout is structured so that most of the fee is paid at completion or later.

- Net Operating Income (NOI) or Cash Flow from Operations from a property during lease-up or a tenant-in-place rehab project (prior to perm loan closing/ conversion) may be included if defended and acceptable based on the type of project and leasing assumptions. (Note: underwriting NOI or Cash Flow from Operations as a Source of Funds places further stress on the cash developer fee and guarantors in the event this source of funds does not materialize.)

Uses of Funds

- All major categories should be identified, including acquisition, construction, contingencies, financing, reserves, developer fee and other soft costs.
- Construction loan interest, financing fees and start-up expenses should be accounted for in detail.
- A third party study (see discussion under Third Party Reports) can be used to review the adequacy of the construction hard cost budget.
- Rehab costs should be a minimum of \$25,000 per unit and should cover all items addressed in a Capital Needs Assessment (CNA). Lower rehab costs per unit may be considered as long as the rehab scope addresses CNA issues and is appropriate for market. 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.
- Construction contingencies should be based on Developer and General Contractor experience, project type, and underwriting of other budget items. Hard cost contingencies typically range from 5% for new construction to 10%-15% for rehab projects. Soft cost contingencies range from 2%-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, unless the project has adequate excess basis.
- Total developer fee (as capped by the Allocation Agency) should be included in the budget with a notation regarding deferred developer fee.

Deal Structuring Analysis

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, Property Manager's and/or Investor's portfolios, as well as data provided in third party reports and other real estate sources, such as Institute of Real Estate Management (IREM) or National Apartment Association (NAA).

Rental Revenue Analysis

- Unit rents should be compared to maximum allowable LIHTC rental rates, as well as rental rates at similar existing market and LIHTC properties, to determine competitive advantage and positioning, and to determine whether there is a cushion available to increase rents when necessary. Rents should also be compared with similar properties in relevant portfolios.

- In order to achieve a competitive rent advantage, proposed rents should be 10% to 20% below average market rent, based on reliable market information. Average market rent can be determined from a third party appraisal, market study and/or due diligence analysis, which often includes rental adjustments to comparable properties based on project quality, proposed amenities, or location.
- When comparing proposed rents to nearby LIHTC properties, note that maximum allowable LIHTC rents at different properties with the same Area Median Income (AMI) restrictions may differ within the same county due to "Special HERA Projects" under the 2008 Housing and Economic Recovery Act (HERA) and HUD's elimination of the hold harmless policy at the county level in publishing annual Section 8 incomes.
- Properties with rents at the maximum LIHTC rents may experience tightening of cash flow in the event AMIs (a factor used to calculate maximum LIHTC rents) do not increase at a rate that allows annual projected rental increases to be made, especially as operating expenses escalate, and/or if utility allowances increase at a rate that causes maximum allowable rents to decrease.
- Investors should analyze AMI trends for the market for deals at or close to maximum LIHTC rents, especially given hold harmless rules, which may hold rents flat while qualifying incomes decrease resulting in tenants paying more than 30% of their income on rent.
- Investors should perform sensitivity analyses on trending assumptions (*e.g.*, instead of 2% trending on rents, trend at 1% or 0% and trace impact through the investment hold period). Base year rents (budgeted rents agreed upon at deal closing) and expenses should be trended upward in financial forecast to the start of leasing, which is 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 relevant sources, and then decide upon whether to allow rents to inflate. Rent trending may not be appropriate in areas where AMI's remain flat as discussed above.
- "Other income" – such as laundry/parking should be reasonable and comparable to other properties within the region and developer's portfolio, and must be voluntary to the tenant (*e.g.*, do not underwrite rent late fees and other charges), recurring and defensible items only.
- Market rate income – there should be no more than 20% market rate units in a project except for Hope VI transactions.
- Commercial Income – Many investors will not rely on commercial income to size hard debt and will require commercial space to be legally separate and excluded from the LIHTC partnership agreement. However, if used to size hard debt (which may be considered reasonable if commercial income is less than 20% of total income), commercial income should be discounted (higher vacancy rate than the rental income) and commercial rents should be less than the market for commercial square footage. For existing commercial tenants in acquisition/rehab deals, be prepared to review the leases in place and determine viability over the investment hold. Another alternative is to not allow an Operating Deficit Guarantee to burn off completely, and keep the guarantor on the hook for commercial income.
- Rental operating subsidies should be valued only if project-based and for the full investment term.

- Project Based Section 8 – in the event that Section 8 rents are at maximum tax credit rents, most Investors would likely size the debt to the Project Based Section 8 contract rents.
 - Section 8 Overhang – if the Section 8 rents are in excess of the maximum allowable tax credit rents, there is a Section 8 “overhang” issue. If an Investor chooses to size the debt inclusive of the Section 8 overhang (and many do not), a sensitivity analysis on these rents is essential to determine the level of risk if the Section 8 contract were not renewed or subsidies were held flat or reduced over time. Consideration could be given to bi-furcating the subsidy income that exceeds LIHTC maximum rents and financing a separate loan with a shorter term, backed by this income stream.
 - Adequate reserves/guarantees should be in place to mitigate the Section 8 “overhang” risk. For example, some Investors may require a Transition Reserve so that in the event the Section 8 rents are not renewed (since contracts are subject to annual appropriations by HUD), there is a reserve in place to deal with the transition of Section 8 rents to tax credit rents.
 - Section 8 Vouchers – most Investors do not underwrite Section 8 voucher rents since the vouchers are tied to the tenant and, therefore, can be lost in the event the tenant moves out of the project.
- Vacancy rates should be justified based on market conditions as verified by third party reports. Vacancy rates are typically underwritten at 5% - 10%; however, they may vary based on proposed tenant profile (seniors or family). Vacancy of 5% is generally acceptable if supported by subsidy or operating history for 3 years prior. Another suggested guidance is to use a minimum of 7% vacancy rate or 2% over the LIHTC average per the market study.

Expense Analysis

- Expenses should be based on comparable property information, preferably audited, obtained from the Developer, Property Manager, Investor, Syndicator or, if applicable, third party reports (listed below), and other real estate resources such as IREM or NAA.
- Investors should be cautious as to assumptions used in expense projections. Expense projections may reflect expected economies of scale based on the Developer or Property Manager’s overall portfolio.
- For multi-phase projects, expense projections may be lower on a per unit basis due to economies of scale and shared amenities or staffing. Investors should not underwrite these shared expenses (*e.g.*, landscaping contract or shared maintenance staff), and, instead, should underwrite the project as a “stand-alone” project.
- Expense escalations should be at minimum 1% above income escalations for the compliance period. Standard expense escalations range from 3%-4%. Investors may want to consider separate trending assumptions for certain line items, such as utilities, real estate taxes and management fees.
- Due diligence should be performed on certain key individual expense line items. If available, Developers should provide back-up on certain items to confirm budgeted amounts, such as an insurance invoice and a letter from the real estate tax assessor. Investors should seek confirmation from the Property Management Company that the operating expense per unit number presented by the Developer is adequate/reasonable for the project, including the

administrative and staffing assumptions, which should include an appropriate provision for payroll and other taxes, as well as benefits.

- Real Estate Tax Exemptions and PILOTs – if underwriting less than tax assessors' computation to determine the real estate taxes on a deal, make sure due diligence is performed at city, county and state levels. Depending on investor comfort level with the certainty of the proposed exemption, some investors are underwriting to the higher level of taxes and sizing debt accordingly, in case the exemption is revoked. If underwriting the real estate tax exemption, some investors are requiring an unlimited Operating Deficit Guarantee to stay in place for the full compliance period to cover the assumed tax exemption.
- 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). Typically property management fees are between 4-8% and in no case more than 10% of total net income, with a minimum requirement of \$25-\$30 per unit.
- Green Building Features – Most investors are not underwriting utility cost savings due to inclusion of energy-efficient technologies, and are underwriting the costs and training required for appropriate technology maintenance.

Reserves

Interest Reserve should reasonably cover construction period financing costs.

Lease-up Reserve should be established to support operating costs during leasing prior to Stabilization/perm loan conversion.

Operating Reserves should be maintained by owner to fund future cash flow problems. Operating reserves should:

- Equal at least 6 months of total operating expenses, replacement reserves and must-pay debt service (OERDS).
- Be funded by capital contributions preferably as early as possible after construction completion
- Stay in place for the duration of the 15-year investment hold period, or releases should be subject to Investor consent.
- If used, be replenished by the Sponsor or through available cash flow from the property prior to release of the Operating Deficit Guarantee or distributions to the Developer.
- Be stress-tested to determine the financial impact of construction or lease-up delays. Operating Reserves can also be stress-tested by performing a sensitivity analysis on the trending assumptions used over the 15-year hold period, and determining the "breakeven point" for the transaction. If the sensitivity analysis reflects negative trending of the DSC ratio, Investors may require additional reserves or guarantees that do not burn off to mitigate that risk.
- Be approved for release by the Investor and/or Syndicator, if applicable, for reserve withdrawals over a specific dollar amount to ensure proper use.

Capital Replacement Reserves should be funded at closing. AHIC recommends a minimum amount for new construction projects equal to \$250 per unit per year for seniors, \$300 per unit per year for family projects, and a higher level (\$400) for acquisition/rehab deals as per the CNA (see Third Party

Reports). Capital Replacement Reserves are also typically required by lenders, and funded on a monthly basis. Consideration should be given to replenishment of this reserve from available cash flow since funds in this reserve account are often insufficient to cover the needs of the project over the 15-year hold period.

Section 8 Reserve – in the event that the Project Based Section 8 contract has a Section 8 overhang issue, as discussed earlier, additional reserves may be required in addition to the Operating Reserve. The size of the reserve is dependent on the amount of the overhang and the amount the project can bear.

ACC Reserves – for HOPE VI projects, an ACC reserve may be required. These reserves can be 12-36 months of ACC subsidy amount, depending on HUD approvals and would be used if the project lost all or significant amounts of its ACC subsidy and had to replace the ACC funding and/or to assist in the transition to public housing units at non-subsidized LIHTC rents. Investors should look closely at the Regulatory and Operating Agreement to determine the rights of the GP to seek higher income households (to improve the tenant-paid portion of income) and/or other remedies in the event the Housing Authority does not reimburse ACC shortfalls or replenish the ACC Reserve.

Other Reserves can be established to mitigate a specified risk associated with the property (*i.e.*, a Transition Reserve should be established for projects with Section 8 or other operating subsidies in case the subsidies go away or are reduced to the point that the units have to be transitioned to non-subsidized units).

Guarantees

Guarantees should be obtained from a financially sound entity in the event the General Partner (GP) does not have financial strength or is a single purpose entity with limited assets. Guarantees should include:

Construction Completion/Development Deficiency Guarantee should be unlimited through completion, run through Stabilization/conversion to permanent financing, and not be repaid as a loan.

Operating Deficit Guarantee (ODG) is negotiated depending upon project and developer variables.

- A minimum threshold amount or capped amount should be considered and is typically sized to 6 months OERDS.
- ODG is generally structured to burn-off or be fully released during the investment hold period. Typically investors want the burn-off or full release to occur after three to five years of stabilized operations and once certain conditions have been met, such as:
 - One to two consecutive years of a 1.15 DSC ratio (ranges from 1.05-1.20) or expense coverage ratio;
 - Fully funded/replenished operating reserves;
 - Operating subsidies, if any, remain in place;
 - Real estate tax abatement or PILOT, if applicable, remains in place; and
 - Payables have been fully paid
- Investors may require a supplemental ODG to cover potential future deficits related to deal specific features, such as potential revocation of a real estate tax exemption or withdrawal of an operating subsidy.

- During the ODG Period, Investors may require that the GP or Guarantor fund deficits under the ODG prior to draws on the Operating Reserves, especially in the case of a weak guarantor.

Tax Credit Compliance/Recapture Guarantee should be a 15-year Guarantee, as the initial compliance and credit recapture period is 15 years and should include amount recaptured, plus interest and penalties.

Repurchase Obligation – the GP is required to purchase the equity interest of the Investor by making payment equal to capital contributions paid + 10% + reasonable costs (less benefits received to date) if a project fails to qualify for tax credits or one or more of the following events occur:

- Significant changes in the tax credit delivery (*i.e.*, 15 year versus 10 year delivery period)
- Failure to meet the final closing requirements of the Partnership often including breakeven operating performance, permanent loan conversion, receipt of 8609
- Significant (*e.g.*, 10% or greater) change in qualified basis
- PIS Deadline is not achievable (or, per some investors, construction delays are in excess of three to six months)
- Project does not achieve placed in service date by end of second year following the credit allocation year
- Project will qualify for less than 70% of anticipated tax credits
- Unacceptable delivery or invalidity of carryover allocation and/or IRS Form 8609
- Sources of funds identified at closing are withdrawn and comparable commitments are not received within a reasonable period, but in any event within 90 days
- Project fails to get Part 3 approval for Historic tax credits; or
- A default occurs.

Financing

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 (*e.g.*, obligation to secure alternative funding sources) should be in place.
- Permanent Debt should be sized using current (base) year rents with no trending of rents during the construction period. Are we saying, at conversion, we want the DSC test to assume the lesser of (1) underwritten or (2) actual rents, and the greater of (1) underwritten or (2) actual expenses?
- Minimum 15 years fixed rate financing is preferred to avoid interest rate and/or third party (in the case of swap-to-fixed/synthetic fixed rates) uncertainty, which could lead to debt service problems.
- Forward locks on permanent fixed rate should be secured at close to remove interest rate risk and possible downsizing of permanent loan, thus creating a financing gap and potentially impacting cash developer fee available for adjusters. The maturity date (expiration) of the forward lock should include cushion to allow for a permanent loan conversion delay resulting from construction and/or lease up delays. [note: A 3 or 6-month extension being available on a construction loan maturity is more helpful if the perm lender's forward lock continues during such extension periods]

- Cash flow from operations should provide sufficient cash to cover “must pay” hard debt service at a minimum level of 1.15:1 or, in the case of Tax-Exempt permanent hard debt and mixed-income properties, 1.20:1. If not, capitalized operating reserves should be sufficient, when combined with cash flow, to bring the deal to a 1.15 or 1.20 DSC.
- If a project has no hard debt, an Expense Coverage Ratio (ECR), which is an expense to income ratio should be used. An ECR of 1.10 to 1.15 is recommended.
- If floating-rate debt is used, a program of 15-year caps, swap, or other rate protection mechanism should be in place at deal closing with particular review of the hedge provider’s rating. For a tax-exempt bond deal, ensure that the swap or other hedge applies to the outstanding bond balance if bonds are being amortized at a slower rate than the loan and the Partnership is responsible for interest on the outstanding bonds.
- Investors should have cure rights on all hard debt.

Capital Contributions

Timing, benchmarks and amount of individual capital contributions can be used to manage various risks of construction, leasing and financing.

- Capital Contributions are typically paid at the later of the achievement of certain conditions or a specific date. Accounting issues can be triggered by date-specific fundings without a triggering event.
- Benchmarks often fall into several or all of the following broad categories:
 - Closing/admission to the partnership
 - During construction – at a % construction completion (*i.e.*, 25%, 50%, 75%)
 - Construction Completion and Certificate of Occupancy
 - Stabilization for a minimum of 3 months, with a “Breakeven” or 1.15x DSC test
 - Conversion to permanent financing and receipt of 8609
- Percentage of total equity paid at each funding depends on sponsor’s experience and financial strength, deal terms (*e.g.*, size of construction contingency, amount of developer fee held back), project risks, availability of other funding sources, targeted IRR and other financial hurdles.
- Enough equity should be held back in the final installment to cover possible downward adjustors, especially if deal risks include a tight development budget, no excess eligible basis, or a tight construction schedule. This helps mitigate challenges of collecting capital from a Developer/Guarantor in the event of an adjustor or guarantee obligation being triggered.
- AHIC recommends at minimum a 15% holdback until Stabilization/8609’s, with pay-ins during construction commensurate with amounts expended.

Developer Fee

The holdback of paid developer fee represents cash that can be used to solve problems during the development process (*i.e.*, if there’s a cost overrun and the developer is unable to satisfy its construction completion guarantee, sources for the payment of developer fee can instead be used to cover the cost overrun). Accordingly, it is important to hold back as much of the paid development fee as is possible within the context of the deal. The larger the developer fee holdback until cost

certification, stabilization and permanent financing conversion, the greater the cushion available to mitigate risk and motivation for developer to reach these important milestones.

- Developer fee should not exceed the amount allowable by state credit agency.
- It is preferable to have as much of the developer fee paid by the project budget rather than being deferred and paid out of cash flow.
- To the extent that the development fee is deferred and paid out of cash flow, it is important to ensure it will be included in eligible basis for tax purposes. Therefore, the projections should demonstrate that the deferred developer fees can be paid from project cash flow within 10-15 years (if not, consult your tax counsel - a guaranty of full payment may be required)
- All deferred development fees should be treated as debt to the partnership. Interest rates on deferred development fees vary.
- All other fees to the developer (up-front, ongoing, and exit) should be clearly outlined in the Limited Partnership Agreement (LPA)
- AHIC recommends that the amount to be held back in any given project depends on certain variables affecting the project including the developer's experience, financial wherewithal of the guarantors and the level of comfort with the overall underwriting and deal structuring.
- As much of the developer fee should be held until all construction, stabilization and permanent financing benchmarks are met with some amount held until receipt of 8609.
- AHIC recommends no more than 25% paid at closing and at least 75% held until 100% completion and 8609 installments.

Credit Adjusters

Timing Adjuster – the amount of tax credits delivered, typically in Year 1 and Year 2, can vary from original projections as a result of a change in the month the project is Placed in Service, or leasing pace. 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 effect on the present value return and internal rate of return.

- Investors must identify and analyze the effect of potential 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 for early credit delivery, although not common in today's market, are usually capped at 5-10% of total equity.
- 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 tax credits only. The latter eliminates any influence from additional losses generated by the construction delay and is preferable.

Basis Adjuster – 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 and are more common than upward timing adjusters in today's market, but are also typically capped at 5-10% of total equity.

General Partner Representations, Warrants and Covenants

Investors should obtain GP Reps and Warrantees in the LPA to be assured that the GPs are taking care to execute their key responsibilities, over which the Limited Partners (LP) have little control. Additionally, restrictions on authority and LP consents are important as well. LPs should maintain control over any GP transfers post-closing, even if to an affiliated entity, and should seek to have lender documents comply with this provision.

Insurance

The Investor's entire investment is at risk if property insurance is inadequate. GPs 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 Rights and Responsibilities

LP rights and responsibilities are outline in the LPA (also called an Operating Agreement or lower tier document). These rights and remedies generally include provisions such as consent rights, rights of removal, and rights to transfer ownership. The following outlines the most important rights and responsibilities:

- LP should have the ability to remove the GP upon the occurrence of events of default, as detailed in the LPA. Events resulting in removal center on actions that jeopardize the tax credits, the project financing, or Investor ownership.
- LP should maintain the right to receive financial statements and any other requested reporting in a timely fashion.
- LP should have approval rights over the following, at a minimum:
 - Property Management Agent Change
 - Accountant Change
 - Significant Operating Budget Changes
 - Major Reserve releases
 - Employment of Related Parties (not previously disclosed)
 - Amendments to the LPA
 - Any new loans, refinancing or change in existing debt terms on the Property, or on GP Interests
 - Any Changes in GP

- Any Property Disposition

Reporting and Asset Management requirements

A detailed description of the requirements can be found on the AHIC website under Asset Management.

Distributions and Liquidations

- Operating cash flow available for distribution is highly negotiated. On projects with a non-profit Sponsor, bottom-line split must be 99%+ to the Investor LP, or, to the extent it goes to the non-profit partner, 40-year depreciation must be used.
- Counsel advises 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 GP – 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.

Due Diligence

Professional analysis should be obtained relating to revenues, expenses, and construction.

Market Study

A third party market study completed less than 6 months before the investor closes into the partnership should be used in the analysis of rental rates, absorption rates and demand assumptions. In weak or declining markets, investors should consider a more current market study or update be performed prior to closing.

Investors should use National Council of Affordable Housing Market Analysts (NCAHMA) certified market analysts to perform market studies using the NCAHMA Model Content Standards for Market Studies for Rental Housing, which is a set of recommendations on the specific types of information, data, analysis, and conclusions that should be contained or addressed in a market study for an affordable rental housing project.

Appraisal

An appraisal completed on the behalf of a party other than the developer can be used in conjunction with property management data, market study and other comparable property information to verify projected operating information, market rents and market demand. If an appraisal is relied on to substantiate acquisition basis, an Investor may seek a reliance letter from appraiser or have the appraisal issued to the Investor.

Environmental Assessment

Environmental site assessments should be completed by a State-Licensed Environmental Professional consultant. The consultant should conduct a Phase I and, if necessary, Phase II Environmental Site Assessment to identify potential environmental risk and recommend a remediation plan. 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.

Earthquake Risk Analysis

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 Probable Maximum Loss (PML) analysis, with no more than a 20% PML factor at 90% confidence level. Variance may be acceptable based on structural design.

Flood Zone Analysis

A 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 property's exposure to other environmental conditions, such as hurricanes, should be assessed and properly mitigated with insurance and/or deal structure.

Construction Document Review

Third party studies (*i.e.*, from an engineering or architectural firm) should review Plans and Specifications for thoroughness, quality and aesthetics, as well as assess construction and construction cost risks. LEED projects need experienced LEED designated consultants.

Construction Monitoring

Construction inspectors are regularly hired by Lenders, Investors and/or often by Syndicators to monitor construction, identify timing and/or financial deficiencies, and determine achievement of construction benchmarks for purposes of equity capital contributions. AHIC does not recommend the sharing of construction inspectors with construction lenders, but consideration should be given to this arrangement if the construction and permanent lender are from the same institution as the Investor.

Capital Needs Assessment

For acquisition-rehab projects, a Capital Needs Assessment (CNA) of 100% of the units, also called a Property Condition Report or Physical Needs Assessment, should be used to identify needs, and set budget priorities. The CNA will identify and provide cost estimates for immediate physical needs and physical needs over the 15 year compliance period. This information may be helpful in determining the appropriate replacement reserve amount for rehab projects.

Tax Review

- 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 (*i.e.*, temporary CO vs. permanent CO)
 - 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 at 2/3 the allocation rate. In most municipalities “placed in service” is determined on a building by building basis and is determined based on receipt of Temporary Certificates of Occupancy (CO) or final COs.
 - Verify acceptability of costs included in qualified basis (*e.g.*, commercial space).
 - Identify whether the credit rate was locked for 4% credits 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” (the property cannot have been placed in service within the preceding 10 years) and “Max 50% continuing interest test” of related party, meaning the interest of any prior owner in any item of loss deduction, profit or cash flow cannot exceed 49% including all fees other than the developer fee payable to such party or its affiliates.
 - Ensure that tax exempt bonds meet the “50% Test,” which means that the amount of the qualifying bond is 50% or more of the adjusted basis of the land and building
 - No more than 20% of developer fee should be a part of the “10% Test,” meaning the amount expended within one year of the date the project received its allocation is at least 10% of the reasonably expected basis at the time the project is completed
 - Payout of deferred developer fees should be within 10-15 years.
 - Site costs should have back-up documentation if they appear to be excessive.
 - No reversionary value should be included in the return calculation and exit taxes should be included as if paid by the investor.
 - Obtain an acceptable “should” tax opinion as to all material tax issues.

Other Underwriting Considerations

Parking

There should be at least one off-street parking space per unit, although exceptions may be made for senior housing, supportive housing or densely urban projects.

Elevators

There should be an elevator if the building is more than two stories high or has more than one underground parking level.

On Site Management Office

Preferable to have an on-site management office in order to improve security and project marketability.

Arms Length Transactions

All material relationships and transaction information and agreements (financial and non-financial) between all parties are arms-length and fully disclosed.

Supportive Housing

Supportive Housing is permanent subsidized housing with ongoing services where units are set aside for people with disabilities, like severe and persistent mental health illnesses, or other special needs that require subsidized housing and ongoing case management for the foreseeable future in order for them to stay housed. This type of housing has certain characteristics that require additional consideration.

- There should be a comprehensive development team in place comprised of one or multiple parties who are contractually committed to the project based on each party's relative experience (*i.e.*, a developer strong in LIHTC will guarantee the performance of the project but will partner with an experienced social service provider under contract to provide services through the compliance period).
 - Developer: The GP should be experienced in developing LIHTC and supportive housing projects.
 - Operator: The operator/service provider should be experienced in providing relevant supportive services to the targeted population.
 - Property Manager: The property manager should be experienced in managing LIHTC compliance and should be experienced in working with and coordinating with on-site social service providers.
 - Preferable to have the agency providing referrals to sign the LIHTC leases
- There should be little to no hard debt and significant soft debt or funds evidencing the public sector's support of the project and ensuring an alignment of interest between the investor and government agencies to secure the long-term sustainability and success of the investment.
- Hard debt should be sized to the lesser of (1) maximum allowable LIHTC rent or (2) Achievable Market Rent. If debt must be sized based on project-based operating subsidy above such levels, the subsidy contract term should be a minimum of 15 years, subject only to appropriations?
- The underwritten operating budget should include all required service costs as an above-the-line uncontrollable cost. Any operating subsidy provided off-budget directly to the GP or service provider should not be relied upon to fund required services
- There should be a regulatory agreement in place prior to closing that will allow the property to transition from supportive housing to non-supportive LIHTC housing if funding for services is

terminated or is reduced to the point that the project becomes infeasible to operate as supportive housing. Ensure that all agreements (*e.g.*, tax credit awards, soft debt, operating subsidies, etc.) contain language that would allow the project to transition.

- Units should be designed to be comparable to non-supportive housing units in the market. Otherwise, the property should be located in a market with high demand for affordable housing and low capture rates for studio and smaller units in the event the project has to be transitioned to non-supportive housing. Assumptions must provide for ample time to transition supportive housing tenants out and to re-tenant the property with qualified LIHTC tenants. Breakeven rents should be significantly below market rents and at or below LIHTC maximum rents even if there is subsidy in place (or there should be sufficient reserves in place), so that the property could operate successfully after transition without subsidy.
- There are substantial reserves in place and/or guarantees from financially strong sponsors for operating support and particularly for transition to non-supportive LIHTC units in order to mitigate subsidy appropriation risk. There is also sufficient revenue underwritten to support ongoing services for any special needs or homeless tenants that would be required to remain after transition. Release of operating deficit guarantees should be tied to performance requirements and continued financial support for supportive services.
- The property contains stand-alone apartment units with private kitchens and bathrooms and also contains communal space for residents such as computer/living rooms or shared dining facilities. [does this mean we are recommending not to invest in SROs?]
- The property has 24-hour monitored access or, if deemed necessary by the project's size, location or targeted population, has front desk security.
- The project provides offices for on-site services staff, and support services are provided by qualified service organizations and are targeted to tenants' needs.